Asset Management: Industry and Economics

Interview preparation summary · HF track

IN THIS SUMMARY

- How the industry works
- The economics of a manager

INT.HA.1.a · How the industry works

Map the players in the asset management value chain and distinguish segregated mandates from pooled funds, ETFs and investment trusts.

Asset management is a chain of specialists. Asset owners (pension schemes, insurers, sovereign funds, endowments, individuals) hold the money. Consultants and advisers help them choose; managers invest the money for a fee; platforms and distributors put funds in front of retail and adviser clients; custodians safekeep the assets and settle trades; administrators calculate the net asset value (NAV) and keep the records. Keeping assets with a custodian, separate from the manager, is a core client protection. A segregated mandate is a portfolio in the client's own name, run to written guidelines, usually for larger clients. A pooled fund holds many investors' money in one portfolio with identical terms. UCITS-style open-ended funds deal daily and follow diversification and liquidity rules (regimes differ by jurisdiction). An exchange traded fund (ETF) trades on a stock exchange and is usually passive. An investment trust is a closed-ended listed company, so its share price can sit at a discount or premium to NAV, and holders cannot redeem. Common mistake: saying the manager holds the client's assets. Interview point: choose the vehicle from the client's size, need for bespoke terms and need for liquidity.

WORKED EXAMPLE: REVENUE AND SERVICING LOAD: ONE MANDATE AGAINST MANY RETAIL HOLDERS

Rosewell Asset Managers (invented) has a segregated UK equity mandate of £250m from a pension scheme, charged at 0.30% a year. Its pooled retail fund charges a management fee of 0.75% a year and the average retail holding is £15,000. How many retail holders produce the same annual fee revenue as the mandate, and what does that say about how the firm serves each client? Ignore other costs and assume fees are charged on the full holding.

Answer: The 250m mandate earns £750,000 a year, the same as about 6,667 retail holders at £112.50 each, so the two need different servicing models, vehicles and routes to market.

> **Interview tip:** Say that the manager earns its fee on assets it does not hold, and that the custodian holds them. Then compare the vehicles on size, bespoke needs and liquidity rather than reciting definitions.

INT.HA.1.b · How the industry works

Explain active and passive management, separate alpha from beta against a benchmark, and recognise capacity limits and closet indexing.

A benchmark is the yardstick a mandate is judged against, such as a UK equity index. A passive fund tries to match it at very low cost. An active manager tries to beat it after fees, and takes active risk to do so. Beta measures how much a portfolio moves with the market or benchmark; alpha is the return left after the return explained by beta, often measured as portfolio return minus the risk-free rate plus beta times the market's excess return. Beating the benchmark is not the same as alpha: a fund with a beta above one beats a rising market simply by taking more market risk. Because active fees are higher, gross outperformance must at least equal the fee gap to leave the client better off than a tracker. Capacity is the assets a strategy can hold before trading costs and market impact erode returns, which bites hardest in small companies and illiquid assets. Closet indexing means charging active fees for a portfolio that hugs the benchmark, shown by low active share and low tracking error.

WORKED EXAMPLE: BEATING THE BENCHMARK IS NOT THE SAME AS ALPHA

Elmfield Equity Fund (invented) returned 9.0% gross of fees over a year. Its benchmark returned 8.0%, the risk-free rate was 2.0%, and the fund's beta to the benchmark was 1.1. The fund charges 0.75% a year; a benchmark tracker charges 0.10%. Is the manager adding value? Ignore tax and use the single-factor measure of alpha.

Answer: The fund beat the benchmark by 1.0% gross, but alpha was only 0.4% before fees and minus 0.35% after the 0.75% fee; most of the outperformance was extra market risk.

Interview tip: Say active return, beta-adjusted alpha and net-of-fee alpha as three separate numbers, and name the beta as the reason the first one flatters. Interviewers listen for whether you adjust for risk before praising a manager.

INT.HA.1.c · How the industry works

Describe what pension schemes, insurers, sovereign funds, wealth managers and retail investors each want from a manager, with horizon and liabilities in mind.

A manager's client decides the objective, so a good answer starts with who the client is. A defined benefit pension scheme owes members future payments, so it thinks in liabilities and the funding ratio (assets divided by the present value of liabilities). It often holds bonds that move with its liabilities, so falling rates raise both. A mature scheme wants predictable cash flows and low risk; a young one can take more. An insurer matches assets to policy liabilities, cares about credit quality and income, and faces regulatory capital charges that penalise riskier assets (regimes differ by jurisdiction). A sovereign fund has a very long horizon, large size and little need for cash soon, so it can hold illiquid assets. A wealth manager advises individuals on goals, tax and income needs, and must judge suitability. Retail investors want simplicity, liquidity and low charges, and often buy after good performance and sell after bad. Common mistake: pitching the same return story to every client. Interview point: state the client's horizon, liability and constraint before any product.

WORKED EXAMPLE: A PENSION SCHEME WHEN INTEREST RATES RISE

Harbour Mill Pension Scheme (invented) has assets of £480m and liabilities of £600m. Assets are 60% growth assets (288m) and 40% bonds (192m). Both the bonds and the liabilities have a duration of 12 years. Rates rise by 1 percentage point. Ignore convexity, contributions and benefit payments. What happens to the funding ratio, and why does it matter to the manager?

Answer: The funding ratio rises from 80.0% to about 86.5% because liabilities fall 12% while only 40% of assets are bonds that fall with them; the client's real objective is the funding ratio, not the headline return.

Interview tip: Open any client answer with the client's liability and horizon. Say that falling or rising rates hit assets and liabilities together, and the manager is judged on the net effect.

INT.HA.2.a · The economics of a manager

Calculate a manager's revenue and operating margin from fee rate and average AUM, and show how operating leverage and fee compression change profit.

A manager's revenue is mostly the fee rate times average assets under management (AUM) for the period. Use average AUM, not closing AUM, because fees accrue on assets held through the year. Fee rates differ by product: active equity and alternatives typically charge more than fixed income, multi-asset and above all passive funds. Large institutional mandates pay less than retail share classes, so mix matters as much as the total. Costs split into fixed (staff base pay, technology, premises, compliance, which do not move with AUM) and variable (bonuses, distribution payments, and some fund costs). Operating margin is operating profit divided by revenue. Because fixed costs do not fall when revenue falls, profit moves by more than revenue: this is operating leverage, and it works in both directions. Fee compression, driven by passive funds, platform pressure and client negotiation, cuts revenue on the same AUM, and since cost stays the same the whole cut falls to profit apart from variable costs. Interview point: show revenue, then profit, then the percentage change in each.

WORKED EXAMPLE: OPERATING LEVERAGE AND FEE COMPRESSION AT AN INVENTED MANAGER

Brindle Row Investments (invented) has average AUM of £20bn and an average fee of 0.50%. Fixed costs are £40m a year and variable costs are 30% of revenue. Work out revenue, profit and margin. Then find the change in profit if (a) average AUM rises 10% at the same fee, and (b) the average fee falls by 5 basis points (to 0.45%) at the same AUM. Finally, how much AUM is needed at 0.45% to restore the original profit? Ignore tax and assume costs behave as stated.

Answer: Base profit is 30m on 100m revenue. A 10% AUM rise lifts profit to 37m (up 23.3%); a 5 basis point fee cut drops it to 23m (down 23.3%); about 22.2bn of AUM is needed at 0.45% to get back to 30m.

Interview tip: Give revenue, cost, profit and margin in that order, then the percentage change in profit against the percentage change in revenue. Name operating leverage and say which costs are fixed.

INT.HA.2.b · The economics of a manager

Build and read an AUM bridge from opening AUM, market movement and net flows to closing AUM, and judge organic growth and the quality of flows.

An AUM bridge explains how assets moved over a period: opening AUM, plus or minus market movement (investment returns and currency), plus gross inflows, minus outflows (together net flows), plus or minus acquisitions and disposals, equals closing AUM. Market movement is largely out of the manager's hands; net flows are the result of winning and keeping clients. Organic growth is net flows divided by opening AUM and excludes market moves and acquisitions, so it is the cleanest measure of commercial momentum. A manager whose AUM rose 8% in a market that rose 9% lost clients. Drivers of flows include performance against the benchmark and peers, ratings and consultant or platform buy lists, distribution reach, fees, product fit and client events such as a pension scheme de-risking. Quality matters too: inflows into a 10 basis point index product and outflows from a 70 basis point active product raise AUM while cutting revenue. Revenue also lags flows, because fees follow average AUM. Interview point: always strip out the market before judging growth, then weight flows by fee rate.

WORKED EXAMPLE: A YEAR IN THE LIFE OF AN AUM BRIDGE

Quarrybank Funds (invented) opened the year with £30.0bn of AUM. Markets added 1.8bn. Gross inflows were 3.2bn and outflows 4.4bn. There were no acquisitions. The average fee is 0.48%. Build the bridge, find organic growth and total growth, and estimate revenue using average AUM as the simple average of opening and closing.

Answer: Closing AUM is 30.6bn, up 2.0%, but organic growth is minus 4.0% (net outflows of 1.2bn) and the market added 6.0%; revenue is about 145.4m on average AUM of 30.3bn.

> **Interview tip:** Say the market and the flows separately and lead with organic growth. Then ask what fee rate the flows carried, because a pound of outflow from an active fund costs more revenue than a pound of inflow to an index fund brings.

INT.HA.2.c · The economics of a manager

Explain performance fees with high-water marks and hurdles, how share classes and ongoing charges work, and what moves the value of a manager's profit.

Beyond the base management fee, some funds charge a performance fee on gains. A hurdle is a minimum return before any performance fee is earned; with a hard hurdle the fee applies only to the return above it, and with a soft hurdle the fee applies to the whole gain once the hurdle is cleared. A high-water mark means a fee is charged only on gains above the highest NAV on which a fee was previously paid, so investors do not pay twice for the same recovery. Long-only funds use these terms less than hedge funds, and some regimes limit them for retail funds. Share classes carry different charges for different investors: retail classes carry higher ongoing charges than institutional classes, which are larger and have lower distribution costs. The ongoing charges figure sums the management fee and operating costs; transaction costs are shown separately. A listed manager is often valued on an earnings multiple of profit after tax, with a rougher check against AUM. Multiples reflect growth, flows, margin stability and key-person risk; performance fees are volatile, so they usually deserve a lower multiple than management fees.

WORKED EXAMPLE: A PERFORMANCE FEE OVER THREE YEARS

Tolland Opportunities Fund (invented) starts at a NAV of 100 per unit with a high-water mark of 100. The performance fee is 20% of the gain above the higher of the high-water mark and a 4% hurdle on the start-of-year NAV. Fees crystallise annually. Gross returns before performance fee are +12%, then minus 5%, then +8%. Ignore the management fee and tax. Find the fee and NAV each year.

Answer: Performance fees are 1.60 in year 1, nothing in year 2 and 0.57 in year 3, with NAV ending at 112.70 per unit; the high-water mark of 110.40 set the year 3 threshold, not the 4% hurdle.

> **Interview tip:** Describe the hurdle and the high-water mark as two separate protections, say which one binds in your example, and note that performance fees are less reliable than management fees when a manager is valued.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.