Life After Benchmarks:

Retooling Active Asset Management

November 2013

Most current active investment strategies are becoming outmoded. Investors' requirements and frameworks are moving away from rigid benchmark-based allocations towards risk-factor and outcome-based mandates.

Next-generation "New Active" strategies will represent nearly 45% of industry revenue opportunity worldwide through 2018. New Active strategies will attract $3.4 trillion of inflows through 2018, while legacy active portfolios will lose more than $1.8 trillion. In comparison, **passive strategies will attract only $1 trillion** during the same time frame.

There will be six categories of New Active strategies, all of which erase the line between traditional and alternative investments by incorporating more innovative techniques in friendlier packaging:

- Broad debt investments
- Benchmark-agnostic equity
- Private capital strategies
- Trading strategies
- Dynamic multi-asset class solutions
- Real assets platform

Asset managers can employ any of three levers to retool legacy strategies: resetting risk guardrails, expanding the investment universe, and obtaining new capital market skill sets.

The optimal path forward will vary according to manager credibility, current client footprint, and institutional appetite for change. Aggressive changes, characterized new capital-market skills, can open up 47% of revenue opportunity from New Active products through 2018.

Managers will adopt New Active strategies using a four-step process: defining their investment return driver, further developing investment skills, designing product and packaging, and enhancing distribution.

To successfully transition to a New Active product set, asset managers must update key elements of their operating models, including product management, fee and capacity management, distribution strategy, investment team compensation model, and investment team structure.

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Casey, Quirk & Associates is a management consulting firm focused solely on advising investment management firms worldwide. Our partners and associates help our clients develop broad business growth strategies, improve investment/product appeal and growth prospects, evaluate new market and product opportunities, and enhance incentive alignment structures. Our unparalleled industry knowledge and experience, detailed proprietary data, and global network of relationships make Casey Quirk the leading advisor to the owners and senior executives of investment management firms in the world.

1. Introduction:

Our firm began predicting the shift toward New Active strategies as early as 2009, with these concluding thoughts from another white paper, *The Hedge Fund of Tomorrow: Building an Enduring Firm:*

"Hedge funds have the opportunity to be at the forefront of asset management, and vie for control of a far greater asset pool… if they can get the alignment and business balance right and become fully-fledged asset management companies, this industry will redefine the products and services that characterize 'active asset management'."

Since then, investors have accelerated their shift away from classic benchmark-centric "active" strategies and into a wide range of newer, benchmark-agnostic strategies. This paper will define "New Active" asset management, regardless of asset class, by addressing the following questions:

- How have the mindset and asset allocation approaches of investors changed?
- What types of products and strategies will capture significant future revenues?
- How should managers evolve to benefit from these changes?

This paper's conclusions stem from more than 120 interviews Casey Quirk conducted with intermediaries and asset owners during 2013. Our firm also gathered data through a number of ongoing surveys, including our Large Asset Owner Survey (focused on large institutional investors worldwide), the Casey Quirk/eVestment Consultant Search Forecast (global asset consultants), and our surveys of key fund-of-hedge-funds and fund-of-private-equity-fund providers.

We also created a financial model that informs asset and revenue growth projections used throughout this paper. The model estimates revenue growth from three sources: shifts in allocation away from benchmark-oriented products; organic growth in new strategies, and capital appreciation. We often estimate *revenue opportunity*, which we define as fees generated from money in motion: both turnover and new flows.

2. The New Active Model

The 2008-2009 global financial crisis accelerated a process that already had started: investors worldwide are starting to modify legacy models built on static allocations to narrowly-defined asset classes.

Exhibit 1

New Investor Expectations

	Allocation-Oriented Approach	Outcome-Oriented Approach
Investor Objective	• Beat return bogey (absolute, policy, peers)	• Improve probability of meeting future cash-flow needs
Investor Framework	• Static allocation • Driven by historical return assumptions across asset-classes • Capital-weighted • Primary investor effort: manager selection	• Dynamic allocation • Driven by prospective return assumptions across risk factors • Risk-weighted • Primary investor effort: risk allocation
Manager Implications	• Narrow mandates tied to benchmark • Differentiation on product and process features	• Broad mandates: only risk factor is well-defined • Differentiation on application: how does this strategy fit with client-specific objectives?

Source: Casey Quirk

An emerging *outcome-oriented* asset allocation approach has profound implications for asset managers. Instead of designing portfolios to beat market benchmarks, outperform peers or avoid mark-to-market losses within narrow time frames, most institutional and individual investors (through their advisors) are orienting portfolio strategy around quantifiable outcomes, often specific future cash-flow needs.

In turn, these customized objectives generate a risk-weighted allocation, not a traditional capital-weighted approach to portfolio design. Inputs are prospective, not historic, risk and return levels, and the output is a target portfolio of risk factors, not simply security types. Furthermore, because risk-return tradeoffs change over time, there is a growing recognition that the asset allocation process must be dynamic.

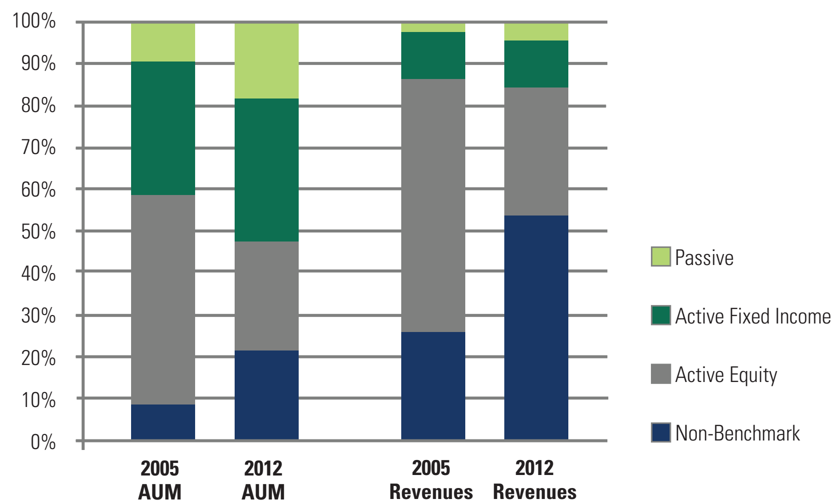
This has three major implications for asset management firms:

- Investment strategies tied to narrow benchmarks (such as style boxes) will give way to broader mandates centered on key risk factors and risk-return profiles.
- Investors will spend more time determining desired outcomes and designing a dynamic asset allocation framework, and less time selecting individual managers.
- Asset managers must differentiate themselves less on product features and more on the direct application of their strategies within a prospective client's asset allocation strategy and desired outcomes.

The world's largest asset owners and intermediaries have spearheaded this transition, particularly as their cash-flow needs have become more acute in the more volatile post-crisis environment. Increasingly, however, we expect investors of all sizes and types worldwide to adopt more outcome-oriented asset allocation frameworks.

Exhibit 2

U.S. Institutional Investors: AUM and Revenues by Strategy, 2005-2012



Source: Casey Quirk

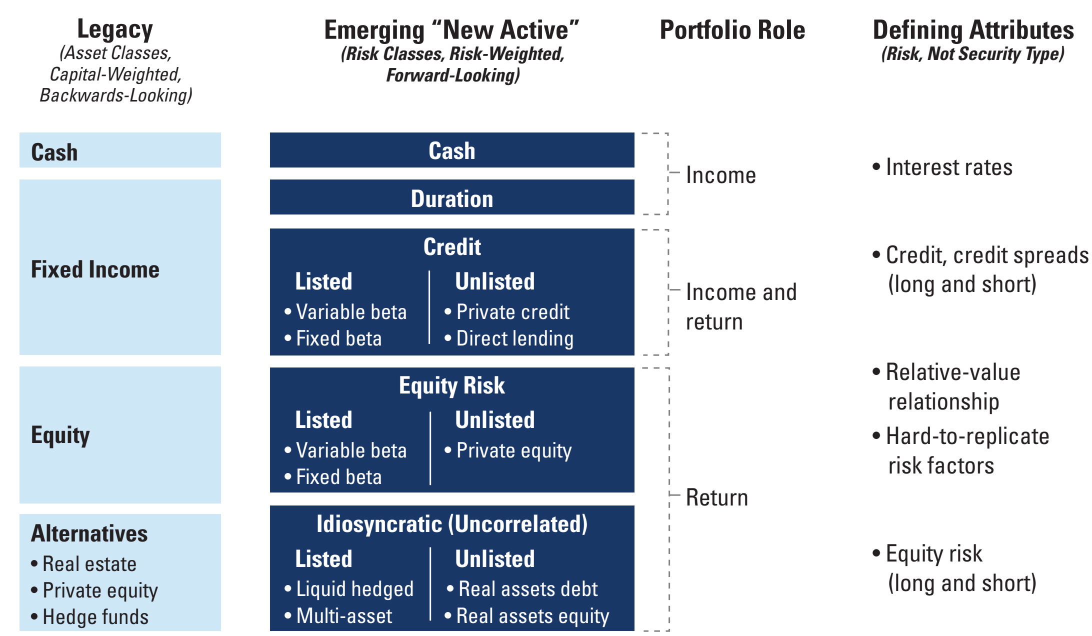
3. A New Allocation Framework

A focus on risk factors rather than security types characterizes the emerging "New Active" allocation framework. In general, three major sets of risk factors will drive portfolio performance:

- Interest rates or duration risk
- Equity risk
- Idiosyncratic risks (including illiquidity, scarcity, relative value, and other trading-oriented or arbitrage risks)

Exhibit 3

The Emerging New Active Asset Allocation Framework



Source: Casey Quirk

Six types of evolving investment strategies will align well with this new framework. All of them share a few common attributes:

- They are built around absolute risk-taking skill sets, not designed relative to a benchmark.
- Their objectives involve delivering returns relative to a volatility target or range.
- They rely on high-conviction investment styles.
- They are not driven by security type or liquidity constraints (where mandates and vehicles allow).

Exhibit 4

Evolving New Active Investment Strategies

	Defining Attributes (Risk, Not Security Type or Vehicle)
1 Broad Debt Investments	• Credit worthiness, credit spreads, interest rates
2 Benchmark-Agnostic Equity	• Equity risk(s)
3 Private Capital Strategies	• Illiquidity, equity risk, credit worthiness
4 Trading Strategies	• Relative value relationships, market inefficiencies, liquidity provision
5 Dynamic Multi-Asset Class Strategies	• Cross risk factor, cross asset relationships
6 Real Asset Platform	• Hard-to-access, hard-to-value assets; illiquidity

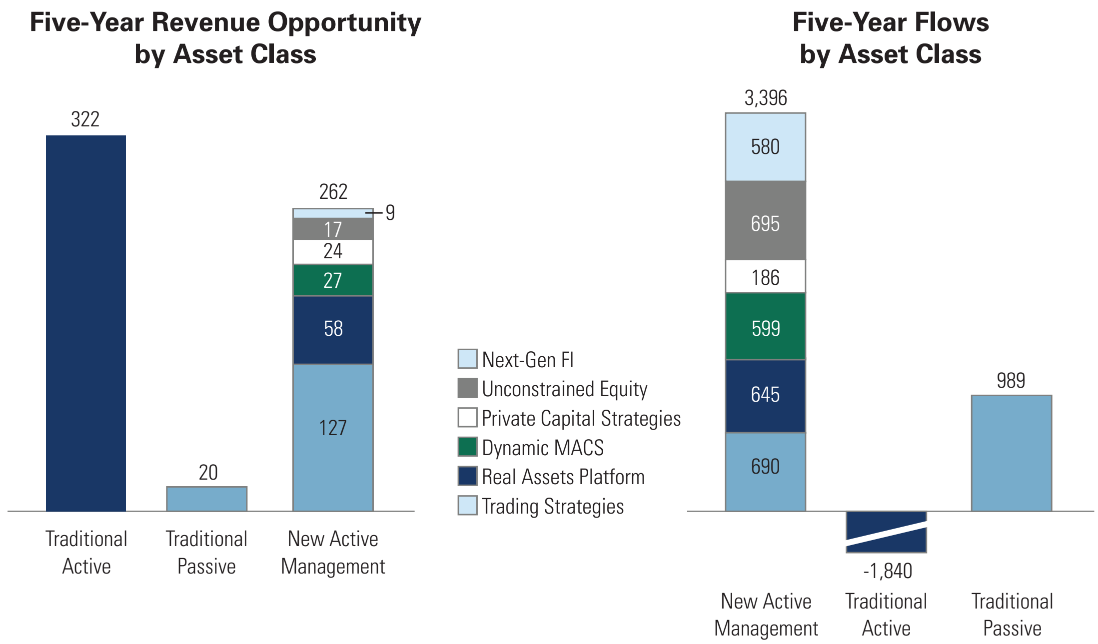
Note: See Appendix for detailed discussions around each New Active strategy.
Source: Casey Quirk

These shifting investor demands will transform the economics of the asset management industry, as sources of revenue shift from outmoded to emerging investment strategies. Traditional, benchmark-oriented active strategies will struggle for share within a large but slowly shrinking global pool of assets, while “new active” strategies will benefit from sustained inflows from organic growth and turnover.

New active products will capture more than $3 trillion of cumulative inflows from 2014 to 2018, much of that coming from $1.8 trillion of outflows from traditional active strategies. In terms of revenue opportunity, turnover within the large embedded base of traditional active assets—driven by investors who remain wedded to benchmarks—will remain significant. But this will become a takeaway game increasingly dominated by scale beta-plus providers. The more vibrant, growth-fueled opportunities will come from new active strategies. New active strategies will grow much faster than passive products, which will represent a smaller fraction of opportunity for asset managers.

Exhibit 5

Global Asset Management Industry Net Flows and Revenue Opportunity, 2014-2018E (US$billions)



Note: Revenue opportunity represents fees from manager turnover and net new growth.
Source: Casey Quirk

Institutional and individual investors should represent relatively equal revenue opportunities for New Active products. On the individual side, liquidity concerns and the need for regulated vehicles will remain key constraints, and so the most relevant New Active strategies will be trading strategies, dynamic MACS, and more liquid, listed forms of real assets. Institutional demand is more evenly distributed across the six investment engines, showing a more pronounced willingness to take on illiquid strategies.

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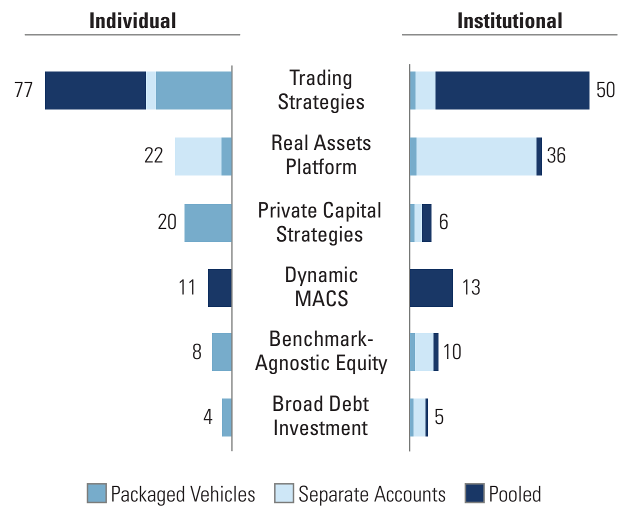
Exhibit 6

New Active Revenue Opportunity by Strategy, Segment and Packaging, 2014-2018E (US$billions)



Note: Revenue opportunity represents fees from manager turnover and net new growth.
Source: Casey Quirk

4. Retooling the Investment Engine

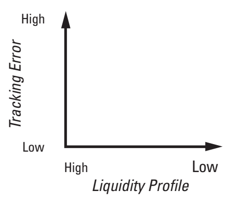
How can asset managers, particularly those firms where legacy benchmark products account for the bulk of current revenues, reposition themselves and regain relevance? To evolve, "traditional" asset managers must adapt their investment engines to new demands by introducing tools and investment approaches from the "alternative" investment world. Managers can pursue any or all of three sets of changes. These innovations are not mutually exclusive: asset managers should consider a mix that best reflects their own business needs and the likely requirement to maintain, for some time at least, both legacy offerings (where current revenues lie) and New Active offerings (from where growth will come).

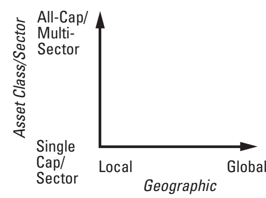
Exhibit 7

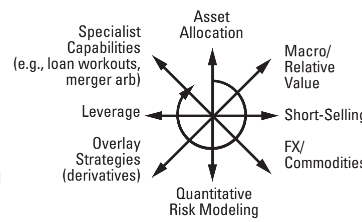
Capability Levers for New Active Management

	1 Risk Lever	2 Universe Lever	3 New Skill Sets Lever
Definition	• Extend existing investment approach by reducing risk guardrails, increasing conviction	• Extend existing investment approach to expanded investment universe	• Develop (or acquire) skill set for entirely new investment approach
Focus	***Risk-Oriented Capabilities***	***Universe-Oriented Capabilities***	***Tool-Oriented Capabilities***

Lever Dimensions







Note: Each capability lever may not apply for every New Active operating model.
Source: Casey Quirk

Changes to the investment engine can be described as three different "capability levers" which managers can pull:

1. **Risk Lever:** Likely the least disruptive lever, the Risk Lever untethers an existing investment process from a market benchmark, instead tying it to an outcome (target risk level and return). This change presupposes that a firm's investment team has the skill and investment insight to generate strong returns without the protective cocoon of a benchmark. Recent fixed income mandates provide a good example of this lever's potential impact, notably the increased growth in allocations to high-yield debt strategies that allow the use of bonds and loans in multiple currencies, permit exposure to select equity or equity-like securities (notably post-reorganization), and mostly disregard legacy U.S. high-yield bond benchmarks.

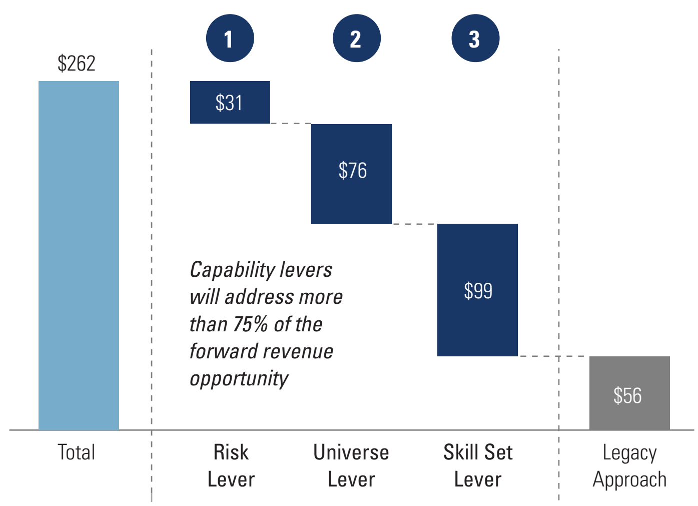
2. **Universe Lever:** The Universe Lever has the potential to unlock more potential revenues than the Risk Lever, but likely requires deeper changes to process and personnel. Applying this lever means appropriately applying an investment process to a broader set of securities. Real assets provide a recent example of using the Universe Lever. Some real asset managers have added appropriate staff to successfully extend a core skill set in unlisted property or infrastructure into related listed equities or debt, public or private.

3. **New Skill Sets Lever:** In certain situations, existing benchmark-oriented investment processes will be insufficiently flexible or effective to let asset managers apply either the Risk Lever or Universe Lever. In these situations, asset managers will need to build New Active capabilities from the ground up, often entirely separate from the legacy team.

Today, these new skill sets are found almost exclusively in either alternative firms or in capital market roles. They include: comfort with investing in securities that have a path-dependent payout (shorting, certain types of derivatives), direct origination of potential investments in the private markets (debt or equity), and experience with top-down, dynamic multi-asset risk taking.

Exhibit 8

New Active Revenue Opportunity Potential By Capability Lever, 2014-2018E (US$billions)



Source: Casey Quirk

5. Becoming a New Active Manager

To evolve, legacy active asset managers must not only determine the most appropriate mix of capability levers to apply to their traditional products, but also create a plan to develop competitive New Active offerings consistent with any of the six strategies outlined in Section 2.

Legacy managers that refuse to change will, over time, see their business erode. Embracing change, however, is easier said than done, as the risks involved in a botched retooling of the investment engine can be catastrophic. Therefore, asset managers should carefully consider the best mix of capability levers with which to retool their investment engines. The most relevant factors guiding this process include:

- **Credibility:** Building New Active capabilities that can co-exist alongside current investment strengths and function as next-generation strategies.
- **Current business footprint:** Creating New Active offerings tailored to the specific needs and requirements of the managers' strongest client channels and geographic markets, and where trust in the manager is highest.
- **Institutional adaptability and resilience:** Developing New Active capabilities that require measured evolution (not revolution) in the broader manager infrastructure, including operations, trading support, distribution, and investment team compensation.

Additionally, a four-step process can guide most managers in the transition from legacy products to New Active offerings.

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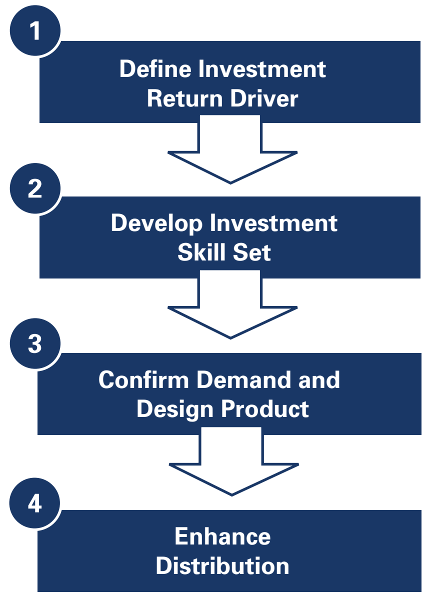
Exhibit 9

New Active Retooling Process



Source: Casey Quirk

1. **Define investment return driver.** Successful New Active managers will adopt the best competitive positioning to differentiate their products from others available in the marketplace. Such positioning not only underscores the value of the New Active approach—a solid defense against fee pressure—but also underpins the firm's investment innovation and leadership credentials, a key success factor for all asset managers. Winning New Active strategies should center on a unique risk-taking ability that is process-driven, repeatable, and capable of delivering meaningful net returns consistent with the desired outcomes of target investors.

2. **Develop investment skill set.** This involves adapting the firm's investment process through adding innovative capabilities, as described in the previous section.

3. **Confirm demand and design product.** Successful New Active managers will create a process to confirm that specific product parameters (e.g., target risk and return, capacity, concentration and turnover) and packaging considerations (e.g., fund structure, fee structure, liquidity terms, and operational factors) are suitable for both the investment strategy, as well as the requirements and preferences of prioritized clients. This is an iterative step, and should include input from client-facing professionals, as well as investment professionals and (within reason) direct client input.

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4. **Enhance distribution.** The sale and ongoing support required for New Active products is more resource-intensive than that of legacy products, and often requires a more complex engagement model. Successful New Active managers will upgrade and augment distribution resources and structures in order to communicate the New Active capabilities in a highly technical, application-based way, supported with deep investment expertise and tailored content and reporting.

The degree of transformation required for many legacy active managers to deliver New Active strategies will force substantial changes to their operating models.

Exhibit 10

Operating Model Impact of New Active Strategies

Operating Model Impact

New Active Investment Engine

Product Management
- Product development centered around client application, not vehicles
- Ongoing product management function tasked with capacity rationing and changes to fees
- Obsolete products retired

Fee and Capacity Management
- Fees must yield competitive net returns to the end buyer
- Ration scarce alpha into highest fee offerings
- Balance maximization of revenues with mix of channels and investors

Distribution Approach
- Application-centric, highly technical
- Close engagement with investment professionals and product specialists
- High level of ongoing, post-sale knowledge transfer to clients and intermediaries

Investment Compensation Model
- Align investment teams with end buyer outcome, not peer performance
- Ensure consistent framework and approach across investment organization– no "special deal" for New Active teams

Source: Casey Quirk

Key considerations include:

1. **Revenue optimization.** Successful New Active asset managers will adopt a multi-disciplinary approach to optimizing scarce investment capacity by ensuring that the products, vehicles, and fees target client relationships representing the greatest potential long-term value. Other industries, in particular luxury goods and services, have systematized and quantified this process. Active asset management should do the same.

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2. **Investment orrganization structure.** For many asset management firms, building New Active capabilities will require co-existing with legacy teams and products. Determining the optimal organizational structure from the outset—including which resources and processes are shared, the degree of autonomy and segregation between teams, and distribution commitment—is a critical step. A guiding value here should be "what makes the most sense to our clients": aligning investment capabilities and team structure to distinct client and channel requirements is a good start.

3. **Retooling compensation.** This applies most directly to investment teams, but over time, the broader organizational requirements of building a successful New Active business likely will impact compensation in other functions as well. Winning New Active managers will find ways to align investment teams' long-term compensation to clients' outcomes, as well as to the health of the broader asset manager, not simply this year's performance of a single portfolio. For the broader organization, but particularly distribution, compensation models that are team-oriented and tied to specific relationship goals (including retention), and not simply gross sales, are more effective in growing revenue growth in New Active product strategies.

4. **Operating support.** As New Active managers move into new security types and trading styles, their support infrastructure must evolve as well. Necessary changes will include technology upgrades, the ability to support a far wider range of securities (including derivatives, illiquid assets), trade allocation policies, and pricing schedules that promote the higher value of New Active strategies without impairing the short-term salability of legacy benchmark-driven portfolios.

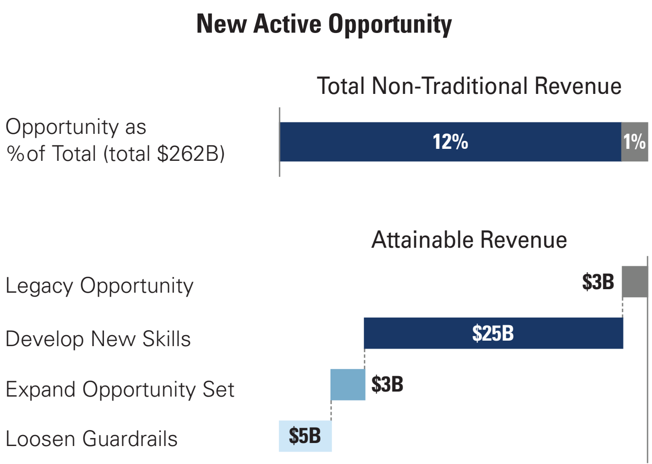
Is your investment engine dead? Casey Quirk's "New Active" Checklist

1. **Identify target New Active capability:** Choose the investment strategy that will have the greatest credibility within core target markets.
2. **Define investment skill set:** Select specific risk factors from which to extract returns, and create a systematic investment process to deliver that capability.
3. **Delineate the investment objectives:** Determine what target clients seek from new strategies in terms of risk (volatility) and return, and consistently deliver these objectives.
4. **Define the skill-set gap:** Understand the innovation required to bridge any gap between current capabilities and client expectations.
5. **Define packaging and distribution requirements:** Ensure packaging and fees are consistent with market demand and business objectives. Equip distribution for a highly customized application-based sales process.
6. **Define organizational requirements:** Confirm operations and technology are capable of supporting the New Active capability, and address investment team structure, compliance and broader compensation issues.

6. Appendix: New Active Investment Strategies: Detailed Descriptions

Exhibit 11

New Active Investment Approach: Benchmark-Agnostic Equity



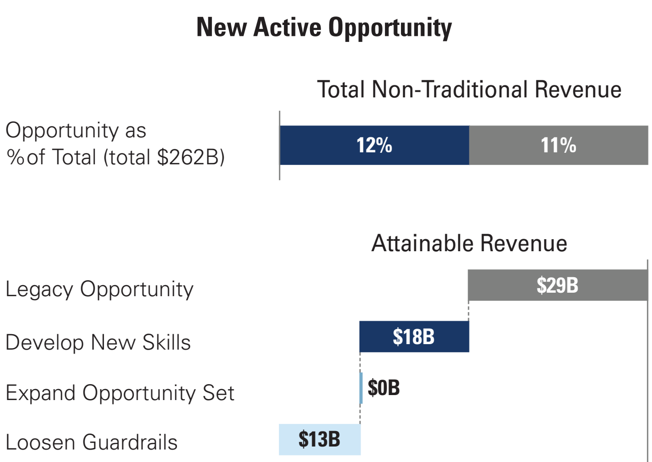
Benchmark-Agnostic Equity Attributes

- Managed to a return and risk target; no tracking error target
- High-conviction approach to the equity asset class
- Differentiated view on either the market or drivers of specific stock prices
- Ability to drive returns from short-term price relationships (trader mindset)...
- ...or through activist-style, transformational ownership (owner mindset)

Source: Casey Quirk

Exhibit 12

New Active Investment Approach: Trading Strategies



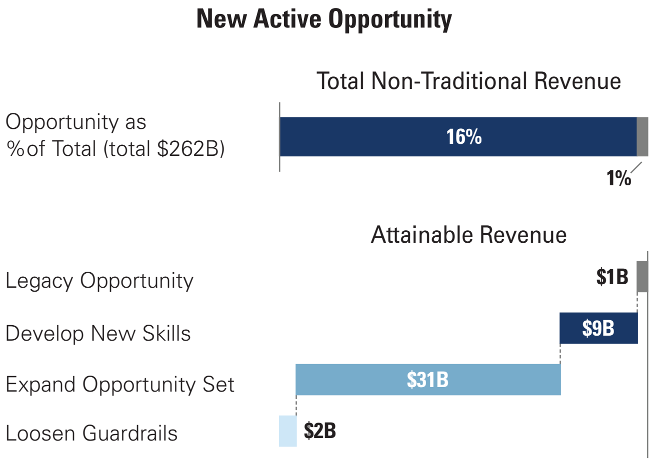
Trading Strategies Attributes

- Focus on liquid risk factors and inter-asset class price relationships
- Full range of securities and approaches, including shorting and strategic use of leverage, employed
- Likely capacity-constrained: capacity rationing will be critical success factor

Source: Casey Quirk

Exhibit 13

New Active Investment Approach: Broad Debt Strategies



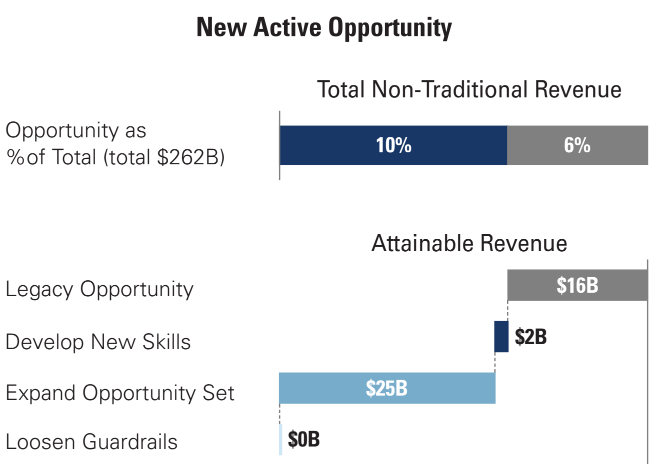
Broad Debt Strategies Attributes

- Built on return drivers for fixed income securities that are not duration
- Credit risk is primary return driver, but may include illiquidity premium, structure risk, currency, trading strategies
- Common risk framework across sectors and geographies

Source: Casey Quirk

Exhibit 14

New Active Investment Approach: Private Capital Strategies



Private Capital Strategies Attributes

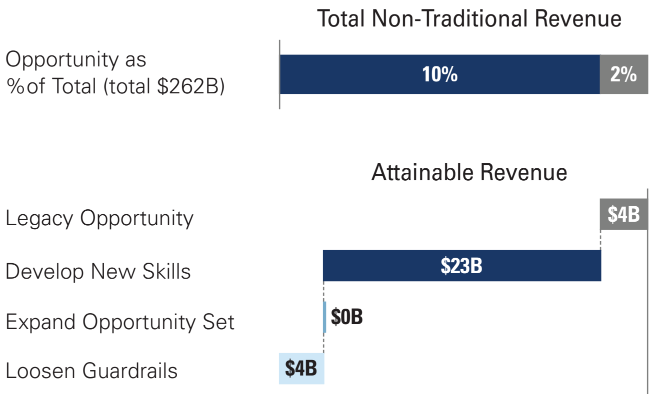
- Deeper specialization (geography, sector, situation)
- Greater capital structure flexibility: not just private equity
- Flexible liquidity profile
- Where appropriate, "back to basics" operating skills, not just capital provision
- Hybrid strategies

Source: Casey Quirk

Exhibit 15

New Active Investment Approach: Dynamic MACS

New Active Opportunity



Dynamic MACS Attributes

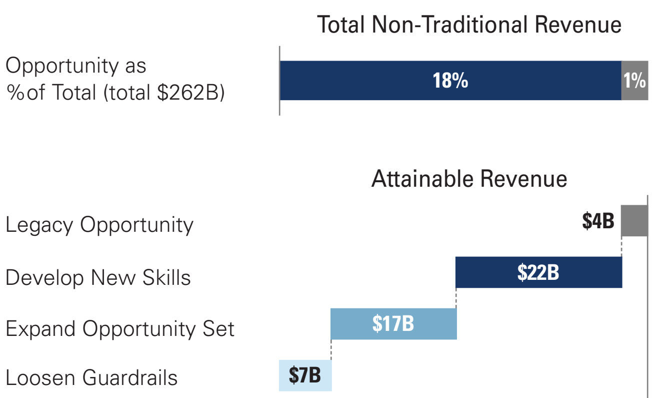
- Far broader asset class and risk factor expertise than equities and fixed income
- Investment philosophy and process built around high conviction portfolio positions
- Ability to actively trade portfolio, intra-day if required
- Dynamic top-down investment input
- Creative use of capital market techniques and instruments
- Flexible liquidity profile based on investor tolerances

Source: Casey Quirk

Exhibit 16

New Active Investment Approach: Real Assets Platform

New Active Opportunity



Real Assets Platform Attributes

- Equity and debt capabilities, listed and unlisted
- Broader and deeper investment reach by asset type, liquidity profile, and geography
- Ability to combine assets of different types and liquidity profiles into a single portfolio
- Systematic capacity rationing

Source: Casey Quirk

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