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When the Tide Turns:

Building Next Generation Fixed Income Managers

Leading fixed income investment managers have enjoyed the greatest success of all industry business models during the past decade. A long-term secular decline in interest rates globally has helped fixed income asset managers double revenue since 2000, and businesses that predominantly manage fixed income currently are more profitable than their equity counterparts.

But storm clouds, in the form of a zero or rising interest rate environment, are already here. The upside/downside ratio on traditional fixed income products is unsustainably low. Individual and defined contribution investors are most exposed: they hold $5T in fixed income, and are not prepared for losses in this part of their portfolio.

U.S. investors facing uncertain bond markets will shift $1 trillion of assets — almost 15% their current allocation to fixed income — from traditional fixed income products (core, core-plus, government and benchmark-oriented strategies) to next generation debt strategies, including global and emerging market bonds, high-yield and loan portfolios, alternative fixed income products, and vehicles designed to defend investors from inflation and rising rates.

This shift will raise annual revenue from next generation debt strategies — especially those with opportunistic, active investment approaches to find alpha from multiple sources — more than 60% between 2012 and 2017. By 2017 next generation debt strategies will represent nearly 80% of the annual revenue created by fixed income mandates from U.S. investors.

Leading fixed income managers in the next decade will successfully execute four primary strategies to survive and prosper in this new environment:

- Define a next generation debt investment philosophy. Successful fixed income asset managers will be highly active and benchmark-agnostic, offer broader capabilities, provide modern risk management, and rely on integrated sector teams.
- Diversify the revenue base. The most successful fixed income firms will position themselves as next generation fixed income managers, yield managers, debt originators, and more diversified asset managers, potentially re-prioritizing their clients and prospects.
- Communicate with the market. Leading fixed income managers will manage client expectations, transition clients to appropriate products, and establish a thought leadership position around next generation debt management.
- Shock-proof the P&L. Winning fixed income managers will prepare the alignment structure and exploit efficiency opportunities in order to withstand temporary revenue downturns.

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Casey Quirk by Deloitte helps 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 by Deloitte a leading advisor to the owners and senior executives of investment management firms in the world.

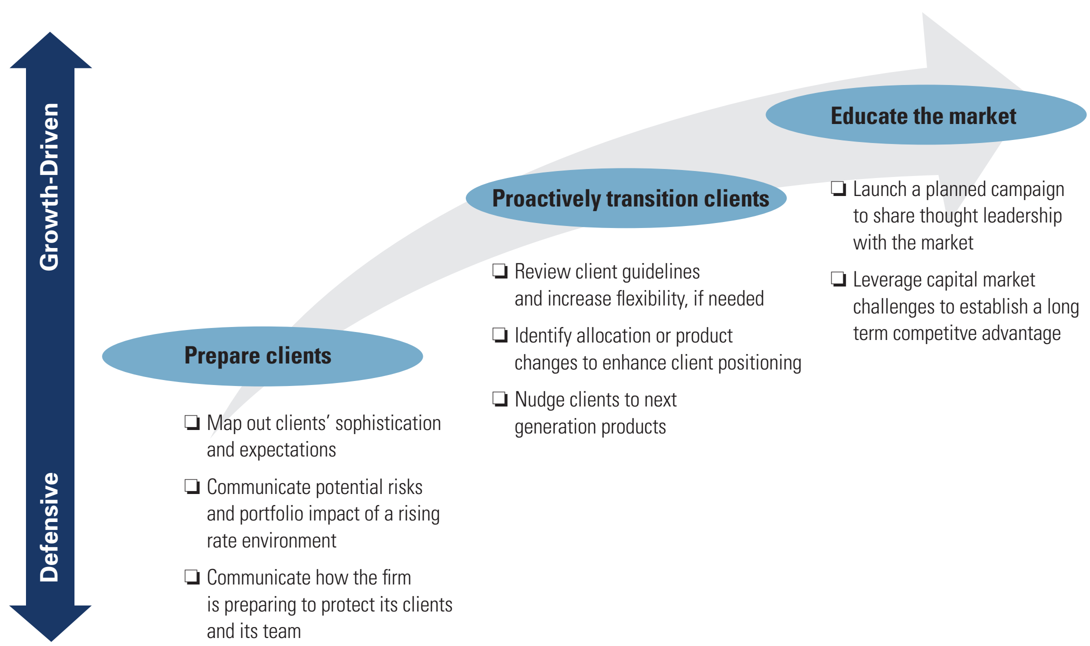
Across all of these positioning alternatives, managers will have another decision to make: their role in the lengthening distribution value chain. A lengthening value chain across the industry will lead all asset managers to continuously evaluate their highest-priority clients. Traditional fixed income managers unable to quickly diversify into next generation products may elect to sell their existing duration-focused products into the multi-asset portfolios of other asset managers and intermediaries, rather than directly to individual investors. Conversely, firms with strong macro and allocation capabilities may further invest in individual client relationships, opening architecture to component providers where necessary.

Strategy 3: Communicating with the Market

Having a well-planned and executed market communication strategy is critical, for both defensive and offensive purposes.

Exhibit 10

Communicating with the Market



Managers who turn the challenge into an opportunity will employ all of the following steps to communicate with the market:

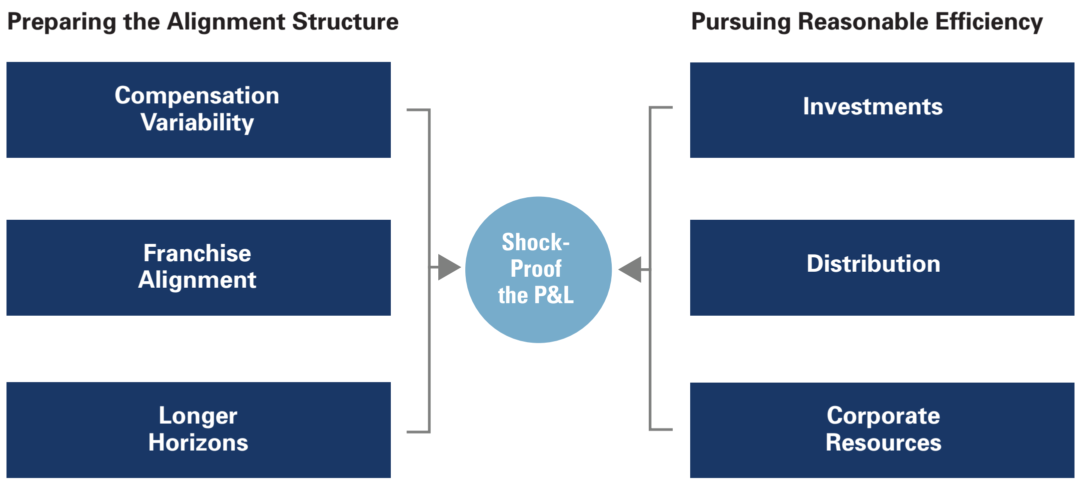
- **Prepare investors.** To defend the franchise, successful fixed income managers will take steps to fully understand their client base, including its composition and broader investment objectives. Successful managers will tier clients by objective and sophistication, and communicate how the current environment impacts the risk investors are taking and return expectations they should have.
- **Proactively transition clients.** As managers develop a next generation fixed income investment philosophy, winning firms will proactively transition their clients to it. At first, managers will modify the way existing portfolios are run. Then, as new next generation products are developed, managers will encourage clients to make allocations to these products.
- **Educate the market.** In this final step, successful managers will launch an appropriate thought leadership campaign and establish a market position as an investment leader in next generation fixed income investing. This position and branding will become invaluable if and when the tide does turn, and investors look for firms that already have formulated a credible strategy and response.

Strategy 4: Shock-Proof the P&L

Successful fixed income managers will not only prepare portfolios and clients for rising rates, but also will prepare their own employees and shareholders. Taking a page from equity-focused investment firms during the recent financial crisis, asset managers with high exposure to traditional fixed income strategies can modify incentive alignment and efficiency initiatives to prepare for a temporary, but potentially sharp, decline in revenues that would result from investors fleeing capital losses triggered by rate increases.

Exhibit 11

Shock-Proofing the P&L



Compensation and incentives represent the largest part — between 63% and 82% on average — of an asset manager's middle line. Aligning next generation fixed income teams and operations around the business success of the entire franchise is always important (and always sought by professional buyers), but it will be crucial to help execute the change management required in transitioning to next generation fixed income management. Winning fixed income managers will align incentive structures in three ways:

- **Increase compensation variability.** When revenues fluctuate, variable compensation structures allow the firm to keep a large part, or the entirety, of their team employed. Firms with high fixed compensation costs often conduct massive layoffs at exactly the moment when they need talent to deal with external pressures.

- **Ensure franchise alignment.** Many fixed income managers have compensation structures that align key personnel with narrow individual-level objectives, often focused on product performance, rather than with the financial success of the entire enterprise. Traditional fixed income teams could suffer as a result, leading them to make decisions that may be best for their individual compensation, but not for clients or the firm as a whole. Ownership and pseudo ownership programs built on franchise value are effective solutions for such issues.

- **Prolong bonus horizons.** Too many firms still have very short-term compensation structures. Longer-term and deferred compensation vehicles help smooth the potential negative effects of short-term revenue volatility.

Additionally, given their long-term historical growth in revenues and earnings, many fixed income managers have not focused on efficiency. True efficiency is not solely about cost cutting, but rather ensuring that the firm's best resources are positioned against its greatest opportunities. Successful fixed income managers will seek efficiencies in three key areas:

- **Investment team.** The structural changes required to develop next generation fixed income products also will provide a longer-term opportunity for streamlining processes and eliminating redundancies. Firms should stomach temporary inefficiency to underwrite change management, but plan to optimize resources against the best opportunities for the long term.

- **Sales and client service.** Most fixed income managers leveraged historically high levels of cash flow to sustain sales and client service infrastructure across a wide range of client segments. The changing operating environment will force fixed income firms to deploy resources only against the opportunities with the highest likelihood of success.

- **Corporate resources.** As next generation products are developed and new markets pursued, successful managers will recognize the need to add operational and managerial resources to manage the flow of activity. In the past, many managers have had the tendency to assume more scalability in their business than there really was, and stifled growth by not investing enough in these functions.

5. Conclusion

Institutional and individual investors already are demanding next generation fixed income; successful fixed income firms will implement it regardless of the timing and magnitude of interest rate changes. Most importantly, next generation fixed income will likely be the largest intersection to date between the traditional and alternative worlds of active asset management, as changes in the yield curve will make a previously theoretical discussion highly tangible and necessary. Transitioning a fixed income business requires a multi-pronged approach requiring investment and organizational changes. Successful fixed income managers will find this transformation challenging, but necessary, and invest time and resources accordingly.

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