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Tasks facing asset manager executives

Nomura Research Institute, Ltd.

We interviewed executives at 20 of Japan's leading asset management companies in December 2006 and January 2007. While many were upbeat on the business outlook, some noted a tightening labor market and indicated concerns about maintaining quality in such a rapidly growing business. We think managers will increasingly need to focus on the scalability of operations.

Upbeat business outlook

We interviewed executives at 20 leading Japanese asset management companies in December 2006 and January 2007, asking them mainly about business issues. Twelve of the companies were foreign and eight were Japanese.[1)] Nearly all of them managed assets in excess of 1 trillion yen.

The companies have benefited from an outstanding business environment in recent years. In FY05, those firms engaged solely in asset management[2)] reported a 34% operating margin on revenues of some 540 billion yen. Revenues had doubled since FY01, rising by about 20% a year. In FY06,[3)] revenues from investment trusts alone are expected to exceed 100 billion yen. When investment advisory firms are included, the likely total exceeds 700 billion yen, a new record.

Encouraged by this business environment, all of the executives interviewed were bullish on the future. But the favorable climate has come at a price. The market for qualified staff is now a seller's market, leading some executives to worry that they will be unable to attract the employees they need and that this will impede further expansion and profit growth. Some also voiced concerns about their ability to maintain quality with so many new staff. Below we discuss what companies need to do to sustain recent profit growth, with a focus on comments from the executives we interviewed.

Investment trust issues: product development and sales

Investment trusts are a pillar of the business. Competition is fierce, and growth requires determined efforts. The most popular investment trusts at present are those that investors treat as a kind of savings account, with many offering a monthly distribution. Some of the executives interviewed felt that funds designed to assist with long-term asset formation would also become more important. One example is the so-called target-year funds that have become increasingly popular in the US and which Japan's post offices are scheduled to begin selling.

Support for the sales of investment trusts is one of the most pressing problems for asset management companies. Only large companies capable of assembling teams with solid sales support skills are able to work successfully with Japan Post and other large entities with broad-based sales organizations. The recent growth in the asset management business has resulted in a much tighter market for skilled staff, with many companies now finding themselves unable to expand their marketing staff to desired levels. Some firms are using life insurers, with which they forged ties in the management of variable annuities, to provide indirect support for sales companies. Eliminating these bottlenecks in sales support is a pressing issue for asset managers.

Towards a consulting-driven pension business

In contrast to investment trusts, the pension business is already a mature market, and substantial growth in assets is unlikely. Many executives are therefore trying to deepen relationships with existing customers. The era of selling single products is over, in their view. Instead, they seek to establish a consulting-based sales model that looks at the entire portfolio of pension funds and offers recommendations tailored to the customer's individual needs. A number of foreign companies are considering transferring consulting expertise garnered overseas to Japan. Going forward, we expect these firms to fine-tune their expertise to the Japanese market and offer more advice to customers.

There is a shortage of marketing staff capable of providing such consultations, and here the labor market is even tighter than for investment trust salespersons. As such, the biggest task facing managers is bringing together needed staff and skills. The shortage of talented staff is a potential bottleneck to future growth in both investment trusts and pension business.

Major issues on the personnel front

In both fields, workforces have surged as the businesses expanded. This rapid growth in staff has created a number of problems for managers.

One is concerns about the allocation of human resources. In their focus on growth, managers have tended to emphasize quantity over quality and may not have done enough to ensure that the right people are being assigned to the right positions in the right numbers. At many of the companies interviewed, the number of staff had nearly doubled in the last three years. One of the foreign firms, however, reported that while assets under management had doubled in the past few years, staff levels had increased only slightly. This company had responded to the increased workload by carefully defining job responsibilities and boosting the efficiency of existing staff. The interviews confirmed a need for managers to conduct comparisons and objectively assess whether current staff postings are appropriate.

Another issue for managers is quality control. Concerns exist about whether all the new staff are discharging their responsibilities capably—ie, whether quality is being maintained. For example, there are concerns about whether data are being properly checked when calculating NAVs or preparing reports for customers. Some managers also noted that it was important to minimize compliance risk by putting stronger internal controls in place.

A third problem was concerns that rising personnel costs would squeeze profits. A tighter labor market has pushed personnel costs sharply higher.[4)] With labor costs representing a significant portion of total costs in the asset management business, this could squeeze profits unless there is continued steady growth in assets under management.

Quality of management may drive growing profit disparities

The next question, of course, is how to deal with these problems. To continue growing without impairing quality or further increasing already high staff levels, the scalability of operations will have to be improved. Enhancing scalability involves building organizational structures and processes enabling the company to adapt flexibly to a larger workload without hiring more staff.

The first requirement is for the preparation of written specifications identifying various tasks within the organization. There is a traditional tendency in this industry for expertise to reside in individuals. Clarifying operational processes by putting them in writing improves transparency and therefore improves quality and promotes the assignment of the right people to the right positions. It also makes it easier to replace individual employees when the need arises.

Another point is the development of systems to enable the efficient implementation of more transparent investment processes. Computer systems play a critical role in enhancing efficiency through the use of quality-assured integrated databases.

Japan's asset management business is expected to grow significantly in the coming years, driven by higher sales of investment trusts. For asset managers to succeed in this rapidly growing field, they will need to improve their investment performance while enhancing the scalability of operations. We think their success (or lack thereof) in these efforts will almost certainly lead to a widening earnings disparity between firms.

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Note

1) We interviewed company presidents at 13 of the 20. At the remaining seven firms, we spoke with managing or senior managing directors.

2) Not including trust banks, life insurers, or managers dealing solely in real estate.

3) Figures for FY06 are based on data through end-December 2006, annualized.

4) Some executives said that personnel costs had risen by about 70% for certain positions.

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