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ASSET MANAGEMENT FIRMS MUST ADAPT OR DIE

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“Many of the jobs and even the industries of today will be gone tomorrow” said the Governor of the Bank of England last year. In just five years, according to BMW, autonomous vehicles will be capable of making life or death decisions. In Seattle, Amazon is trialling a store with no cashiers or checkouts, consumers simply walk out of the store and are automatically charged for their shopping. Much has been written on the impact of technology on consumer industries, but what does the future look like for those tasked with the critical role of managing our money?

News announced recently by BlackRock, the world’s largest asset manager, offers a clue. The company announced a shift from active management to technology driven investing affecting \$30bn of assets under management. Albeit small in terms of BlackRock’s overall assets under management the news has sent reverberations around the industry.

So what’s going on in asset management?

Three powerful forces are combining in such a way that will drive profound and lasting change for an industry that looks, in places, increasingly anachronistic. These forces are: the ongoing proliferation of data, rapid technological advances and fees not commensurate with performance.

It’s hard to find words to convey the sheer volume of data that is now available to collect and analyse. A typical day at our firm involves the collection and presentation of 2.5 terabytes of information mainly in the form of market data, equivalent in scale to a typical academic research library. Growth in data has been exponential and this trend will continue, giving - in the short term - those firms and people comfortable working with big data sets a clear advantage. Over time this won’t just be an advantage, it will be a prerequisite.

In the 26 years our firm has been in existence we’ve witnessed the end of, inter alia, the fax machine, the use of the telephone for placing orders and the telex. For those firms that have invested in it, technology has revolutionised both the collection and analysis of data and also the interaction with those local and global exchanges that underpin financial markets. The asset management firm of the future will more closely resemble a technology firm.

We use servers to collect data and powerful computers to execute trades and monitor the impact of our trading on the market. But this isn’t simply a case of the march of the robots. The people we hire, from academic backgrounds like engineering and science, will become ever more prevalent in asset management. The emphasis will continue to shift from firms full of people trying to read the markets, to people that can manage and build the machines and algorithms that trade the markets. Systematic trading isn’t something to fear, after all the increasingly popular indexing is the simplest and oldest quantitative strategy.

And this is set against the backdrop of a more widespread acknowledgment that, on average, investors are better off tracking an index than giving their money to an active manager, an activity still seen as synonymous with asset management. Poor performance is not the only criticism levelled at the industry, fees are also much maligned.

But the issue isn’t simply poor performance and high fees. It’s complicated by the fact that the nomenclature and basis upon which investors invest is binary and outdated. Alpha and beta should be unambiguous concepts with genuine alpha (returns decorrelated to a mainstream or alternative index) rare, necessitating sustained innovation and investment to generate and therefore commanding appropriately high fees. Beta is simply tracking the market and can be delivered at scale and at low fees reflecting its abundance.

But there is a growing grey area in between the two with products akin to beta, like smart beta (index tracking on factors other than market cap) and further up the scale alternative beta increasingly offered by hedge funds as scalable strategies which deliver low levels of correlation to mainstream indices, but with lower fees than a pure alpha fund. For too long many hedge funds and others have masqueraded under the banner of alpha generators and charged associated fees, when in fact the outcome is no better than a market index. Not unreasonably, investors have had enough.

So what does the future hold?

Data proliferation will continue and all firms will need to equip themselves to be able to cope with this and use it to build investment strategies. There will be more sophisticated and transparent ways to measure performance, forcing firms to charge fees associated with the returns they deliver. Technology, already important, will remain a dominant theme and drive structural change as an enabler of both analysis and executer of

trading strategies and the winners will invest in the right human capital to manage this trend. And the good news for investors is that they will have an increasing range of products to choose from right across the returns spectrum, with more sophisticated and quantitative ways of mitigating risk. As Charles Darwin said: "It is not the strongest of the species that survives, not the most intelligent that survives. It is the one that is the most adaptable to change."

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