November 2008

Crisis in Asset Management:
Industry Profitability Under Siege

Falling equity values are reshaping the asset management industry

- Q3 and Q4 2008 are warm-ups for the challenges looming in 2009
- Asset management company operating profits are likely to decline by an average of 35% in 2008 and, if expenses are not cut significantly, by another 35% in 2009
- Actual 2009 profits will depend on the interplay of several factors:
  - Each firm’s asset mix and its exposure to equity markets
  - Decisions on the tradeoffs between incentive payouts, headcount, and profitability
  - Each firm’s net asset flows
- Incentive pools and headcount are the largest sources of potential expense reduction, and we expect that both will decline
- There will be winners and losers:
  - Global firms, although challenged, should be able to ride out the storm while focusing on growth opportunities
  - Smaller firms, equity-focused fund managers, and multi-capability firms without strong competitive differentiators will face punishing headwinds; some of these firms will not survive
- All firms should immediately assess their strategic options through two lenses:
  - ***Focus on competencies:*** Protect flagship capabilities, eliminate “hobbies,” and exit subscale business lines
  - ***Rationalize costs:*** Right-size businesses, merge products and functions, eliminate redundancies, and plan layoffs, if necessary

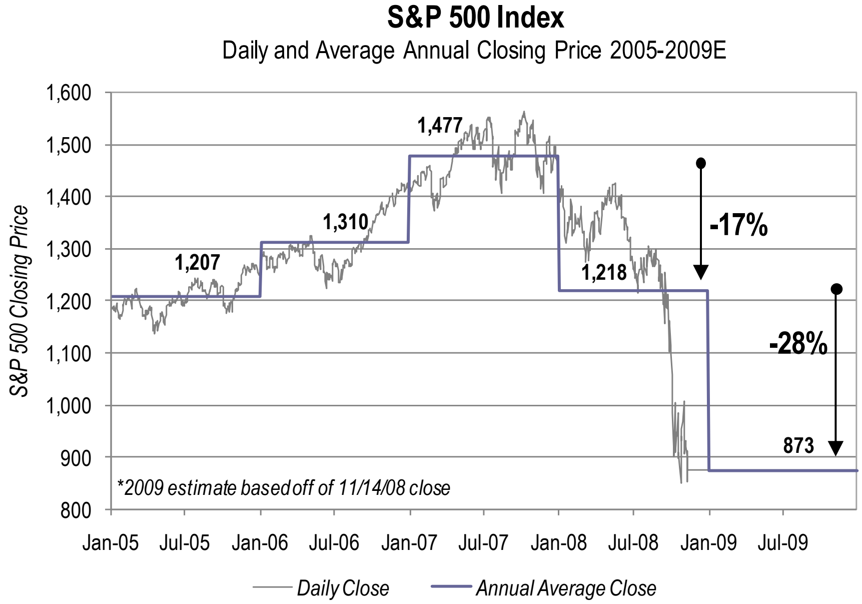
Precipitous market declines will put asset management companies under significant financial pressure in 2009

Industry revenues will decline significantly

The collapse of global securities and commodities markets since October 2007 already guarantees significantly reduced AUM and revenues for 2009. We forecast that annual asset-based fees among equity-focused investment managers will drop by more than 40% between fiscal 2007 and 2009.

For example, we estimate that the average annual level of the S&P 500 will fall 17% in 2008 versus 2007. Assuming no change in the S&P 500 through year-end 2009, we estimate a further 28% collapse of average annual equity asset levels between calendar years 2008 and 2009.

Exhibit 1



Source: Casey Quirk, McLagan Analysis

Asset mix mitigates some of the revenue decline

Firms that primarily manage fixed income or that manage a diversified mix of asset classes (fixed income, equities, and other) generally have more stable asset and revenue outlooks. Based on our analysis of the actual asset mix of a broad cross-section of firms, we forecast that asset-based fees will fall by 25% between 2007 and 2009.

Asset flows are the wildcard in our forecast

Our revenue forecast for 2009 assumes that there will be neither asset inflows nor outflows. While we recognize that asset flows of individual firms will vary, it is unlikely that asset inflows can offset the far greater impact that declining markets have on revenues. In considering the asset flow impact, it should be noted that retail investors, prone to chasing returns, are unlikely to come back in force in the near-term. And, while institutional investors might add to their equity exposure to restore their policy allocations, these firms were already moving away from U.S. equities and toward alternatives prior to the market meltdown. Also, we believe that rising commitments to global equity will limit the demand for pure U.S. equity mandates. Therefore, U.S. equity-focused firms are unlikely to win enough new business to reignite revenue growth.

The impact on industry profitability will be immediate and severe

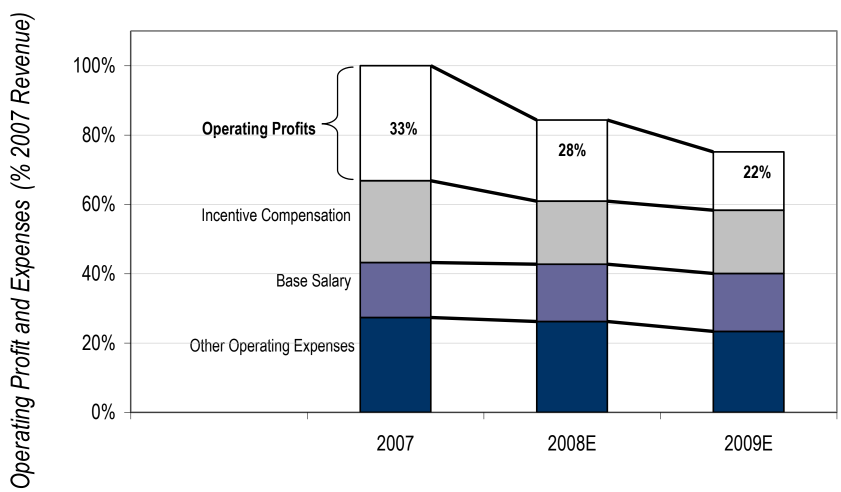
Industry profits will shrink as a result of the market meltdown

We used revenue, expense, compensation, and headcount data collected from nearly 50 asset management companies that participate in *Performance Intelligence*, our annual survey of investment management firm financial performance, to model industry profitability.

Our model suggests that asset management firm operating profits will drop 30-35% between 2007 and 2008 and by an additional 30-35% in 2009, if costs are not cut significantly. Expressed in terms of margins and holding most expenses constant, our model suggests that operating profits will decline from 33% of net revenues in 2007 to 28% in 2008 and to 22% in 2009. This provides a baseline that highlights the impact that falling revenues could have on profits.

Exhibit 2

Asset Management Profit Forecast
Average Expenses and Profit Margins



Source: Performance Intelligence Study, Casey Quirk, McLagan Analysis

Incentive compensation down an estimated 25% in 2008

Our assumptions are based on a bottom-up revenue forecast of our sample firms' mix of business lines and asset classes. For 2008, we assumed all operating expenses would be in line with 2007 levels, except for cash bonuses and long-term incentive grants, which we estimate will be cut by 25% from 2007 levels.

For 2009, we assumed 20% expense reductions in discretionary operating expenses, such as marketing, technology, and travel and entertainment. Estimating 2009 staff costs is admittedly more complex, given that each firm's pay management practices will vary: some firms are more likely to focus on cutting headcount, while others are more likely to focus on reducing bonus pools. In addition, the ability and willingness of individual firms to tolerate lower operating profit margins will depend on factors such as ownership structure and initial level of profitability.

Cutting headcount and incentive compensation appear unavoidable

Actual profit margins in 2009 depend on strategic tradeoffs

Changes in compensation and benefits—the largest expenses for asset management companies, usually accounting for 40-60% of revenues—have the greatest impact on profitability.

We modeled potential tradeoffs between reductions in incentive compensation and reductions in headcount. Our analysis showed that if headcount and incentive spend remained flat between 2008 and 2009, then operating profit margins would decline by over 5.0 percentage points, from an average of about 28% of net revenues in 2008 to 22% of net revenues in 2009.

Exhibit 3

Impact of Headcount and Incentive Compensation Cuts on Profit Margins

2009E Profit Margin Percentage Point Change From 2008

2008-2009 Changes in Incentive Compensation Spend						
-20%	-2.5	-0.4	1.7	3.7	5.8	7.9
-15%	-3.8	-1.6	0.5	2.6	4.8	6.9
-10%	-5.1	-2.9	-0.6	1.6	3.8	6.0
-5%	-6.3	-4.1	-1.8	0.5	2.7	5.0
0%	-7.6	-5.3	-2.9	-0.6	1.7	4.0
5%	-8.9	-6.5	-4.1	-1.7	0.7	3.1
	5%	**0%**	**-5%**	**-10%**	**-15%**	**-20%**

2008-2009 Changes in Headcount

Source: Performance Intelligence Study, Casey Quirk, McLagan Analysis

To improve 2009 operating profit margins from our baseline forecast of 22%, important cost cuts will be necessary. From a human capital perspective, restoring the 5.3 percentage points of profit margin "taken away" by the market meltdown will require cuts in headcount and/or incentive spend. Illustrated above, to restore 2009 margins to 2008 levels through compensation-related spending cuts, the average firm will likely have to slash incentive spend by more than 20% and headcount by more than 10%. Even more drastic cuts will be required to return to 2007's level of profitability.

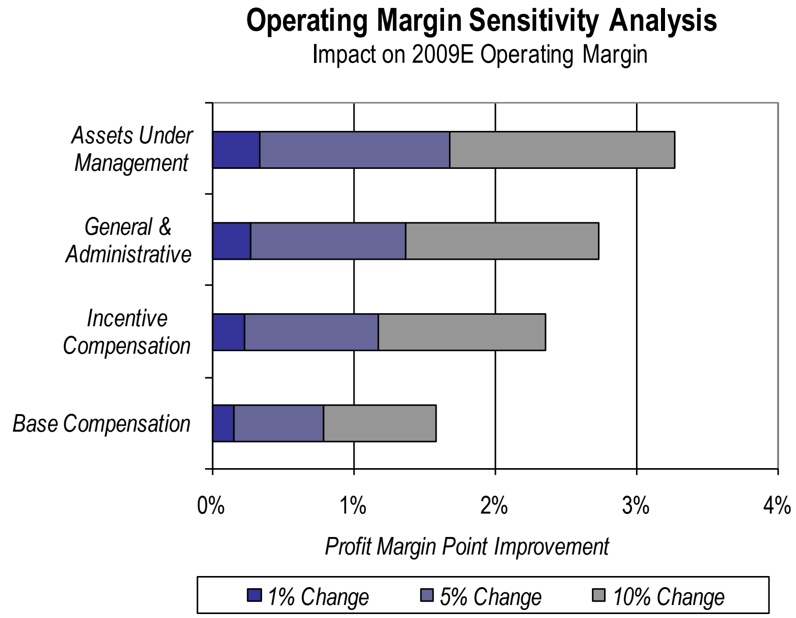
Layoffs will be a reality

Even after an anticipated average decrease of 25% in incentive compensation levels during 2008, further expense reductions in 2009 will be necessary. If firms want to maintain 2009 profit margins at anywhere close to 2008 levels, managers will have few options. Non-compensation-related expenses, such as rent, telecommunications, and technology, are semi-fixed. Also, bonus pools can decline only so much before these reductions adversely impact top performers who drive revenues. Therefore, we believe that further industry layoffs will be required as managers look to cut their total compensation and benefit expenses. In many firms, these cuts will be added to, and far exceed, the 10% staffing reductions that already commenced during Q4 2008.

Can layoffs be avoided through other expense reductions?

Profit margins are most sensitive to changes to average asset levels and, therefore, vary directly with market action and net asset flow. As shown below, if assets under management rise 5%, we estimate that profit margins will improve by just over 160 bp, on average. Changes in general and administrative (G&A) expenses also impact profit margins, but managers have little real ability to cut G&A expenses significantly in the short-term. A 5% reduction in total G&A expenses contributes about 140 bp to average profit margins. Cuts in compensation expenses, particularly incentive payouts, can also have a meaningful impact on operating profit margins.

Exhibit 4



Source: Performance Intelligence Study, Casey Quirk, McLagan Analysis

The impact of lower profitability will vary across firms

The impact of 2008/2009 financial markets on business results will be most acute within firms compelled to deliver an expected margin, as well as within firms that were already operating at suboptimal levels of profitability. Captive asset managers, that are part of larger financial services firms, are generally in the worst position, as these firms must deliver profits to parent companies that are often in far worse shape.

Publicly-traded firms are a mixed group: some firms are slashing staff now, while others are trying to wait the market out, allowing margins to fall and reducing compensation costs through voluntary attrition and bonus pool cuts.

Private firms, conversely, may have greater flexibility to operate with lower operating margins in the near-term. However, while many private firms are currently clinging to historical “no-layoff” policies, we expect that the patience (and wallets) of top partners will have limits.

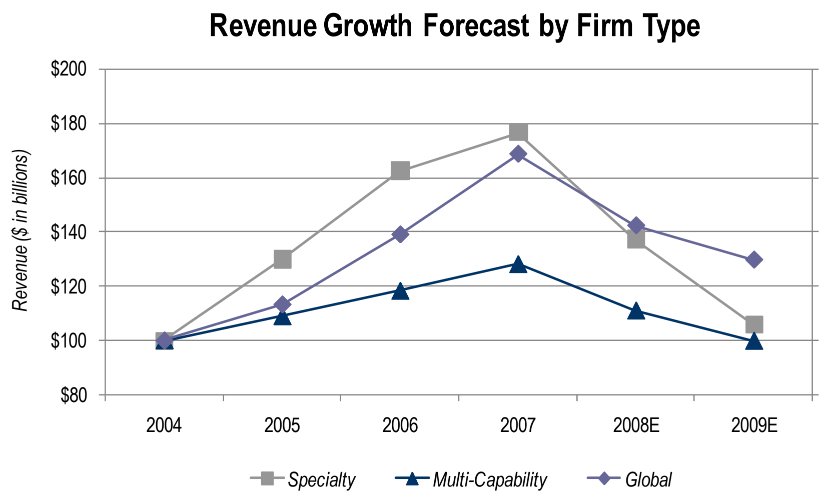
A firm's business model, asset class mix, and ownership structure will all affect its ability to withstand profit pressure

There will be winners and losers

While all firms will feel the impact of the adverse market, not all firms will endure the same financial pressure. Equity-focused firms will be under greater pressure than fixed income-focused firms. Also, we believe that mutual fund-focused firms could face the "double whammy" of declining markets and significant redemptions from retail investors.

Specialty equity-oriented firms are likely to see the worst top-line compression, with their revenues potentially falling by 40% between 2007 and 2009. If these firms do not significantly reduce compensation and benefit expenses, their average operating profit margins will drop from 39% in 2007 to 18% in 2009.

Exhibit 5



Source: Performance Intelligence Study, Casey Quirk, McLagan Analysis

Revenues of the more globalized firms, which typically have the most diversified business and product mix, are forecast to decline the least, sliding about 25% between 2007 and 2009.

Multi-capability firms, which offer a broad product array and serve multiple distribution channels but are not yet global, will suffer the most financial pressure. Historically, these firms carried the burdens of subscale products, distribution or both; consequently, these firms already had operating profit margins that trailed industry norms. Without significant reduction in compensation and benefit expense, these firms' operating profit margins are forecast to decline from 25% in 2007 to 13% in 2009.

Asset managers must carefully weigh their strategic and tactical options

Firms must focus on core competencies

We believe that asset managers should view the 2009 budgeting process as both a strategic and a tactical exercise. Required expense reductions will force firms to exit entire business lines, particularly those that are non-performing or non-competitive. Firms must operate with a strategic perspective, grounded with a clear understanding of their core competencies and competitive advantages.

Deep cost-cutting is unavoidable

The industry will face unprecedented pressure to cut costs. Operating budgets will be under scrutiny, and given that non-compensation-related costs are relatively low and are often semi-fixed, firms will have no choice but to reduce headcount, incentive compensation, or both. In making these cuts, managers need to do everything possible to insulate their top performers. This will require careful scrutiny of their current talent pool, business capabilities, as well as conviction about their future staffing and business requirements.

Weaker firms will require partners

In the most dramatic cases, expense reductions will not be sufficient, and firms will not be profitable. Many firms will need to seek partners to help stabilize their businesses, either financially—through recapitalization or acquisition—or through alliances that better align their operations with expected client requirements. For some asset managers, the combination of market declines, changing buyer demand, and higher cost structures will create headwinds that they cannot overcome. These firms will not survive.

Stronger firms should prepare for the long-term

Conversely, firms able to ride out the current storm will find themselves better positioned to capitalize on the opportunities that emerge when financial markets inevitably recover. Firms able to attract and retain top performers through this difficult period will be poised to capture future growth opportunities.

An upcoming Casey Quirk whitepaper, "The End of the Beginning," will further outline how the crisis changes the fund management industry, and outline tactical and strategic options for surviving current conditions while positioning for long-term growth in a dramatically reshaped asset management marketplace.

Casey, Quirk & Associates (Casey Quirk) provides management consulting services exclusively to investment management firms. The firm specializes in developing business strategy, enhancing investment practices, and crafting distribution plans. Casey Quirk draws on over 40 years of experience advising investment managers and delivering value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to create change within organizations.

Casey Quirk periodically publishes perspectives on topics of interest generated by ongoing industry research. To discuss this perspective, please contact:

Jeb B. Doggett
Partner
j.doggett@caseyquirk.com
(203) 899-3034

Benjamin F. Phillips
Partner
b.phillips@caseyquirk.com
(917) 476-2140

Rahul Patel
Associate
r.patel@caseyquirk.com
(203) 899-3041

Casey, Quirk & Associates
19 Old King's Highway South
Darien, CT 06820 USA
www.caseyquirk.com

McLagan provides compensation consulting services and compensation and performance studies to asset management organizations, including advisory firms, hedge funds, insurance companies, banks, endowments and foundations, and plan sponsors. We currently serve over 450 asset management organizations, including all of the world's leading firms.

To discuss this perspective, please contact:

Adam Barnett
Head of Asset Management
abarnett@mclagan.com
(203) 602-1200

McLagan
1600 Summer Street
Stamford, CT 06905 USA
www.mclagan.com