

The Glass Hammer / Stone House Consulting Survey of Buy-Side Industry Trends

27 October 2009

by Holly H. Miller¹

Executive Summary

Margins in the investment management industry are under siege, facing threats from both directions – lower fees and rising costs. The Glass Hammer / Stone House Consulting Survey of Buy-Side Industry Trends indicates that while regulators are contributing to the cost pressures, the industry’s own client base, together with the investment consulting firms that advise those clients, are a key factor in the equation. Not only are investors demanding greater due diligence, improved risk monitoring and controls, but they are calling for lower fees without any concession on the performance expectations, high levels of customization and quality client service they have always required.

Many managers, seeking to protect their margin, have responded in the market crisis with staff cutbacks and hasty outsourcing deals that, in some instances, have resulted in increasing operational risk within an investment management firm – or have set the stage for potential problems as the job market improves.

Respondents to The Glass Hammer / Stone House Consulting survey represent more than 75 investment management firms with nearly \$7 trillion in assets under management including US and non-US mutual funds, institutional separate accounts, hedge funds, private equity funds and SMA (‘wrap’) accounts.

Following sharp market declines, the fall of Lehman Brothers and the discovery of Bernie Madoff, Alan Stanford and other fraudsters, 88% of survey respondents agreed that investors are spending more time and attention than ever before on due diligence and were nearly unanimous that the importance of operational due diligence has risen. And the vast majority of respondents (98%) agree that investment professionals are expected to be well versed in due diligence and how the business as a whole operates.

Despite the increased focus on risk, 16% of respondents considered current counterparty approval and monitoring processes to be insufficient and more than 80% believe that staff cutbacks increase an organization’s operational risk profile. Nearly one quarter of those surveyed indicated there were no new processes for monitoring counterparties; instead managers were seeking to consistently and sometimes more frequently apply existing policies and approaches.

The survey’s responses show that low staff morale, cutbacks and taking advantage of “a buyer’s market for talent” in the industry may be precursors for some significant staff turnover when employment stabilizes. Yet respondents also indicate that it is all but impossible to protect intellectual property when employees leave an organization.

¹ Holly H. Miller is a partner at Stone House Consulting, LLC, providing strategic, operational and IT consulting services to investment managers and hedge funds. Prior to founding Stone House Consulting, she was Chief Operating Officer at M.D. Sass Investors Services, managing \$15 billion in hedge funds, private equity funds, traditional separate accounts and SMA (‘wrap’) accounts across 18 investment strategies and 15 investment management firms. During her 30-year career, Ms. Miller was East Coast Region Manager for Citisoft, Inc., a business process and IT consulting firm, where her clients included Nuveen Investments, Dimensional Fund Advisors, Lord Abbett, T. Rowe Price and DuPont Capital Management. She has also managed operations teams for Bank Julius Baer, J.&W. Seligman and Citigroup.

The Glass Hammer / Stone House Consulting Survey of Buy-Side Industry Trends

27 October 2009

Barriers to entry in the investment management business have increased in the last two years, according to 64% of participants. Further, two-thirds of respondents project that hedge funds, when pitching a firm's performance track record, will need to be compliant with the Global Investment Performance Standards (GIPS®) and, despite a lack of details on future requirements, 45% of survey participants believe it is possible to prepare for a new regulatory environment. Nonetheless, 87% think it is still possible to launch new firms and products.

Survey respondents call overwhelmingly (89%) for shadow investment accounting by both hedge funds and mutual funds, though they remain non-committal about whether outsourcing operations and IT is a panacea, with half of respondents responding to questions with a 'neutral' response.

More than half of the survey's respondents think that hedge funds will move to lower base management fees while traditional investment managers may begin to introduce performance-based fees. Yet despite all the fee pressure from clients and investors, two-thirds of survey participants indicated that managers will allow customized reporting or even customized invoices if clients request them.

Perhaps most interesting were the responses to several questions on investors' perceptions of risk, including manager risk. While there was no clear agreement on whether investors are more or less risk averse than before the market crisis, there were numerous responses highlighting investors' oversimplification of risk definition, measurement, monitoring and oversight, both in terms of investment risk and operational risk. Criticisms were not simply levied at high-net-worth investors, but institutional clients and investment consultants were also singled out by some participants for their lack of understanding of risk.

When it comes to what makes an investment management firm an attractive acquisition target or why a firm might agree to be acquired, survey participants provided no surprises. All respondents pretty much agreed that the successful new leaders of any merged entity must be able to discuss and manage all aspects of this changing, challenged business – the front, middle and back offices – and manage the risks that arise in each area as well as those that cross boundaries throughout the firm.

For more information regarding the full survey, please contact Stone House Consulting at <http://www.stonehouseconsulting.com/Articles/Articles.html>