**INTRODUCTION**

1 Global asset management: an introduction to its processes and costs

by Michael Pinedo

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In this introductory chapter, we first give a brief outline of the recent history of the asset management industry, focusing in particular on the difficulties encountered in recent years. We proceed with a discussion of processes, costs, productivity and operational risk issues that are of importance in the industry and examine the inter-relationships between these issues. In the last section of this chapter, we provide an outline of the volume, giving a brief description of the ten chapters that follow.

**A historical perspective**

The global asset management industry can be divided into two broad categories, namely institutional asset management and retail asset management.

These two categories have fairly different cost characteristics, productivity metrics and risk metrics. The institutional asset management groups include traditional investment advisory firms (such as UBS Asset Management), hedge funds and private equity funds (buyout or venture capital). This category of asset management firms deals directly with large institutions and does not have to deal with the complexities of the retail business. The retail category includes all mutual fund companies (such as Fidelity and Vanguard) as well as pension funds (such as TIAA-CREF); this category must maintain individual accounts for individual people. The retail category requires a higher level of technology than the institutional category (more elaborate websites, larger call centres etc.) so that it can handle individual account registration, maintenance, accounting and a host of other activities. There are a few asset managers who deal with both institutional and retail clients.

The asset management industry in general has undergone some major changes over the last two decades. These changes took place in several phases. During the phase from the early 1990s until about 2008, assets under management (AUM) skyrocketed due to the high liquidity in the global financial markets caused by abundant credit and ever-increasing personal asset valuations (for example house prices). This phase also witnessed the formation of hedge funds (asset managers who typically have a smaller number of clients and who can take very risky positions and bets that may yield substantial returns). These funds continue to play a major role in the financial markets, mainly because of their ability to take advantage of arbitrage opportunities.

The asset management industry is now finding itself in a new phase and undergoing major changes. After the credit crisis, the sector has suffered tremendously, as financial markets all over the world tumbled, and liquidity, once abundant, became either highly restricted or non-existent. Even when the markets recover, it is not to be expected that the same level of liquidity and wealth will be the norm again. Hedge funds that had been set up all over the world have been closing in droves. A sector that a few years ago thrived in a vast sea of liquidity today faces a very different reality.

Before the current crisis, most asset managers were not too worried about operating costs or operational risks, as ever-increasing personal wealth made their AUM grow at a steady pace. Excessive costs and errors were buried under the increasing revenues from a growing asset base, and under the solid profits that were generated by high returns in world markets.

Today, the story is very different. Many of the largest asset managers have seen their AUM drop 30–40%, not only because of a decline in asset prices (which had a major impact on the funds), but also because of clients who withdrew their money either out of necessity or due to concerns regarding the financial health of their asset managers. The crisis also brought regulatory failures to light, such as the Bernie Madoff case (one of the largest operational risk events in history). Many investors close to retirement lost their pensions, not only because of market conditions but also because of a lack of caution and a lack of responsible risk management on the part of their pension funds.
Processes, costs and risks

The new reality has forced asset managers to develop a much stricter discipline with regard to their operational processes, in particular with regard to their costs, productivity and risk management. These factors, which, historically, have played a very important role in manufacturing, began only recently to play a role in asset management. Each one of these factors has started to receive attention in academic literature (see Harker and Zenios [1999 and 2000] and Melnick, Nayyar, Pinedo and Seshadri [2000]); however, the interdependencies and trade-offs between costs, productivity and operational risk have not yet been thoroughly analysed. For example, it is very likely that a reduction in costs established without proper planning can substantially increase exposure to operational risk.

Processes, operational controls, costs, productivity and quality control have been studied extensively in other industries, in particular in the manufacturing sector, where these issues are nowadays fairly well understood. Large manufacturing companies such as IBM and Toyota have extensive cost accounting as well as productivity measures and quality measures in place. In service industries, operational aspects are harder to analyse: costs, productivity and quality tend to be harder to measure. Nevertheless, various service industries have made real progress over the past few decades with regard to their operational controls, as well as with regard to costs, productivity and quality measurements. In particular, the aviation, healthcare and hospitality industries have made solid advances; they appear to be ahead of the financial services industry. It seems that the financial services sector can learn a great deal from many other industries (see Cruz and Pinedo [2008 and 2009]). For example, the procedures used for Total Quality Management (TQM) in manufacturing and services turn out to be very similar to procedures that can be used in the management of operational risk in financial services.

In financial services, the type of firm (whether it is a retail or institutional firm) and its organisational structure (in other words, its corporate structure, line management, etc.) have a significant impact on costs, productivity and risk management. The organisational structure is just as important for a retail asset manager as it is for an institutional asset manager, and many strategic decisions have to be made with regard to the organisational structure. For example, to what extent should a firm be outsourcing and/or ‘offshoring’ its operations? These decisions affect both the cost structure and the operational risk profile of the firm. In subsequent chapters, we will study these factors and their interdependencies in more detail.

In the financial services industry, it has been primarily the retail firms that have been at the forefront of productivity and quality measurements and improvements. For example, retail banks often perform extensive cost and productivity analyses of their branch networks and call centres. On the other hand, trading operations in financial services typically pay more attention to risk management and, in particular, to operational risk. The same is true in asset management: retail asset managers have focused more attention on costs, productivity and client care, whereas institutional asset managers have focused more on the operational risk profile of their trading operations. Nowadays, however, it has become clear that even institutional asset managers with large trading operations have to keep their costs under control.

Asset managers in general are susceptible to several forms of risk, including market, credit and operational risks. These risks can manifest themselves in two ways: they may have either a direct or an indirect impact on the asset manager. Asset managers can be directly affected, for example by operational risk events. Errors in processing transactions or a systems failure can cause severe damage and have an impact on the balance sheet of the asset manager. Failure to comply with local regulations or business ethics may also generate large operational losses and result in serious reputational damage. An indirect impact on the asset manager may be due to client funds being subject to market and credit risk. Market risks originate in the daily fluctuation of asset prices, and credit risks stem from the possibility that some counterparties with whom the funds have business dealings can go bankrupt, rendering certain financial assets worthless. Such losses would have an indirect impact on the asset manager’s revenue, as dwindling funds result in lower commissions; however, most of these losses are still carried by the clients.

The most important cost and operational risk factors in both categories of asset management firms (institutional as well as retail asset management) can be summarised as follows:
- the costs and risks with regard to human resources (employees, such as portfolio managers, administrators, research analysts and call-centre operators);
- the costs and risks with regard to client contact centres and distribution channels (for example physical assets);
- the costs and risks with regard to systems development and transaction processing.

In this book, we consider all the cost and risk factors mentioned above. It is evident that the first factor is important for both categories of asset management firms. The second factor is clearly more important for a retail firm than for an institutional firm. The third factor is important for both categories of firms. However, the emphasis on IT infrastructure and systems development in a retail firm may be slightly different from that in an institutional firm. In a retail firm, systems development often centres around Customers Relationship Management (CRM) activities, including call-centres and clients’ Internet access. The emphasis on systems development in an institutional firm (such as a hedge fund) may centre around transaction processing at high frequencies.

As stated earlier, the operational performance measures of interest in global asset...
management are mainly concerned, on the one hand, with costs and productivity and, on the other hand, with quality management and operational risk. Clearly, there is a trade-off between costs and productivity, and quality control and operational risk (in a way that is similar to manufacturing industries and other service industries).

**Outline of the book**

The severity of the financial crisis of 2008–2009 and its impact on asset management has left academics and practitioners around the world in a state of some confusion. Questions abound. What happened, and what are the prospects for the next few years? To stimulate discussion and intelligent policy responses to these questions, we decided to collect contributions from leading academics and executives, and bring them together in this publication. The focus of this book is mainly on the operational aspects of the global asset management industry, particularly with regard to processes and costs.

The main body of this volume consists of two parts. Part I presents perspectives from industry, whereas Part II presents perspectives from academia. Part I contains six chapters that deal with general managerial, technological, and cost models that are pertinent to global asset management. The authors of these six chapters are closely connected to the asset management industry. These chapters focus on general cost and technology management as well as on the firms’ operational structures. Part II contains four chapters whose authors are more academically oriented. These four chapters are based on data that have been collected by the authors themselves and lead us to interesting new conclusions and recommendations.

In Chapter 2 (the first chapter of Part I), Ümit Alptuna, Manos Hatzakis and Reha Tütüncü from Goldman Sachs describe a best-practices operational and control framework. They focus on governance issues, infrastructure and control, valuation, outsourcing and risk management. Chapter 3, written by Adam Schneider from Deloitte Consulting, focuses on the operations and costs in an asset management firm from a value chain perspective. He discusses the key issues in examining investment management cost structures and comes to the conclusion that, in order to achieve sustainable cost reductions, the cost reduction implementations should have a clear focus with regard to project resources as well as with regard to deadlines. He concludes that cost reduction activities have to become part of the company culture. The fourth chapter, by Klaus Arfelt from SimCorp, focuses on Lean Six Sigma in asset management, emphasising what is needed to maintain high productivity in conjunction with good quality control. Arfelt discusses how lessons learned in the automotive industry with regard to Lean Six Sigma can be applied to the asset management industry. The fifth chapter, by John H. Biggs, retired chairman of TIAA-CREF, discusses responsibilities at the different levels of the corporate structure as far as risk management and technology management are concerned and the effects on total costs. He concludes that, in order for an asset management firm to function well, the risk management and technology management functions should not be kept at the corporate level, but should be delegated down to the line managers. In Chapter 6, Marcelo Cruz, who is a management consultant as well as an adjunct professor at New York University, zeroes in on both strategic and tactical cost management. In his analysis of tactical cost management, he studies the types of cost reduction efforts that have been made in the past few years in industry. In his analysis of strategic cost management, he analyses the trade-offs between levels of corporate expenses with levels of operational risk exposure. Chapter 7, by Kjell Johan Nordgard from SimCorp and Lars Falkenberg from SimCorp StrategyLab, discusses the impact of information technology on cost effectiveness in the asset management industry. The impact analysis discussed is based on a survey of 100 interviews conducted with asset managers around the world.

Chapter 8 (the first of the more academically oriented chapters in Part II) is authored by Dennis W. Campbell and Frances X.Frei of Harvard University. They focus on the relationship between annual revenues and annual selling, general and administrative (SG&A) expenses in the 2001–2008 period. They find that indirect costs related to SG&A expenses appear to increase as revenues climb (often rising at a faster rate than revenues); on the other hand, these indirect costs remain relatively fixed when revenues decline. The authors also describe the implications for cost management efforts in asset management firms. In Chapter 9, Yakov Amihud of New York University and Haim Mendelson of Stanford University analyse transaction costs in the asset management industry and show that transaction costs affect the values of assets: for any given level of risk, securities with higher transaction costs tend to have lower prices. They then discuss the implications for asset managers as far as trading frequencies are concerned. In Chapter 10, Anitesh Barua from the University of Texas at Austin, Deepa Mani from the Indian School of Business in Hyderabad, and Andrew Whinston, also from the University of Texas at Austin, study the value of strategic outsourcing. They describe the risks and managerial challenges in strategic outsourcing. They analysed the 100 largest outsourcing initiatives implemented between 1996 and 2005 and determine the number and value of the sample contracts over time as well as reasons behind outsourcing failures. Kosrow Dehnad, who works for the Samba Financial Group and is also an adjunct professor at Columbia University, compares in Chapter 11 the trading processes in financial services with the production processes in manufacturing; he contends that procedures similar to those used in Total Quality Management (TQM) in manufacturing can improve risk management processes in financial services considerably. He provides four examples of error detection procedures (based on TQM thinking) and discusses the importance of automation and IT investments in the implementation of such procedures.

With the insights obtained from the chapters in this volume, several interesting
directions for future research and development become apparent. One direction could be a study of the interrelationships between the various different aspects of global asset management: in particular, between the management structure, the various cost factors (for instance human resources and information technology), the operational risk exposures, and the relative performance of the fund in question. Such studies may be either of a theoretical nature or of a more applied and empirical nature.

References


