INNOVATIONS IN INVESTING

Radical changes in market conditions require new solutions

Amin Rajan, chief executive of CREATE-Research, a research boutique based in London, UK, works with financial institutions in general and asset managers in particular to improve their innovation processes. Rajan's latest study focuses on innovation challenges for asset managers who invest US$65 trillion in assets worldwide, yet lag in innovation. In an interview with *Compass*, Rajan spelled out his recommendations for adapting to this new era.

• *by William J. Holstein*

***COMPASS:* How is the asset management business doing?**

AMIN RAJAN: The industry has been in a crisis mode for 15 years. It has had two significant bear markets, which were two of the four worst bear markets in the past 100 years. Investors are scared. Their environment has changed radically. The 24-hour news cycles amplify investor paranoia and glee. With globalization, when something goes wrong in one country, it affects many others. The old style of investing isn't working.

AMIN RAJAN
Chief Executive, CREATE-Research

Clients are saying, "We need new types of products. We can't cope with this feast-and-famine mentality that has prevailed since the collapse of Lehman Brothers."

As investors get closer to retirement, are they becoming more demanding?

AR: It's quite startling. Around 75% of assets held by retail asset managers are owned by people who are either retirees or near-retirees. Their risk profile is very different. They are saying, "I want assets that give me income and low volatility. I want certainty rather than volatility."

What can asset managers do to innovate in response to these needs?

AR: In some cases, they can offer better versions of old products. They also have to engage with their clients much more than in the past. Market dislocations create price anomalies or mispricing. In that kind of environment, it is possible to convert volatility into gain. Asset managers also need to help investors to avoid herd instincts. That has killed many portfolios.

It seems you're suggesting that asset managers have to adopt a more activist style.

AR: Right. The old way was to "set it and forget it." But because of the volatility, that style doesn't work anymore. Retirement planning is not a one-shot decision like buying a house. Jobs change. Family situations change. You have to be savvier and to adapt, especially when markets are moved more by politics than economics.

What about creating new products?

AR: You can create new products, or you can update existing ones. If you are selling a fixed annuity, how about linking it to price inflation? Or how about having a draw-down product? A customer invests only half of his or her portfolio into an annuity. The other half is invested in a draw-down product where funds are reinvested to deliver regular income and inflation protection. The eggs are spread among different baskets.

Do you have suggestions for managing the risks involved in creating new products?

AR: The way it has worked in the past is that a salesman met a client and found an interest in a particular product. The asset management team put the product together and then they sold it. They didn't do stress testing. They didn't do market research. They just went for it. But a good process will develop a business case around the product, then do a proof of concept. This is like putting a new car through a wind tunnel. A product should be tried and tested. Perhaps it should have a "paper portfolio" and run it for six months to see how it works.

Ongoing volatility in the investment markets requires investment managers to develop new products and serve their clients in new ways. (Image © Scott Eells/Bloomberg – Getty Images)

So asset managers haven't had the benefit of fully developed innovation processes, like technology companies do?

AR: No, which is why asset managers have to move in the same direction as 3M and Johnson & Johnson. They have to develop a very robust process before they bring anything to the market. They need to create a bank of ideas submitted by people from every part of the organization. The ideas have to be evaluated by peers. The good ones are escalated.

But the financial industry attracts highly individualistic people who prefer to come up with their own solutions, doesn't it?

AR: Yes, but that is changing, because the asset management business is becoming more industrialized. It has to blend ideas with processes. The craft nature of the business is giving way to process discipline. It is not a cottage industry anymore.

What role does tougher regulatory scrutiny have?

AR: More regulation means you can't just come up with an idea. Now, it has to be approved via a robust process. Here in the UK, before I register a product with the regulators, I have to show them all the thinking that has gone into its creation. There also is more stringent enforcement of existing rules. Regulation is a double-edged sword. It is slowing things down, but it is also ensuring greater rigor.

Your report observed that there are hurdles, or "blockers," that discourage innovation. What are they?

AR: In cultural terms, we see the prevalence of a "permission" culture, where people are reluctant to think outside the box. There are also dysfunctional tensions between members of innovation teams – especially between portfolio managers who understand market dynamics, and sales people who understand client psychology. There is also an absence of tools that promote real-time collaboration among people.

So what is your advice to asset managers?

AR: The first step is to tackle the factors that act as blockers to innovation. It is easy to identify these barriers, like the syndrome where people are not open to ideas they didn't invent. And you have to make sure that processes are in place. I hate bureaucracy, but I know we must go through certain processes to ensure the integrity of our products. Lower or eliminate the barriers to good ideas, give people the tools to collaborate, and put in place the processes. ◆

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