



BNY MELLON
ASSET MANAGEMENT

Over the course of the decade or so that preceded the onset of the credit crisis in 2007, Newton had grown increasingly concerned about the over-indebtedness of the Western consumer and financial system. These concerns were expressed in our theme of *debt & credit* about five years ago. The popping of the credit bubble validated our concerns and our thinking has now shifted to considering the implications in the aftermath of the credit crisis. We replaced *debt & credit* as a theme in the second half of 2008 with *all change*, which explores the implications of the very significant deleveraging which is already under way. These implications will reach all corners of the financial services industry, including asset management.

The objectives of this paper are:

- (i) to explore the effects and consequences that we (Newton) expect to come about within the asset management industry from *all change*, and
- (ii) to discuss the attributes which we believe will differentiate the 'winners' within asset management in the years to come.

We expect the forces of *all change* to have a profound impact on the asset management industry and that successful asset managers will need to adapt their approach to the new environment accordingly.

All change

The central idea behind the *all change* theme is that the popping of the credit bubble marked the end of the long-running trend of rising private debt levels in the developed world. The increasing importance of credit in the generation of economic output, and in particular growing levels of financial sector debt, were major features of the economic landscape in developed economies for more than two decades. The trend had many tailwinds, the details of which are beyond the scope of this paper. Suffice it to say that falling inflation and bond yields, globalization, deregulation, the emergence of the 'shadow' banking system, financial engineering, central-bank policy, technological advances in computing, and political influence all had roles to play in exacerbating the growth of credit.

Like all trends, the demand for credit was founded upon a simple belief: low economic volatility along with low interest rates and gently rising asset prices were permanent features of a globalized world. In this apparently less risky world, awash with plentiful and cheap credit, it was rational to 'gear up'. That this trend was ultimately unsustainable was the subject of our longstanding *debt & credit* theme.

The expected impact of *all change* on the asset management industry

NEWTON
The Power of Ideas

Both the supply of, and demand for, credit are likely to be significantly reduced, and this is a structural change that may last for many years.

The central precept of *all change* is that, now that the credit bubble has burst, leading to increased economic volatility and falling asset prices, the trend of rising credit has clearly gone into reverse. Importantly, the 'credit multiplier', which was heavily influenced by risk appetite in the 'shadow banking' system, has been permanently damaged. Indeed, we believe that the substantial wave of regulation that will follow in the wake of the credit crisis will cap financial institutions' leverage (debt) at much lower levels. Massive government intervention in economies, in the form of the biggest fiscal and monetary boost ever seen, almost guarantees further economic volatility. Intervention on this scale is unprecedented and there are enormous long-term risks in relation to the unintended consequences of government actions. Heightened economic volatility and lower asset prices mean that the deleveraging that affected financials initially will spread to corporations and households.

The key contention within *all change* then is that both the supply of, and demand for, credit are likely to be significantly reduced, and that this is not simply a cyclical adjustment, but rather a structural change that may last for many years.

The initial response of the authorities has been to use fiscal and monetary policy to soften the impact of deleveraging. As suggested above, there is a chance that governments will severely overdo the stimulus, leading to rising long-term inflation concerns. Given the scale and scope of the systemic deleveraging that policymakers are attempting to fight, it is unlikely that they will rouse another credit boom, but it is nonetheless a possibility.

The potential consequences of, first, the popping of the credit bubble and, more recently, the issues identified in our *all change* theme are profound and wide-ranging for all economies, sectors, asset classes, and investment strategies. In the following section, we examine some of the potential implications for the financial services industry, and for asset management firms in particular.

Implications for the asset management industry

The credit crisis, deleveraging, recession, and the associated bear market we find ourselves in are all the result of the popping of the credit bubble, whose aftermath is characterized by the features encapsulated in our **all change** theme. **All change** has a number of possible, wide-ranging implications for economies in general and for asset management firms in particular. We refer to these implications in this paper as forces of change. The list of these forces below is not comprehensive and is not set out in any particular order of importance or magnitude.

Disillusionment with equities

Returns from equities over the last decade have been very disappointing and we believe this is fuelling growing disillusionment with equities and 'risk assets' in general. The good news, however, is that investors are now being fairly rewarded for risk for the first time in a long while. In a long-term context, this is typically the type of occasion when equities should be accumulated and when active asset management can be of great benefit. Investors' short-term appetite for equities may nonetheless be suppressed.

Rising savings rates

Rising unemployment and falling asset prices are severely impacting household net worth and incomes, and we believe that savings rates are highly likely to rise as a consequence. However, we believe that, in practice, savings rates will rise largely as a result of diminishing indebtedness rather than because of the above factors given an inherent paradox in the investment landscape. Just at the time when individuals need to save (most have absolutely no idea how much it would cost to fund a long, leisurely retirement) and can secure some attractive returns in risk assets, they are strapped for cash, disillusioned with equities, and have lost faith in most financial institutions.

Global shift to defined contribution (DC)

In the aftermath of the financial crisis, the responsibility for funding the retirement of individual workers across the globe will inexorably shift over time from benevolent corporations (typically through defined benefit, or DB, plans) and governments to the individuals concerned. Where that responsibility is not properly assumed by individuals, we believe that, sooner or later, the combined pressure of demographics and the dire state of developed-world public finances will result in governments imposing this as a mandatory requirement (as per the Australian model).

Although the shift to DC has already clearly started in the private sector, we believe there is a real possibility of its happening within the public sector in the not too distant future. A case in point for this is the United Kingdom, where we believe that there is an increasing possibility that something radical will happen in relation to public sector schemes; unfunded government pension liabilities are

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estimated to exceed £1 trillion¹. With the election of a Conservative government in June 2010 seeming likely, and given the expected focus in the coming years on reducing government expenditure, a shift to some sort of DC or hybrid scheme for public sector employees could offer an attractive solution to the government's pension-funding conundrum. In summary, we believe that there is a combination of forces driving the shift to DC across the spectrum of providers and that this is one of the biggest structural changes that the asset management industry will experience.

Increased volatility

We believe that 'Goldilocks-like' economic scenarios (i.e. robust growth with low inflation) are unlikely to occur for the foreseeable future. Given the size, scope, and longevity of the growth of indebtedness over the last decade, we believe that the effects of deleveraging and the accompanying fiscal and monetary responses of the authorities should fuel 1960s and 1970s style volatility, instead of the 'great moderation' and mini cycles that typified the 1980s and 1990s. The scale of credit-related problems and of associated responses significantly increases the dispersion of potential outcomes, and thus the range of possible investment returns.

Reduction of leverage

This point is the most self-evident, but needs to be stated plainly nonetheless. As mentioned above, the key contention within **all change** is that both the supply of, and demand for, credit are likely to be significantly reduced, and that this is not simply a cyclical adjustment, but a structural change that may last for many years. The economic and investment implications are far reaching.

Back to basics of investment performance

There is widespread frustration among all types of investors about the shortfall of their investment returns versus what they were promised (and versus what, perhaps unrealistically, they expected). We believe that poor investment performance and, in some cases, mis-selling, have significantly undermined confidence in distribution-led models. Investors' focus is going to revert to the ability of individual asset management firms to meet investment objectives. This focus will take precedence over the next gimmick or trend, bandwagon, or new-fangled piece of wizardry that is intended more to raise assets than to meet investors' aspirations.

Return solutions instead of 'products'

This point is closely related to the previous one in reverting to the basics of meeting clients' objectives. We believe that investors are going to be looking for credible return solutions, instead of 'products'. In particular, the events of the last 18 months have thrown into relief the inadequacies of single asset class solutions and rigid, benchmark-related portfolio structures. Outperforming a benchmark by 5% over a given period is inadequate in meeting investors' long-term

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1. Institute of Economic Affairs, Sir Humphrey's Legacy: An update. UK Public Sector Unfunded Occupational Pensions, January 2008.

investment objectives if, in outperforming, a portfolio's capital value falls by 45%. In response to the obvious deficiencies of a product-driven approach, we believe that diversification and flexibility will be privileged attributes in the years ahead. We expect to see an increased emphasis upon service-orientated approaches and we are anticipating a shift towards absolute or real-return types of strategy in particular.

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Shift towards simplicity

One consequence of the credit crisis has been the realization that Wall Street (defined broadly as the financial professions) engineered a set of financial innovations that not even its own 'experts' were ultimately able to understand or properly value. With investors and their advisers having been let down by products and instruments which were not properly understood, it is very likely as a consequence that there will be opposition among those investors and advisers to complex and convoluted investment propositions (in favor of simpler ones). This is closely related to our previous point above about going back to the basics of investment performance. To use an automobile analogy, having failed to reach their 'destination', investors are going to want to focus on a vehicle that gets them reliably from A to B rather than on the vehicle's wizardry, gadgetry, or fashion appeal.

Investors, their advisers, and regulators are going to be advocating far greater transparency in the provision of investment solutions.

Shift towards transparency

This point is closely related to the previous point on simplicity. Investors, their advisers, and regulators are going to be advocating far greater transparency in the provision of investment solutions. 'Black box' approaches, cascading chains of 'feeder' funds, and other opaque investment arrangements are likely to fall out of favor, to the benefit again of simpler and more transparent and intelligible approaches. What investment managers are proposing to do, how they are intending to do it, and how and what they are actually able to achieve will be the questions that take center stage.

Focus on service and relationship

The substantial increase in investor anxiety and uncertainty as a result of the financial crisis is making it increasingly important for asset managers to have strong relationships with their clients. Investor anxiety and the necessity for client service are directly correlated. First-class service depends both on direct and effective interaction between investment professionals and their clients and on all parts of an asset management firm (including account management, distribution, sales and marketing) embracing the importance of client service.

Clients will seek a greater degree of interaction with, and understanding from, the professionals who manage their portfolios. Ultimately, we believe that delivering service successfully will become a significant differentiator and driver of asset-management success for at least the foreseeable future.

Active investment strategies

The new environment we foresee should favor active investment strategies. Low volatility and gradually increasing asset prices worked in favor of passive investment strategies over much of the last two decades. However, lower returns and higher volatility diminish the value added of the 'market' and demand greater differentiation and added value from investment managers in the form of active management.

If one assumes that financial markets are effectively a 'zero-sum game' (in relative performance terms at least), it should follow that greater volatility and a wider dispersion of returns increase the potential for one set of asset managers to add value at the expense of another. Obviously, though, the challenge for investors and their advisers will continue to be identifying those managers who are positioned best to add that value.

Big is not beautiful

The reputation and credibility of very large financial organizations has been dented severely. In fact, the biggest firms seem to have had the most trouble in the recent turmoil: UBS, Citigroup, AIG, Fannie Mae, and Freddie Mac. One could claim that size, as well as perceptions that such institutions were 'too big to fail', fostered complacency within them. We believe that in future, culture and reputation will be much more important than just 'size' in terms of building trust with clients and other audiences.

Regulatory scrutiny

There is a wide perception among the public and the political class that a key source of the credit crisis has been a lack of proper regulation. A backlash has already started in relation to this and the attitude of regulators across the world has hardened significantly. We expect a much greater degree of regulatory scrutiny to permeate all parts of the financial services industry, including asset management, and we have formulated our thoughts about this in our **more government** theme. Product complexity, transparency and compensation practices are all expected to come under scrutiny.

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Expected attributes of 'winners' within asset management in future

The next step in our analysis is to apply what we believe will be the primary forces of change within the asset management industry as a consequence of **all change** (described in depth above) to the attributes we think will distinguish the 'winners' in the industry in a post-crisis world.

In a nutshell, we believe that the key attributes of success are fairly universal truths that should apply to all asset managers. They may, subject to sufficient emphasis being placed on the requirements of clients rather than simply on the accumulation of assets, be applied effectively to a number of different types of asset management business model. However, our focus in this paper is upon the attributes which we think derive from our **all change** theme; we are not seeking here to carry out an exhaustive analysis of all aspects of the asset management industry.

Taking into account all of the forces of change described above, which we are anticipating as a consequence of **all change**, we would summarize the key attributes which we think will differentiate the 'winners' in asset management as:

1. Delivery of strong and consistent investment performance
2. Organizational structures that attract and retain top investment professionals
3. Clear branding and a conviction about what the brand stands for
4. Close relationships with clients and emphasis on service
5. Distribution efficiencies and scale, balanced by an investment-led focus
6. Ability to operate successfully within a much tighter regulatory framework
7. Simple and transparent investment approaches
8. Ability to deal successfully with the structural shift from DB to DC

We discuss each of these in some depth below:

1. Delivery of strong and consistent investment performance

We believe that generating strong and consistent investment performance will be at the heart of asset management in future; saying so implies that this has not necessarily been the case in the past. Indeed, we believe that many asset management firms became more distribution and product-driven over the course of the last two decades. In an environment in which a rising tide of increasing asset values 'lifted all boats', success became a function of gathering more assets than your neighbor. Credibility became a question of size rather than of the quality of what you did. One manifestation of this became constant product innovation and proliferation.

In a post-crisis world, we believe the winners will be those organizations which focus on producing consistent and strong investment performance for clients in as clear and transparent a way as possible. Disappointing performance and

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perceptions of widespread mis-selling have significantly undermined confidence in distribution-led models and we believe investors' emphasis will shift from quantity to quality. The environment is going to merit a much more discriminating approach in future.

This should lead to a shift in favor of credible return solutions instead of 'products'.

The size of an organization and its assets under management have been discredited as criteria for winning trust, being replaced by reputation, culture, and the results being delivered. In a related vein, there will be a shift in relation to the expectation of the types of returns that investment managers can produce. We believe that there is widespread investor disappointment, across all channels, with what investment managers have been able to achieve for their clients.

Again, this should lead to a shift in favor of credible return solutions instead of 'products'. Meeting clients' objectives (for example, in providing a steady income or in generating a particular long-term real return) will take precedence over relative return approaches and the provision of 'off-the-peg' products. We believe this will benefit significantly those investment managers who have broad and flexible investment approaches and who can offer return-driven solutions. In particular, we believe that flexible, multi-asset approaches (sometimes referred to as 'new balanced') have much to offer in meeting the objectives of a broad range of clients.

2. Organizational structures that attract and retain top investment professionals

Organizational structure will play an important role in the ability of asset management firms to attract and retain top investment talent. If one accepts the importance in future of delivering strong and consistent investment performance, it follows that investment professionals are ultimately the central pillars upon which success in investment management must be built. This is even more the case in relation to fundamental, qualitative 'active' management. In future, the organizations that we believe will be most successful in attracting and retaining top investment talent will have three key attributes:

The **first** is being an organization on a human scale, with a strong culture and sense of 'self'. Talented employees need to be able to identify with their employers and to have a strong sense that they are contributing to something in which they believe. In a world where even the largest financial organizations have 'crashed and burned', prospective or existing employees will not perceive any organization as perfectly safe or solid. Size will have a lot less to do with employment decisions than the employee's ability to identify with the values and culture of the organization.

The **second** is a compensation structure that emphasises long-term success and makes employees feel like owners. Compensation needs to have a strong correlation with the economic value being generated by investment professionals, and a compensation structure must include long-term incentives that align the interests of clients, employees, and firms (or economic entities) properly.

The **third** is the demonstrated stability of management and employees, and the clarity of strategic direction. People-heavy businesses are built on the strength of the human relationships that they comprise. A key element in the decision to join or to stay will be based on the employee's perception of the organization's ability to prosper and succeed. Low staff turnover, management stability, and a clear sense of direction are all going to be important attributes in that context.

Clear branding and a conviction about what the brand stands for will become increasingly important in asset management.

3. Clear branding and a conviction about what the brand stands for

We believe that clear branding and a conviction about what the brand stands for will become increasingly important in asset management. There are three principal drivers behind this:

The **first** is related to the point (described previously) that, in the aftermath of the financial crisis, trust, reputation, and culture will become increasingly important factors. Branding is the key mechanism through which an organization can articulate and disseminate these differentiating factors. How can investors differentiate if they don't know truly what they are buying?

The **second** driver is the brand as a key motivating factor for investment professionals. As noted above, employees and prospective employees will be influenced in their decisions about whether to stay with or join a business by the culture and sense of identity embodied in that business's brand.

The **third** driver is closely related to the expected shift from DB to DC and the influence of the choices made by members of DC pension schemes. There will be an inexorable shift in terms of the ultimate responsibility for pension provision from corporations and governments to the individuals concerned, perhaps ultimately on a mandatory basis. In that context, a large part of the ultimate investment decision comes down to branding and name recognition. The necessity for brand to be communicated effectively to pension scheme members as well as to scheme trustees and advisers is a profound change for the institutional side of asset management businesses.

4. Close relationships with clients and renewed emphasis on service

The destruction of wealth over the last 18 months has been colossal. As previously discussed, we expect there to be increased volatility and a wider dispersion of returns in future. The combination of those factors creates the potential for severe stress in the relationship between asset management firms and their clients.

The most successful firms in future will be those that are able to build and maintain strong (direct and indirect) affiliations with their ultimate clients.

It is essential under these circumstances for asset management firms to have very close and strong relationships with their clients, as those relationships are bound to be tested as rarely before. A natural extension of this is the importance of a renewed emphasis on 'service' rather than an emphasis only on performance (albeit that strong performance will remain an elemental factor in differentiating between asset management firms). Clients need to have a strong sense of connection with the people who manage their money and, by extension, a very good understanding of the rationale behind the decisions made by investment

managers in relation to clients' portfolios. An important aspect of this is the imperative for investment firms to have access to their clients. We make this point in light of the often complex and extensive web of intermediaries that have increasingly weaved themselves between investment managers and ultimate investors. This is true within the institutional, retail, and (even) wealth management segments of the asset management industry.

We believe the most successful firms in future will be those that are able to build and maintain strong (direct and indirect) affiliations with their ultimate clients. The quality and strength of account management and servicing functions will be key differentiators in 'direct' relationships. By contrast, brand identity, communication mechanisms, and PR will be key differentiators in relation to 'indirect' relationships.

5. Distribution efficiencies and scale, balanced by an investment-led focus

This point is closely related to the importance of generating strong and consistent investment performance. There is no doubt that distribution will remain important to asset management. With the asset management industry being global in nature, and with the investor base being complex and fragmented, successful asset management organizations require significant efficiencies and scale in their distribution channels.

That said, efficiencies and scale are of little use if the investment proposition is not rock-solid. This remains our key thesis: in a post-crisis, **all change** world, strong and consistent investment performance must be at the heart of an investment proposition. We believe the most successful asset management organizations will be the ones that are able to maintain a healthy balance between distribution and investment performance. By understanding and respecting principles of investment capacity, prioritizing commercial opportunities, avoiding excessive mandate and servicing complexity, and refraining from product proliferation, we believe asset management firms can achieve this balance to good effect.

6. Ability to operate successfully within a much tighter regulatory framework

An important force of change following the credit crisis is increased regulatory scrutiny. We expect a much greater degree of regulatory scrutiny to permeate all parts of the financial services industry, including asset management. We believe that important attributes for 'winners' within asset management will be the ability to (a) operate successfully within a much tighter regulatory framework and (b) bear the increased costs of doing so.

Operating successfully within this much tighter regulatory framework entails avoiding potentially catastrophic reputational damage from significant regulatory breaches, while continuing to deliver a strong investment and servicing proposition to clients. Indeed, in the post-crisis world, where reputation trumps size in terms of earning client trust, managing regulatory risk will need to take a more prominent role in successful organizations.

This point has implications for product simplicity, transparency, compensation practices, compliance and monitoring resources, as well as for close coordination between investment professionals and distributors within asset management firms. In relation to the ability of an organization to bear the costs of increased regulatory scrutiny, it is important to note that management of regulatory risks within firms needs to be balanced properly between centralized functions and those areas of a business that need to remain more 'local'.

In light of this, investors and their advisers will seek investment propositions that are intuitive and in relation to which the investment process is clear, transparent, simple, and consistent.

7. Simple and transparent investment approaches

Complex financial instruments and black-box models have been discredited and are perceived to have contributed materially to the current financial crisis. As a result, we believe that complex investment products and 'structured' solutions based on the modelling of historic returns and volatility may be much less well adapted to the environment in future. In light of this, investors and their advisers will seek investment propositions that are intuitive and in relation to which the investment process is clear, transparent, simple, and consistent. This will require confidence in the judgement of chosen asset managers; proven track records, tested processes, and robust and demonstrable risk management will be highly prized. Those asset management organizations which possess these attributes should benefit significantly.

8. Ability to deal successfully with the structural shift from DB to DC

We believe that the shift from DB to DC in institutional asset management will accelerate in the aftermath of the financial crisis, and may spread to the public sector or even become a mandatory feature imposed by some governments. We also believe that the shift implies a slow and gradual graying of the boundaries between institutional and retail markets. The shift to DC will have profound consequences for the asset management industry and, in our opinion, is of utmost importance.

It is our strong conviction that, for asset managers to be successful in the long term, they must adapt and capture the opportunities created by this shift. Whereas success for asset managers in relation to DB hinged on convincing consultants and a small set of pension fund trustees (or an even smaller set of their advisers) about the validity of investment propositions, success in DC will hinge on a two-fold selection process: first, being selected by the scheme sponsor and its advisers (as in the current DB process) and, secondly, being selected by individual plan participants.

DC is by nature, therefore, much more closely related to the choices of individual investors than is typically the case with DB, with ultimate responsibility for the choice (of either a default option or of individual funds) shifting to the 'end user' investor. As a consequence, we believe that asset managers' success in DC will require three components: The first component is a strong range of investment choices, including default options and specialist choices. Echoing our comments above, a strong set of real-return or credible 'return solution' options will play a part in this.

The second component is a credible institutional process and infrastructure. The first stage of the selection process (being selected as a choice) will remain similar to the current process that asset managers experience on the institutional side of the business.

The third component is a strong brand (and name recognition among individuals). Given that an important part of the ultimate investment decision will shift to the individual investor, asset managers must consider the factors that will affect the decision maker. This suggests a considerable shift towards more of a retail market mindset, with a firm's name and strong recognition of its brand becoming very important factors in the new, increasingly DC-driven world.

The popping of the credit bubble and its aftermath are going to generate tremendous change for asset management firms who are going to need to anticipate this and to adapt their approach.

Conclusion

In conclusion, the main point that we have tried to convey in this paper is that the popping of the credit bubble and its aftermath are going to generate tremendous change in both the financial services industry in general and in asset management in particular.

Asset management firms are going to need to anticipate this change and to adapt their approach. It would be a significant mistake to think that this crisis is just a normal cyclical occurrence or to fail to adapt one's course in its aftermath. Newton does not claim to have all the answers or to be correct on every point made in this paper; indeed, counter arguments can be made in several cases. We are, however, well positioned to comment given our experience and track record as investment practitioners and given the inherent nature of our thematic investment approach (which seeks to anticipate change and to benefit on clients' behalves from that change). Our primary intention in this paper has been to outline the issues to which we believe the **all change** world gives rise and to stimulate debate at the wider level about how asset management firms can anticipate change, adapt their approach and deliver thereby a first-rate service to their clients.

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Standish Mellon Asset Management Company LLC
Urdang Capital Management, Inc.
Urdang Securities Management, Inc.
Walter Scott & Partners Limited
WestLB Mellon Asset Management