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Riders on the storm

Crisis creates challenges for asset manager business models

July 2020

When markets enter rough waters such as we've seen in 2020, there are often second-order effects worth thinking about which aren't immediately on an investor's radar.

One of those is how your asset managers are holding up in a broad business sense. You may have identified certain firms as skilled operators when it comes to investing, but how well are they placed to sustain that capability when markets are turbulent or in decline?

Fortunately we’ve seen equity markets stage a substantial rebound from their lows in late March. However, the environment remains a challenging one. In this article, we discuss current conditions, highlight aspects which Mercer is particularly conscious of as part of ongoing due diligence, and provide tips for your own monitoring of managers to help avoid unwelcome surprises.

Crisis creates challenges for asset manager business models

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A focus on business management

Across all asset classes globally, Mercer adopts a “4-factor” approach when assessing whether a strategy is worthy or not of our high conviction.

Generally speaking, Idea Generation is paramount because without a manager being able to identify compelling stocks and securities, there is little hope of superior performance.

Also important is Portfolio Construction. A manager has to have skills in working out how to compile those securities into a portfolio which suitably balances-off the risks.

And Implementation is vital because a manager has to actually execute their ideas in the market, without being let down by poor dealing capability or by managing so much money that trading fails to be reasonably nimble.

But it’s the fourth factor which resonates most in the current context, and that is Business Management. This component captures a number of facets including a firm’s financial strength, culture, management quality, and mechanisms for paying and motivating staff. In its broadest sense, it asks the question - how well placed is the firm to survive and thrive?

In times when an asset manager is impacted by a market correction and/or material client redemptions, its business model is stressed due to an inherent feature known as ‘operating leverage’. The reality is that revenues are closely tied to the level of total assets managed. After covering core expenses, any additional income from asset management fees largely represents profit. While that model provides an attractive margin when asset values are rising, it also works in reverse. As assets and revenues fall, profit margins shrink quickly unless expenses are re-adjusted to account for that fall.

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The broad outlook

The last shock comparable in magnitude to the current downturn - the Global Financial Crisis - saw a significant number of asset managers fold in its wake. This year, the market recovery in the second quarter has reduced risks of the same outcome in the near term, but a range of hazards remain.

At this stage we don’t anticipate a widespread collapse of asset management firms, assuming markets maintain or kick-on from current levels. However, we do see scope for an increase both in outright casualties and in M&A activity. At a minimum, cost reduction will be to the fore, particularly where short-term earnings expectations need to be managed (often felt most keenly by listed entities).

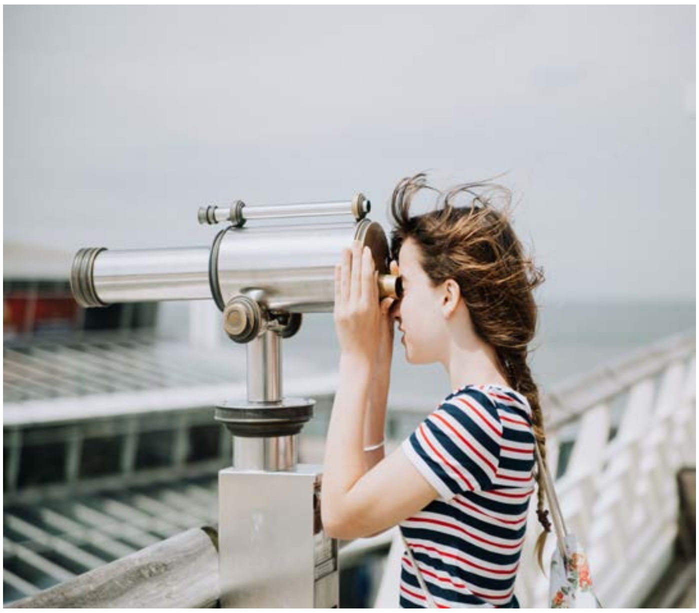
On a regional basis, managers focused on the US market will have seen the value of their portfolios largely recover to start-of-year levels, helping underpin the viability of their operations. Managers in Japan, other parts of Asia and in New Zealand are in a similar position. Meanwhile, firms focused on the UK, Europe, Australia and emerging markets still face market valuations well off earlier highs.

Some managers, particularly but not limited to boutiques, may be travelling ‘close to the wind’ in terms of breakeven profitability levels. Firms experiencing most stress are likely to be those relying on just one asset class for revenue, or those which are still in the establishment phase and may have been subscale even prior to the downturn.

Market conditions may have delayed the achievement of a positive net return to the firm’s owners. In some cases, the cost/benefit trade-off for carrying on with the business becomes marginal. Longevity will require having sufficient owner commitment and capital reserves so that the firm can 'look through' a period of lower asset prices, and the follow-on revenue impact, without undue cutting of staff or other resources.

We may well see an increase in the number of smaller firms looking to partner with larger institutions or those which provide umbrella services. This would amplify a trend already seen to varying degrees for some years, as boutiques look to bolster their balance sheets or enhance their distribution models.

Business valuations can generally be expected to soften, to the extent that earnings multiples have declined. Potential acquirers of boutiques can naturally be more selective as to who they partner up with. At the same time, the pace of new firms starting up will inevitably ease off for a period. The entrepreneurial spirit tends to weaken when the economic outlook turns cloudy; or if the spirit is willing, financing may be hard to come by.



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Key aspects to monitor

So what are some of the key areas Mercer has been focusing on as part of our research activities?

Most immediately, from an operational perspective, is Business Continuity. We've been asking questions about how the team has been able to function while working from home and not being able to travel. How has that affected the research process? How have their systems held up? And more subtly, has it impacted on how well the team interacts?

From a strategy perspective, we look at how the firm has coped with trading in the market during bouts of impaired liquidity. Have they maintained the integrity of the portfolio in cases where there have been notable client flows? Have return outcomes been similar to what we might have expected, given what we know about their standard investment process?

We're looking for any signs that a manager has demonstrated 'style drift'. In essence, this is when a firm changes its spots – altering the types of securities it normally invests in. This is of concern because it compromises an investor's ability to be fully cognisant of what investment approach is being adopted, and hence how it may perform under different conditions.

Experienced investors will be aware that few highly successful alpha generators go out of business, whereas the opposite is true. So we have a particular focus on instances where a manager has delivered recent under-performance to the extent that clients may be unsettled. An uptick in redemptions, on top of falls in asset markets, represents a 'double-whammy' for the manager to grapple with.

Key aspects to monitor cont'd

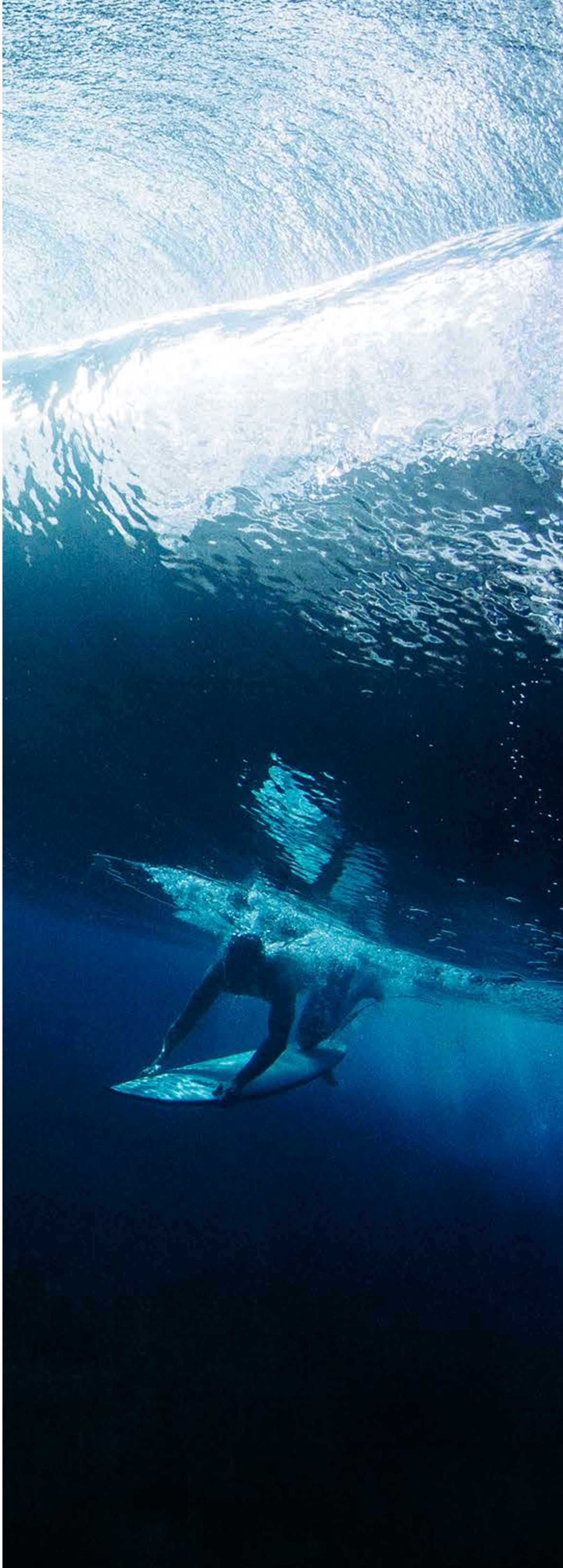
Some investment styles have tended to fare worse than others. Value style strategies have faced performance headwinds for some years now, and for most of them, 2020 has not offered much respite. The situation is similar for funds with a tilt to smaller cap stocks. In these and other cases, clients could be running out of patience.

At a business level, we're looking for any indications that an asset manager may be experiencing cashflow challenges. We have seen isolated cases of firms putting their hands up for financial assistance schemes offered by Governments. This has the potential to reflect something more chronic underlying the business.

A noteworthy characteristic of any firm is its ability (or otherwise) to resource itself through a cycle with the long-term in mind. We're looking more intensively for signs of organisational cutbacks that might impact on core investment capability. An advantage held by firms with material self-ownership is flexibility on the cost side in terms of paying staff, which is a major expense of any people-oriented business. Reducing salaries in favour of other incentives - be it through deferred payments or benefitting from longer-term business value - can mean resourcing is maintained through lean periods. However, we would not regard that as a long-term solution.

Where there have been major adjustments to the business structure, we're also wary of any fall-out in terms of morale. A lack of motivation, or distractions, when it comes to the core investment task can soon show up in weaker return outcomes.

How the business accrues fees has additional relevance. For firms with a high reliance on performance fees, a recent period of good returns versus index may be their saving grace, while for firms travelling under benchmark it will tend to add to financial pressures. Ideally we're looking for base fees, rather than performance fees, to be covering operational costs.



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Staying secure

It's worth noting that if things do take a sudden turn for the worse, and an asset manager closes, in the vast majority of cases the funds will be held in custody by an external party. The value of your assets is not lost. Investments can be transferred to another manager - ideally one that you already had lined up as part of a reserve bench.

To sum up, asset manager research is arguably more relevant than ever in a tough economic and social environment. There is no shortage of issues to be wary of. For Mercer's part, by doing the right legwork we aim to be quick to update our advice to clients if we identify signs of weakness at an asset manager, and recommend switching to another which can more ably ride out the storm.

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*As at 30 June 2019.

**As at 30 November 2019.