The magnitude of change in the institutional investment industry continues to accelerate, creating a sea of challenges and waves of opportunities for investors, consultants, and investment managers. In 1980, total pension assets were less than $1 trillion. Today, one firm alone manages more than $2 trillion dollars and at least seven firms manage in excess of $1 trillion each.

Our article is a random walk through seven major changes that are transforming our industry:

1. Restructuring of Investment Plans – Out with the Old; In with the New
Perhaps the most profound change in the past decade has been the redistribution of retirement assets. Individual retirement accounts (IRAs) and employer-sponsored defined contribution (DC) plan assets have overtaken defined benefit plans, which ruled the institutional investment arena for decades. Total retirement assets were $16.4 trillion at year-end 2006, up 11.6 percent from 2005. IRAs and DC plans are the largest components, representing $4.2 trillion and $4.1 trillion, respectively, at year-end 2006. While many have predicted the demise of defined benefit plans, a sizeable asset pool of $2.3 trillion in 2006 remains, and some forecast modest future growth, but DC and IRA assets are projected to win the future asset growth race.1

The 2006 Pension Protection Act (PPA) will affect the entire retirement system including defined contribution, defined benefit, hybrid plans, and IRAs. The PPA creates a more reliable way for DC participants to accumulate retirement assets. As many as 30 percent of individuals who are eligible for 401(k) plans do not invest in them. The 70 percent of individuals who do invest in 401(k) plans have not fared well overall due to poor asset allocation decisions, market timing, cash flows, and lack of access to the diversity of investment opportunities available to defined benefit plans.

If the new Department of Labor guidelines are adopted, there will be a rapid and dramatic shift of plan assets from capital-preservation funds to target-date funds, balanced funds, and managed accounts. Target-risk and target-date funds, also commonly known as lifecycle or lifestyle funds, already are attracting significant assets. They are the fastest-growing mutual fund category with $180 billion in assets under management, and are projected to grow to $400 billion by the end of 2009. Many target-date funds will make greater use of specialty strategies such as emerging markets, real estate investment trusts, high yield securities, Treasury inflation-protected securities, and even hedge funds.

Changes are not limited to migration from defined benefit plans to defined contribution plans. Public plans, endowments and foundations, and union plans all are undergoing enormous change and pressures. Defined benefit plan sponsors are grappling with actuarial assumptions, matching assets and liabilities, asset allocations, rebalancing, too much money chasing too few alpha opportunities, education of new board and committee members, and political pressures.

Small- to mid-sized plans of all types are outsourcing the investment management function, often to manager-of-manager platforms. Providers that offer investment policy assistance, asset allocation, portfolio construction, manager selection and monitoring, risk management, as well as shared fiduciary responsibility, are a compelling solution for small- to mid-sized plans.

2. Evolving Investor Skills and Preferences – The March to Higher Ground
When traditional assets posted double-digit returns for much of the 1980s and 1990s, most investors—institutional or otherwise—stayed true to traditional stock/bond/cash allocations. Then along came the tech bubble and other global market events. What investors thought were well-diversified plans turned out not to be. With outlooks for stock and bond returns in the single digits, looming unfunded liabilities, and difficult meeting income needs or fulfilling spending obligations, institutional and individual investors sought other opportunities.

Alternatives, including real estate, private equity, hedge funds, and hedge funds of funds, had irresistible appeal. Hedge funds, offering prospects of more reliable alpha, absolute return, less downside risk,
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and low correlations to traditional assets, presented heroic solutions.

Hedge Fund Research reports that the hedge fund industry saw inflows of $60 billion in the first quarter of 2007, representing about half the industry’s inflow for all of 2006.² Aggregate assets in the hedge fund industry are nearly $2 trillion. Much of the recent growth has come from pension funds, endowments, foundations, and other institutions looking for alpha, or excess return, to diversify traditional investments. According to a Bank of New York/Casey, Quirk & Associates study, retirement plans will account for the majority of asset flows into hedge funds by 2010, and will represent more than 40 percent of total hedge fund assets by 2010.³ Experts predict that rapid growth of hedge funds will continue; they foresee a multitrillion-dollar hedge fund industry dominated by a few players. Morgan Stanley reported that the 100 biggest hedge funds with at least $1 billion control about 70 percent of the money in hedge funds worldwide, compared with 50 at the end of 2003.⁴

Sophisticated investors now separate management of the different return elements of a portfolio—alpha and beta. Core-and-explorer investment programs using passive management coupled with skill-based management have become popular. Exchange-traded funds (ETFs), appealing to investors for their flexibility, liquidity, and inexpensive sources of beta, are stealing market share from index funds. Constraints are being lifted on the quantitative side as well as on the traditional active management side. Corporate plan sponsor concerns about matching assets and liabilities have sparked renewed interest in liability-driven investments.

IRA roll-overs, inheritances, trusts, and foundations will multiply, with current demand for growth at controlled risk levels supplanted by an appetite for high income at minimal risk. Financial advisors will grow in both prominence and power as the demand for guidance explodes. As more participants retire, rollover assets grow, and life expectancy expands, investment solutions must evolve.

3. Globalization – Expanding Competition and Broader Opportunity Set

Globalization is a growing force—in both the competitive pool for institutional investment managers and the opportunity set. More and more managers from outside the United States have been targeting the lucrative U.S. institutional market. Nomura Capital Management and Phillips & Drew were successful entrants in the early 1980s, and today Paribas, Investec, Fortis, Robeco, Degroof, and Pictet are vying for market share. Conversely, the easing of investment restrictions in countries such as Canada and Australia, along with the rise of global consultants and overseas distribution partners, has presented opportunities for U.S. managers to build presence in non-U.S. markets.

Global equity mandates, long the norm in non-U.S. markets but quietly ignored in the U.S. market, are gaining momentum with U.S. institutional investors. Fixed income has been a global proposition for decades. Casey, Quirk & Associates’ latest institutional product review shows that in 2006, global and international bonds enjoyed net inflows of $16.7 billion and emerging market debt took in $4.8 billion.⁵ Now globalization finally is influencing equities—in both passive and active mandates, and in both traditional and alternative investments. Global equity strategies garnered $27 billion in net inflows during 2006, a sharp contrast to the $91 billion in net outflows for U.S. equity products. Emerging markets equity and international equity gathered assets as well, with inflows of $7.1 billion and $6 billion, respectively.⁶ Numerous opportunities will be open to investment firms offering global mandates.

4. Specialization in Professionals’ Roles – Creating Barriers to Entry and Opportunities for Growth

In the 1970s and 1980s, most investment companies were run by investment professionals who also were responsible for client service, presentations, finals, and in many cases, request for proposal (RFP) responses. Today, business leadership, client service, legal/compliance, sales management, consultant relations, marketing expertise, operations, and administration all have developed into professions in their own right. Firms, even start-ups, without strong business leadership and infrastructure, lacking expertise in the above areas, are at a strong competitive disadvantage in the institutional investment arena.

5. Advances in Technologies and Systems – Penny-wise or Pound-foolish?

Emergence of new or advanced technologies are changing the way investment firms support marketing initiatives as well as the way managers are measured and monitored. In the 1970s, index cards were a marketer’s customer relationship management system. Today, relational databases are critical to the sales and client service process. Dozens of databases and the Internet provide a plethora of information on prospects, consultants, and competitors. Global communications have become seamless with the sale of overnight mail to fax machines to E-mail, webinars, and videoconferencing.

These tools make it easier to support sales and client service professionals around the world and to leverage senior management and compliance professionals. One example, Proposal Software, offers one databank and multiple levels of users with different levels of access. It gives traveling professionals online access to all marketing documents, from RFPs to presentations to client reports to answers to tough questions. Management can design
reports that help track activity, accountability, and results. Managers leveraging technology have an enormous advantage, while those unwilling to invest or those that lack the vision to employ it are at a stark disadvantage.

Performance measurement and attribution analysis also have evolved. With the latest tools, clients and consultants can see which managers are adding value versus just managing beta. Clients easily can discern value-added management over time and weed out traditional active managers that are just managing beta. Consultants and clients readily can assess managers’ performance against a variety of quantitative screens and metrics such as information ratio, alpha, beta, Sharpe ratio, R², and more. The previously labor-intensive process of screening managers against specific criteria now can be executed in minutes. Once you define your quantitative criteria, you simply select your database, enter your search criteria, and a list of qualified managers is at your fingertips.

6. Proliferation of Consultants and Their Changing Roles – Gatekeeper, Competitor…Friend or Foe?

Experienced, progressive consultants are well-positioned to benefit from the changes in investment programs and investment offerings. Specialty knowledge and resources are limited; consultants provide clients both. It is challenging and expensive to restructure investment programs, and even more difficult to find strong skill-based managers that can deliver consistent results. Consultants, again, can help investors with both.

The traditional consultant’s business model, however, is labor intensive and difficult to leverage. Many consultants, seeking ways to enhance the profitability of their business models, are abandoning their own proprietary databases and subscribing to independent industry databases such as eVestment Alliance, Nelsons, and PSN/Mobius. The answer for some is expansion into the investment management domain. With so many investors grappling with the same issues—need for higher, more consistent returns, less risk, more education—many consultants have risen to the occasion. A number of the larger, more recognizable consultants have developed manager-of-manager and funds-of-funds programs and limited partnerships, which in turn have translated into more successful business models for the consultants and simultaneously fulfilled the needs of mid-sized and smaller institutional investors.

At the same time, regional consultants, family offices, specialists by markets, and specialist consultants in alternatives have gained and continue to garner market share via expert knowledge in territories neglected by the major consulting firms.

With consultant power continuing to ascend and the number of consultants proliferating, how does a manager address a consultant’s needs for research and insights, and achieve the manager’s goal of a strong, mutually productive relationship? The answer is simple: Those that view consultants as allies or conduits to success and support consultants’ initiatives for education, manager research, and contact, will have greater success. That assumes that the manager is competitive—in its disciplines, clarity of approach, and consistency in fulfilling investment objectives.

7. Distribution Opportunities – “Two roads diverged in a wood, and I—I took the one less traveled by, and that has made all the difference.”

—Robert Frost

In the early years, most managers focused their businesses by client type (institutional or private client), asset management style (balanced, equity, or fixed income), and perhaps geography. Today, managers can leverage a variety of distribution channels including consultants, brokers, financial advisors, subadvisory platforms, manager-of-manager and funds-of-funds platforms, databases, and of course, the good old-fashioned direct-call approach. Market leaders serve virtually every client base, leveraging multiple distribution channels, offering a broad spectrum of investment capabilities and services around the world.

Target markets have become much more specialized. The institutional market, while to some degree still generalized, has specific needs for its various segments: large, mid-sized, and small public funds; large, mid-sized, and small endowments and foundations; Taft-Hartley funds; corporate defined benefit and defined contribution plans; public deferred compensation plans; insurance and reinsurance; hospitals; operating cash; and variations.

The consultant and intermediary industry has segmented as well—by plan type specialists, global consultants, regional firms, brokerage firms, financial advisors, and others. Individual assets now are segmented into high-net-worth, family offices, bank clients, financial advisors, separately managed accounts, and brokerage firms.

Subadvisory markets, funds of funds, and managers of managers all offer viable ways to grow assets under management. With such a spectrum of distribution opportunities, strategic marketing is essential.

Summary

With so much rapid change on so many fronts, and opportunities unfolding with virtually every change, tomorrow’s investment leaders need to aspire to the following attributes:

- Flexibility and foresight to adapt to and serve asset pools shifting from defined benefit to defined contribution to IRA accounts
- Innovative investment solutions to meet changing investor needs
- Ability and resources to capitalize on global investment and distribution opportunities
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- Strong, well-managed business on every level—business leadership, investments, marketing, client service and sales, legal/compliance, and operations/administration
- Commitment to invest in new tools, systems, and technologies to enhance alpha generation and business efficiencies, and to lower costs
- Collaborative relationships with clients and consultants
- Strategic, focused, well-managed marketing, sales, and client service efforts

As Charles Darwin said and we are here to echo, “Success will belong to the one most responsive to change.”

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**Endnotes**

6. Ibid.