



## Investment management in Asia — Eight predictions for 2010 and beyond

The world of investment management has been brutally shaken throughout the financial crisis. No corner of the industry has been spared. The fall and volatility of the markets, asset devaluations and substantial redemptions have combined to deal a major blow to the industry. Traditional fund managers have seen their assets under management (AuM) fall by 20 percent to 40 percent.

March 2009 seems to have been the low point, when many in the industry were wondering where and when the downward spiral would stop. In the last few months however, global markets, including those in Asia, began to bounce back and we noticed a significant improvement in morale. Some optimistic observers even started talking about green shoots; suddenly, many felt that the worst was behind us. A common view emerged that the recovery would begin at the end of 2009 and would gradually accelerate throughout 2010. (See chart outlining the expectations for recovery by sector, page 6.)

As senior-executive search consultants, we are naturally inquisitive and skeptical and tend to question common wisdom. We decided to find out what is really happening in the investment management industry. We approached 40 leaders in asset management, private equity and real estate, and asked them three simple questions:

- > How is your business impacted by the current crisis?
- > What will it take to survive and thrive tomorrow?
- > What will the battlefield look like once the smoke clears?

Our conversations turned out to be fascinating and often counterintuitive. Clearly, there is no consensus about the future of the industry, but some common themes emerged. We distilled the eight most interesting themes from these discussions and explored their implications for firms' talent needs and their ability to address talent gaps.

## Mid-2009: a brief snapshot

Four months into the Asian equity markets recovery, the mood is better than it was earlier in the year. However, we should not fail to notice the seriousness of the situation. The real economy is still in shambles and growth projections for 2010 outside Asia are flat at best. What, then, are we to make of talk about green shoots? A more apt metaphor for some is the eye of a cyclone; these observers await another onslaught before calmer skies arrive.

What are we seeing today in key segments?

### **Asset management — cautious optimism**

Equity managers and hedge funds have been the hardest hit. Assets under management have dropped and managers have responded accordingly by cutting their costs and laying off staff. Fees are under pressure. The absence of leverage has eliminated the strategies of many hedge funds. Yet, as long as the equity markets hold — if they do — the revenue line for the rest of 2009 and 2010 is largely a known quantity. In addition, the recovery in Asian markets has helped create a sense of optimism. Institutional investors, tired of having their money parked in low-yield vehicles, are issuing RFPs again. For many long-only equity and fixed income asset managers, there is hope that the worst is over.

### **Private equity — slow motion**

Recovery appears to be farther out for private equity managers. Portfolio company values have plummeted. Refinancing is challenging and will likely remain so until year end. Portfolio companies are struggling for survival and deal makers have to get actively involved in their management. For the most part, the accretive mindset has stalled and the focus has been on making what you own operate more efficiently. There are fewer deals to be made. Even pure equity transactions are hard to close as valuation expectations between buyers and sellers vary significantly. Finally, many limited partners are defaulting on commitments or selling their current and committed stakes in the secondary market. While some PE firms are still trying to raise funds, this is proving very challenging, as investors are negotiating better terms in their existing limited partnerships.<sup>1</sup>

### **Real estate — gloomy days ahead**

Property values keep dropping and leveraged transactions have lost their equity. Given the lag between real estate and the real economy, investors expect things to get much worse before they get better. This is the gloomiest

sector in the investment world, with many professionals expecting continuous asset decline for another one or two years as tenants vanish and yields fall. There has already been significant discounting in the commercial sector with office rental yields falling more than 50 percent from their 2008 highs. New deal flow has dried up and deal makers have had to reinvent themselves as asset managers, focusing on refinancing their properties and salvaging yields.

## **Eight themes for 2010 and beyond**

### **1. The industry will consolidate and weaker players will exit, creating opportunities for the strongest firms**

Many investment firms are expected to disappear in the next 24 months. The weaker, less motivated and less profitable players will close down, merge or sell to a stronger competitor. Which are most at risk?

- > Investment management arms of global investment banks have been the hardest hit as their parents decided to refocus on their core banking business, sometimes because they simply needed the money to repay the government. Some recent transactions include the sale of Barclays Global Investors<sup>2</sup> and iShares<sup>3</sup>, partial divestments of Credit Suisse<sup>4</sup> (of its traditional fund management business) and by Deutsche Asset Management<sup>5</sup> (of its Asian retail business), and the merger of Societe Generale Asset Management with Crédit Agricole Asset Management<sup>6</sup>. Many others will follow.
- > Special situation groups in investment banks will be closed down as their parents attempt to deleverage and exit what is now seen as a marginal business.
- > REITs that cannot easily access refinancing will be acquired by stronger entities with balance sheet strength.

<sup>1</sup> Including lower management fees, lower carry with possible clawback, key man provisions and control on deals

<sup>4</sup> Credit Suisse completed the sale of its traditional fund management business in Asia Pacific to Aberdeen

<sup>5</sup> Deutsche Bank sold most of its DWS Asian retail business to Beijing-based Harvest Fund Management

<sup>2</sup> Sold to BlackRock

<sup>3</sup> Sold to CVC

<sup>6</sup> Merged into Crédit Agricole Asset Management

- > Private equity managers that have over-levered will lose their equity, with two major consequences: distressed assets will be taken over by entities with stronger balance sheets, and investment teams who have given up hope of getting rich quick will discreetly look for greener pastures.

This, of course, creates interesting opportunities for investors who are committed to their presence in Asia and who will pick up the pieces at a good price. This could also represent a convenient entry strategy for Western investors not present in the region yet, and not affected by the crisis. Well-capitalized institutions will acquire assets and talent that would not have been available before and will emerge stronger from the crisis.

Top investment talent will come at a premium in the next few years. Firms with a weak track record or culture will lose their best people, and the most forward-looking and meritocratic firms will continue attracting them. Meanwhile, the surplus of average professionals will gradually be absorbed by smaller firms, or they will exit the region (in the case of expatriates returning home).

## 2. Independent boutique managers and distributors will emerge

While the industry consolidates at the top, leaving the weaker firms and their assets to be acquired by more committed and better managed competitors, a new generation of boutiques will emerge at the foot of the pyramid. Scale is certainly an important driver of profitability in the industry but there will always be a niche for well-managed sector-specific boutiques to flourish. Where will these boutique managers come from?

- > **From asset management arms at global investment banks.** Many of the best managers and sales people will be drawn to boutiques and pure-play<sup>7</sup> managers that have the patience necessary to build a fund track record and the operating knowledge required to man-

age a portfolio company or a property. In addition to the consolidation described above, banks under TARP or equivalent programs may not be able to compensate their best professionals adequately.

- > **From retail and private banks.** We expect to see a similar trend in retail distribution. Investors will increasingly want to pay for performance or for advice. The best relationship managers, who truly understand the value of long-term advice, will set up independent advisory firms serving high net worth clients and family offices. While a vibrant, independent financial adviser industry (like the one found in Australia) will take time to emerge, independent financial advisers will be winners in this crisis and will capture market share over retail and private banks.

## 3. Product segmentation and pricing will be more transparent

Investment managers will increasingly focus on delivering a transparent performance to their clients. At one end of the spectrum, beta<sup>8</sup> will be delivered by ETF<sup>9</sup> products with very low fees. On the other end, absolute returns delivered regardless of market performance (alpha) will be delivered through de-correlated asset classes (e.g., long-short, commodities, mezzanine/distressed debt, real estate) and offered, for example, by hedge funds or private equity managers. These products traditionally have commanded higher fees, typically 2 percent of assets managed and 20 percent share of the positive performance above a given hurdle.

The crisis revealed that many investment managers were in fact correlated to the markets and therefore delivering beta performance for the price of alpha. Investors are becoming more selective in choosing providers based on their objectives. The days of 2/20 are gone and will be replaced by a more balanced risk sharing and alignment of interest between investor and investment manager (who will now have more “skin in the game”).

<sup>7</sup> Independent long-only or hedge funds that are not owned by a bank or insurance company.

<sup>8</sup> Returns highly correlated to the performance of a given market <sup>9</sup> Exchange-traded Funds (part of the Index Funds family)

Money flows will concentrate either towards cheap, ETF-like products at one end, or towards higher-fee, risk-adjusted-return products at the other end, in a barbell fashion. In between, traditional active long-only equity managers will have the hardest time justifying their value as the belief that active equity management delivers higher returns than an index has been eroded.

#### **4. Investors are becoming more sophisticated**

All too often, Western institutional investors have trusted Asian managers with their money without really understanding how it was being invested or the risks associated. As mentioned above, investors paid managers serious money just to get the benefits of a bull market. Investors are now putting significant effort into understanding Asia. We see this happening in several situations:

- > As money begins flowing more freely into private equity and real estate, investors will scrutinize deals, negotiate carry and fees, and get significantly more control over the general partners than they did in the past. Blind trust will yield to closer control over investment decisions, and funds will become less discretionary. Governance and liquidity of the funds, particularly hedge funds, will be reviewed thoroughly.
- > Risk sharing will be the norm, not the exception. Managers who do not generate returns will not get paid. A number of private equity, real estate and hedge funds have lost significant equity for their investors. These “zombie” funds should logically be closed as the prospect of generating a positive return over the next three to five years is thin.
- > Investor expectations will be more modest. Clients recognize that they will not soon see the levels of return generated between 2004 and 2007. Mega-LBO deals will be scarce, and transactions will center on smaller, earlier-stage situations, where the skills of the managers

in mentoring business owners and coaching companies into successful growth and IPO will be critical.

To implement these strategies, investors will need capabilities on the ground. Flying to Asia four times a year from Frankfurt, Chicago or Stockholm will no longer be sufficient, and we anticipate that investors will soon build local capabilities and absorb some of the surplus talent from the industry.

#### **5. Investment managers will rediscover asset management**

An old Wall Street adage goes, “In a strong wind, even turkeys can fly.” We certainly saw a few Thanksgiving birds flying in the last few years. Across all asset classes, some funds were staffed with young, inexperienced, immodest professionals looking for an avenue to get rich quick. At best, their real skill was in creating leveraged structures to amplify the bull market gains and make them look like geniuses.

Tomorrow’s investment managers will have to understand, in great detail, the underlying companies or assets they are buying into. As markets remain volatile, value will be created by understanding and managing assets. Deal junkies certainly hate the thought of having to manage anything once the deal is done, but the reality of investing means that an asset needs to be seriously looked after in between acquisition and divestment.

In Asia, the scarce skill is not in transacting, it is in managing. Investment banks have produced thousands of vice presidents and directors who can run a transaction. But how many PE professionals really work hand-in-hand with a business owner in Surabaya or in Dongguan when his company gets in trouble? How many real estate investment managers really understand the potential yield of a retail mall in Seoul or in Bangkok with tenants strangled by the crisis? Not surprisingly, the best performing funds today — in private equity or in real estate — are those

that have always emphasized asset management as a core competency. Firms that do not have that capability will need to build it really soon to survive.

The evolution from structuring artist to asset manager has begun.

## **6. Investment managers in Asia looking for plentiful distressed opportunities will be disappointed.**

This is not a repeat of 1997. This crisis is not Asian. It is Western and has been imposed on Asia by way of economic recession. And we won't see too many assets in distress this time.

- > Asian banks are liquid and while they are careful with their lending these days, they are also more than willing to support companies that are fundamentally healthy and are poised to be long-term survivors. Banks are actively working on refinancing and restructuring assets of all classes — corporate debt, REITs and buildings — and charging very healthy fees for this.
- > Asian markets are liquid and rights issues are well-subscribed. There is new equity to be had for solid, long-term assets, even though current shareholders must agree to be diluted.
- > Instead of creating opportunities for distressed funds, many companies will look for growth capital and mezzanine debt that they need to sail through the liquidity crunch and allow them to continue implementing their growth strategies.

Undoubtedly, distress can take many forms and is not always synonymous with cheap debt. As valuations decrease, equity holders can find themselves significantly diluted as new equity is needed just to keep financing in place. Investors with “dry powder” will be well-positioned to take convertible debt positions. Hence we are seeing

borrowers, not lenders, facing distress.<sup>10</sup> Similarly, companies in trouble will be acquired by healthier competitors.

As the crisis unfolds, there will be a large amount of financing needed. But for the majority it will not come from hedge funds or distressed funds. It will come from banks, with stricter lending covenants, from the public markets, and from cash-rich industry leaders.

## **7. Asia will soon again be the brightest spot of the investing world**

As we noted earlier, this crisis is not Asian. Asian economies are well-prepared to survive and rebound. Investor demand remains strong. By 2011, Asia will be positioned to soar faster and higher than ever. What's behind the optimistic outlook?

- > Asia has a high savings rate. Many people made a lot of money in the three years leading to the crisis. People in the region can now afford to continue spending some, even though many are being careful. From Seoul to Jakarta, restaurants, hotels, bars, shopping malls are still busy. Asian economies are driven by wealth as much as by income.
- > Individual and corporate balance sheets in Asia are generally conservatively geared in comparison to their debt-hungry counterparts in Europe and North America. Asia learned its lesson 10 years ago. That's why we see very little activity in the distressed space, as noted earlier.

So what will the region look like tomorrow?

- > According to most observers, the three countries with large domestic economies will continue producing significant growth in GDP. For 2010, the IMF forecasts GDPs of China at more than 7.5 percent, India at more than 5.6 percent and Indonesia at more than

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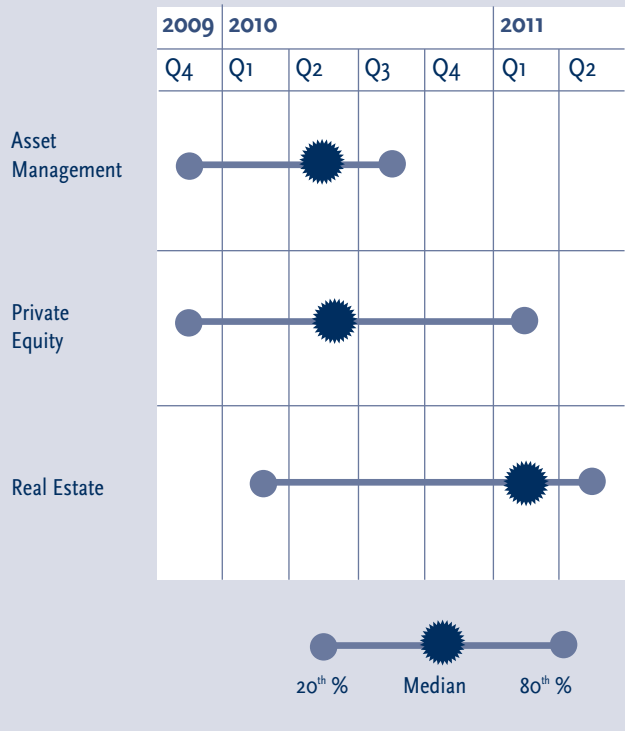
<sup>10</sup> See for example the refinancing of Singapore's South Beach real estate project where original investor CDL and new investor Nan Fung subscribed to a new convertible notes issue, thereby considerably diluting other original investors El-Ad and Dubai World.

3.5 percent. Goldman Sachs recently revised its 2010 GDP forecasts for China and India upward to 10.9 percent and 5.8 percent, respectively.

- > The export-led economies of Singapore and Hong Kong are expected to be flat or modestly positive in 2010 and to bounce back by 2011 when the global economy starts improving. Meanwhile, as they remain attractive locations for multinational headquarters, global investment managers and top talent in the region, these two countries will continue to be as vibrant and exciting as ever. They are at the intersection of current of ideas, in constant reinvention and serve as gateways to China and India (and increasingly the Middle East).
- > There are likely to be economic losers from the crisis, at least in the short term. Countries like Thailand, Malaysia or Vietnam offered attractive rewards for opportunistic investors, but the same rewards can now be achieved by investing in the distressed Western markets. To many, when a foreclosing property in London, distressed debt in Spain or a private corporation in the U.S. are available at fire-sale prices, the riskier economies in Asia lose their shine. These markets are generally expected to take the longest to fully recover as an investment destination.
- > A fast return to growth may not be all that beneficial to Asia. Firms may be tempted to quickly return to the hiring and operating practices that led up to the crisis, and abandon the “back to basics” approach that we are advocating.

## Timing of recovery

We asked leaders when they believe their industries will begin recovering from the crisis.



## 8. The war for talent will continue raging — for a long time

Employers and recruiters will be much more selective. Here are the implications of the seven predictions above. Here is our take on who the winners will be.

**Risk management.** We wrote extensively on the topic in a previous *Viewpoint*<sup>11</sup>, anyone who can implement a robust risk infrastructure at an asset management company or a fund will be in high demand.

**Knowledge of industry and underlying assets.** Real estate investment managers will hire construction managers and asset managers, people who are not afraid to wear hard hats, to talk with maintenance and engineering about upgrading a building, to negotiate rents with tenants or to map foot flow in a mall. Similarly, private equity firms will hire managers who can sit on boards, coach business

<sup>11</sup> Look for the April 2009 article by James Lawrence-Brown, “One eye in the rearview mirror. A look at the challenges facing the risk function in Asia,” at [www.spencerstuart.com](http://www.spencerstuart.com)

owners, review a competitive strategy and implement a cost-cutting plan. Professionals with engineering or consulting backgrounds will be in increasing demand.

**Fund raising.** As institutional investors become more demanding, fund raising will be much more challenging than it has been. The ability to work closely with investors, to help them understand what they are buying into, to explain and negotiate fund prospectus, will be critical.

**Product design.** Fund design strategy that appeals to investors — retail or institutional — will once again become the core component of managing a successful investment shop. As simplicity and transparency dominate, product designers won't be able to dissimulate their ignorance of customer needs behind overly complex structures. Conveying the values of the investment team, including governance and risk management, will be an important theme.

**Investment skills.** It may sound like a platitude to emphasize that investment skills should be core to any asset management business. Yet, as leverage dominated and the bull market produced investment “gurus” by the handfuls, the obvious was forgotten. While the most conservative, long-only, equity and fixed income houses maintained rigorous recruiting and evaluation processes, others took their eyes off the ball. Tomorrow will be “back to basics,” with a focus on process and investment track record, deep understanding about the assets that are being bought and the ability to create value in excess of the index.

**Asian skills.** When the U.S. and European markets started to tumble in late 2007, we received many candidate calls from North America and Europe. Suddenly, passions about Asia were discovered. As we listened to the litany of “I always wanted to work there” and “my skills must be in demand,” we occasionally found ourselves wondering, “Where were you when we really needed you five years ago?”

The ability to work across Asian cultures, to understand companies, business owners, the way local banks think about lending and the legal environments; the ability to communicate, to understand and to be understood; the ability to negotiate, to know when to push and when to yield — all of these capabilities take years to acquire. For the most part, our senior search mandates see successful candidates being Asians or expatriates having broad experience acquired working across multiple countries in the region with very few cases of “importing” talent from the distant major markets.

**Overall talent management strategies.** The competencies critical to succeeding in 2010 and beyond are scarce. Many firms are not fully equipped to operate in the “back-to-basics” scenario we are describing. Meanwhile, many investment professionals do not have the skills that they need to advance their careers in Asia. We foresee this mismatch being resolved progressively over the next few years through a number of talent management strategies:

- > **Direct hiring from competitors** — firms with an attractive talent acquisition and retention strategy will continue to get the best people.
- > **Mentoring** — pairing up younger talent with experienced investors to facilitate skill transfer.
- > **Re-positioning (a.k.a. demoting)** — giving staff who have been promoted too soon simpler responsibilities until they acquire the skills they lack.

For firms and professionals alike, this adjustment may be painful but necessary. As we see hiring slowly resuming and picking up in the second half of 2009, it is time for everyone to reflect on what strategies will work best for them.

## Conclusion

No one has a crystal ball to accurately predict the timing of the recovery. Many of the senior professionals we spoke to expect that we will see the first signs of improve-

ment in the industry at some point during 2010. The road to recovery will be fraught with challenges as the crisis is helping to purge the system of the excesses of the past few years.

What we know for sure is that, regardless of timing, the fundamentals for growth are so compelling in Asia — dynamic and hard-working population, high savings rates, healthy financial system, improving governance and infrastructure — that the region will experience tremendous growth in the coming years.

To fuel this growth, talent will be at a premium, and the winners will once again be those who can attract the best of the best, motivate them, compensate them, train them and provide the best opportunities.

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