Survival of the Smartest
Asset Management & Performance in Turbulent Times

Today's Market: New Territory, Same Players, Different Rules & Unknown Outcomes

Winston Churchill once said: "If you're going through hell, keep going." Today's market behavior is unprecedented. Major financial institutions which were once believed to be invulnerable (and were so for generations) have either closed up, been acquired or have restructured. Central banks, finance ministers, governments and market participants seemingly have a handle on what has led to the crisis, and even to some extent know what needs to be done to solve it.

What no one can control or legislate is when and how market participants will deal with two irrational underlying drivers that are critical to responding effectively in the global markets. Those drivers are confidence and risk. And since the mercantile classes emerged in the early Renaissance, economists and market participants have known that a positive relationship between the two is the linchpin on which the success of any market is measured.

Restoring confidence and taking risk in the current market environment, given the number of "unknowns" that will affect performance, is a tall order. But risk aversion has its own costs and consequences. Simply put: someone has to get back in the game.

The fundamental fact is that until investors perceive that there are rewards for risk, markets will continue to be stressed and confidence will be difficult to restore.

Given the changes to come in the industry, in Washington and in the structural, competitive and technological landscape, asset managers and hedge funds will need to look at their roles as market participants in new ways. There will be a new regulatory and brokerage environment within a year, although the specifics are not known. There will certainly be new players at the Fed, the Treasury, and the SEC. There will be increasing influence in equity markets by the Fed and the Treasury Department. And Congress may pursue a regulatory overhaul.

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The Old World in the New Universe – Responding to the Cold, Hard Facts

What Can a Manager Do to Survive and Thrive?

The cataclysmic events of recent months have stressed market dynamics. Yet one thing that has not and will not change (short of a complete economic collapse), is the simplest proposition on which all financial markets operate: someone will want to buy a financial instrument and another party will want to sell a financial instrument.

The first thing asset managers can do to assure continued viability and success is to recognize that the world is operating on the same set of assumptions but the universe around it has changed. This creates a fundamental tension - because the operating principles that were once known have become suspect - and new practices and behaviors need to be incorporated into firms, without complete assurance that they are correct.

For managers, be they in traditional money management, hedge funds, RIAs, SMAs or UMAs, there are a number of questions that will dictate whether they have the confidence again to take the risks they must if they are to perform for their investor end-clients. The risk and reward profile they have certainly relates to investment strategy and style and to stock selection. And performance, even in this emerging environment, will be critical for those who wish to protect current AUM and to secure a capital raising platform for the future.

To get back in the game as the new environment develops, managers need to conduct a "critical appropriation." This exercise, properly executed, may mean the difference between success and failure. As a first step, it means a firm will understand and establish its true differentiator. But in addition, on an operating level, it will mean a firm will respond to three questions (given the fact that the dominant thought and practice has gone away and the new environment has yet to emerge): first, what practices can be retained; second, what practices can be modified; and finally, what must be jettisoned? This exercise will enable a firm to define and have a guide for best practices as the new environment emerges.

Given the fundamental recognition that there will continue to be trading in financial instruments but that the environment and rules of the game will be different, there are a number of steps that firms can take on the management and operations side to assure their viability in the current crisis and to continue to provide value to clients.

A firm can immediately implement both strategic and tactical steps simultaneously and rapidly to weather the storm and emerge prepared for the future. The strategic approach has to do with a firm's recognition of it marketplace position and operating style. The tactical steps will achieve exponential rather than arithmetic results if the manager always keeps the strategic view in mind.

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The Strategic View

Strategically the first thing that hedge funds and asset managers need to do is to recognize that they run businesses with trading operations as the means of profitability and performance, rather than as trading operations that require business support.

As a business, the manager must constantly keep in mind the changing marketplace dynamics and the effect these dynamics have on clients, the competition and business development. These dynamics include technology innovation, regulatory and rule changes, and the operating principles on which the industry itself operates.

Further, the entire cycle of the business, from the raising of capital through the trading cycle, through client management and reporting, needs to be based on sound practices and principles. Not least of these is to recognize that there may be a need for expanded resource and capacity to accommodate to the anticipated new regulatory environment. Infrastructure matters.

If the management knows its differentiator and the firm's place in the market, the tactics become more effective and tied to a defined outcome.

The Tactics Managers Can Deploy Now

Step 1: Restore Confidence and Act

The first step relates to market psychology. Firms cannot expect their investors to have confidence if the firm itself does not exhibit confidence and act on it. This will require firms to be prudent, but to continue to act. Those that do will have a larger AUM base once the crisis has past and will have shown to potential future investors that they are not panic driven but operate on a rational basis even in seemingly irrational markets.

Step 2: Diversify Custodians

One of the most tested operating principles of investment is diversification. Yet historically many managers have diversified their portfolios but not their operations or their risk. As a result, when the financial collapse occurred, many learned the hard lesson of the risk associated with having a single, rather than a multiple prime relationship. What was once questioned is now an operating necessity.

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It wasn't so long ago that managers had to be convinced that multiple prime brokerage would be a benefit. The thinking was that a multiple prime approach could take into account fiduciary responsibility. With the collapse, what was once exotic became standard industry practice within days. So, the question is not whether to multi-prime, but what multi-prime means.

Multiple prime takes the principle of diversification and applies it operationally to fund management. With this choice, the manager diversifies risk. Importantly, the question for the manager becomes "diversity within diversity." It is one thing to move to multiple primes. It is another to move to a multiple prime environment where the manager can have the option of choosing a broker or a bank. Having both in the arsenal increases a manager's flexibility in tough situations.

Step 3: Efficiency in Platform Selection

Additionally, there is the question of access to the multiple prime relationships. This is directly related to the question of efficiency and cost. Simply put: can the manager access the multiple prime relationships from a single platform, or must there be a separate front-end for each relationship? A separate platform environment is costly in time and dollars. Single platforms are more efficient. But even here, managers must ask whether they have the choice of platforms or if there is only a single selection which is dictated to them.

Step 4: Take a Comprehensive View of Risk

This is aligned with the strategic view of the firm looking at itself as a business entity rather than solely as a trading operation. It requires a broad, comprehensive and systematic reassessment of risk profiles. The more comprehensive this assessment, the better. Traditionally, risk management relates to portfolio risk management. And certainly firms need to reassess their strategies and styles in the new environment. That said a broader view of risk management will be required for success in the future. It involves the standard analyses of credit and counterparty risk, as well as marketplace risk. Firms now need to also assess and develop operational and regulatory risk profiles.

Step 5: Communicate, and then Communicate More

Critical to success is constant communication with clients as an outreach rather than as a reaction. Here more is better and there's never enough. Managers must consider every opportunity they have to communicate, and then design both content and distribution of communications that will at once give a realistic picture and the steps the firm is taking to secure (and hopefully build) client assets. The most sophisticated organizations will actually triage what will work most authentically with different types of clients: it will know their concerns are and address each accordingly. From reports, to phone calls, to Q&As, client service will be paramount to retention and building for the future.

Step 6: Secure Multi-Asset Global Investments

Another key proactive step will be to assure clients that the firm has access to multi-asset, global trading. As the crisis is global, the ability to move in and out of markets rapidly in a variety of securities will likely be a critical step in mitigating loss and improving gains once the situation stabilizes.

The Selection of an Introducing Broker

In each of the considerations detailed above, the primary principle that should drive a firm is the flight to quality. Absent quality, the steps will not only be ineffective, but completely meaningless.
Here is where a firm must consider the full range of services available to them through an introducing broker relationship. The questions will not only reside with whether the introducer can deliver on multiple primes, but who are the firms that clear and custody? Can the introducer deliver on a single access front end of the manager's choice? And is the introducer expert and experienced in the delivery of boutique client service?

The measure will be not only on whether the introducer can deliver on these questions, but whether the broker has taken extra steps on behalf of the clients. This will be evidenced if the firm can recommend a range of fund services (accounting, legal, administration, etc.) that are of equal quality to the prime broker relationships.

Traversing the Terrain

Tough environments are strewn with obstacles. Some can be predicted, others not. Astute managers recognize this, and map a course through the obstacles, layering in relationships that will assure a successful trek. The steps articulated here constitute a comprehensive map for managers to consider. The selection of the team who will traverse the course with the manager must be dictated by experience, expertise and quality. The development and implementation of a plan and the selection of partners substantially increases the chance for success.

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