

The State of the Asset Management Industry: Tipping Points and Trends

By Ranjan Chakravarty and Joseph Cherian (November 2015)

Asia is now a major asset management player. Total AUM in Hong Kong and China as of end 2014 was over US\$3 trillion, with China having grown by a resounding 61% over the previous year. In Singapore itself, AUM has jumped by 30% from US\$1.8 trillion in end 2013 to US\$2.4 trillion by end 2014. Some of the largest and most respected government and sovereign funds are located in this region. Hence, at this time in the history of Asian asset management, which is at the cusp of change, it especially behoves us to understand and internalize ongoing strategic trends in our industry.

The massive growth underway in asset management, with AUM estimated at over US \$70 trillion globally and the paradigm shifts occurring and expected to occur therein, was discussed in an August 2015 article in Asia Asset Management by one of us. Functionally, the article highlighted that our industry is moving to a core-satellite paradigm, with low-cost, beta-harvesting strategies at the core, and specialized alpha-delivering investment strategies as satellites. Furthermore, it identified what elements comprised this paradigm shift.

We elaborate on some of those components in this article, and on the basis of our analysis, present our assessments about the industry for the near future.

Size

In the core-satellite model, a few major players will cluster around the core, or the centre of the investment galaxy, which will account for the largest chunk of the AUM universe. Clearly, this model is already in place, and we expect this trend to continue aggressively. International Pensions Europe's 2015 survey indicates that the top 10 managers account for a third of all assets worldwide, with BlackRock alone accounting for 7.6%. Total AUM in the top 400 managers accounts for close to 80% of total AUM, and this has jumped from approximately 67% in 2014 and 56% in 2013.

The converse should therefore occur in the satellites, with ever increasing competition among specialized alpha strategy manufacturers for a proportionately shrinking share of global AUM. As an indication, the number of managers in Singapore reached 591 in 2014, up by 38 from 2013. Yet research by one of us indicates that between 2000 and 2012, almost 1 in 2 Asian hedge funds passed away!

We can hence expect two sub-themes in size: consolidation at the core, and fragmentation in the satellites, with systematic risk strategies such as exchange traded and index investing

strategies, to firmly and rapidly consolidate in the core. From economies of scale, we expect the cost of investing in such strategies to fall even further in the near term.

Fragmentation in the satellites is bound to occur in the initial stages of the ongoing transformation of the industry. As the smaller players compete in skill, their end result will be a shedding of players, given the proportionately-shrinking AUM will have more choices, and will exact and expect greater levels of performance. Those who survive the competition over the next few years, and show time consistent performance, will then be logical targets for acquisition by firms in the core as they will need value-added differentiators in their monopolistic competition with one another. This phenomenon isn't necessarily irreversible. The larger satellites could very well gobble-up the smaller players in the core. In this regard, long-term institutional backing, such as that of a well-regarded sovereign fund, will help in this process.

Skill

Competition among satellites is and will be skill based. As we move away from systematic risk-based pricing of beta, to the projection of unsystematic risk onto alpha, the domain-skilled manager's value will initially rise. One case in point would be infrastructure finance. Similar to the early days of the asset-backed market, we expect the infrastructure asset manager's domain expertise at issuer level, and at counterparty credit appraisal and risk hedging, would be of great value, and be compensated heavily in the next three to five years.

A second area of domain skill demand would be in retirement finance. This includes private managers that can provide liability-driven investing with the goal of repaying targeted liabilities according to a schedule, as in a defined-benefit public pension fund. Or in providing a (defined contribution) life annuity product where the goal is inflation-protected retirement income for life adequate to sustain a dignified standard of living from the point of retirement. Once the track record is established and some emerge as consistent leaders in the set of such managers, the key differentiator will be the replicability of skill. Once replicable, the intellectual property will be acquired by a core firm, and then industrialized, hence leading to the lowering of costs. We expect this process to occur within a market cycle.

Process

When it comes to the required discipline in the conduct of our business, the role of risk management models and processes is essential, especially in the big data world of today. The last two decades have seen major strides made in risk measurement, management and reporting. Since risk paradigms originated from academic research, it is a natural home for managers to return to.

As such, we expect our industry to be a major beneficiary of the state of the art in risk management modelling. A case in point is Value at Risk, a market risk measure whose efficacy has been long debated. A great deal of research has been conducted and should soon culminate in much more realistic and alternative measures of market and credit risk than Value at Risk. We expect they will be applied and used in the asset management industry extensively.

In addition, it is the turn of the rest of the industry to contribute to asset management in the risk management area. The lessons and deficiencies from the implementation of Basel II and III and Solvency II, hedge efficiency testing, stress testing, backtesting and capital attribution, would be of value to the asset management industry. We hence expect these would be implemented at the state of the art level along with risk modelling in a big data world. This is the asset management world of the future and the future is now.

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