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Slash-and-Burn Budgeting Can't Save Managers' Profits: Baillie Gifford

By Jill Gregorie March 11, 2019

The investment management "gravy train" is rapidly losing steam, and shops need to spend more money — not less — if they hope to stay on track, according to a Baillie Gifford executive.
"[C]ompanies that respond to customer pressure by cutting their costs rather than investing in their capabilities will, in our view, merely hasten their journey to irrelevance," wrote Tom Coutts, a partner and portfolio manager at Baillie Gifford, in a first-quarter 2019 commentary.

Coutts compared shops' current predicament to the "Peak Oil" concept, or the point at which no more value can be extracted from one resource.

Active managers that now recognize their business models are unsustainable can make changes and seize opportunities if they are willing to take on risks and don't focus only on protecting the assets they've already acquired, Coutts wrote.

"It seems to us that most funds' fees are too high, most so-called investors' time-horizons are too short, and most firms operate with their eyes focused inwardly on their own interests rather than outwardly on their clients," he wrote.

Instead, shops should consider taking on more of the costs they may have traditionally pushed onto end investors, "and those costs should increase as [they invest] more in in-house corporate governance and investment research functions," Coutts wrote.

Perhaps the most immediate example is with the cost of third-party research, according to Coutts, whose firm's headquarters is in Edinburgh, Scotland. European regulations that took effect last year require managers to break out for investors what they pay various institutions for research from what they pay for trading.

Many firms were cast in a negative light after "foot dragging attempts" to avoid paying for broker research out of their own coffers, according to Coutts. But the regulation prompted others to begin absorbing the cost of research that was previously bundled into the fund price and passed along to investors.

Ultimately practices in Europe prompted some managers to begin doing the same in the U.S. Companies including Capital Group, Dimensional Fund Advisors, MFS and T. Rowe Price have begun covering the costs of third-party research out of pocket, as reported.

Another example of shops' swallowing costs they may have previously passed on comes from Pimco, which this year ate the costs of commissions and underwriting fees ahead of a closed-end fund launch. The Newport Beach, Calif.-based shop determined that eliminating financial barriers might “give investors a reason for buying closed-end funds at IPOs, especially if they had been disincentivized by upfront fees in the past,” a spokeswoman told *Ignites* at the time.
Seed capital for new products is another area where shops’ spending now can pay off later, says Whitfield Athey, CEO of **Delta Data**.

Many funds take years to get to scale, and may not be accepted onto intermediary platforms until they hit $200 million in assets, Athey says. Shops need to think hard about the potential for viability and scale of new products, particularly at a time “when everybody agrees there’s too many out there,” he says.

But for companies who have true conviction in a new idea, it may be smarter to plow resources into that product than to try out many options, he says.

“Asset managers need to be less focused on the latest ‘it’ product and more focused on where they can deliver the most value, which should be strong portfolio management and deep research expertise,” Athey says.

Baillie Gifford’s Coutts points to governance as another smart place for investment managers to invest in themselves.

Athey points to monitoring holdings and ensuring that portfolio managers are engaged in the companies within their portfolios.

While cutting costs won’t necessarily lead to profits, shops still must trim the fat by identifying overlapping functions, automating tasks where possible and killing off low-growth product lines, says Amanda Walters, senior manager at Casey Quirk.
“In the past, many managers dabbled in a lot of different hobbies, some of which were only marginally profitable, and then sustained them rather than rationalizing things that weren’t working or aligning with their long-term goals,” she says.

Companies are now looking carefully across strategies, channels, geographies and products to identify where they may be sacrificing revenues or compromising the longevity of their firms, she says.

Firms should assess where they may have a competitive advantage, and determine how to supplement it with technology, Walters says. A research-oriented value investor, for example, may want to build up data systems and hire quants who can run them.

Savings through those exercises should be redeployed into other areas, such as technology, says Walters. In fact, most firms that successfully reinvested 2017 profits to boost revenues allocated more than 9% of that kitty toward technology, compared with the average of 6.2% across all firms, according to a November Casey Quirk white paper titled “Industrial Evolution.”

The “profitable growth firms” also increased tech spending levels three times as quickly as lagging peers, Casey Quirk found. The analysis included responses from asset managers in the U.S. and Europe, but the number of firms was not available at press time.

Until now, the managers seem to have chosen one of two paths to address margin pressures: “Get big or get specialized,” says Sean Tuffy, head of market and regulatory intelligence at Citi.

But a middle ground that more managers are likely to pursue involves smaller acquisitions that help them fill product gaps or get access to overseas or new markets, he says.

Expanding the vehicles in which products are delivered is another option, Tuffy says, citing a “surge in interest in things like collective investment trusts and interval funds.”