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BY SUSAN TRAMMELL, CFA

Roundtable discussions among experts find consensus on major trends shaping the investment industry

Four years from now, will the investment world look measurably different from the way it looks now, and if so, how? To address this two-part question, CFA Institute convened three panels of about a dozen practitioners drawn from diverse industry specialties. The advisory sessions—held in New York, London, and Hong Kong—elicited opinions about the trends that are shaping the investment industry and professional firms, the demands being made of investment professionals, and the role CFA Institute should play in the industry between now and 2012.

When the 200 pages of meeting transcripts are considered as a whole, perhaps their most notable feature is what they are missing: hype. The participants saw no revolutions, upheavals, or paradigm shifts on the horizon. The common theme was convergence—not of markets but of viewpoints. Such a consensus indicates that the changes identified by the participants are truly global trends.

From the dozens of predictions that were made, nine major themes emerged: (1) speed and transparency, (2) alpha–beta separation, (3) market segmentation, (4) pension worries, (5) globalization, (6) arbitrage under environmental asymmetry, (7) demand for alternative investments, (8) talent shortage, and (9) agents of change.

Participating in the New York session were (from left, front row) Jeff Diermeier, CFA, CFA Institute; Charlotte Beyer, Institute for Private Investors; Scott Evans, CFA, TIAA-CREF; Suzanne Duncan, IBM Institute for Business Value; (back row) John Ilkiw, CFA, CPP Investment Board; Martin Leibowitz, Morgan Stanley; Nicholas Barberis, Yale School of Management; Heather Pelant, Barclays Global Investors Canada Limited; John Bogle, Sr., Bogle Financial Markets Research Center; John Malvey, CFA, Lehman Brothers; and Russell Read, CFA, CalPERS. (Not pictured: Abbey Joseph Cohen, CFA, Goldman Sachs.)

Speed and Transparency

Greater speed and transparency are putting enormous pressure on profits derived from agency transactions and financial innovation. According to a global survey of more than 400 financial markets executives conducted by the IBM Institute for Business Value in cooperation with the Economist Intelligence Unit (published in 2006 as the white paper "The Trader Is Dead, Long Live the Trader: A Financial Markets Renaissance"), respondents plan to reduce their trading departments across most product groups.

"On average, for every 40 traders today, there will be four left standing tomorrow," Suzanne Duncan, one of the study's authors, told the New York session. In 2004, sell-side firms derived 50 percent of their revenue from agency trading and 50 percent from principal trading (risk-incurring activities that include proprietary trading). By 2015, principal activity is expected to account for 70 percent of revenue.

"The essentially risk-free intermediary will not provide the value that

it once did," the authors of the study concluded. "With almost limitless electronic access to market information, clients will seek to lower costs by trading and performing investment research themselves. While the majority of surveyed firms acknowledge that agency profits are dwindling, it is striking that most respondents associate the threat only with equity products—in fact, electronification will have a similar impact across the entire spectrum of instruments."

According to this analysis, margins on simple transactions may dwindle to the point of becoming loss leaders for more profitable areas of business. The winners may be firms with electronic platforms that enable them to become the low-cost producers. These firms could produce premium products that would command premium fees.

The speed at which financial ideas are developed and then emulated is accelerating, Duncan told the participants at the New York session. For commoditized products, the window to realize substantial profits from an innovation has been compressed from 11 months to 4–6 months. As a result, the pace of organizational and business model shifts has shortened from yearly to quarterly as investment firms struggle to renew franchise values more frequently.

Alpha–Beta Separation

According to fund-separation theory, the sources of return attributed to a firm's added value (alpha) should be separated and managed separately from the portion of return that results from more market exposure (beta). Theory continues to intrude on practice as the gradual disentanglement of alpha and beta affects how firms position themselves, the management of portfolio risk, and the modification of performance and compensation models.

Financial executives surveyed in the "Financial Markets Renaissance" study expect the ongoing process of alpha–beta separation "to shift profit away from traditional long-only active managers toward the extremes of *unconstrained alpha-generating investing* (more volatile pools, such as certain types of hedge funds and private equity) and *passive investing* (index funds, exchange-traded funds, and certain types of derivatives)."

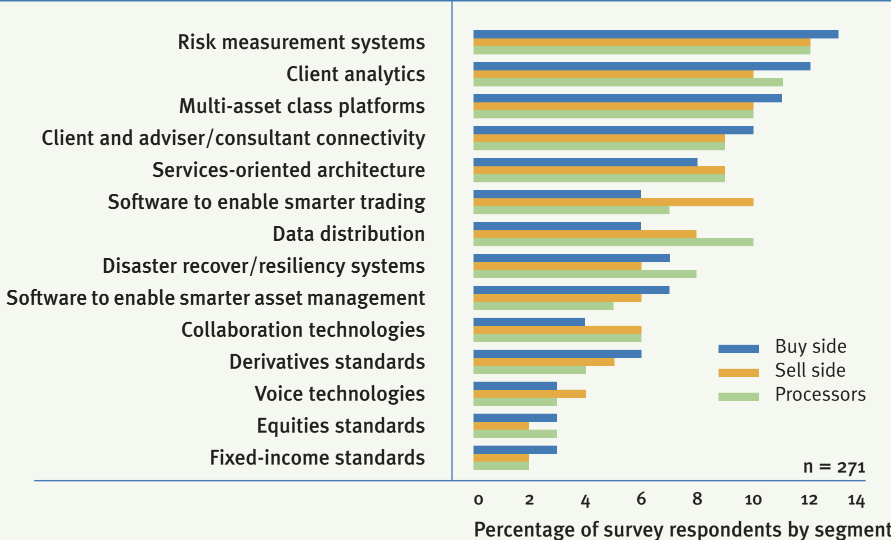
The new value engines will be risk assumption and risk mitigation. Investors will turn their attention from buy-side to sell-side firms in their search for portable alpha, and the sell side will respond with the creation of structured products and other risk-taking activities. The market return will be supplied by index funds or replicated through derivatives. Firms concentrated on beta will be pressured to reduce costs, and the beta function likely will be outsourced to low-cost providers that can economically deliver the market return.

To avoid paying alpha-premium-fees for beta performance, more asset manager bonus systems will focus on alpha generation rather than overall portfolio performance. "We're herding the alpha into very precise mechanisms, where the alpha can be more and more clearly delineated," Scott Evans, CFA, head of asset management at TIAA-CREF in New York, told the participants at the New York session. "It's all a question of who's doing the measuring. What is the price-discovery process? The more the pricing on the margin is being directed by large institutional buyers, the closer we'll get to active managers being paid for the value that they produce."

Short-termism, a chronic complaint, could be addressed through the adoption of multiyear bonus schemes that smooth disappointments resulting from macroeconomic conditions. Still, panelists advised, don't expect the industry's short-term orientation to change dramatically in the foreseeable future, because a multiyear performance-reward system makes it harder to attract investment talent.

Roundtable participants repeatedly mentioned the growing influence of asset owners as their confidence in making financial choices grows. Clients have

Technology: Greatest Impact on Ability to Achieve Strategic Goals over Next 10 Years



Note: Executives were asked: "Which of the following technology-related innovations will have the greatest impact on your firm's ability to achieve its strategic goals over the next ten years? (Choose all that apply)"

Source: IBM Institute of Business Value/Economist Intelligence Unit Survey.

Participating in the London session were (from left, front row) Amin Rajan, CREATE-Research; Anne Cabot-Alletzhauser, Advantage Asset Management; Carol Kennedy, Pantheon Ventures Limited; David Damant, FSIP, Consultative Advisory Group; Steve Wellard, CFA Institute; (back row) Lindsay Tomlinson, Barclays Global Investors Europe; Massimo Tosato, Schroders Plc; Roger Urwin, Watson Wyatt Investment Consulting; Jacob Bjorheim, CFA, Bank for International Settlements; Lionel Martellini, EDHEC; Jeff Diermeier, CFA, CFA Institute; Didem Gordon, Yapi Kredit Asset Management; Alexander Ineichen, CFA, UBS Global Asset Management; and Andrew Dyson, BlackRock.

been putting pressure on all aspects of costs—particularly compensation. "We've relied on client inertia and we've relied on client ignorance, and clients have realized that they've paid dearly for financial illiteracy," Amin Rajan, CEO of CREATE-Research, told the London session. "If asset management houses don't really look at the compensation issues, they'll be forced to do it."

Market Segmentation

Many panelists predicted that the separation of alpha and beta would further divide the investment industry into providers of products and providers of solutions. Clients will rely on portfolio managers and consultants to develop smart asset allocations around clearly defined outcomes and then put together the building blocks of alpha and beta generators. With the help of derivatives, asset allocation specialists will be able to slice and dice more finely the views they want to incorporate into portfolios. The demand for customized portfolios will require a distinct set of skills, training programs, and compensation systems.

Roundtable participants expect the development of customized asset allocation benchmarks that will be designed to match an individual's specific liabilities, objectives, and time horizons.

"I think the old ways of doing things, such as [focusing on universal equity benchmarks like] the S&P 500 in the United States, and then proposing a mandate with a time tracking-error constraint and things like that, these days are really gone," Lionel Martinelli, professor of finance at EDHEC Business School, told the London session. "I'm not talking about forecasting a trend here," he added. "I'm talking about where the trend is going to push us."

Pension Worries

Funding pension plans and postretirement health care systems for a growing number of workers is becoming a challenge, especially as many governments are trying to move away from their responsibilities. At the country level, some of the greatest producers of savings have not yet developed a major pension industry or generated jumbo asset pools that need to be professionally managed. These countries will be thinking in terms of inflation-linked liabilities, which will have enormous implications for the kind of investments needed to maintain a standard of living under such fiscal realities.

In the United States and Europe, the transition from defined-benefit to defined-contribution (DC) plans is shifting agency risk from employers to individual investors. Because workers are unlikely to become better informed about how to manage their pension portfolios, panelists at the advisory sessions agreed that retirement savings and payout products will have to be smarter. Lifestyle funds and insurance-type offerings that assume different types of risk are expected to play a major role in the structuring of packaged solutions to address postretirement cash flow as well as medical and long-term care. Investors want choices, but they also want some guarantees, and insurance companies will have a unique role in providing some form of "wrapper."

Behavioral finance is playing an increasingly important role in structuring DC plans to overcome investor inertia and mitigate poor investment choices. "Individual investors don't save enough for their retirement, and that is partly driven by self-control problems," said Nicholas Barberis, professor of finance at Yale School of Management. "A lot of the research is actually focused on trying to design new institutions and products that will help individual investors do a better job of saving for retirement."

Globalization

Money flows today are coming from the emerging markets that have capital account surpluses. Liquidity is being pumped into the capital markets to the point of depressing risk premia and inflating asset prices. By 2015, sovereign funds could control total assets worth US$12 trillion. Emerging economies in Asia and the Middle East are expected to become major exporters

of capital. Their clout will become a third voice in the investing community, providing a diversity of opinion that the United States and Europe have historically dominated.

According to a 2007 study prepared by the IBM Institute for Business Value ("Get Global. Get Specialized. Or Get Out. Unexpected Lessons in Global Financial Markets"), investable assets worldwide are projected to more than double from almost US$300 trillion today to nearly US$700 trillion by 2015, and 60 percent of the growth will come from nontraditional places that the study's authors call "prospect markets." Foreign investment flows into local markets are increasing as a percentage of worldwide GDP, with a projected compound annual growth rate of 9 percent from 2005 to 2015, compared with a worldwide GDP growth rate of only 5 percent.

Participating in the Hong Kong session (from left, front row) were Jan Squires, CFA, CFA Institute; Jamie Allen, Asian Corporate Governance Association; Thomas Welch, CFA, Wells Capital; Hon Cheung, State Street Global Advisors; (back row) Philip Yang Wu, CFA, Applied Strategy Ltd.; Jane Shao, CFA, Istithmar Shanghai; and Stuart Leckie, Stirling Finance. (Not pictured: Louis-Vincent Gave, GaveKal.)

"With half a million dollars in the technology budget, you can get all the information you can possibly need."

LOUIS-VINCENT GAVE

Although 74 percent of the financial market executives surveyed in the 2007 IBM Institute study believe that globalization is leading to significant changes, only 37 percent of them felt that their firms had the ability to respond to external forces in the marketplace. From a financial services standpoint, 79 percent indicated that they only pretend to be global, and they are afraid that many of the profits may go unrealized.

To evaluate the effect of globalization on the fund management business, CREATE-Research's Amin Rajan and fellow researchers surveyed more than 100 asset and pension fund managers. The survey was followed by structured interviews with a subset of chairmen, chief executives, and chief investment officers at 60 companies with strong global orientations. Two out of three global firms reported that they have not achieved the operating leverage in their overseas markets that they enjoyed in their home markets. Only 45 percent of respondents have developed clear bottom-line profit in their global operations. This finding includes companies that have been operating on a worldwide basis for more than seven years.

Sell-side firms are expected to partner for back-office operations and compliance management to achieve their goals, according to industry data from the IBM Institute for Business Value.

Arbitraging Environmental Asymmetry

Despite the mixed economic results for international expansion, declining technology and communications costs will keep the barriers to entry very low and enable even the smallest firms to expand globally. "With half a million dollars in the technology budget, you can get all the information you can possibly try to analyze and all the information you can possibly need," Louis-Vincent Gave, CEO of GaveKal, pointed out to the Hong Kong session.

Judging from the measured progress toward converging accounting (and by extension, auditing) standards, the global village is becoming a reality. Overall harmonization, however, may be proceeding at a slower pace than expected because of bottlenecks caused by cultural considerations. Every economy wants to increase its economic value, and that's a difficult hurdle to overcome. Thus, where a firm decides to anchor its business is still influenced by differences among local regulatory, compliance, tax, and legal environments. The markets perceived as more friendly will reap the benefits of hosting big spenders and big taxpayers.

"An inordinate complexity can actually reverse the flow of globalization," reported the authors of the 2007 IBM Institute study. "The U.S. regulatory environment is a prime example. To avoid the cost of complying with its extensive, rule-based regulations, many organizations are choosing to do business in other markets."

Demand for Alternative Investments

Fundamental capital needs in the world economy and the maturation of public markets are creating inflection points for alternative asset classes. But the public markets may be limited in their ability to effect transformative changes, and this constraint will put pressure on the private equity markets and "cheap" alternatives to supply fresh money and innovation for energy and other infrastructure spending in rapidly industrializing countries.

China's central government alone will spend about US$300 billion on infrastructure, observed Gave. "India will be spending US$140 billion or US$150 billion in infrastructure, although arguably at this stage it should be spending twice what China is spending, given how far back they are on the infrastructure scale," he said.

Even in developed markets, the maturation of public markets has catalyzed the movement from stocks, bonds, and cash to hedge funds, real estate, commodities, and other assets outside the traditional classes. "I think that when the futures market opens in China and investors can start shorting index futures and then individual stocks, I foresee tremendous activity in hedge funds in China and gradually the e-share market opening up," said Stuart Leckie of Stirling Finance told the Hong Kong session.

With demand outstripping supply, little pressure on fees among the alternative asset classes would occur.

Talent Shortage

In fiscal year 2007, the CFA Program had more candidates in Asia than in the United States. The financial centers are no longer confined to New York and London. Hong Kong may maintain its regional supremacy, but Beijing, Shanghai, Shenzhen, Singapore, and even Mumbai may emerge as the dominant financial centers in the next 10 years.

"When we recruit, we look for people who are willing to accept international assignments," said John Malvey, CFA, of Lehman Brothers in New York. "In our organization, at the level just below the executive committee, virtually every single person has done an international tour. On a prospective basis, our organization probably has very few senior managers who have not been posted in a different geographic region."

In Asia and other parts of the world, the bar has been raised for the technical skill set of investment professionals; asset, risk, and data management are only the tip of the iceberg. Specialists and technicians will be expected to move beyond a focus on delivering alpha to develop a better understanding of client context. Asset management firms are also looking for soft skills, such as the ability to communicate with and make presentations to clients. Employers want a greater breadth of generalist knowledge that goes beyond a narrow focus on the mainstream asset classes and includes familiarity with alternative investments. Professionals on the sell side may find their work centered around not only new securities but also new asset classes that may not exist today.

Agents of Change

The investment industry will continue to be an agent of change—and a force for good—while not losing sight of the goal to maximize profits. The restructuring of a country's social security system and savings framework can transform a sovereign's capital markets for the better, as Chile has experienced. The firms involved in "clean tech" and green investing are shedding their puritanical image by moving into products and services that offer potentially attractive investment opportunities while representing socially responsible investing. Closer to home, members can expect CFA Institute to become more vocal about a wider range of advocacy and standards-setting issues over the next four years. CFA Institute will continue to lead the investment community in the advancement of industry professionalism and integrity.

Susan Trammell, CFA, provides business plan writing and market research services through her New York City consulting firm.

Convergence and Divergence: New Forces Shaping the Financial Universe

Over the next three years, what average annual growth rate are you expecting for the global investment management industry in the following asset classes?

	Annual growth rate (% of respondents)				
	<1%	1–10%	11–15%	16–20%	>20%
Hedge funds	12	38	32	10	8
Funds of hedge funds	10	32	36	16	6
Private equity	4	38	28	18	12
Infrastructure	12	41	25	14	8
Real estate	14	48	26	12	0
Structured products	20	36	26	10	8
Reinsurance products	14	38	28	12	8
Mainstream long-only assets	12	42	24	14	8

Source: CREATE-Research and KPMG International 2007