Asset Management Industry Analysis

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This white paper assesses the Asset Management industry, analyzes its attractiveness using the five forces model, and identifies issues that must be addressed before entering into the asset management arena. For purposes of this analysis, the terms Asset Management and Investment Management are used interchangeably.

Industry Description

The asset management industry is comprised of firms that purchase, hold and sell securities for investment purposes. Many different types of firms participate in the investment management industry, such as mutual fund companies, investment advisors, banks, insurers, brokers, third party administrators and service providers.

The major objectives that asset managers strive to achieve include:

- Creating superior investment returns within the parameter of a portfolio's investment mandate (as measured against its performance benchmark and its defined peer group)
- Managing the execution costs of growing trading volumes, and convincing clients that the firm maintains the necessary technology infrastructure to manage money well and cost effectively. 5

State of the Industry

Morgan Stanley Dean Witter predicts, "In the end, not all asset management companies will survive, [but] for firms that have built a 'culture of excellence' over the years, have segmented their customers efficiently, built brand, and delivered performance, the ongoing opportunities to take market share have never been more significant." 2

Investment management fees represent 15%-25% of net revenues for those brokers with asset management businesses. 7

Jupiter forecasts that growth in assets under management in online trading accounts will grow from $415 billion in 1998 to more than $3 trillion by 2003.

Consolidation
Forbes claims we can expect more consolidation in the asset-management field, like Charles Schwab's purchase of US Trust. 3

Growth
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Economic Issues
While the asset management industry has enjoyed explosive growth over the past three years, Garry L. Moody, national director of Deloitte & Touche's Investment Management Services Group notes that, "the industry faces a period of unprecedented change, brought about by a variety of forces. In the U.S., for example, satisfying investor expectations in a volatile market and responding to changes in distribution channels are only two of the challenges firms must face. The landscape is getting increasingly competitive, and firms are going to have to continually reassess their strategies…in order to stay on top." 1

Goldman Sachs' claims that in terms of the broader economy and market, a prolonged decline in equity prices from either inflation or corporate profit concerns would negatively impact investment banking, asset management, and trading. Large, sudden spikes in rates and credit spreads would also exert detrimental effects on the trading businesses. 7

Move to High-End
Last year Schwab began offering some high-end services, including the invitation-only "Signature Service" branch for high-end accounts beginning at $1 million, which includes research reports and access to dedicated brokers. The average account size is $3 million.

Schwab figures he can … translate his low-cost strategy to the advice-giving business. Says Schwab, “Most of the advice offered by full-service firms can be boiled down to simple asset allocation and diversification using low-cost indexed mutual funds, [so] investors don't need access to proprietary equity research and underwriting connections of the sort that Merrill and Morgan buy with their $3-million-a-year analysts.” 4

Industry Issues

Opportunities for asset managers are increasing, but their strategic challenges and operational complexities are keeping pace. Asset management firms are now facing a variety of issues, some of which must be addressed In order to take advantage of e-business opportunities.

Straight-Through Processing

- Automating all the interactions involved in the investment management cycle reduces the costs, delays, and errors associated with the manual interventions that so often riddle the process of trading and settling securities.
- This entails streamlining or reengineering investment management processes, and upgrading or replacing support systems. Customer Expectations*
- The next challenge is for asset management companies to gain better knowledge of their customers.
- Central to this effort will be the implementation of customer relationship management (CRM) tools to integrate customer data across all products and channels. 6
- Utilizing these tools and techniques allows the firm to capture information about its customers, to understand its customers' behavior, preferences and needs, and therefore continually improve its product offerings.

Automating Retail Distribution Channel

- For investment management firms, this means implementing systems and processes that can readily connect their own back office systems to any player in the distribution channels.

Providing for the Self-Served Client

- Investment management clients are increasingly demanding the ability to conduct the full range of transactions and get information online.· For the investment management firm, this helps contain cost, since the marginal cost of conducting a transaction online is almost always less than that of conducting it manually.

Ability to sustain superior performance

- Shift of asset managers toward index funds is reactive to investors pouring money into this area in the US and Europe. Studies have shown that actively managed funds continue to rarely outperform the market. Distribution taking gaining increasing power
- For most firms, distribution is becoming a major challenge
- As consumers seek more investment advice, financial planners and intermediaries are becoming more important.
- Pricing is increasing controlled by the institutions that sell funds, rather than the companies that manufacture them.
- Neil Bathon, president of the Financial Research Corporation stated, “The power is leaving the manufacturer.”

Challenge of the Internet

- Forrester Research predicts that electronic sales of financial products will increase five-fold by 2003 to become the largest service sold on-line. Consolidation
- There is a “view that bigger is better in asset management because of the economies of scale,” claims Jeff Peek, head of Merrill Lynch's Asset Management Group. “All else being equal, the larger the funds, the more profitable you are.”
- Look for industry consolidation to continue as firms seek to gain the scale to expand globally, expand product offerings, and increase efficiency. 6 Building brand equity
- Len Short, executive vice president of advertising and brand management for Charles Schwab & Co. states, “Our goal is to be the power brand for financial services.”
- Schwab increased its advertising budget from $103 million in 1998 to more than $200 million in 1999.
- Asset managers that create strong brands will not only grab the attention of consumers, but will also attract third-party distributors. Unless strong competition incentives exist, banks, insurance

companies, and financial planners are reluctant to offer funds that are unknown quantities and are therefore harder to sell. They want funds where there is instant recognition and a comfort level. 6

Controlling risk

- Value-at-risk (VAR) – the maximum value that a total fund can lose over a given period at a certain confidence level – has been used by predominantly by banks and brokerage firms, and is now gaining popularity among investment managers.
- Outside of market risk, asset managers face a variety of operational risks including rogue traders, fictitious trades, deceptive sales practices, money laundering, and computer breakdowns among others.
- Creating a profile of the risks that an asset management company faces is a major task. Managing risks across the entire organization allows a firm to diversify risks and assess the importance of each risk to overall corporate business objectives.

Shift to defined contribution pensions

- The number of years in retirement is increasing as people are living longer.
- Worldwide, there is a shift in from defined benefits pensions, with specific monthly payment upon retirement, to defined contribution pension plans that make a certain contribution each year that an employee works.
- Under this new model, the responsibility for managing retirement assets is transferred to the individual. 6

Regulatory maze

- Convergence among different financial sectors means that many firms have to comply simultaneously with securities, banking, and insurance regulations, each administered by a separate regulatory authority.
- Asset management companies are up against a variety of regulatory schemes and philosophies for each of the countries in which they operate.
- Due to the repeal of the Glass-Steagall law, we can expect more acquisitions of asset managers by commercial banks and insurers.
- Asset management companies operating throughout the EU have the challenge of satisfying 15 regulators. Werner Seifert, chief executive of the Deutsche Borse, termed the regulatory situation a “nightmare.” 6

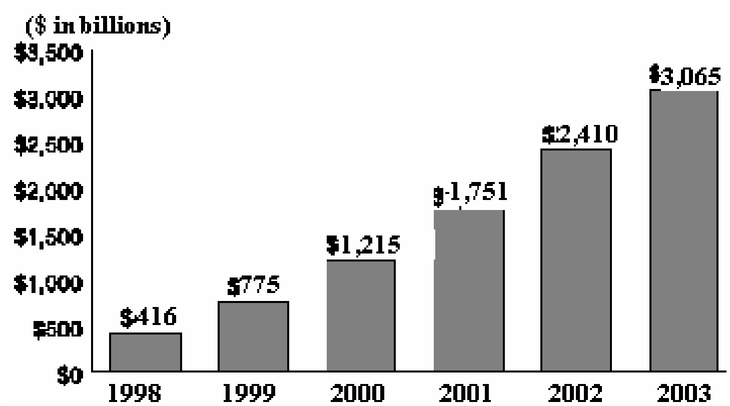
The Online Outlook

Forrester Research interviewed 50 financial institutions that already offer advice to consumers through channels other than the Internet. One-third of the firms they spoke with currently offer advice online, and another 50% plan to do so by the end of 2000. Still, 54% of the respondents feel that automated advice will never be a compelling alternative to human advisors. 9

Jupiter defines an online brokerage account as one that allows a trustee or owner to place orders for securities or other investment vehicles through the Internet. 8

As much of the predicted asset base from traditional accounts gains Internet access, the line between online brokerages and traditional brokerages will fade.

Assets under Management in Online Brokerage to Reach $3 Trillion by 2003



In the full-service brokerage firm area, Merrill Lynch and PaineWebber have each announced plans to deliver online trading, increasing the pressure on firms such as Morgan Stanley Dean Witter and Salomon Smith Barney to do the same. Regional firms are also affected by this trend, as well as financial planners and investment advisors associated with Charles Schwab & Co., American Express Financial Services, and other traditional discounters.

In the discount brokerage firm area, deep-discount firms such as Datek, Ameritrade, and Suretrade will face steeper competition from firms that provide broader product offerings, and may feel pressure to lower prices even further. They may take the Buy.com approach— lose money on every transaction but make up for it on advertising. They will need to improve their asset-gathering strategies in order to survive. Firms that charge $10 or more on commissions are in a better position, usually offering more services and having partnerships with companies in related arenas, but they are probably watching new competition closely.

Major Players in the Industry

Revenue and Market Share	
Industry / Competitors	Market Share * / 12 Month Revenue
The Securities Industry	$188,612.2 Million
Merrill Lynch	22.3% $42,048.0 Million
Schwab	3.5% $6,606.5 Million
Bear Stearns	5.4% $10,277.0 Million
Putnam	$2,502 Million (9 Month Revenue**)
* Valid as of 1/4/01. ** Valid as of 10/30/2000 – for the Investment Management sector.	

Five Forces Analysis

Success in the asset management industry is achieved through consistent superior performance and excellent service and advice. However, these two accomplishments are not enough. Power is beginning to shift from the manufacturer to the distributor who controls the customer relationship and controls which products to offer and recommend. Distribution will be increasingly important as asset managers seek to serve the needs of the fastest growing investment sector, which encompasses those of high-net-worth. 6

The Industry - Rivalry among Existing Competitors

- As a result of recent mergers, distribution is becoming concentrated in a few major banks and brokerage firms that are gaining greater leverage.

Threat of New Entrants

- The Internet is providing the opportunities for new entrants and nontraditional firms (E*Trade, Virgin, AOL, and Yahoo!) to penetrate the financial services market.
- They face large start-up costs, but the benefit from lower operating costs by operating online and have the opportunity to build a customer-centric culture from the start.

Bargaining Power of Suppliers

- Third-party distributors (banks, securities firms, and insurance companies) are beginning to play a more important role in determining which funds their customers choose.
- As consumers seek more investment advice, financial intermediaries have become more important
- Pricing is increasing controlled more by the institutions that sell funds than by the companies that manufacture them.

Bargaining Power of Buyers

- Buyers are gaining power as the distributors begin to realize the necessity of the customer relationship.
- Buyers see their choices increasing.
- Buyers also expect their financial services institutions to provide access to their assets around the clock. 6

Threat of Substitute Products or Services

- One threat is in the sector of online investors that choose to manage their own investments, mainly through online trading, bypassing asset managers that offer advice and service.
- This is a weak threat, since savvy investors – knowing that their risks decrease with diversification – will choose include an asset manager at some point in their investment plans.

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