Strategic Business Risk

Asset Management 2008

In collaboration with:

Oxford Analytica

Ernst & Young

Quality In Everything We Do

It is never the risk that causes damage or creates opportunities – it is how we respond.

About this Report

Risks are inherent in every forward-looking business decision, so successful risk management should be an integral part of an organization's strategy and operations – an important dimension of good management practice.

There has been a great deal of work done in the area of risk management in recent years. Ernst & Young has been engaged in a significant amount of work to understand the views of stakeholders and management and identify leading practices from which both parties can benefit. At the same time, many companies have invested significant resources globally in risk and compliance initiatives.

Financial risk and regulatory risk have been the focus of much of this effort. In both cases, there are externally determined rules and frameworks with which companies need to comply and emerging best practice guidance on processes and controls that can help. We have worked with many companies who have found that the challenge of compliance can lead to opportunities for performance improvement through improved processes and enhanced communication. Some companies are now looking more closely at their operational risks, prioritizing these and thinking about how they can manage and monitor these in a coordinated way, which can again result in opportunities for performance improvement. What is clear is that to gain further business advantage, companies must increasingly look at the extended risk universe, from finance and compliance risk – to operational and finally, strategic risk.

A Different Perspective on Strategic Risk

Our experience, however, suggests that strategic risk has not necessarily benefited from developments in management practice. Much that has been written about strategic risk seems to be at such a macroeconomic level that the implications for action by the management of a specific company can be lost. More significantly, the different implications for companies operating in different sectors can be blurred. Someone's challenge is frequently someone else's market opportunity.

We decided to explore the area of strategic risk from a different perspective. In collaboration with Oxford Analytica we focused on the strategic risks facing 12 of the world's most important sectors: asset management, automotive, banking and capital markets, biotechnology, consumer products, insurance, media and entertainment, oil and gas, pharmaceuticals, real estate, telecommunications and utilities. These sector studies served as the primary source for the overall comparative report of our findings.

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Ratan Engineer
Asset Management
Sector Leader
Ernst & Young

Strategic Risk – a risk that could cause severe financial loss or fundamentally undermine the competitive position of a company.

The asset management industry is evolving at a deceptive pace. Trends including those driven by demographic change – the shift of power to distributors, the blurring of asset management boundaries – and the consequences of market, regulatory, and customer pressures such as the trend towards asset gathering versus money management, the polarization between managers offering beta versus alpha seeking strategies, and the rise of alternatives, are forcing the industry to adopt new strategies.

In addition, the credit crisis is having an impact on the pace and nature of change in the industry. It will be some time before we can discern the full extent of the crisis, but it is likely that both the larger hedge funds and traditional asset management companies can seek to benefit.

An understanding of how to respond to these trends is essential for asset management firms to effectively manage risk, optimize performance, and increase operational effectiveness. To gain further insight into the strategic business risks that will drive the fortunes of asset management firms over the next five years, we have been talking with leading Ernst & Young global industry analysts, together with leaders from more than 20 disciplines that shape the industry environment, including law, finance, the sciences, business strategy, geopolitics, regulation, medicine, economics, and demographics. Together we have identified leading strategic business risks and then rated the severity of the strategic risk management challenge posed by each emerging issue.

In the report that follows, we comment on each of the top 10 risks for asset management companies that have emerged from our research, and profile some thoughts on responding to these challenges. We also report on risks currently 'below the radar' that our panelists believed may emerge to top the risk tables for asset management in years to come.

I would like to thank all of our panelists for their valuable time and insights.

The Ernst & Young Strategic Business Risk Radar

Risk Weighting and Risk Prioritization

Phase 1:

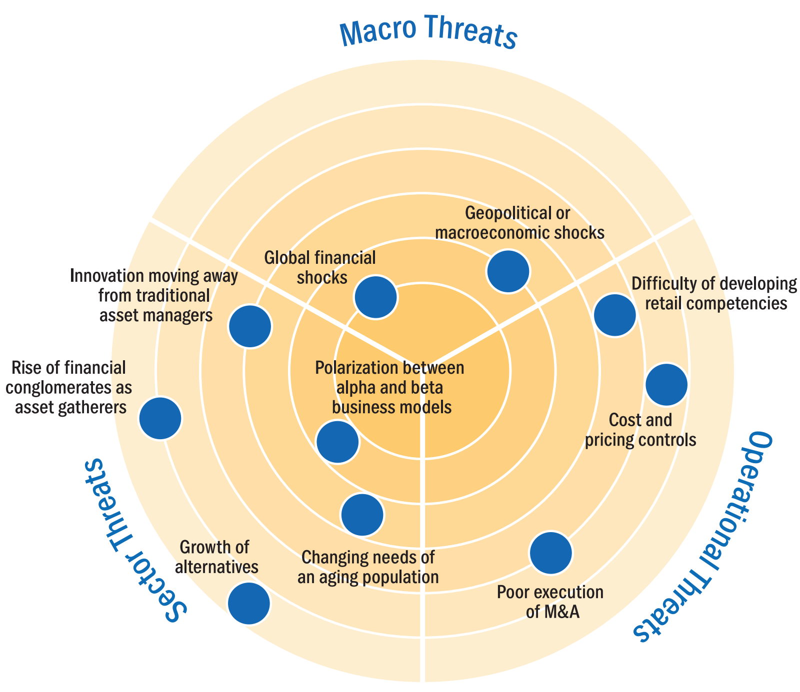
- We asked the pool of analysts to list and to rate (on a scale of one to 10, with one having the least impact), the 10 most significant trends or uncertainties that may impact companies, and to provide commentary on why these are important to their industry.
- Analysts were then asked to list the five most significant business risks to firms within asset management – considering in particular those of a strategic nature – that might bring about shifts in the industry or put leading firms in peril of losing their position. A numerical rating was applied from one to five.

Phase 2:

- In order to prioritize the top risks for each sector, panels of sector experts including journalists, researchers, advisors, and our own Ernst & Young practice professionals rated the severity of each of the risks for the sector concerned. Panelists were asked to assign a numerical severity rating, from one to five, based on the likelihood that a risk issue would lead either to severe financial impact or undermine the competitive standing of the leading firms in their sector. The ratings assigned by each sector panelist were averaged to build the lists of top risks by sector.
- The research took place in the second quarter of 2007, and focused on predictions for 2008.

The Ernst & Young risk radar is a simple device that allows us to present a snapshot of the top 10 strategic business risks for asset management. The risks that appear at the center of the radar are those that our panel believed will pose the greatest challenge to the asset management industry in 2008.

The radar is divided into three sections: (1) **macro threats** that emerge from the general geopolitical and macroeconomic environment; (2) **sector threats** that emerge from trends or uncertainties that are reshaping the industry; and (3) **operational threats** that have become so intense that they may impact the strategic performance of leading firms.



Executive Summary

Top 10 Strategic Risks

1. Global Financial Shocks
2. Polarization Between Alpha and Beta Business Models
3. Geopolitical or Macroeconomic Shocks
4. Changing Needs of an Aging Population
5. Innovation Moving Away from Traditional Asset Managers
6. Difficulty of Developing Retail Competencies
7. Poor Execution of M&A
8. Cost and Pricing Controls
9. Rise of Financial Conglomerates as Asset Gatherers
10. Growth of Alternatives

The top strategic risks for asset managers are being driven by two main themes: the polarization between managers offering beta versus alpha seeking strategies, and macro shocks. The much discussed polarization of the industry is contributing to risks associated with divergent business models, the migration of innovation away from traditional asset managers, difficulties in the development of retail competencies, poor execution of mergers and acquisitions and the increasing importance of cost and pricing control, as companies struggle to develop the competencies they need to be competitive. (In addition, as insurers and banks may be better positioned in an industry bifurcated between alpha and beta models, there is the threat from the revival of financial conglomerates.)

At a macro level, global financial shocks and geopolitical or macroeconomic shocks could strain risk management capabilities, affect market size, and rapidly change the popularity of different products. Our research was conducted before the credit crisis, but now we are beginning to see the longer-term effects such shocks might have on the industry.

A further macro trend driving potential strategic risks in the industry relates to the shifting savings demands of an aging population. The tremendous growth in individual savings triggered by demographic trends (and rising health care costs) presents a major opportunity for the industry, but also an increasingly competitive battleground.

1 Global Financial Shocks

As the top risk to the asset management sector in 2008, our panel of industry analysts selected global financial shocks. Analysts were most concerned about the credit crisis, and the possible declining ability of regulators to manage systemic risks in finance.

2 Polarization Between Alpha and Beta Business Models

Strategic risks created by the increased polarization between alpha and beta business models is a significant threat. Our analysts predicted increasing difficulties for firms caught in the "swampy middle." Asset managers will need to think carefully about where they sit in this spectrum, and how they adapt will become a central strategic issue.

3 Geopolitical or Macroeconomic Shocks

Another significant risk is from geopolitical or macroeconomic shocks. The potential shocks included a disorderly unwinding of global imbalances, real estate market crashes, a setback in China, and the threat of terrorism.

4 Changing Needs of an Aging Population

An increasing threat to the industry is the inability to adapt to the changing needs of an aging population. This fast-growing market segment creates a new competitive battleground into which today's leading asset managers may struggle to extend their dominance.

5 Innovation Moving Away from Traditional Asset Managers

As the asset management sector continues to transform, a significant competitive challenge highlighted by our panel is the migration of product and investment innovation away from traditional asset managers. Boutiques and alternative investment managers are proving successful but a considerable amount of innovation in investment applications is taking place at investment banks.

6 Difficulty of Developing Retail Competencies

A further competitive threat is the difficulty of developing retail competencies. This is becoming more crucial as the wholesale market declines and as distribution channels and customer relationships become more important.

7 Poor Execution of M&A

With the increase in the number of deals, the growing desire to build diverse portfolios and complementary investment disciplines, consolidation is continuing at a significant pace within the sector. As a consequence, the pressure to deliver post-acquisition value is growing and the poor execution of mergers and acquisitions (M&A) is a significant challenge for the sector.

8 Cost and Pricing Controls

A growing risk is the increasing importance of cost and pricing controls, which is driving margins. As companies seek different strategies to control costs, such as pooling, locating activity offshore, and M&A, they will need to anticipate and manage risks associated with these alternatives.

9 Rise of Financial Conglomerates as Asset Gatherers

Our panel selected the rise of financial conglomerates as asset gatherers as a significant strategic risk. The competitive pressure to meet the savings needs of an aging population is increasing and with their close client relationships, and excellent position as distributors, banks and insurers have structural advantages.

10 Growth of Alternatives

As the last challenge in the top 10, the panelists selected the growth of alternatives, noting hedge funds, private equity and real estate managers.

Our panelists were also asked to nominate risks that are 'Below the Radar' – those not in the top 10, but with the potential to emerge onto the list in the next five years. These risks include:

1 Poor Execution of Globalization Strategies
2 Global Competition for Financial Talent
3 Possible Regulatory Intervention Against Alternatives
4 Offshoring of High Net Worth Clients
5 Increasing Compliance and Institutionalization Challenges

More detail on 'Below the Radar' risks on page 15

The Top 10 Risks for the Asset Management Industry

1 Global Financial Shocks

Given the challenges faced by the financial services industry, it is perhaps not surprising that our panel of industry analysts selected global financial shocks as the top risk for the asset management sector in 2008. One panelist noted, "Disintermediation in the credit markets replaces international banking as a finance source with a range of specialized credit instruments held widely with risk exposures that regulators find it difficult to assess. There will be unexpected pockets of vulnerability." Another panelist commented, "A crisis in CDO/structured finance markets could lead to potential systemic problems. Sustainability of financial sector growth is more fragile than markets recognize. There is the potential for dramatic fallout from excessive leverage. Carry trades are cited as a risk area, but other hedge fund strategies are exposed to a change in the macroeconomic environment. There are potential systemic issues in the financial sector."

A specialist in financial markets regulation made similar comments: "To what extent do pressures on regulators to reduce regulation out of competitiveness concerns increase systemic risk? Since there is no comprehensive global regulator for financial issues, the ability to monitor and oversee systemic risks that arise from leverage is limited. Companies can play off the current trend toward lessened regulation to optimize their regulatory operating environment; rational corporate decisions could magnify overall risk levels."

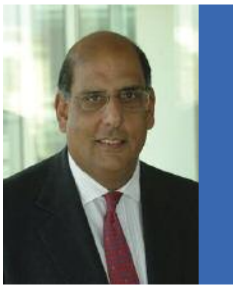
The depth of the impact of the sub prime problems is still unclear and is likely to remain so for some time. One analyst noted that, "There are two potential outcomes for industry players: the larger hedge funds that survive are likely to become stronger, and the event could extend the life of the 'traditional asset manager'." What the crisis has clearly highlighted for all financial institutions is that as financial markets become more complex, maintaining risk management systems that stay abreast of and support the aggregation and modeling of risks will be critical.

2 Polarization Between Alpha and Beta Business Models

The asset management sector is undergoing a transformation. Strategic risks created by the polarization between alpha and beta business models still presents a major challenge. Ten years ago, the industry was dominated by long-only active managers. One analyst wrote that, today, looked at from a product point of view, the industry is slowly dividing into two camps: "on the one hand, the providers of beta strategies – massive asset-gathering machines that drive down costs and provide cheap access to markets and market risk – and on the other, alpha seekers, those that hope to achieve but certainly offer (although with potentially more risk) better than market returns." An industry panelist made a similar point, forecasting "an even sharper distinction between low-cost index trackers and active managers with pure success fee structures, and contraction of the active fund management sector – closet trackers and traditional balanced funds."

The majority of our sector analysts commented that asset managers that fail to adapt to one of the two models, 'beta' asset gatherer or 'alpha' specialist, will be caught dangerously in what is commonly called the "swampy middle." At the expense of those in this middle ground, the rewards for both 'alpha' and 'beta', will include greater returns on investment, asset flows and improved market ratings. One analyst noted, "The industry is in transition with a whole host of participants clearly claiming they are both. This proposition is not sustainable in the long run." Another commented that, "Closet indexation and the concomitant gaining of active fees for passive management are reaching epidemic proportions, provoking a backlash." However, not all the analysts were agreed on this point. One industry panelist commented, "Polarization is not extreme. Competition in asset management is slow, because no fund can consistently out perform. Deep and wide markets will allow funds that are neither specialist nor gatherers to survive for many years to come, however strategically untidy." Nonetheless, the perceived bifurcation creates substantial strategic challenges for today's industry-leading firms. Asset managers should not get stuck in this 'swampy middle' and should act quickly to assess strategically where they are or need to be on this spectrum.

The Industrialization of the Hedge Fund Industry



Ratan Engineer
Ernst & Young

Hedge funds started with a simple business proposition. They were a small group of innovative investment professionals who were compensated very largely on the basis of investment performance. The success of hedge funds has fuelled growth in the assets they manage and put increasing pressure on their organizational structure.

Many funds must decide whether to become institutions able to manage further growth, or stop growing. Those who decide to cross the line will become more like mainstream asset managers, creating new processes and organizational structures. Management fees will become an increasingly important source of income and an essential component in assessing and managing business risk.

Along the Path of Industrialization, Hedge Funds Face a Number of Challenges:

First, they must **avoid strategic drift.** As the industry is polarizing between specialists and asset gatherers, hedge funds must avoid the tendency for a growth in assets under management to lead them to become flabby generalists. They must retain their focus and position themselves as performance driven specialists. Being caught in the middle between specialists and generalists is not a sensible place to be.

Second, hedge funds must **set limits** in terms of their assets under management in any single strategy and team size. They must decide how much growth they can sustain and how the organization will change to manage this growth.

Third, they must **develop a succession plan.** Institutionalization is often a painful process for the founders, as they are unable to be involved in all aspects of the firm and exercise direct control. The final objective is to create a business, something that is independent from the individuals. This requires a deep change of mindset for the founders and a new culture for the firm. New functions, some much maligned, will have to be created, such as human resources and marketing, and the next generation of leadership will have to combine investment skills with managerial talent.

Fourth, they must convince investors that they are still **performance driven.** Hedge funds were perceived as a more honest proposition – fund managers could get rich only by enriching their investors. Inevitably, the growth of management fees creates a source of income that is not performance dependent. The fund will have to create a combination of experience of the founders with a new generation that still has to prove itself, and create a compensation system that rewards both and is aligned with the interest of investors.

It is difficult, if not impossible, to say exactly when precisely such businesses cross the line and become asset gatherers. However, the need to grow, manage more funds, build up processes and organizational infrastructure is often perceived as the natural path for a business. The result is a progressive and yet dramatic change of mindset.

Not all hedge fund managers will want to create large businesses. Some will decide to remain focused and stick to their boutique models. However, they will be a small minority, albeit a potentially profitable one. Driven by a natural desire to grow, most fund mangers will find the urge to gather assets irresistible so long as this can be sustained without margin erosion. The danger is not spotting the loss of margins in time.

Not everyone will succeed. How tough the selection will be depends in part on market conditions. In the recent bull market, failures have been relatively easy to hide. The quality of asset managers is difficult to assess; performance can be evaluated only over long periods of time, and monitoring is complicated by considerations regarding the relevant benchmark and measurement period. Unlike a washing machine, it is difficult to say when a fund is broken and does not work anymore. In a bull market, funds that fail to institutionalize may survive or fold quietly, by failing to convince investors to commit new money. However, in a sustained bear market, the selection process will be brutal, and the shortcomings will be blatantly exposed.

■ **Ratan Engineer is the Head of Global Asset Management.**

> "Thirty-plus [asset management] firms account for 50% of global market share, indicating a fragmented marketplace. A period of consolidation is under way and set to continue."
>
> Ernst & Young

3 Geopolitical or Macroeconomic Shocks

Geopolitical or macroeconomic shocks pose major strategic risks to asset managers. Our panelists differed in their views on what might be the most likely shock, but the most frequently cited were a disorderly unwinding of global imbalances, real estate market crashes, a setback in China, and threats of terrorism.

Sector analysts focused on the threat of a sudden stop to China's extraordinary growth. One industry panelist noted, "China's growth model is an extraordinary and untested phenomenon where corporations are owned and managed very largely by the state, financed by state-owned banks which in turn are compelled to purchase government bonds. This has a very direct bearing on world markets and asset allocation and flows – China is in absolute terms the world's fourth largest economy." A China-based economist commented, "The successful transformation of the banking sector and effective management of bad debts in China will significantly improve China's economic prospect."

Another frequently mentioned concern was the unwinding of global imbalances. At the time of the research, which took place before the credit crisis, one industry panelist noted, "There is a risk of a major and sustained fall in the US dollar and eventual tightening by the US Federal Reserve (the Fed) triggering a global recession." One possible scenario outlined by the panel is an escalating chain of events following a crash in the value of the dollar, including the Fed being caught between letting the currency go or aggravating inherent recessionary conditions; a drop in demand by the US for foreign goods; Europe and Japan weakened as their exports become more expensive; knock-on effects in other economies. There was not much support for an emerging market decoupling taking up the slack.

A further issue mentioned by the asset management industry panelists was the continued threat of terrorism, specifically the corrosive psychological effects such attacks might have.

4 Changing Needs of an Aging Population

One panelist commented, "The combination of populations aging, the aged living longer and spiralling health care costs is the single most important secular trend underpinning savings markets." The sector's inability to adapt to changing needs of an aging population is a significant risk for the industry, "Governments have made promises to their people about their welfare in old age: both in terms of pensions and health care. Almost universally, these obligations have not been funded. Whatever the tribulations might be, the asset management industry should be a beneficiary of this opt out." Unless other forms of saving are developed, or people are prepared to pay more for their dependents, there will be unsustainable imbalances between workers/taxpayers and beneficiaries – pensioners.

In addition to the need to develop new products and new capabilities to capture this new demand, there are risks that arise from the demographics of aging – namely that asset managers are entering an environment characterized by policy uncertainty and a charged political atmosphere. Governments are universally encouraging personal saving, transferring responsibility for welfare to individuals and adopting fiscal measures that encourage saving without causing them to lose the political initiatives of the moment. A specialist in regulatory affairs noted other government options for managing demographic challenges, "Increasing retirement ages, reducing benefit levels, increasing taxes on current workers, or increasing immigration to expand the size of the workforce, any of which would be highly controversial." An industry panelist noted that there would be a "decline of viability and possible large increase in failures of traditional pension funds, leading to financial uncertainty in Western middle classes, increased saving, and a more conservative savings mix." In several countries, the privatization of parts of the pension systems, typically with the introduction of a mandatory private pillar, has brought asset managers from the periphery to the core of pension financing, and several analysts worried about the impacts of an outright 'pensions crisis' leading to political and regulatory turmoil.

5 Innovation Moving Away from Traditional Asset Managers

The migration of innovation moving away from traditional asset managers is an increasing strategic risk. Several panelists commented that the polarization of alpha and beta also means that financial innovation is concentrated in the specialist firms at the alpha end of the spectrum (as well as alternatives such as hedge funds and private equity). One sector analyst noted, "The best money managers are setting up boutiques to deliver alpha. This is unusual; one would almost go so far as saying unique, in the financial services industry. The giants cannot hope to compete with the boutiques, despite the risks." The leading firms are left with the challenge of trying to retain centers of innovation, or acquire it with mergers and acquisitions (as some 'multi-boutiques' have attempted). Other panelists worried about the migration not just of innovation but of clients' funds away from leading asset managers and into alternatives and real estate. As the best money managers leave the traditional firms, the 'war for talent' is also polarizing in the industry – another significant threat for asset managers. The giants may retain the best marketers and distributors but may struggle to compete with the boutiques for money managers.

6 Difficulty of Developing Retail Competencies

A further competitive issue that is of great significance to the asset management sector is the difficulty of developing retail competencies. One analyst wrote, "Accessing, capturing and retaining the client and grabbing an increasing share of his spend reigns supreme, so all the ancillary things that go with distribution begin to gain importance: size, capital, scale, marketing, brand, and the ability to deal with volume. The independent asset managers are ill-equipped to deal with this." Another analyst explained, "As corporates opt out of pension provision – like governments – the plan sponsors as professional intermediaries wane and the suppliers of asset management products necessarily have to deal with the customer. This has led to the weakening of wholesalers in asset management markets and the ascendancy of retailers."

7 Poor Execution of M&A

A number of asset managers face significant threats through the poor execution of M&A. One industry panelist noted the need to achieve economies of scale, "There is a drive to consolidation in asset gathering." Other sector analysts pointed to the motivation of "acquiring alpha-generating talent that cannot be home-grown." One panelist wrote, "Thirty-plus firms account for 50% of the global market share, indicating a fragmented marketplace. A period of consolidation is under way and is predicted to continue."

For the last five years, asset management firms have increasingly engaged in M&A activity. But these acquisitions may or may not deliver shareholder value. Lack of strategic fit in terms of client base, organization structure or corporate culture can spell disaster for the integration from the start. Even if the fit between two firms is perfect in theory, it must also work in practice, and panelists noted substantial execution risks associated with consolidation strategies. Today the risk is increased by four factors: 1) the frantic pace of M&A activity, which leaves little time to absorb acquisitions; 2) the high acquisition premium paid; 3) the diverse nature of the firms being integrated (e.g., boutiques with large retail fund managers); and 4) the range of opportunities for the most talented fund managers to leave or set up new firms. In such a highly regulated sector, accounting, financing and taxation issues are key, even more than for other sectors. This is particularly true in the case of cross-border mergers. On top of these risks, poor or slow integration of IT systems can slow down the process of assimilating the target company. Firms are likely to reap greater benefits by taking a focused and modular approach to M&A activity from due diligence, through to post-merger integration.

“Acquisitive growth is no longer seen simply as a way to immediately increase funds under management, but as a way to strategically position a firm’s service offering in a demanding marketplace. As a result, high-acquisition premiums are being paid as firms seek to get one step ahead of their competitors.”

David Barker, Ernst & Young

The Strategic Challenges for Mergers and Acquisitions

David Barker
Ernst & Young

The asset management industry is undergoing an unprecedented period of transaction activity. There is an increasingly competitive search for elusive alpha as firms continually look for niche expertise to give them a competitive advantage.

Asset management firms either have a clear focus on traditional strategies with lower margin beta or, through alternative and innovative strategies, performance driven alpha. This has led to the trend for asset managers increasingly to go to market as large ‘boutiques,’ focusing on their ability to generate alpha.

If alpha-generating talent cannot be home-grown there is a need to acquire it. Boutiques, particularly within the hedge fund sector, are being snapped up as larger players seek to buy in alpha in order to expand their product offering. Acquisitive growth is no longer seen simply as a way to immediately increase funds under management, but as a way to strategically position a firm’s service offering in a demanding marketplace. As a result, high-acquisition premiums are being paid as firms seek to get one step ahead of their competitors.

For the targets, deciding whether to remain independent and grow organically, look for acquisition, or sell a significant stake, requires careful consideration and analysis of all possible options. A sell-out to a large financial corporation is a tempting exit strategy but the risk of losing independence and even the ability to continue generating alpha is high. An IPO may help maintain this independence and the strategic vision of the management but can lead to increased public scrutiny and pressure to deliver growth in shareholder value. In an industry that is driven by growth in funds under management with increasingly astute institutional investors, opportunities are available to sell investors a stake in the firm in return for guaranteed and more permanent investment funds. The private equity industry is also hungry for asset management targets. If managers feel their alpha-creating talents would be limited by a controlling parent, a management buyout can provide clear advantages for all parties.

In an industry where high prices are being paid for the best managers, strategic options need to be carefully assessed. Buyers are prepared to pay significant premiums in order to secure talent but selling out to the wrong buyer may not be worth the extra premium received, particularly when assessing the long-lasting effects of loss of independence.

In a market where bigger is not always seen as better, buyers must carefully consider whether an acquisition should be part of their long-term strategy. The risks of integrating a new business are high and where the majority of acquisitions lead to value destruction – a rushed or forced deal which does not adequately consider the target’s fit may not be the best solution. In many cases ensuring the right cultural fit is often as important as finding the correct strategic fit.

Whether from the buyer or seller’s point of view, M&A strategy may be fundamental to success in this very competitive marketplace. However, in an industry that can seem to be both consolidating and fragmenting at the same time, the strategy that should be followed is not always obvious and requires very careful consideration before a decision is made.

- **David Barker leads Ernst & Young's Global Financial Services M&A Practice.**

How to Go Global

Gillian Lofts
Ernst & Young

As the industry landscape is polarizing, asset managers are forced to choose between specialization and retail capabilities. For those players that do not want to be confined to a specific niche, international scale becomes crucial.

International expansion can be seen as a response to three challenges:

1. Pressures on margins from international competition and increasing regulatory requirements
2. Pressures on product innovation created by the need to offer a wide range of funds that cover the whole set of strategies
3. Convergence in international regulatory standards, reducing the barriers to cross-border operations.

Offshoring, one of the drivers to international expansion in many industries, is not a key feature of globalization in the asset management industry. Few players have already reached the size that would make offshoring truly beneficial.

Avoiding the Pitfalls when Entering New Markets

One of the most common mistakes firms make in seeking to enter new markets is that they adopt a one-size-fits-all approach. As the search for scale is such an important factor in international expansion, it is easy to focus too much on standardization. However, global asset managers can be successful only by finding the right balance between standardization of global operations and adaptation to local market conditions.

Globalization of financial markets has not eliminated national differences, which are particularly marked in the retail asset management sector. Differences in regulation, distribution channels and customer preferences mean that asset managers must carefully plan their operations in new markets.

In some countries, such as Germany and France, distribution channels are controlled by banks and insurance companies. As distribution is tied up by local partners, foreign entrants are faced with a significant challenge. In some emerging markets, such as India, customers may still prefer investments in tangible goods, such as property and gold, rather than mutual funds. Without a deep understanding of the local market, in terms of distribution, regulations and taxation, foreign companies are unlikely to succeed.

One key to success is to be able to integrate local knowledge within a global operating model. Of course, local knowledge is exactly what new market entrants lack and one common approach is to speed up the entry process by relying heavily on local advisors. By doing this, international firms can however find it difficult to monitor the quality of the activities of their local partners and a problem of local knowledge could turn into a problem of accountability.

To create successful operations in a new market, asset management firms should:

- Undertake a thorough analysis of tax, accounting, distribution and products: a superficial understanding of local regulations, such as money-laundering requirements, can cause embarrassing hiccups in a firm's operations
- Prepare the right tools: when advising new clients firms need to be able to compare a wide range of investment opportunities, for example, the tax implications of foreign investments
- Find local advice that you can trust: developing wider relations with advisors whose international network mirrors the asset management's objectives can help build a longer-term relationship, limiting the costs and time to manage local relations.

■ **Gillian Lofts is an Advisory Leader in Ernst & Young's Asset Management Group. She has extensive experience working with Global Asset Managers and is responsible for the development of services linked to the design and implementation of Global Target Operating Model for Asset Managers.**

> “In a bull market, hedge funds that fail to institutionalize may survive or fold quietly, by failing to convince investors to commit new money. However, in a sustained bear market, the selection process will be brutal, and the shortcomings will be blatantly exposed.”
>
> Ratan Engineer, Ernst & Young

8 Cost and Pricing Controls

For many leading asset management firms, success may increasingly depend on low costs. Our panel selected increasing importance of cost and pricing controls as a major risk. One sector analyst noted the success of “massive asset gathering machines that drive down costs.” In part lower costs can be achieved through scale and a well-designed product mix. Other strategies might include outsourcing or offshoring and improved controls. The issue with many of these strategies is that they can bring with them a number of additional costs and risks. With offshoring for example, an asset manager must be prepared to answer a range of questions covering structure, culture, clients, products, processes, technology and people before making a decision, and be clear on what is core to the organization. Whatever strategy is adopted, our panelists all agreed that cost and pricing control would be key to maintaining margins. One analyst predicted “burgeoning variety and segmentation” and “more niche” players.

9 Rise of Financial Conglomerates as Asset Gatherers

A major competitive threat to asset managers is the rise of financial conglomerates as asset gatherers. Large banks and insurers can benefit from their experience and long-standing direct relationship with clients in the asset-gathering game. One panelist noted: “Far from being a simple cog in the money transmission system, banks have recognized that they may well be best placed to own the customer and their distribution engines are useful and insatiable asset-gathering machines.” These factors have led to a blurring of the boundaries between banks, insurers and asset managers, all of which now play in the ‘wealth management’ arena. Asset managers have historically won the wars against insurers for investment performance. But insurers and banks may have advantages this time: “Some of the largest asset gathers are collecting, on a business-as-usual basis, assets at the rate of some US$30bn a quarter. In other words they are building something, in asset-gathering terms, the size of a reasonably large asset manager every two years.” An analyst commented that these firms’ comparative advantage is the ability to adopt ‘open architecture’ platforms, contributing to the following value proposition, “We will act as your aggregator and wholesaler and find you the best money managers, some of which may be in-house.”

10 Growth of Alternatives

Our panelists selected growth of alternatives as a major risk for asset managers, noting hedge funds, private equity and real estate. Many of these sub-segments are not new: what is new is their propensity to hit the headlines. One panelist wrote, “High returns on real estate in recent years, with weak performance from equities and bonds, have produced a strategic reallocation of portfolios toward real estate. Real estate markets have traditionally been dominated by domestic investors, large institutions and listed companies. A proliferation of real estate funds, both unlisted and listed, has dramatically increased the ability of smaller investors to access markets.” Some industry panelists, however, noted that the biggest risk was not alternatives’ growth but their collapse: “Hedge funds and their prime brokers have achieved exceptional growth over the last decade. Private equity houses have grown similarly. The slowdown of the hedge fund and private equity sectors could result in a hard landing.”

The Importance of Private Equity

Simon Perry
Ernst & Young

Growth Continues

The annual Ernst & Young study *How do Private Equity Investors Create Value?* revealed how the private equity (PE) industry is consistently able to grow and strengthen the companies under its ownership. By focusing on the business performance and strategies of PE firms across the largest deals exited throughout 2006, the study confirmed that the annual rate of growth in enterprise value (EV) achieved last year by the largest private equity-backed businesses significantly outperformed equivalent public companies in the same country, industry sector and timeframe. Average annual EV growth rates were 33% in the US and 23% in Europe, compared with public company equivalents of 11% and 15% respectively, with over 80% growth in total enterprise value.

Private equity ownership creates value from sustainable improvements in performance and business growth. Two-thirds of the earnings growth in PE-owned companies comes from business expansion, with increases in organic revenue being the most significant element. This includes the benefits of investment in sales and marketing, new product launches, acquisitions, investment into attractive industry sectors in the US, and expansion into new geographies in Europe. Cost reduction, including operational efficiencies, is also a very important element of earnings growth in both the US and Europe, accounting for 23% and 31% respectively of the total growth in earnings.

What are the Secrets of Private Equity's Success?

The study showed that private equity investors are highly selective and well researched when making the decision to buy a business, and have the ability to drive real efficiencies through the business plan under their ownership. This finding was true across deals in the US and all main European countries. Three-quarters of investments resulted from proactive deal origination strategies, including company or sector tracking, building relationships with management, or introductions from established contacts. Across almost all deals and ownership strategies, private equity investors were actively involved in the business after acquisition, making rapid decisions alongside management, challenging progress and making available specialist expertise. The intensity of engagement between private equity investors and management was often stronger than under the previous owners.

This rapid growth in the scale and success of private equity has brought with it increased scrutiny: politicians in many countries are reviewing whether and how to regulate and tax the industry; corporates are considering how to compete with and learn from the different business model; concerns are being raised about the security of jobs and employment benefits. Despite those concerns, the clear advantages of the private equity model are likely to result in continuing investment and growth.

The Credit Crunch – Implications for Private Equity

Recent developments in the credit markets may have caused concern. The credit crunch has meant that the debt markets are more or less closed for new large Leveraged Buy-Out (LBO) deals resulting in a significant slowdown in transactions. Market participants view this as a short-term dip in activity prior to returning to a more rational climate in 2008. There is a long-term belief in the PE model by the market and the long-term fundamentals remain strong. The recent events may well prompt a more conservative approach by banks when doing deals. This could result in an increasing need for due diligence at acquisition.

Although the credit squeeze may reduce the benefits from leverage and enhance the importance of underlying profit growth, private equity will continue to be an important factor in the world's financial markets.

What are the implications of the continued growth of private equity for corporates? Every company needs to develop a strategy for engaging with private equity, whether partnering with, buying from, selling to or competing with them.

■ **Simon Perry is the Global Leader of Private Equity at Ernst & Young.**

“The combination of populations aging, the aged living longer and spiralling health care costs is the single most important secular trend underpinning savings markets.”

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How Big Will the Sovereign Funds Get?

Robin McConnachie

Despite the Hype, Much of This is Not New

Sovereign Investment Funds are not new: the Kuwait Investment Authority, for instance, was set up over 50 years ago to invest the country's oil surpluses for the future in a more diversified and cost-effective way than would have been possible if the country had simply increased its official reserves by accumulating foreign exchange surpluses.

The search for investment performance also is not new. Government investment managers, like central banks, have in the last few years increasingly deployed market-related investment techniques such as benchmarking both to increase the returns available on government securities and to diversify the currency mix, often by reducing their holdings in dollar bonds such as US Treasuries. (Though they may be constrained in their investment policies by prudence or government regulation or both.) The older investment funds like the Abu Dhabi Investment Authority (1976) and the Government Investment Corporation in Singapore (1981) have always discreetly sought higher returns for their parents by investing in a wider range of currencies and in particular by buying and holding equities, foreign as well as domestic.

Scale, Leverage and Strategic Intent are New

What is new, and what has attracted the attention of commentators, is the scale (actual and projected) of this newer investment, and the willingness of these newer funds both to gear up aggressively like a private sector hedge fund and to take controlling stakes in foreign companies, which are possibly of strategic importance to their national governments.

Recently, new players have arrived on the scene – such as Russia and China, with its State Investment Corporation. The recent global surge in asset prices generally – with a fall in government bond prices, especially US Treasuries – has been ascribed by many to the increasing wave of liquidity from this source.

How Big will They Get?

Sovereign Investment Funds will undoubtedly grow in size and importance if only because, for some time to come, the Middle East will need to find a home for its petrodollars. In addition, other countries, for example, China, are currently generating trade surpluses far beyond established benchmarks of reserve adequacy.

However, constraints on future growth are likely to manifest themselves both from the point of view of the investing country and the recipient country. In the first place, governments and central banks, which remain responsible for investing a country's reserves, will not be willing to entrust more than a certain percentage of the totality of funds available to these funds. They will remain essentially conservative in balancing risk against return, showing concern about excessively leveraged funds whether private sector or semi-official. While greater investment freedom can assist national development, for example, by financing massive infrastructure projects, it will take only one big failure for the authorities to pull back on the reins. This is especially true if the newer and brasher funds continue to be noisy about the scale and location of their investments.

Secondly, as a general rule, Ministries of Finance and their investment managers or financial regulators will not think it prudent to abandon this area entirely to the private sector. There is an irreversible trend both towards greater transparency and in favor of increasing cooperation among financial regulators which will require national authorities both to respect international norms and, partly in consequence, to retain a considerable element of central control.

On the other side of the coin, recipient countries will not be prepared to stand back and let other governments, or what are effectively their investment agents (whatever nominal freedom of investment they may be given), take control of their leading companies. This does not just apply to firms engaged in strategic industries such as defense. The attitude of the US to foreign bids in sensitive sectors – for example, for a high tech firm – is already clear and many European countries either have or are contemplating introducing/strengthening legislation in their countries that would limit the growth of this development.

■ **Robin McConnachie is Former Deputy Director, Centre for Central Banking Studies, Bank of England.**

Below the Radar

- Poor Execution of Globalization Strategies
- Global Competition for Financial Talent
- Possible Regulatory Intervention Against Alternatives
- Offshoring of High Net Worth Clients
- Increasing Compliance and Institutionalization Challenges

Our ‘Below the Radar’ risks did not make it into the top 10, but have the potential to emerge onto the list in coming years.

This is not a quantitative survey exercise and we are well aware that in identifying the top 10 risks we may have missed important risks that could have an even bigger impact on the industry.

Poor Execution of Globalization Strategies was rated as a significant risk to the industry. Asset management is becoming more international, driven by deregulation, reduction of barriers to cross-border investment, technology, and the need to achieve scale. But the successful management of this is particularly difficult in the asset management industry, especially on the retail side, where differences in the nature of competition, financial market structures, and savings culture can impact investment habits and choices. To be successful, asset managers must strike the right balance between adapting to local conditions and cross-border standardization to drive down costs.

The threat posed by the **Global Competition for Financial Talent** is considerable for asset management firms, as it is for the rest of the financial services sector. Industry analysts commented that, as growth in China and India increases, London and New York would no longer be able to draw on the “global pool of mobile, multilingual professionals possessing advanced degrees from leading universities, a growing share of which originate from emerging markets.” Another panelist noted, “Because of fabled rewards and their agility, mobility and the simplicity of their business models, alternative investments continue to attract the brightest and best people into an environment in which they can prosper.”

Below the Radar Continued

The extension of greater regulation for the industry is seen as a risk to asset management. In particular our industry panel focused on **Possible Regulatory Intervention Against Alternatives.** In the past year, public debate about the role of private equity, especially in Europe, has been loud and sustained. A regulatory affairs specialist noted, "There has been a preference of laissez faire or self-regulation for highly leveraged investment entities (hedge funds, private equity firms), and cutting-edge (also highly leveraged) financial instruments (derivatives). There is the risk of a backlash against these more flexible approaches." A specialist in EU politics commented, "For some, hedge funds are the chief villain of the international financial system. G-7 finance ministers recently discussed a number of proposals at length for reining in hedge funds, finding some common ground."

The **Offshoring of High Net Worth Clients** was acknowledged by our panel as a growing risk to asset management. An industry panelist argued that the rich are increasingly basing themselves globally, describing the "growth of international plutocracy domiciled in (offshore) centers which maintain congenial policies on tax, corporate control and privacy." Aside from regulatory risks related to taxation disputes involving these offshore centers, there is the challenge of following and meeting client needs when there are increasingly "more internationally based dynastic fortunes than national ones."

Our final 'Below the Radar' risk is **Increasing Compliance and Institutionalization Challenges.** Financial regulations are more complex, including regulations targeting money laundering, and globalization. The rapid transformation of the industry is creating new challenges. An unexpected challenge posed by the industry's success in innovation, for example, has been the growth in boutiques and hedge funds that must now decide "whether to build the infrastructure to manage growth or stop growing."

Conclusion

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This study was a structured consultation with industry leaders and subject matter experts from around the world. They have identified trends and uncertainties, and assessed risks and their impact both on individuals and markets.

The asset management industry is going through an exciting, and important period of evolution. In rating the top 10 strategic business risks for the asset management industry, there is tremendous variation in the selection and relative importance. This report illustrates a wide range of risks that companies need to understand and address over the next five years.

Approached properly, the process of risk management can add value even if the event never occurs. Working through scenarios and impact studies can result in opportunities to tighten processes and controls, encourage lateral thinking and help to build action plans that deliver value.

Ernst & Young's work with companies around the world suggests that there is a body of leading risk management practice emerging, but that companies are doing too little in this area. Many global organizations recognize that they have gaps in their risk coverage, with most focused on operational and financial risks. There are steps that company leadership can take to address these issues:

- **Keep an open mind about where risks can come from.** This is an increasingly interdependent global economy and risks that can damage a business can initiate in any market or sector. High risk mortgage lending in the US to people with limited or no creditworthiness can hurt the pension funds of the most cautious saver.
- **Conduct an annual risk assessment** that defines key risks and weights probability and impact on business drivers. Many companies do some form of risk assessment, but experience suggests that too many do not do so on a rigorous basis.
- **Risk assessment needs to go beyond financial and regulatory risk** to consider the wider environment of the organization and the full extent of its operations. This would include effective controls for M&A, IT implementation, business continuity planning, and expansion into new international markets.
- **Conduct scenario planning for major risks** and develop a number of operational responses. This can be a useful part of the planning cycle and help to encourage innovative thinking.
- **Evaluate the organization's ability to manage the identified risks** – in particular, ensure that risk management processes are linked to the risks that the business actually faces. While a risk function may bring great value in focus and expertise, companies must avoid the danger that some central function thinks it can or should have responsibility for risk management.
- **Effective monitoring and control processes** can provide both earlier warnings and an improved ability to respond. There can be value from much of the compliance activity required by regulators, particularly if properly integrated in a business's strategic thinking.

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EYG No. EH0011