



Everybody has been hurt by current market conditions. For example, hedge funds, traditionally focused on absolute rather than relative returns, have inevitably been hit hard, although a number of funds are continuing to do well in attracting new investment. **Dave Seymour** argues that investment management is likely to emerge changed but probably stronger from the crisis. There are exciting opportunities ahead. But success will depend critically on rebuilding trust and confidence.



Dave Seymour

Confidence must return

An investment management perspective

The simplest way of summarizing the current state of the investment management industry is to say it is confused. A large part of the industry is still sitting on the sidelines. Funds with private capital reserves still have investable resources. But they can't be sure the market has bottomed out, and are wary of investing into assets which may lose further value. Overall, there is a lot of uncertainty over where the market is going and how to respond.

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Getting in shape

One sensible and effective strategy is to concentrate on getting into shape for the upturn, when it comes. Here, one of the most important challenges is to rebuild trust and confidence by strong customer relationship management.

Historically, the most successful investment management firms have been those which focus clearly on their customers. This is going to be even more important in the future. Whether they are private capital investors or retail investors, customers are increasingly going to demand better, more frequent and more transparent communication. The crash, exacerbated by high-profile frauds has made investors very nervous. Risk management processes have been called into serious question. Perceptions of risk have changed. The investor community is rattled, and confidence will not return easily.

The firms which come through the crisis best are likely to be those which are currently investing in creating or growing meaningful customer relationships.

Successful firms are taking the opportunity to improve the organization, build new skills and capabilities, and perhaps acquire complementary expertise or capacity through corporate restructuring. Those who have been badly burned by the crisis need to rebuild and re-organize their operations for the new risk environment. As ever, it's the simple things which can count for most. After a period of irrational exuberance, focusing on execution will be the key to achieving returns.

Many firms are already beginning to restructure themselves, their products, teams and capabilities. In an industry where many players don't have deep in-house infrastructures, instead relying on networks of third party vendors for many operational activities, focusing on execution also means ensuring that the total risk profile is effectively managed.

The future of regulation

The chorus of calls for tighter regulation should be met with care. Many of the participants at the G20 London meeting are seeking to build new regulatory frameworks, to curb what they see as the excesses of 'Anglo-Saxon' capital markets. There is a tendency to characterize hedge funds, in particular, as opportunist players who damage rather than support local economies. Tighter regulation is an understandable and instinctive response.

A risk with stand alone or knee-jerk regulatory changes is that they can open up arbitrage opportunities between different markets and stimulate firms to find alternative ways of investing capital in situations which match their risk appetite. Financial markets are very creative, and will seek to invent new structures, products and techniques in the pursuit of a return on investment.



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Furthermore, traditional regulatory frameworks, from the Securities Exchange Commission (SEC), Financial Services Authority (FSA), the G10's Basel Committee and the like, are focused on corporate entities. But investment funds are not companies, and are not like companies. They are products. Any move to greater regulation may be more appropriate if it follows the model of consumer product safety regulation in order to satisfy the objective of protecting investors. The authorities need to move carefully if they are to avoid frustrating the market's natural recovery and readjustment after the crisis.

They should also seek to guard against appearing to guarantee investor protection, since this could lead to distorted consumer behavior. In the particular case of hedge funds, there is a risk that if these are more tightly regulated it could give investors the false illusion that this type of investment has the same risk profile as a traditional fund for example. People could then misunderstand the risk of hedge fund investing – mistaking higher regulation for lower risk.

A return to boutiques

One area where the market already seems to be in tune with regulators' concerns is in the increasing move back to smaller boutique operations. The last 15 years or so have seen a great deal of consolidation in the industry, with asset managers being acquired by large institutions, financial conglomerates expanding into third party business and so on. Financial institutions have become complex and opaque, and the potential for localized risk management failure to contaminate entire corporate balance sheets has become painfully apparent. Regulators and politicians have begun to call for smaller, simpler and more transparent institutions.

The market already appears to be responding. Among the major global institutions, one has exited from retail asset management; another is divesting a high-growth business to a private equity firm; continued pressure to deleverage and bolster balance sheets will inevitably lead to more de-consolidation over the next few years. Conversely, traditional fund management firms are looking to make acquisitions to develop complementary capabilities or increase capacity.

Talented individuals are already moving in the same direction. Since the major investment houses became mainstream banks, a steady stream of start-ups and boutiques has been forming. The difference today is that the infrastructure of third-party vendors which has developed over the intervening period provides a ready made, mature support environment for these new boutiques. Smaller, nimbler firms will increasingly dominate the market in the years to come. And customers will find it easier to relate to and understand simpler, more focused firms as well.

The future is full of opportunities

The recession and its aftermath will provide great opportunities for the investment management industry, magnified by demographic and geo-political trends which have been under way for some years. We expect private capital to play a critical role in deleveraging the financial system.

Many economists argue that we are seeing not simply the bursting of another bubble like that of the dot-com crash, but a more fundamental realignment to a higher-saving world – much like the Asian markets. The consumer spending boom will give way to more restrained behavior as individuals and families respond to uncertainty and the fear of unemployment and repossession. History suggests that fundamental changes in attitude persist for many years after a major financial crisis. If savings ratios rise to consistently higher levels, more assets will be under management and the demand for investments of all types will grow.

Against this, however, are some key demographic trends, especially the great transition in developed western economies as the baby-boomers move into retirement and begin drawing down, rather than building up, their savings. In addition, the long-term transfers of wealth from the developed world to the oil-rich nations and the developing world will be of crucial significance. Middle-Eastern and other sovereign wealth funds are already major players in the investment community.

In the 1980s, the US was the world's largest creditor nation. Today that role has been taken by China, overtaking Japan to hold some US\$1 trillion of US debt. The US itself has become the world's biggest debtor nation. How these unsustainable imbalances are sorted will prove of vital importance for 21st century geopolitics.

While the immediate outlook remains uncertain, the medium- and long-term opportunities are tremendous, and tremendously exciting. Those investment funds which keep their nerve, concentrate on improving transparency and communication with customers, and get themselves in shape for the new financial world order stand to enjoy an exciting and profitable future.

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