The Once and Future INVESTMENT MANAGEMENT Industry

After the financial crisis, investment firms are looking for a different skill set. ***"You need to be able to work in different asset classes, across different geographies,"*** says Sergio Focardi.

BY RHEA WESSEL

The Place de la Bourse in Bordeaux, France © Arnaud Bertrande/Corbis

The full impact of the financial crisis on the investment management industry has yet to be determined, but one outcome is already clear: the recent market turmoil reestablished the key role of asset allocation in generating returns and protecting against downside risk. Greater emphasis is also being placed on risk management, in particular counterparty risk, liquidity risk, and systemic risk.

Adapting to these trends, employers are now looking for investment professionals with different attributes and abilities, according to Sergio Focardi, a professor of finance at EDHEC Business School in Nice, France, and co-author of *Investment Management after the Global Financial Crisis*, a study of global trends recently published by the Research Foundation of CFA Institute.

In this *CFA Magazine* interview, Focardi explains why investment professionals must sharpen their quantitative and organizational skills to succeed in the future. Those who can add value to a top-down investment approach, demonstrate a strong grasp of asset allocation, and possess a conceptual understanding of market dynamics will be in high demand for years to come.

What did you observe in your study regarding asset allocation?

The global financial crisis highlighted the need for a top-down approach to investing in which macroeconomics plays a much bigger role than it has in recent times. Investors are diversifying their asset classes, and this makes sense, given the globalization of stock markets. Worldwide, you now have something like 46,000 listed stocks available. About one-third are from North America, one-third from Europe, and the remaining one-third from Asia and the rest of the world. This means that large asset management companies have portfolios that include thousands of stocks. Ten years ago, a large portfolio included 1,000 stocks. There is no way an individual or small groups of people can manage these types of numbers. They require some sort of higher organization, such as subsets of asset classes.

With this huge number of stocks, it's actually easier to make predictions on a *technical* basis using models rather than on the basis of fundamental analysis. If you look at each individual stock or each individual asset, you won't find much information. However, if you are assessing a larger number of stocks, for example a subset, your information will come from aggregate data and its correlations. So, in a sense, it is easier to work with subsets of asset classes rather than with individual stocks.

Institutional investors maintain that the selection of asset classes or subsets of asset classes remains critical for portfolio performance, and in the quest for profit, they are switching in and out of asset classes with much more frequency than before. They are trying to time their entry and exit into asset classes and implement dynamic asset allocation.

What does this mean for particular asset classes? How are investors allocating their assets now?

Many sources surveyed in the report said that investors will be taking risk off the table. They will be reducing exposure to equities (and domestic equities in particular for sources in the United Kingdom and the United States). We also heard that investors will be reducing their investments in complex products with hidden fees, such as funds of funds. In contrast, we found that investors plan to increase diversification and be more opportunistic—for example, by investing in distressed debt and real estate based on the low valuations in those asset classes.

The preferred asset classes were emerging market equities, bonds, private equity (often through direct investments), infrastructure (typical of continental Europe), hedge funds, and more generally, nonpublic assets, including intellectual property rights.

What are the implications for investment managers who are conducting a job search or considering a career move?

By all means, you've got to have the ability to understand asset classes and their subsets and understand the market on a conceptual basis. You need to understand how to work with stocks and assets that come from different currencies, so you need at least some skills in dealing with different currencies. An understanding of the behavior of intercountry and interregional relationships, for example, is also useful. And you will also need more quantitative and macroeconomic skills than before. Finally, you'll need to be organized and be a team player since you'll work together with people with different competencies, such as

modeling and risk management skills and macroeconomic and fundamental analysis skills. If people had collaborated in cross-disciplinary teams more frequently, the subprime crisis could have been forecast with a correct macroeconomic analysis of the income distribution of mortgage owners.

Have you observed more job opportunities in areas demanding these skills?

As we all know, one opportunity generally comes at the expense of another opportunity. What I can say is that we'll see fewer jobs that involve pure stock picks and more jobs involving higher-level asset classes.

You identified the trend that investors are paying more attention to market risk in their portfolios as well as liquidity risk, counterparty risk, systemic risk, and the effects of leverage. What will be the impact on people looking for jobs or considering a change?

Since the failure of Lehman Brothers in September 2008, people have become more cautious about counterparty risk. The result is that investment professionals who can effectively assess counterparty risk are in high demand. But there is also a growing demand for professionals who work in the areas of liquidity risk or systemic risk. The traditional view was that liquidity risk and systemic risk were the government's concern. But after the 2008-09 financial crisis, asset managers have understood the need to incorporate these risks into their analyses. In a sense, one could say that the next frontier will be systemic risk. By the way, finding people who can understand liquidity and systemic risk is not easy: Liquidity risk is ill defined. There's a lack of data, and liquidity shocks likely have a nonlinear impact on assets.

How do you advise people to gain such skills?

I tell students that if they want to have the broadest possible spectrum of opportunities, it's important to know how to work a balance sheet and to understand a corporation beyond the obvious. And even if they're not immediately involved in matters of liquidity risk or counterparty risk, professionals need to understand the consequences of these risks. Good investment professionals must integrate the knowledge of many other people into their own understanding.

Any other advice you give professionals?

I say that you need to understand extreme events. Before the crisis, extreme events were considered, well, extreme. They were thought to be unlikely to occur. Now, we all know that extreme events occur quite frequently in finance. You need to understand that another crisis can emerge. You need to understand the statistics of phenomena that are extreme. These skills are sought by asset management companies, banks, and even big corporations that want to better manage their risk.

Exchange-traded funds (ETFs) are booming as investors move from active to passive strategies. What's the trick to breaking in at an ETF provider?

Investors are moving into passive investments and standard products because in today's low-return environment they're skeptical about the ability of active managers to generate alpha after management costs. They're going back to the basics. This has shifted some job opportunities toward passive investments, though I wouldn't say there's a boom in hiring since it's clearly more efficient to manage passive investments than active ones. When ETF providers do hire, they want people with the strong quantitative skills necessary to replicate large submarkets and understand niche indices.

During the interviews you conducted for the study, what other trends did you pick up on?

Many people said that mandates are now more complex than before. In the past, investors used consultants who did the asset allocation and then typically selected investment managers in functions with narrow mandates. Now, investors are focused on total returns, which typically require wider mandates with flexibility in terms of getting in and out of asset classes. This in turn calls for people with multiasset experience, a skill that is in high demand and difficult to find.

Investment Management after the Global Financial Crisis: A CFA Institute Research Monograph

Frank Fabozzi, CFA, Sergio Focardi, and Caroline Jonas were commissioned by the Research Foundation of CFA Institute to assess how the financial crisis affected the investment management industry and how it will continue to affect investment management decisions and processes. In the authors' third survey-based study of investment management trends, they reviewed literature and interviewed industry observers, executive recruiters, and academics in the second half of 2009 and early 2010. The team held 68 in-depth interviews, which included professionals from 17 institutional investors with a total of €570 billion in investable assets, 15 investment consultants and private wealth advisers with cumulative assets under advisory of around €5 trillion, 15 asset and wealth managers with around €4.5 trillion in assets under management, six industry observers, six executive recruiters, and nine academics. A majority of sources for the report were from Europe.

What about boutiques?

Investors also want boutique niche skills. But going to a boutique can be a high-risk career move, especially given the trend toward dynamic asset allocation. If an asset class doesn't perform, people will cease to invest in the asset class. If you want to be on the safe side, you need to be able to work in different asset classes, across different geographies. Regardless of your skills, you cannot force the market. You may find yourself in a difficult position if you specialize in too small a niche or a niche that goes out of favor.

Looking across Europe, we see the Irish market in ruins and the Spanish market teetering. Where do you think the opportunities will be in the future?

I don't have any statistics, but it seems in the long run opportunities will be where the economies are the strongest. The lesson from 2007 is that crises are foreseeable. The crisis was foreseen [by some]. When you plan your career, you may want to consider a target country's macroeconomic situation.

Another thing to consider is the large influx of wealth being transferred from developed countries to developing countries and the new wealth being created there. The people we interviewed said they expect the money to stay in the developing world since there are more opportunities there and investors in the region are getting more sophisticated. What many outsiders forget is that they must now compete with local talent in the developing world when conducting a job search. There are no more virgin territories. In emerging markets, many people are well educated and multilingual. I always advise people to personally check out any market they are considering from afar. It helps give you a realistic view.

What about recruitment trends and compensation?

Personnel search mandates in the asset and wealth management industry were down 20–55 percent in 2009 compared with 2008, although searches picked up in mid–2009. The positions for which headhunters were recruiting most in 2009 were asset allocation specialists and persons with multiasset experience and quantitative skills. Hiring was occurring in fixed income for both managers and analysts, but it was soft in equities and for stock pickers, as investors moved assets into index funds. The figures are not out for 2010, but I expect that these trends continued.

Our research showed that in 2009, salaries were flat or declined against those in 2008, and one interesting point is that the structure of compensation is changing. More companies are structuring pay packages to retain people longer and achieve a better alignment of incentives with the long-term profitability of the firm. In the United Kingdom, for instance, the Financial Services Authority (FSA) is pressuring companies to defer a greater part of bonuses and turn them into a long-term incentive plan. Since asset management firms benefit by locking in their staff, they are obliging.

A professor of finance at EDHEC Business School in Nice, France, and a founding partner of The Intertek Group (Paris), Sergio Focardi publishes frequently on quantitative finance and portfolio management. He co-authored the report *Investment Management after the Global Financial Crisis* for the Research Foundation of CFA Institute. Professor Focardi holds a degree in electronic engineering from the University of Genoa and a PhD in mathematical finance from the University of Karlsruhe.

Have you seen a renewed interest in public sector jobs versus private sector jobs, given the overall job insecurity and cuts in pay in the private sector?

Let's put it this way. There are two types of attitudes [for those interested in working for the public sector]. One is that many people want to play a role in shaping the landscape of the industry. They want to help define policies because they want to contribute to the overall social good. Others are more concerned with finding a secure job, so they may now consider the public sector when they may have not done so before.

What trends do you see moving forward?

In the wake of the Bernie Madoff and Galleon scandals, investors are stepping up their due diligence, especially in alternative investments. One person we interviewed reported that investment consultants have to put in much more work than in the past to win back the trust of the client, particularly if they are suggesting an investment into a structure that is not 100 percent transparent.

The other trend we observed was toward risk management activities. Risk management has moved up the investor agenda, and many companies are now providing additional training in risk management techniques. The result is that investment consultants are being taken to task for not being accountable for their investment decisions. Some people we interviewed, particularly those in northern Europe, suggested that investment consultants will have to go beyond just giving advice, eventually teaming up with or selling their organization to those responsible for managing the assets. To provide the best possible dynamic asset allocation and risk management strategies, you've got to be close to the market. In the end, it comes down to being close to the market.

How would you summarize your advice to those looking to make a career change?

Invest in your competence. My overall advice is to read the market trends and see that the shift means a greater need for higher-level skills and ongoing education. This is not going to change.

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