The day after tomorrow for asset management

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PricewaterhouseCoopers

The Day after Tomorrow for Asset Management

While the unprecedented crisis of late 2008 revealed clear flaws in the banking system, the asset management sector was shown to be considerably more robust. Assets under management did shrink, of course, and individual cases of malpractice arose, but the reputation of many firms did not suffer unduly. Nevertheless, the consequences of the crisis on the sector are likely to be felt at a profound level and for a long time. Changes in regulations, investor preferences and within the industry itself will provide a range of opportunities and threats that no asset management firm can afford to ignore.

PricewaterhouseCoopers, in the second of its 'day after tomorrow' perspective series, sets out some of the most critical issues the asset management sector faces today and in the future:

Business models are under stress

Many businesses are still in full survival mode and will examine ways of further reducing costs in the short term to maintain profitability or contain losses. But they will also need to evaluate exactly what sustainable cost management means for them. Market volatility may encourage firms to seek new fee models that are more predictable over the long term and not highly correlated to the market. A key variable cost – human resources – will remain a focus and firms must decide which sections of their staff contribute directly to the bottom line. This stress and the need for capital could force some institutions, especially banks, to reconsider their long-term commitment to asset management. Successful and opportunistic independent asset managers and insurance companies could benefit from these situations to grow their asset base and enhance their skill sets.

How will investors react in the post-crisis environment?

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. 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 by some. Products that contain capital guarantees and other kinds of embedded 'insurance' will remain popular.

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Fiscal pressure will change the shape of the industry

Asset managers, in common with the rest of the financial services sector, will be significant contributors to tax-raising efforts and can expect more rigorous enforcement of tax rules, swifter closure of loopholes and a more adversarial environment. Asset managers will need to consider how they should position themselves while remaining protected from excessive tax burdens. There will be renewed focus on privacy laws and tax evasion, mainly relating to individuals.

A new spirit of cooperation between the G8 and G20 nations will have consequences for most asset managers

There will be a particular focus on the activities of non-cooperative and lightly regulated domiciles as the possibility of coordinated sanctions now exists. Any activity that is viewed as systemically important to the financial system will attract regulation and oversight. It may be that unregulated offshore 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?

Under political pressure, regulators will target investment firms directly, predominantly those in the alternatives space. Many mainstream financial institutions may find that connections with 'light-touch' financial centres will no longer be commercially viable. The European Union has already taken steps to impose regulation on alternative investment funds and managers, and this may be replicated elsewhere. There is, however, less pressure on regulated mutual funds, where the regulatory construct has not led to widespread failures. However, some mutual fund vehicles – such as the UCITS model in Europe – are steadily broadening the range of permissible instruments, which could weaken the model.

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. Significant new entities emerged using this model, particularly in the private equity space. 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. There could be a flight to quality by investors – to asset managers that are owned or backed by FS groups that have financial strength.

Deleveraging in the banking system will affect asset management

Asset management firms are not highly leveraged at the company level, but they

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have a high natural gearing to markets, so in a downturn their earnings tend to be hit disproportionately. This leaves them exposed to potential breaches of covenant and other cash-flow and balance-sheet difficulties. The biggest impact of deleveraging is on those hedge funds and private equity firms that depend on debt to gain access to transactions and magnify successful investment strategies. Without access to affordable leverage with reasonable levels of collateral, their business models may struggle.

Compensation in asset management is likely to take its cue from banking

If management and performance fees continue to decline, there will be an imperative to implement a long-term review of compensation. Where the asset manager is owned by a banking parent that has accepted state financial assistance, the influence of government is likely to make itself felt, even at the asset management level. The continuing ability of hedge funds with illiquid strategies to earn performance fees from unrealised profits will be the subject of significant challenge from investors and consultants. In private equity, the size of the management fee on large commitments may be challenged.

Overall, the fact that the asset management industry is likely to be less constrained by government interference or direct regulation on compensation is likely to be a source of competitive advantage for the asset management industry. Most countries have lower rates of tax on capital gains, so the more flexible remuneration regarding share arrangements that the asset management industry can offer is also a competitive advantage.

The reawakening of Asia

Patterns of consumption and saving in both the West and emerging markets are shifting. 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. A one-off rerating of Asian stocks in the short-term could be complemented by long-term growth at a higher trend rate than in the West. 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 full report is available on our dedicated ‘day after tomorrow’ website. Access the page here **www.pwc.com/dayaftertomorrow**

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