International
Capital
Market
Association

ICMA

Asset Management and Investors Council

Managing Client Expectations

Introduction

The International Capital Market Association (ICMA) is one of the few trade associations with a European focus having both buy-side and sell-side representation. Buy-side and sell-side members within ICMA are both entitled to have their views represented separately (e.g. to the European Commission and CESR), where they wish to do so. ICMA is also keen to encourage dialogue between the buy-side and sell-side, where both sides consider this appropriate.

The purpose of the ICMA Asset Management and Investors Council is to represent the views of the buy-side members of ICMA and to add value for them by discussing asset management issues of common interest, reaching a consensus and recommending any action that ICMA should take. This may include proposing market-led initiatives and market practice guidelines, where these are appropriate, and responding to consultation papers from regulators. The focus will be on asset management in Europe, while recognising that asset management is a global business.

This paper recognises and addresses the asset management industry's reputational issues, and in particular the observed fact that clients' expectations are increasingly not met – whether through overpromising, because of the different cycles of the asset management industry or because of the effects of the credit crunch on the industry. In numerous instances, clients' portfolios or the products that were bought have achieved results different from what was expected. The paper concludes that to a certain extent, many of the industry's problems are related to current market conditions, but others are also inherent in the structure of the industry.

The paper also touches upon risk management and perceptions of clients. The fact that actual results are different from expected results is not mis-selling practice. However in order to re-establish the credibility and reputation of the industry, risks and downsides of products should be clearly established with clients.

The Asset Management and Investors Council decided to take this paper forward in the form of a set of principles. The set of principles (at the end of this report) is intended to apply, on a global basis, to firms ('managers') who manage clients' assets as separate accounts or pooled assets. These principles hope to set minimum standards when proposing asset management services to clients.

The need for client satisfaction

For any company, whatever its line of business, one of its main assets is its reputation and the impression that customers form of it. The value of its reputation will depend to a certain extent on what the company's style of business is, and very crudely, the more that one seeks repeat or ongoing business (as opposed to one-off business), the more important the company will find that a good reputation for satisfying its customers or clients is.

- For example, industries that tend to deal with a customer only once, or very infrequently, can more easily survive customer dissatisfaction with their service (because the customer is unlikely to offer repeat business anyway), and individual companies can even survive a general industry-wide reputation for poor service.

- On the other hand industries and companies that are built on multiple repeat business pay very close attention to their reputation, especially if it is easy for customers to switch that repeat business to a competitor.

Of course most industries are neither wholly one-off nor wholly repeat-business, but somewhere on the spectrum between the two extremes. In the case of the financial services industry, the brokerage side for example has elements both of a one-off nature (each transaction generates its own income) and repeat nature (the need to keep customers returning). Some companies respond to this by paying great attention to their reputation for good customer service, but equally others clearly place less emphasis on it.

But while that may be true in varying degrees for the general financial services industry, the asset management industry clearly depends much more on repeat business and the retention of existing business. The fee structure of the asset management industry means that companies enjoy an income stream which in the absence of any client action (such as terminating a mandate) will continue. Of all parts of the financial services industry, therefore, asset managers should be among the most concerned to provide client satisfaction, to preserve existing business.

Assessment of the Asset Management industry in practice

Given the analysis above, how does the asset management industry perform in practice? It is this paper's contention that the general business model of the asset management industry is by and large geared to overpromising and consequent client disappointment, which is the exact opposite of what one would expect.

The cause of this starts right at the selection stage, when a client is choosing an asset manager for the first time. Whether through the guidance of consultants, or simply through optimism and unrealistic hopes, clients often set performance and administration targets which encourage asset managers to compete in the promises they give simply to win business. Every asset manager has met the prospective client who "hopes for" a risk-return combination that the manager knows that the market simply will not provide: of course if all the manager's competitors in the mandate search gave realistic estimates of the out-performance they could generate, then so would they, but this is not the normal experience and so each manager's prediction ends up being "heroic".

This is compounded by the client's tendency to be attracted to managers who offer the prospects of the greatest return. Of course, clients and consultants do not always automatically choose the manager who makes the most bullish promises, but there is an undeniable tendency for those offering higher forecasts of performance to win more mandates. Finally, it is all too easy to agree at the contract negotiation stage to the client's demands for a specified level of client service, whether it is attainable or not[1]. This tension is further noticeable when the sales person is responsible for closing/negotiating the deal as promises may be made which the client manager is unaware of and cannot keep further along the relationship.

This is a very unsatisfactory business model for the industry as a whole, because it builds in probable – indeed almost inevitable – disappointment right at the point of winning a mandate, ie right at the start of the relationship with a new client. This gets relationships off on the wrong foot, and ensures that at rebid time, incumbents (who are judged on actual past performances and administrative competence) are usually at a significant disadvantage to new bidders (who can promise extravagantly). More significantly the asset management industry would earn as a whole the reputation of failing to deliver (or therefore justify their fees).

Additional factors

The above analysis is, or should be, concerning enough for those that manage asset management companies. At its worst, this tendency to overpromise has earned the industry a poor reputation for honesty, and has contributed to a widespread distrust of the financial services industry which at its most virulent in the UK has led to the almost complete collapse in the general public's confidence in pensions and pension providers. But two additional factors – one structural, the other the result of current markets – provide further opportunity for client disappointment. In fact those companies favoring an open, honest approach, and keeping clients informed, are more likely to retain clients during difficult times.

The first of these is that the cycles of manager performance and manager selection interact unfavourably. Even if managers' performance was relatively constant, the analysis above would lead to over-promising and regret. But managers' performances tend to move in cycles: given the temptation (for both clients and consultants) to pick a manager after a period of better than usual performance, the risk is that the client and their portfolio then experiences the downswing part of the manager's performance cycle [2].

On top of this, in the period 2002-2006, all markets saw volatilities compressed (which reduces out-

---

[1] And both of these are often compounded by the fact that the person negotiating the sale is usually different from the person responsible for delivering on the promises so readily made.

[2] Most of the academic work on this subject, eg that done by WM Performance Measurement, a division of State Street Corporation, relates to the US mutual fund industry, where it has been observed that investors definitely have a tendency to chase returns by investing in "hot funds". This creates further problems, because it leads to an environment where underperforming mutual fund managers are tempted to increase their risk, particularly as the relationship between fund inflows and performance appears to be non-linear: whilst top-performing funds gain significantly in terms of inflows, the worst performing funds are not penalised to the same degree in terms of losing assets.

performance opportunities), and in addition credit markets experienced hugely compressed spreads over risk-free assets (which adversely impacts any performance aspirations which involve utilising the "carry trade"). In such markets managers can either return to clients and admit that previously promised performance levels are now unattainable – never an easy thing to do – or increase the risk in an attempt to meet return targets. This is a very risky strategy (in every sense of the word) and leads to fund performance meltdown if events turn out unfavourably.

Indeed, the current market crisis merely underscores the challenge faced by an industry that has a reputation for poor management of client expectations and for under-delivering against promises. The defence that we are seeing unprecedented and wholly unexpected events, which would not have had a place in any reasonable person's forecasts when investment mandates were entered into say 2 years ago, is not entirely unreasonable: even the most rigorous stress-tests of investment strategies and portfolio constructions done in 2006 would not have included the events of the latter part of 2008. But the asset management industry's general reputation for failing to deliver, even in less difficult times, means that the credibility of this defence is very limited, and the goodwill from clients which is necessary for the defence to be accepted is in short supply. Open communication with clients is critical, and if fund managers are unable to deliver in accordance to previously agreed objectives, this should be communicated clearly and pro-actively to clients.

Summary

The asset management industry appears to be suffering from a combination of unrealistic client expectations, both on performance and administrative/reporting capabilities, and a lack of ability/willingness on the part of managers to rein these back. As a result the industry risks being enmeshed in a cycle of over-promising and subsequent disappointment, which if left unaddressed will migrate from a firm-specific reputational issue ("ABC Asset Management never deliver what they promise") to an industry-wide one ("the asset management industry never deliver what they promise").

For a fiduciary industry, in which one of the chief assets of any participant is trust, this is not a healthy position at the best of times. For an industry facing considerable client losses, many of which exceed the levels of even the most pessimistic a priori assessments as the market crisis of 2008 continues to unfold, the position carries considerable risks: the spectre of lawsuits from clients to recover losses arises, and in the current atmosphere of general and widespread distrust of the financial sector, avoiding costly outcomes cannot always be relied upon.

Possible solutions

It is clear that action is required to break out of this downward spiral of trustworthiness and client confidence. It is no longer sufficient or adequate to market asset management products with a historic chart of performance and the limited warning, somewhere in the disclosures, that "past performance is no guarantee of future performance". A much more fulsome assessment of future risks and potential losses will be necessary to overcome the client response that "you didn't tell us we could lose that much"[3]. A more in-depth discussion of and understanding of a client's true

[3] One possible method of presenting uncertainties of outcome is the Bank of England's "fan-charts" for the future course of inflation, which show not just the expected outcome, but also the outlier possibilities. A similar presentation of the possible outcomes from an investment strategy would not only provide advance

aversion to loss will also be valuable in providing lower limits to acceptable performance and early warning, to both parties, of when risk-tolerance limits are being reached.

Beyond this, there is a clear need to increase client understanding of the products and strategies that they are buying. Whether this education is done by the asset manager themselves, or by a consultant or independent financial adviser working for the client, is not material, but the asset management industry as a whole must undertake to make more certain that clients are well enough informed to make a considered decision about the financial products the industry offers[4].

In parallel with this education process runs a need to explain more clearly the asset management industry's cost structure. While competitive pressures will always mean that an individual asset manager has to temper the transparency of how his fees are constructed, the current level of lack of clarity is counter-productive in itself, and when combined with poor performance can lead to clients showing a lack of acceptance of the fees charged – every asset manager will have faced the irate client who exclaims "You lose me money and I have to pay you fees on top?"

This opacity of the fee structure (not in the sense that the fees themselves are opaque, but in the sense that what they represent and how they are constructed is often far from clear) is doubly damaging – it frustrates fee negotiations with individual clients, and it can colour the debate about whether the industry as a whole is over-remunerated[5]. Greater clarity about the cost of the component services a client is receiving as part of an asset management relationship will further client understanding of the asset management process in general and therefore also acceptance of outcomes that do not entirely meet expectations. Performance related fee scales may make sense in current market conditions.

Conclusion

In conclusion, it is this paper's contention that the asset management industry, both through its own past failings and through the more general distrust of the wider financial sector that has emerged as a result of the current financial crisis, is in a position where it needs to rebuild client

---

notice of the "worst case" outcome, but could be used to encourage a deeper dialogue with clients about their expectations and understandings.

4 This is a very large issue which goes well beyond the scope of this short paper. It is at its most acute in the retail sphere, where the counterpart of enabling the individual consumer to take control of his or her own finances – most obviously with the increased emphasis on personal provision of pensions and retirement finance – is a need for much increased financial education. Providing a choice for individuals without providing the educational tools to enable them to use that choice wisely and effectively is not delegation of responsibility, but abdication, and the asset management industry needs to play its part in avoiding this undesirable outcome.

5 This has unexpected consequences when governments set up national savings schemes and mandate a maximum fee that asset managers can charge. The general "received wisdom" that the industry routinely sets fee levels based more on what the market will bear rather than what the services cost to provide, plus a natural desire to pander to populist "bashing the asset managers", leads to the risk that maximum fee levels will be set too low for the industry to do more than provide a very basic service – further compounding the reputation for poor service that the industry enjoys.

faith in its services.

The standard ways that any industry achieves this are simple and threefold: clear explanations in advance of the sale of what the product is and what it is designed to deliver, early and pro-active management of expectations if delivery starts to fall short of prior commitments, and equitable and understandable fee structures.

Moreover the asset management industry should establish a positive cooperative relationship with clients. The industry should work better with the consultant industry and aim to build deeper relationships with them. The fund management community does need to build bridges but it cannot do this in isolation.

The asset management industry is no different, and should note both the need to address its past failings, and the solutions required.

Managing Clients' Expectations – General Principles

In light of the above report, the AMIC recommends the following principles:

- Understanding clients' profile

Prior to running an asset management programme for a client, it is critical for the asset manager to fully understand the risk profile of the client, and to explain to clients, in conjunction with their consultants, the projected market risks of the programme and therefore test whether the client is comfortable with the suggested risk profile.

Asset managers should fully understand the return expectations of clients and test whether these expectations are realistic, particularly to align return expectations with projected market returns.

Asset managers should ensure that their clients fully understand the products and strategies they are offered. Clients should be informed in order to make a considered decision about the financial products presented.

- Setting appropriate objectives

Asset managers should clearly establish with clients whether they have absolute return requirements or relative return objectives based on a market benchmark.

Marketing meetings with clients and their consultants should focus on investment processes, resources and risk management and in presenting performance, while historical performance is a guide, asset managers should emphasise risk adjusted projected performance.

Asset managers should explain clearly their administrative and reporting capabilities and test whether these are consistent with client requirements.

- Ensuring transparency

Asset managers should be transparent over their investment processes, the sources of performance and their risk management systems.

Asset management fees should be transparent and any other revenues accruing to the asset manager, whether directly or indirectly, should be disclosed to clients. Performance fees should be designed so that clients only pay fees where performance has been added over a minimum of a market cycle.

- Reviewing investment guidelines

Investment return objectives and risk limits should specify a time horizon over which the asset manager's work will be assessed.

Asset managers should review investment guidelines with clients to ensure that guidelines are consistent with market conditions.