VIEWPOINTS

VIEWPOINTS is a quarterly newsletter from Basis Point Group providing timely commentary on topics of interest to senior investment management, including technology, operations and finance managers. We select topics that help firms enhance profitability, increase operating efficiency and improve services to their customers. In this issue we spotlight Investment Management Profitability and discuss alternative methods of measuring and managing the bottom line.

BASIS POINT GROUP provides business, technology and operations advisory services to investment managers, service providers and plan sponsors. BPG specializes in finance, trading, technology, operations, compliance, acquisition due diligence and integration. We are a results-oriented group of senior industry professionals with a broad range of specialties and substantial hands-on experience. Information on our company can be found online or call Bob Fawls for more information.

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Back to Basics:
Looking at the Bottom Line

Who would have thought that managing the bottom line of a money management firm would be as challenging as managing for top quartile performance? Weren't we the industry that glided along at 60% margins and valuations approaching 15x earnings? Life was good; net contribution flows, AUM and new customers all rose with the rising markets. Fast forward into the third year of a bearish market and we're now facing a number of options that will likely require us to rethink, retool, reduce, or even retreat. Consider the similarities with the auto industry; challenging market conditions, product proliferation, overcapacity, high expense structure, lower margins and skeptical buyers.

Playing defense doesn't necessarily play to our strengths nor does it put us in a better position to compete once we emerge from this market cycle. *Retool*, *Reduce* and *Retreat* speaks to how well firms are repositioning themselves to hit the ground running in what will likely be a very competitive landscape.

- **Retooling** requires a realistic look at what the market expects, how products and service stack up and steps necessary to make us more competitive (and profitable). Are there more creative ways to produce a product that is better, faster and cheaper? Are there existing product lines with too few assets or similar 'strategies' that are simply variations on the same theme?

- **Reductions** should be considered in areas that don't contribute value to your customers. Look at staff redundancies, vendor uses and charges, in-house administrative and operations functions (do you really need in-house HR, event planning, and legal services?). Are existing products and services profitable? How do you know?

- **Retreat** from those markets or distribution channels where costs and management attention are high, asset retention is low and long-term prospects are doubtful. Every firm has a few 'initiatives' that were initially great ideas, but are unlikely to ever make a significant contribution to profit. Let it go.

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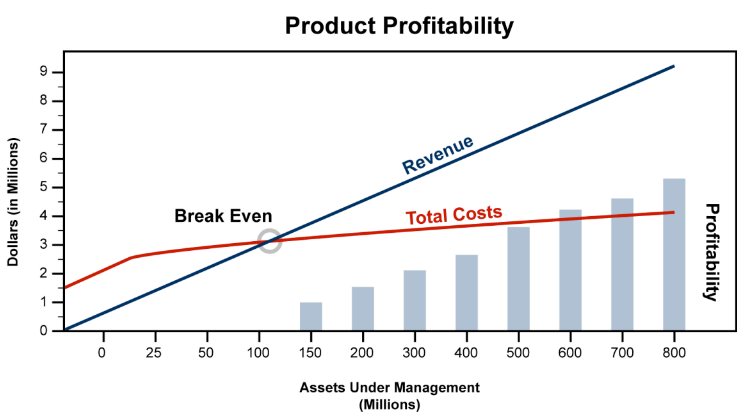
Taking a Methodical Approach

Let's face it; no one likes to deal with expenses, unless they qualify as soft dollars. If current trading volume is not keeping pace with commitments, then it's time to consider Plan B, "Cost Rationalization". We are not talking about draconian measures that may impact services to clients or inhibit our ability to grow AUM, rather a measured and dispassionate review of the levers that enhance (or detract from) profitability. Expenses fall into two categories; fixed and variable. Fixed costs remain reasonably constant over time (e.g. rent, insurance, depreciation), while variable or discretionary costs change in proportion to the level of products and services (e.g. staff, technology, travel, professional services). Some may argue that staff costs are fixed as they typically represent 2/3 of total expenses for most firms.

A typical response to reducing or rationalizing expenses is to reduce the usual discretionary suspects, such as travel, consultants, contractors, client events, marketing materials and conferences. Many firms have been faced with painful, but necessary cuts in personnel expenses. Frequently, this type of cost reduction approach ignores the impact on product profitability or its effects on services that our clients perceive to be of value. Our view is that a product based analysis approach more accurately identifies those costs and services underlying investment products and provides a better perspective on measuring profitability. Using this approach, every expense is rationalized against the financial implications of what we're selling, what customers are buying and whether leverage exists within each investment product to improve margin. A simple depiction of this methodology illustrates the relationship between costs, revenues and margin.



Summary

Market conditions not only influence our investment decisions but also our thinking about where our business will be positioned once market conditions become more favorable. As our industry emerges from this downturn, we will be challenged to reinvigorate margins on a much smaller asset base among a very crowded product environment. Different skill sets and even a different business standard may be required to succeed in the new marketplace. When markets were more favorable, it was rare to find investment managers who understood or felt a need to manage for costs. Today, the issue isn't whether to reduce, but to how to incorporate these decisions within the framework of a new business model. Those that look at expenses in the context of value and service will be in a better competitive position once the markets recover.

Thinking Like a Manufacturer

The notion of activity-based management has been around for years, although not universally applied to financial services. This approach looks at every expense in an organization and classifies each as either value added or non-value-added costs. The premise is straightforward: improve upon those functions that add client value and directly enhance your profitability while eliminating those costs that are non-value-added. This technique has been used successfully in manufacturing when overhead is high, products are diverse and complex, and competition is stiff. Perhaps a manufacturing perspective may not seem so offbeat when you consider that we create and manufacture investment products (the factory), distribute them into the marketplace and service the customers who buy our products. Thinking along product lines, may help identify the 'value' inherent in the process of creating, distributing and servicing investment products. We suggest that the following viewpoint may be worth considering:

Measure profitability by product and monitor each product's break-even point.

Identify the costs associated with each investment vehicle and/or service (e.g. personnel, distribution, operations, internal overhead).

Ask your customers what they consider to be of value in your relationship.