Profitability measurement and expense management for alternative asset managers

Critical information for profitable growth
by Samer Ojjeh, Sridhar Kadaba and Mike Coletti
As a result of current and continuing market trends and competitive pressures, alternative asset managers (AAMs) have been focusing on better and more comprehensive understanding of their cost structures and their overall impact on profitability. Further driving this need is the continuous refinement of their operating models — AAMs seeking competitive and leverageable advantages through a more detailed focus on core business processes and operational expense optimization (through the effective use of outsourcing and managed services). This refocus has underscored and accelerated the need for AAMs to integrate profitability and expense management with their budgeting and forecasting processes.

In recent years, AAMs have altered their strategies and adjusted their approaches as they have been impacted by a variety of factors, including, but not limited to:

- **Asset growth**: AAMs have continued to focus on growing profitable assets by adding new strategies or increasing penetration with existing clients and markets. As we go digital and disruption becomes the norm, this focus will continue to gain importance.

- **Prime brokerage costs**: As the borderless economy marches forward, and governments and regulators share data, banking regulations have resulted in an increase in prime broker fees for AAMs.

- **Fee pressure from investors**: Investors will continue to negotiate on fees, putting the 2/20 model under pressure as private equity (PE) firms and hedge fund managers develop and address more attractive fee models for their investors.

- **Evolving operating models**: As disruption and evolution unfold, take root and magnify, AAMs will continue to define their core competencies and leverage managed services strategies to support their operations and technology environments and gain reach in the market.

Compared with other sectors within financial services in recent times — banking and traditional asset managers, in particular — AAMs have lagged behind in properly understanding and effectively managing their costs and profitability. Though they have seen their direct and indirect costs increase over time, for the most part, AAMs have not kept pace through formally established management/governance processes and responsibility/accountability for both profitability and expenses in tune with the changes happening in markets globally. This has resulted in limited transparency to costs and profitability, while impacting the performance and effectiveness of the manager. As AAMs tighten their focus on profitability and expense management as a means of effectively managing costs and profit margins, some AAMs now include profitability measures by strategy, fund, geography or sector as a metric to evaluate and reward portfolio managers.
Focusing on measurement of profitability and management of expenses

Focusing on profitability and management of expenses helps AAMs more properly, consistently and proactively support and manage an efficient and effective infrastructure. In addition, the information supports analysis of the impact of growth and changes to the operating model on profitability and performance. Fully leveraging this approach requires an ongoing commitment to developing, implementing and maintaining a repeatable and sustainable performance measurement and management framework. This framework can provide greater insight into drivers of value (both expense and profitability), drive higher levels of accountability and responsibility to help focus and manage expenses, and help execute and drive profitable growth through enhancing value from new and existing business opportunities (e.g., markets, geographies, investors and products). The insights gained through this framework will serve as a significant competitive advantage to AAMs as the importance of analytics grows and the grasp of disruption advances.

Why this is important for AAMs

AAMs are reviewing their cost and profit management processes in order to respond to the challenging economic environment and pressures generated from recent market trends. Moving forward these processes will increasingly affect:

- **Asset growth**: Managers view asset growth as a key strategic priority for their business. Managers with larger portfolios (i.e., those with >US$10b AUM) have focused on adding new strategies or increasing penetration with existing strategies and products as their primary means of growth. As managers add new strategies or expand, they need to consider much more than just the revenue side of the equation (e.g., growth in AUM, investor satisfaction, impact on brand), but also appreciate, address and anticipate the associated costs and the impact on operating margins as well as personnel workload and skill set requirements. As managers enter new markets and strategies, they may be forced to hire resources with specialized skills and implement new and forward-leaning processes (e.g., to settle, account for and report on new asset classes or products). A robust profitability model will allow managers to model their revenues and costs under various scenarios and help them prioritize their approaches for profitable growth.

- **Fee pressure from prime brokers**: Recent banking regulations – with many more in the pipeline or in the process of being modified as governments focus on funds – (e.g., Basel III, Dodd-Frank) have forced prime brokers to reassess and better assess how they are managing their balance sheet and capital requirements. As a result, AAMs have seen – and will continue to see – the impact in the form of rising fees. To date, 29% of managers have seen fees increase from their prime brokers, while another 22% expect an increase in fees in the near future, according to EY’s 2015 Global Hedge Fund and Investor Survey. Rising costs and changing relationships with prime brokers also impact talent and talent retention in the sense that leading managers have formalized and centralized their treasury function and have added resources such as a treasurer to manage the process.

- **Investor pressure on fees**: Parallel to prime broker costs increasing, investors have been negotiating to reduce the fees they pay AAMs, especially management fees. Managers have seen an erosion of the 2/20 model (2% management fee, 20% performance fee). The typical 2% management fees have been decreasing across the board for AAMs, with the largest managers averaging 1.51%, according to the EY survey. The industry perspective is that this trend will continue before it abates.

Moving forward, managers that want to gain advantage should assess the profitability considerations of growth (both revenues and cost drivers), as well as plan for the two-sided pressure from rising prime brokerage fees and shrinking management fees, which has led to a fee squeeze for AAMs. In order to find balance, AAMs have deployed various approaches to measuring and managing costs as one means of responding to the fee squeeze and evaluating profitable growth opportunities.
Understanding your business

The context for measuring cost and profitability

In order for firms to evaluate the impact of their decisions and start to appropriately manage their costs and profitability, they need to properly frame their analysis within the context of their business – both current and projected. Firms should devote resources (time and money) to reviewing, strengthening and aligning their processes, organization and technology within an operating model that supports their current overall business objectives and strategy, with a look toward and appreciation of the future. Having a well-designed operating model in place to serve as a guide for the business will allow the stakeholders to more fully understand key drivers of revenue and costs across their businesses and portfolios. Under this model, firms should be able to identify business levers that trace objectives to drivers of value in support of their strategic objectives.
Given some of the examples of objectives as outlined above, a profitability model can help enable the value drivers as follows:

<table>
<thead>
<tr>
<th>Objective for the AAM</th>
<th>How can profit models help?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enhanced investment performance</td>
<td>• Profit models enable understanding of the true and potential value of different revenue streams. This assists AAMs with more keenly targeting new products or investor bases to improve the valuation of the organization as a whole, and helps to refine fee structures based on product offerings and investor appetite.</td>
</tr>
<tr>
<td>Institutionalization of the business/ability to scale and grow rapidly</td>
<td>• As AAMs grow in size by AUMs, profit modeling and reporting become increasingly instrumental in planning/forecasting and developing KPIs to run and grow the organization.</td>
</tr>
<tr>
<td>Improved investment decisions: Product mix</td>
<td>• Profit modeling provides deeper and more focused insights into product/investor profitability based on consumption of resources to serve the product/investor.</td>
</tr>
<tr>
<td>Improved investment decisions: Investor targeting</td>
<td>• Profit models also help in more definitively analyzing profit and cost trends to drive improvements.</td>
</tr>
<tr>
<td>Improved investment decisions: Geographical footprint</td>
<td>• Profit models help to more sharply evaluate process efficiencies driven by the operating model, enhance control over costs and improve cost/revenue ratios.</td>
</tr>
</tbody>
</table>
The expense and profit model: basic components and considerations

The expense and profitability model starts with a fundamental understanding of the business costs and revenues. A sample cost development framework follows (see the "Expense and profitability framework").

**Resource allocation**

- Define cost centers and accounts (e.g., salaries, occupancy, technology) within the general ledger for the business
- Categorize resources into resource pools and departments (e.g., functional groups – finance, legal, operations)
- Identify resource drivers to facilitate the allocation of indirect costs (i.e., support and overhead costs) to the resource pools and departments
- Align direct expenses to identified cost dimensions (e.g., invoices, time, expenses)

**Activity allocation**

- Apply cost drivers across business processes and activities (e.g., business lines or strategies – credit funds, private equity funds, real estate funds)
- Apply business drivers, such as AUM, transactions, holdings
The graphic below illustrates in general terms the flow of costs from the general ledger and the application of resource and activity allocations. To gain full value and efficiency, each AAM will need to customize and calibrate the framework for their particular business objectives and operating model.

Expense and cost allocation framework

Based on EY’s experience working with clients to develop expense alignment and cost allocation capabilities, we have a fundamental approach to support attribution to business cost dimensions such as funds, limited partnerships (LPs) and advisors. The cost pools, activities, business drivers and cost dimensions should be customized to align to the unique operating model of the AAM.
Integrated framework: operating model and profit model

The blended integration between the operating model and the profit model allows managers to better align their capabilities, adjust costs and modify pricing to deliver and sustain their objectives.

Alignment of capability to delivery is the integration between the operating model and the organizational structure that serves to more accurately and efficiently guide processes, resources and technology globally to facilitate and manage:

- Investment support
- Middle and back office operations
- Technology infrastructure

Alignment of cost to delivery is developed by allocating expenses to operating model functions. This provides greater insight into costs, enhances cost transparency and supports profitability measurement. Key areas of focus for cost allocations include:

- Management company expenses
- Fund expenses
- Driver-based cost allocations (full cost absorption)
- Fixed vs. variable costs

Alignment of price to delivery helps ensure that the organization will be scalable and strategically respond to market opportunities. Aligning price to delivery allows managers to more discriminately evaluate decisions around:

- Investor segmentation
- Distribution channels
- Products and strategies
- Geographical reach
The graphic below illustrates the importance of the operating model and the profit model, the organizational framework and the Expense and Profit Model. The alignment of the models provides an actionable mechanism and associated levers for managers to more accurately use when managing costs and profitability.

A comprehensive expense and profit model starts with a well-defined operating model and understanding of key business drivers.

**Alignment of cost to delivery**
- Management company expenses
- Fund expenses
- Driver-based cost allocations (full cost absorption)
- Fixed vs. variable costs

**Alignment of price to delivery**
- Investor segmentation
- Distribution channels
- Products and strategies
- Geographical reach
- Structures

---

*The integration of the operating model and organizational structure guide processes, resources and technology globally.*

*The organization must be scalable and built strategically to respond to market opportunities.*
Critical success factors for cost and profit management

When implementing an expense and profit model framework, AAMs should consider the following success factors to identify the effectiveness of the established program:

<table>
<thead>
<tr>
<th>Relevance and transparency</th>
<th>Reliability</th>
<th>Timeliness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs and profits can be accessed at the right level of detail and in a timely and consistent manner with appropriate ownership and accountability.</td>
<td>Executives trust the data they receive, and more importantly, learn to utilize and leverage it.</td>
<td>Information is available when needed for more informed decision-making and a wider audience (if so determined).</td>
</tr>
<tr>
<td>• Transparency for costs and cost drivers that trend away from AUM-based allocations</td>
<td>• Means to measure a unique source of cost information at the lowest level of granularity for all data</td>
<td>• Integrated source systems that efficiently capture driver information</td>
</tr>
<tr>
<td>• Integration with planning, budgeting and forecasting process</td>
<td>• Allocation applications and tool sets that are integrated or linked with the financial and operational systems</td>
<td>• Robust reporting capabilities that offer flexibility to meet the various information needs</td>
</tr>
<tr>
<td>• Focus on strategic objectives and support for operational decisions</td>
<td>• Allocation models that account for all costs and revenue</td>
<td>• Rationalized cost driver information that streamline allocation models</td>
</tr>
</tbody>
</table>

Conclusion

As AAMs face growing and continuous industry challenges and increased pressures to their fee structures, an effective and efficient expense and profit model framework that is aligned to their operating model can help ease the burden and be leveraged for competitive advantage. It is imperative that managers first design an operating model that supports a scalable approach to growth and adapt an expense and profit model that supports the business. When successful with the approach, managers will benefit from transparent, relevant, reliable and timely management reporting that can guide more informed decisions and drive profitability for their business moving forward. With the importance of harvesting information growing, developing an operating model and an expense and profitability model framework facilitates AAMs to better understand levers of profitability and enhance their business insights, and add value by leveraging the insights gleaned.

AAMs that act today with a strategy that involves optimized resource allocation, effective cost and profit management and levers of cost will better control outcomes, be better positioned for future trends and will have the insights to effectively manage their business.
Contacts

**Marcelo Fava**
Americas FSO Private Equity Leader and Americas FSO Advisory Wealth & Asset Management Leader, Ernst & Young LLP
marcelo.fava@ey.com

**Samer Ojjeh**
Principal, Ernst & Young LLP
Financial Services Organization
samer.ojjeh@ey.com

**Sridhar Kadaba**
Senior Manager, Ernst & Young LLP
Financial Services Organization
sridhar.kadaba@ey.com

**Mike Coletti**
Senior Manager, Ernst & Young LLP
Financial Services Organization
michael.coletti@ey.com
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

EY is a leader in serving the global financial services marketplace
Nearly 43,000 EY financial services professionals around the world provide integrated assurance, tax, transaction and advisory services to our asset management, banking, capital markets and insurance clients. In the Americas, EY is the only public accounting organization with a separate business unit dedicated to the financial services marketplace. Created in 2000, the Americas Financial Services Organization today includes more than 6,900 professionals at member firms in over 50 locations throughout the US, the Caribbean and Latin America.

EY professionals in our financial services practices worldwide align with key global industry groups, including EY's Global Wealth & Asset Management Center, Global Banking & Capital Markets Center, Global Insurance Center and Global Private Equity Center, which act as hubs for sharing industry-focused knowledge on current and emerging trends and regulations in order to help our clients address key issues. Our practitioners span many disciplines and provide a well-rounded understanding of business issues and challenges, as well as integrated services to our clients.

With a global presence and industry-focused advice, EY's financial services professionals provide high-quality assurance, tax, transaction and advisory services, including operations, process improvement, risk and technology, to financial services companies worldwide.

© 2016 EYGM Limited.
All Rights Reserved.

SCORE No. 02387-161US
1607-1979269 BDPSO
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com