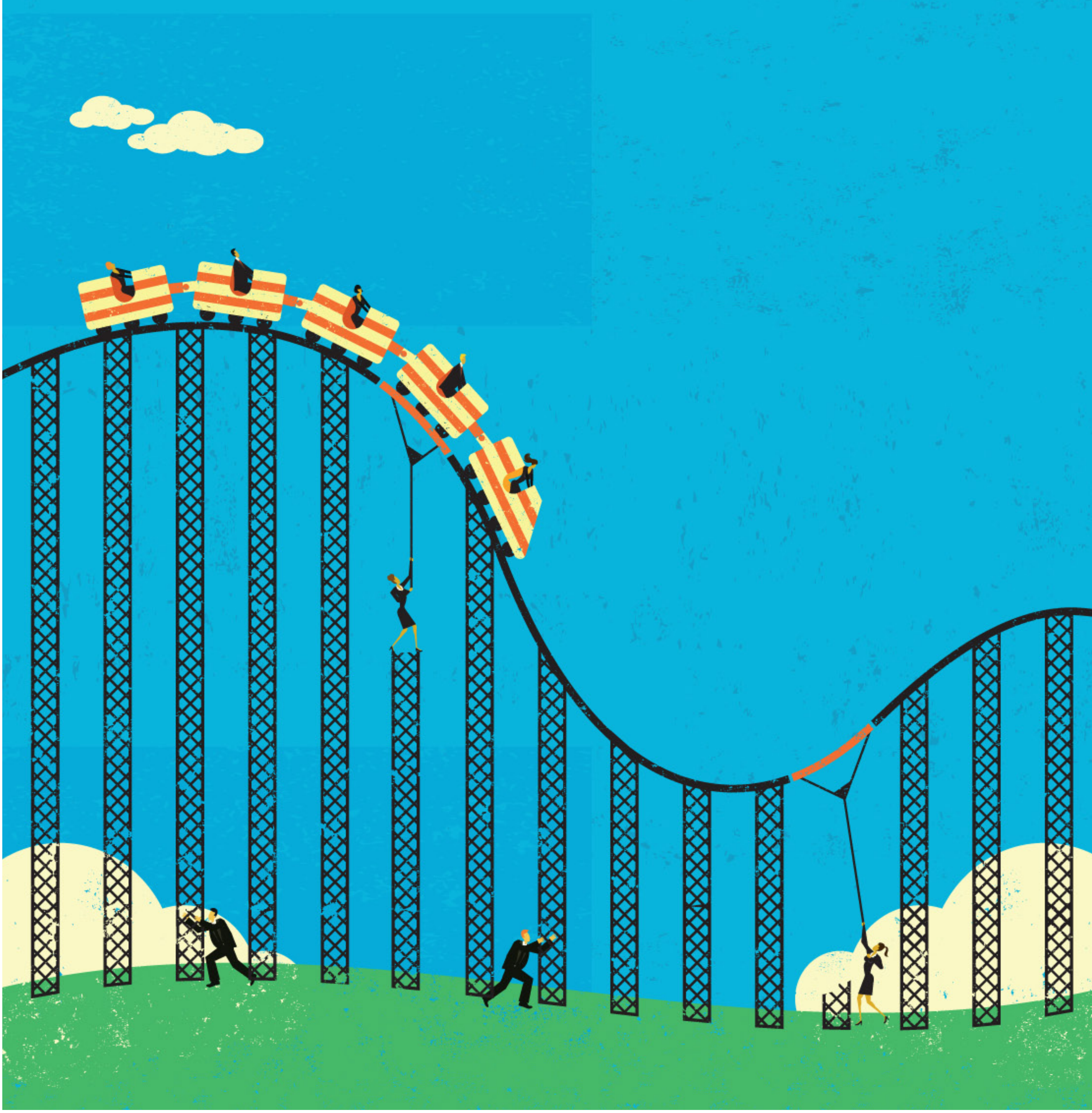
# Upping The Innovation Game
## In A Winner Takes All World



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We are pleased to partner with CREATE-Research on our inaugural asset management study. Prof. Amin Rajan is one of the most respected commentators on the subject of asset management. This publication represents his most recent research on understanding the innovation imperatives for the industry.

We currently operate in a world where regulators are demanding greater transparency, shareholders push for improved operational efficiency and customers demand solutions not products. In the midst of these complex challenges asset management companies still rely on manual processes in many key aspects of their business. In order to significantly improve fund innovation outcomes, firms must begin the systematic and organisational change required to satisfy regulatory, client and shareholder demands.

We, at Dassault Systèmes, recognise that many firms aspire to make this change, yet don't have the tools or knowledge to execute it. Leveraging over three decades of experience across twelve industries, Dassault Systèmes provides financial services firms with the ability to realise these outcomes. Our experience with some of the world's most innovative companies has shown that by coupling talented people and streamlined processes with enterprise collaboration the innovation process is dramatically improved. As a result the reliance on manual processes is also significantly reduced and corporate memory becomes an enterprise asset. Ultimately asset managers will be able to operate with greater efficiency, be more client centric and deliver increased value to all stakeholders.

We, together with Prof. Amin Rajan are pleased to present this study and hope its insights on innovation alpha can be leveraged by your organisations.

Regards,

**Kevin Pleiter**
VP, Financial and Business Services
Dassault Systèmes

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# Foreword

## This study comes at an important moment for the asset management industry. Its focus on best practices in innovation addresses so many of our industry's current challenges today.

Indeed, an unexpected convergence of structural factors is sapping its decade-long secular pillars: sustained low levels of real interest rates; an expectation of low to no future organic growth due to debt deleveraging; an ageing client base; and increasing regulatory intervention.

These are challenging the way asset managers perform their fiduciary duties to their clients.

In this new landscape, asset managers can't escape harsh truths. There are simply too many of them and few will thrive in the years to come. The partnership structure will be challenged as revenues (not just profits) will no longer grow, and perhaps even fall.

For too long asset managers – and clients – have been lazy when it comes to innovation, following fads and ultimately damaging themselves.

Investors have followed past performance blindly to such extremes that almost 100% of flows go into top star funds, giving the industry a blockbuster culture.

As we know, a 'winner takes all' industry leads to a 'one size fits all' business model, which is doomed to fail both clients and manufacturers.

This study shows that in this new and bleak environment, the soul-searching for asset managers has already started. Respondents are realistic about their own failings in the product innovation processes.

Too often 'bright ideas' are the engine of product creation at the expense of the rigorous testing of clients' needs.

Think about smart beta today: are they really smart for investors? There is hope in the report's finding that, in pursuit of a better alignment of interest with clients, asset managers are shifting their emphasis from product-push to product-pull. This is a top item on their agenda.

As Amin Rajan puts it very elegantly: "Collaboration is the new alpha behind alpha."

I can quite confidently bet that all readers of this foreword have heard *ad nauseam* the new industry 'mantra': the move from products to solutions and outcomes.

What makes the reading of Prof. Rajan's report invaluable is that it provides some of the keys on how to be successful at it. Idea generation is good, but execution is what counts. And, as an industry, we haven't been particularly good at it.

Wouldn't it be exciting if now were the time for change?

Enjoy your reading.

Best wishes,

**Pascal Duval**
CEO, EMEA Russell Investments

# Acknowledgements


*According to Albert Einstein: “The problems we face cannot be resolved at the same level of thinking as that which gave rise to them.”*

This report turns the spotlight on an important issue facing the global asset industry: how to create a clear line of sight between innovation and client needs.

Active management in general and innovation in particular have had a bad press in the wake of the two bear markets of the last decade and a debilitating sovereign debt crisis since then.

Worldwide, there is a savings glut. The key concern is whether it can be put to good use, since the majority of active managers have failed to deliver value when it was most needed.

Investors are wising up; as are regulators.

Asset managers, too, are recognising their fiduciary role in delivering products that are built to last.

Many among them see the current crisis as an opportunity to create businesses of enduring value.

They have improved their innovation process to gain a competitive edge in today’s winner-takes-all world of asset management.

This report provides an initial assessment of progress so far and the work that remains to be done.

I am deeply grateful to 223 asset managers, pension plans and pension consultants for participating in our survey. I am struck by their candour as well as their earnest intention to do better.

I am also grateful to Dassault Systèmes for supporting the publication of this report at arm’s length, without influencing its findings in any way.

Finally, my grateful thanks go to Lisa Rajan for co-ordinating the survey and report preparation, and to Dr Elizabeth Goodhew for her editorial help.

And, while I have striven to raise the level of thinking on this topic, if there are any errors and omissions in this report, I’m solely responsible.



**Amin Rajan**
Project Leader
CREATE-Research

# Contents





# 1 Executive Summary

> Big companies are rotten at innovation.
>
> *Jim McCaughan*
> *CEO, Principal Global Investors*

## Background

Currently, there are some 70,000 share classes in the fund universe. Yet only 185 of them (0.003%) attract almost 100% of the new inflows.

Today's low-yield environment has intensified the search for such blockbuster products.

Like supernovas, they can be ultra luminous. They outshine the fund galaxy momentarily, only to fade away just as fast.

Their success rests more on luck than judgement – often driven by the prevailing market sentiment, deft marketing and clients' wish to chase the next rainbow.

In the last decade, too many of them were rushed out without much regard to their intrinsic value. Some were simply a resprayed version of the old. Risk was stacked up like a wedding cake.

Innovation became a much-used, misused and abused word in the investment lexicon.

No wonder regulators now demand unusual rigour and transparency around the innovation process to curb fads.

Ageing populations, too, are shifting attention from capital growth to income upside, raising the spectre of yet another mis-selling scandal, this time involving the most vulnerable clients.

An attitudinal change is discernible.

Competitor leapfrogging to deliver copycats has proved wasteful. Innovation is now about creating new ideas that add value for clients within a definable timeframe.

Over the past three years, there has been growing interest within the asset industry in how to improve the outcomes of its new products by adopting approaches used by the world's most innovative companies – such as Apple, Johnson & Johnson, BMW, GE and Toyota, to name but a few – as identified in a previous study from CREATE-Research.

The approaches in question aim to replace the prevailing *ad hocery* with robust discipline in four sequential activities in the innovation value chain:

- ***ideas generation:*** spots emerging or disruptive gaps in the product market and creates new ideas to bridge them
- ***evaluation:*** calls for a feasibility study and business case
- ***design:*** calls for stress-testing, proof of concept, paper portfolios and seed money
- ***delivery:*** calls for product launches, transition planning and marketing.

Thus, the process promotes new ideas to meet pre-identified market needs, weeds out the 'dogs' from the 'stars', subjects them to a reality check, kills off unsound ideas, banks those whose time is not ripe, and escalates the rest to deliver products that are fit for purpose.

## Aims and method

Against this background, this report aims to:

- assess the effectiveness of the approaches being currently adopted by asset managers
- highlight the constraints that have conspired against better outcomes so far
- suggest actions that can overcome the constraints.

This three-point remit was pursued via a survey of 223 asset managers, pension plans and pension consultants with global AuM of US$13.4 trillion. The survey was followed by structured interviews with 50 participants. The survey provided the breadth, the interviews the depth.

Our key findings are presented under three headlines below, followed by the five themes that emerge from them.

## Headlines

### 1 So far, asset managers have been more effective at generating new ideas than executing them

The effectiveness of individual activities along the innovation value chain has been variable.

Upstream activities such as ideas generation and product specification have fared better than downstream activities such as feasibility studies and product launches.

Focusing on the overall effectiveness of their own innovation process:

- **3%** of managers rate it as *'excellent'*
- **43%** as *'good'*
- **47%** as *'average'*
- **7%** as *'so-so'*.

For some managers, these numbers reflect work-in-progress on a nascent phenomenon that is taking time to embed in the cultural fabric of their businesses.

For others, they reflect the classic innovator's dilemma: why rock the boat when a big legacy book of assets is already delivering a steady handsome fee income?

### 2 Fears about the loss of craft heritage have created teething problems

The effectiveness scorecard also speaks to a structural shift.

For a long time, asset management was a craft business with a strong culture of individualism based on a reservoir of talent.

However, as it expanded its global footprint in the last decade, industrialisation became inevitable.

The ensuing process disciplines have proved alien to the long-prevailing cottage industry mindset, giving rise to a 'permission' culture, silo working and petty turf wars.

They have ensured that ideas generation is one thing, their execution quite another. A lot more people are involved in the entire food chain, not least clients.

The process no longer relies on personal chemistry between a handful of people mainly accountable to themselves.

It reflects the new reality that innovation is about identifying and meeting client needs, including those that clients are not even aware of. This is easier said than done.

First, industrialisation has resulted in disintermediation, which has made it harder to understand clients' investment goals and risk appetites.

Second, the new processes demand a gold standard in client engagement. A concerted shift from products to solutions is now in progress in four key segments: defined benefit plans (DB), defined contribution (DC) plans, retail clients and high net worth individuals (HNWI).

In each case, customisation will dominate the next wave of innovation.

Third, the inclusion of more stakeholders in the innovation process has helped ideas generation. On the flip side, many good ideas are stillborn due to stringent scrutiny from four sets of entities: pension consultants, fund boards, senior management and risk & compliance teams.

Post-crisis, their role has become invidious.

They have to walk a fine line between:

- innovation and client needs
- business profits and franchise risk
- product-push and value for money
- the letter of the law and the spirit behind it.

There are no easy answers, only tough choices.

> Bandwagonism is a powerful driver of innovation. Yet good products often travel on their own. We provide opportunistic as well as core products that aim to deliver what it says on the tin.

*An interview quote*

> With excessive market volatility since 2008, product-push has far exceeded product-pull.

## 3 Success is about striking a balance between product-pull and product-push

Financial markets worldwide have been more volatile in the past four years than in the previous forty. Opportunism has been on the rise, as conventional investment wisdom has been sidelined by the debt crisis across the Atlantic.

Hence the emerging innovation architecture has had to contend with far more than the transition from craft to industrialisation.

While directing the innovation effort at meeting client needs, asset managers have yet to strike a balance between two opposing forces (Figure 1.1):

- ***product-push:*** where product success mainly rests on the prevailing market sentiment and deft marketing (south-west box)
- ***product-pull:*** where success rests mainly on knowing the client's needs and the quality of skills and processes aimed at meeting them (north-east box).

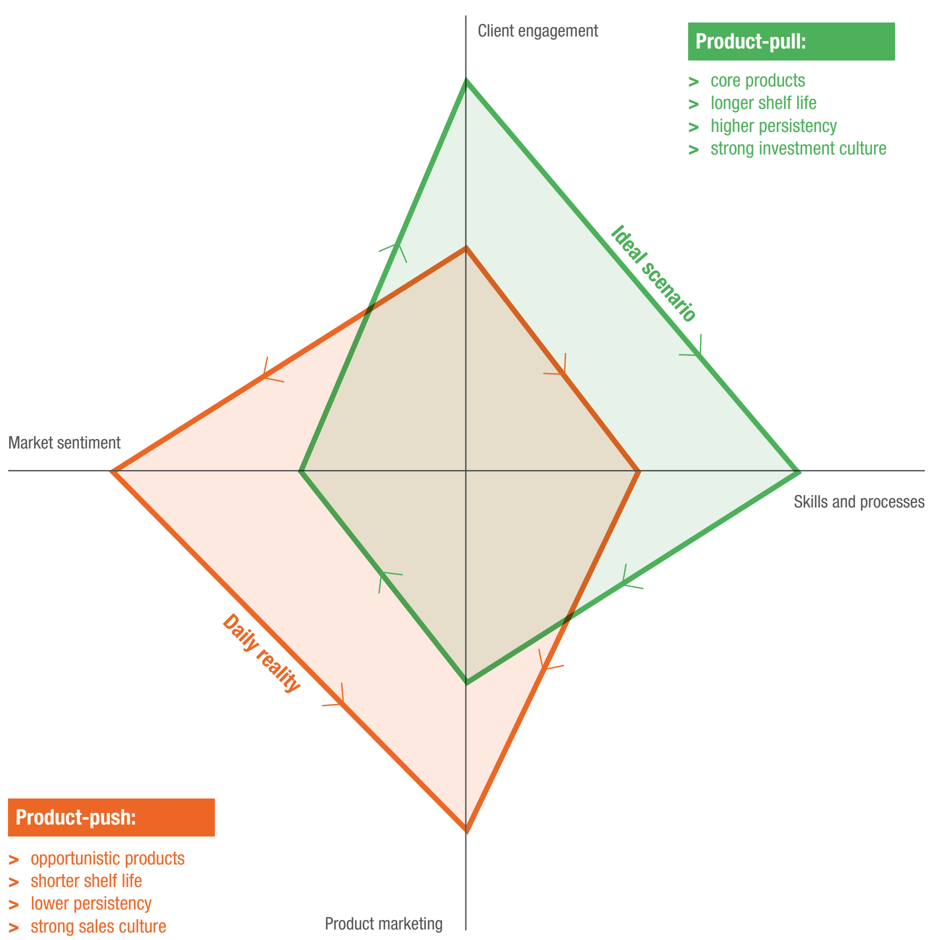
With excessive market volatility since 2008, product-push has far exceeded product-pull.

When markets have headed south, many investors have left the money on the table and gone after the next fad.

On asset managers' part, the innovation disciplines needed to promote product-pull are taking time to embed.

**Figure 1.1**

**Current approaches to innovation lack balance: they require greater emphasis on skills, processes and client engagement**




Source: CREATE-Research/Dassault Systèmes Survey 2013

**71%**

cite AuM raised within a specific timeframe as a very important metric.

**67%**

cite client feedback as a very important metric.

The problem is compounded by the lack of balance on the innovation dashboard that measures success: financial metrics overwhelm the non-financial ones.

Two metrics matter most: AuM raised within a specific timeframe **(cited by 71%)** and client feedback **(67%).**

Less than **20%** cite two metrics that raise clients' comfort level: external seeding of new products **(18%)** and co-investing by employees **(10%).**

These numbers reflect the hit-and-miss image of innovation.

Finally, less than **20%** cite two other metrics on the robustness of their innovation process: the size of their 'ideas bank' **(18%);** and the number of 'rejects' after stress testing **(12%).**

These numbers imply limited interpersonal collaboration in the innovation process. Yet 82% believe that it can make a difference.

Hence, two sets of actions will improve innovation outcomes.

The first one is a better balance between product-pull and product-push.

In a cyclical industry, driven by greed and fear, it is unwise to rely too much on either.

The second action is greater interpersonal collaboration between all stakeholders in the innovation value chain.

After all, innovation means seeing what everyone has seen but thinking what nobody has thought.

The requisite insights often come from intensive interpersonal encounters that ensure that ideas beget ideas (see the themes that follow).

Unless innovations leverage the collective memory of the entire business, outcomes will fall short of expectations.

That is also the key lesson from the exemplar companies mentioned earlier.

> “In a cyclical industry, driven by greed and fear, it is unwise to rely too much on either.”

# **Theme 1:** The innovation focus is shifting from quantity to quality

## When millions lost billions in the crisis of 2008, innovation had a bad press. Trust evaporated.

Worse still, the lethal combination of ageing populations and the extreme market volatility of the past five years has heightened clients' awareness of the 'sequence of returns' risks that can both severely hurt their portfolios after big losses and diminish their ability to catch up during subsequent years. Two outcomes have been inevitable.

First, the pace of product innovation has slowed down compared with the pre-crisis level when product churn hit its peak. As Figure 1.2 (left-hand chart) shows, **74%** of our respondents currently have 10 or fewer products in their innovation pipeline: roughly half compared with the pre-crisis level. The changing market environment and client risk tolerances are not the only factors. Regulators have also been demanding extra scrutiny around innovation, making it a costly exercise.

Accordingly, asset managers are now enjoined to deliver products that are fit for purpose. These rely on innovation processes that generate new ideas, reject the ones deemed inappropriate, bank those whose time is not ripe, and escalate those that meet market needs.

As Figure 1.2 (below) shows, currently only **3%** of our respondents class their innovation process as *'excellent'* and **43%** as *'good'*. Of the rest, **47%** rate it *'average'* and **7%** *'so-so'*.

These numbers reflect a subtle transition now in progress. As asset management has gone global with footprints in multiple jurisdictions, via varied channels, it has been losing its craft heritage – under which innovations relied on personal chemistry and a magic inner circle more than quality processes and reality checks.

The switch is happening, albeit gradually. Checks and balances are replacing blind faith in *ex ante* numbers or anecdotal evidence. Notably, practices in the world's most innovative companies – e.g. Apple, 3M and Toyota – are attracting attention.

This search for quality is requiring disciplines that are alien to many asset managers.

**Interview quotes:**

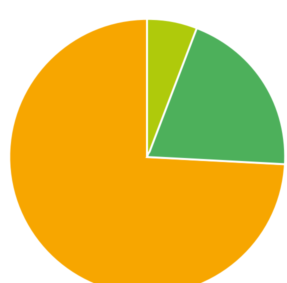
*"Our innovation process says 'no' ten times as often as 'yes'."*

*"Regulators decide what constitutes advice. That makes client engagement very difficult in the retail market."*

*"Investors are always chasing the next rainbow. They often act in ways contrary to their best interests."*

**Figure 1.2**

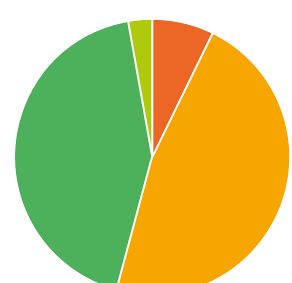
**Roughly how many products do you currently have in the innovation pipeline in your jurisdiction?**



**Innovation products**

| | |
|---|---|
| Over 20 | 6% |
| 11-20 | 20% |
| 10 or fewer | 74% |

**How would you rate the overall effectiveness of various activities in the innovation process in your business currently?**



**Innovation effectiveness**

| | |
|---|---|
| Excellent | 3% |
| Good | 43% |
| Average | 47% |
| So-so | 7% |

Source: CREATE-Research/Dassault Systèmes Survey 2013

# Theme 2: Success of new products is as much about ‘when’ and ‘how’ as ‘what’

**Before the 2008 crisis, competitor leapfrogging was common. Since then, there has been a recognition that innovation is about value creation for end-clients, by paying attention to three factors.**

First, the timing of a new launch is important so as to capitalise on tailwinds from the prevailing market sentiment.

Furthermore, how clients perceive the product – both at launch and thereafter – is important. In the risk-on/risk-off environment of the past five years, panic buying and selling have been widespread.

Finally, what the product can deliver and the marketing around it are also important.

Pre-crisis, product success overly relied on market sentiment and expert marketing. Since then, other priorities have emerged (Figure 1.3): improved responsiveness to client needs **(cited by 63% of respondents);** better leverage of organisational knowledge **(57%)**; creation of blockbuster products **(53%)**; and optimal product planning **(43%).**

Let us take them in turn. First, client engagement via focus groups, surveys or intermediaries has been on the rise. Such engagement seeks to assess needs, raise awareness and manage expectations of what can and cannot be delivered in different market phases. Second, the focus on leverage aims to harness talent across the entire value chain, rather than just rely on the chosen few. Third, the emphasis on blockbuster products reflects the winner-takes-all nature of today’s investing. Finally, product planning is seen as vital for cost-effective innovations.

Thus a more robust process is emerging alongside the old scattergun approach.

**Interview quotes:**

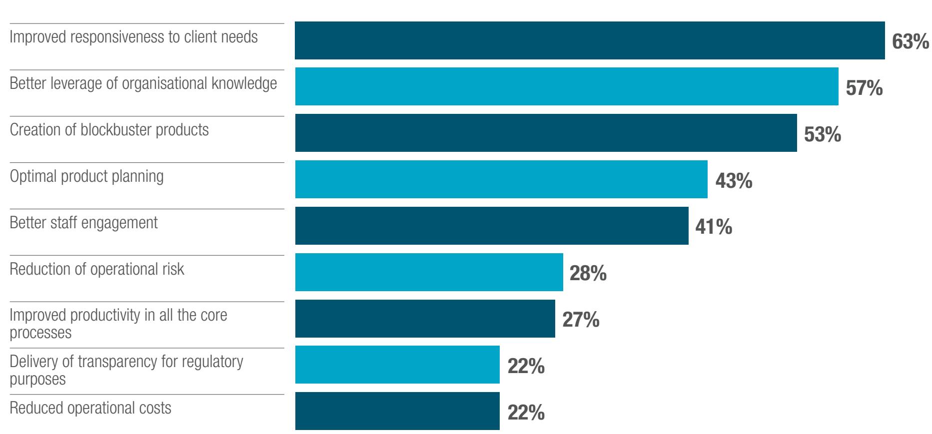
*“Innovation has turned into an expensive game attracting a lot of scrutiny. You need to pull out all the stops to succeed.”*

*“Blockbuster products have a longer shelf life if their marketing push is underpinned by intrinsic worth and market sentiment.”*

*“Corporate memory is rarely downloaded. 90% of our staff can’t remember the defining ideas behind our past successes.”*

**Figure 1.3**

**What are the key priorities in the innovation lifecycle and the new mandate process in your business currently?** (% of respondents)




Source: CREATE-Research/Dassault Systèmes Survey 2013

# Theme 3: Customised asset allocation will drive future innovations

## Bulls won't be roaring back to life any time soon. There is too much uncertainty about the unintended side effects of the QE programmes in the West.

Yet the feast and famine mentality of the past will not go away in the next wave of innovation. Its prevalence, however, is expected to reduce. The new rules on shorting, leverage and derivatives in many jurisdictions are shifting the balance from creating new products to improving the old. Similarly, ageing populations in all the key fund markets are also shifting the balance between DB and DC plans; between products and solutions.

Solutions-driven investing is gaining traction. In a low-yield environment, clients are shifting from high returns to other goals. Customisation will dominate the next wave of innovation. Its pace will vary by client segment (Figure 1.4): **78%** of our respondents anticipate the pace to be *'fast'* or *'moderate'* in the HNWI segment. The corresponding figures for the other segments are **71%** for retail investors, 60% for DC plans and **48%** for DB plans.

Taking each segment in turn, the relatively fast pace in the HNWI segment reflects the reversal in risk appetite after it vanished in 2008-09. The segment also enjoys greater engagement with its wealth managers, who offer proactive investment ideas and a deeper understanding of the associated 'health warnings'.

However, there will be a clear divide between the East and the West. Clients in the East will be pursuing uncorrelated absolute returns and capital growth. Those in the West will be pursuing capital conservation, inflation protection and regular income.

For their part, retail investors are expected to pursue products that provide regular income, inflation protection and low volatility within a single product. Some **75%** of the assets in this segment will be held by retirees or near-retirees over the next five years. So innovation will have a strong retirement flavour.

DC plans will see more refinements in lifecycle funds and diversified growth funds. Both will aim to adopt a clear income benchmark for the decumulation phase. Such customisation will also involve an LDI-lite dynamic asset allocation.

Finally, ever more DB plans are expected to adopt an LDI glide path that will progressively immunise them against risks, as plans advance in the run-off phase.

Owing to the 70% contraction in the pool of 'risk-free' assets since the 2011 sovereign debt crisis, DB innovations will focus on surrogate assets that provide inflation protection, regular cash flow and steady income. Such assets will include real estate (long lease), infrastructure (listed) and farmland, among others.

In all segments, the adoption of new disciplines in the innovation process will slow down product development. They will seek to deliver fewer but better products. Time will tell whether new disciplines will deliver better outcomes.

**Interview quotes:**

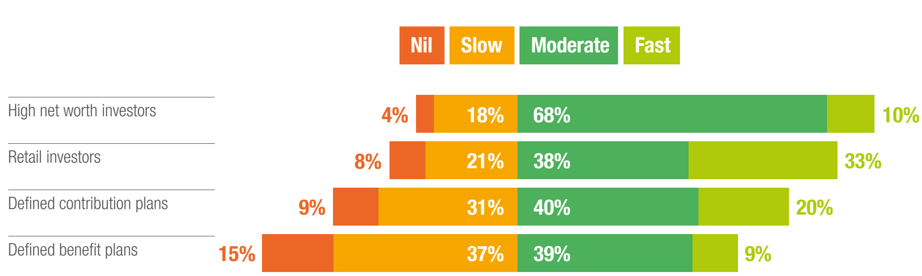
*"There have been too many me-too products with the pretence of sophistication."*

*"Some products catch the attention of the markets more than others. It's a 20:80 rule."*

*"Most innovations today seek to customise old asset classes rather than create anything new."*

**Figure 1.4**

**What will be the pace of product innovation in your business over the next three years with respect to various client segments?** (cumulative % of respondents)




Source: CREATE-Research/Dassault Systèmes Survey 2013

# **Theme 4:** Collaboration is the alpha behind alpha

## A number of cultural and structural factors currently conspire against optimal innovation outcomes.

As shown in Section 3, on the cultural side they include: 'permission culture' **(cited by 55%),** no 'white space' for free thinking **(45%),** fear of failure **(42%)** and unhealthy tensions within the innovation teams **(42%),** 'not invented here' syndrome **(37%),** and 'knowledge is power' syndrome **(36%).**

On the structural side, the key blockers include: silo working **(58%),** absence of tools that permit real-time collaboration **(51%),** and over-reliance on manual input that causes errors and delays **(45%).**

Most of these problems are the outward manifestations of the gradual demise of craft heritage as asset management has gone global (Theme 1). Greater interpersonal collaboration in the investment value chain is key to reducing the transitional pain. As Figure 1.5 shows, **40%** of respondents believe that greater collaboration would *'definitely'* help and a further **42%** believe that it would *'probably'* help.

In this context, one option being considered is the digitisation of the innovation process that relies on the multiple functionalities of an IT platform.

Digital tools are deemed to promote: the retention and enhancement of corporate memory; the generation and evaluation of new ideas; virtual teamworking across space and time; a transparent audit trail and the online availability of relevant data on all products (past, present and future); an integrated work flow document; and the minimisation of 'key person' risk.

Prior to the crisis, the dominant belief was 'fix the asset allocation and the numbers will follow'. For example, the urge to follow the Yale model was intense. Now there is recognition that this model's success came from an amalgam of factors: strong investment beliefs, clear short-, medium- and long-term goals, a strong risk framework, the quality of thinking that went into asset choices, and their vehicle-agnostic delivery and the governance around it.

Collaboration is key to minimising the pain from the transition to a mass-market industry where scale, scope and reach will differentiate winners from losers.

**Interview quotes:**

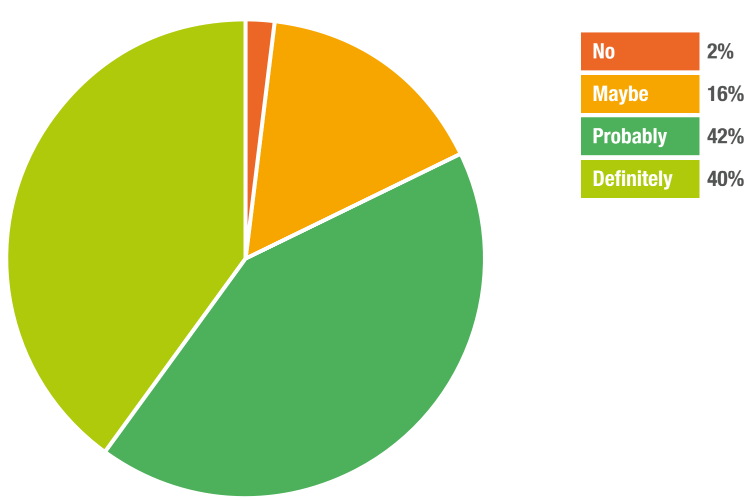
*"Regulators have ensured that innovation is a laborious process."*

*"Innovation is 99% perspiration and 1% inspiration. Unless you're passionate about it, it won't happen."*

*"We need to reduce the time to market. Many intervening activities are prolonged by bureaucracy and hassle."*

**Figure 1.5**

**To what extent do you think better collaboration between various stakeholders in the innovation cycle can help to overcome the factors that slow things down?** (% of respondents)




Source: CREATE-Research/Dassault Systèmes Survey 2013

# **Theme 5:** Innovation is about leveraging the corporate memory

*"If HP knew what HP knows, we would be three times more profitable," said a former CEO of Hewlett-Packard, Lew Platt.*

Within the world's most innovative companies (Theme 1), this observation has since intensified the need to leverage their corporate memory via a robust innovation process based on the traditional trajectory of explore–evaluate–design–deliver.

Whereas this process is used in companies worldwide, what distinguishes the exemplar companies is the quality of execution. It relies on a simple guiding principle: ideas beget ideas and talent begets talent.

This positive chain reaction is fed by tacit knowledge. Unlike explicit knowledge, it cannot be transmitted in an oral, written or image form.

Tacit knowledge is personal, context-specific and hard to formalise. It comprises insights, instincts and intuitions that emerge mostly from interpersonal encounters. It gets embedded into corporate memory through collaboration and learning-by-doing at three distinct levels: know-what, know-how and know-when.

Taking them in turn, the first involves mapping what the company knows. In the asset management context, it's about investment expertise, market intelligence and ideas creation through collaboration.

The second involves exploiting the knowledge to identify the market gaps, generate new ideas and develop executive bandwidth to exploit them by leveraging the corporate memory.

The third involves developing insights into market timing via client engagement and targeted marketing.

This whole process uses hard and soft metrics for new launches. Outcome-based metrics like market share and product profitability are used alongside input-based ones like the number of ideas rejected or banked.

In asset management, more than **65%** of managers use two metrics: total AuM raised from new launches and client feedback. Four important metrics have the lowest incidence: external seeding **(19%)**; size of ideas bank **(18%)**; 'kill' rate **(12%)**; and employee investment in new funds **(10%).**

Innovation retains a hit-and-miss image. The culture that drives it is ripe for a big makeover.

**Interview quotes:**

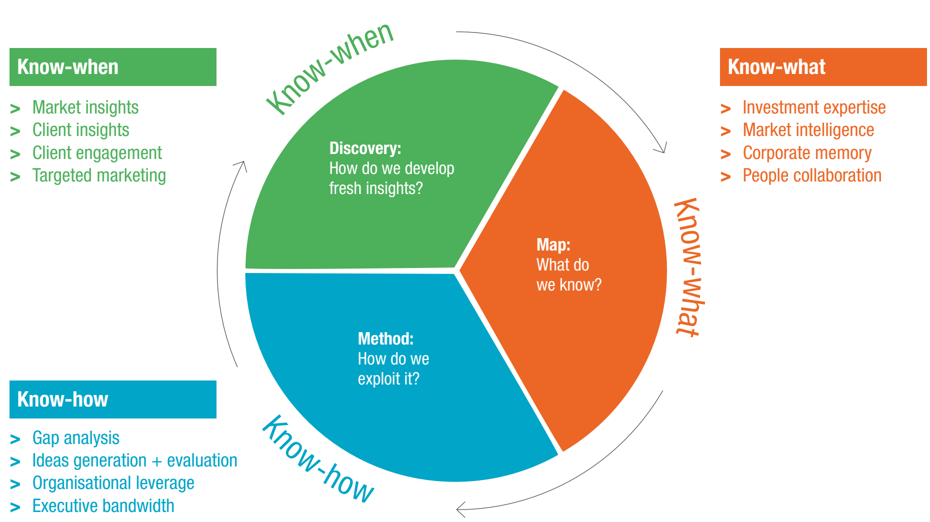
*"The person who invented the first wheel was clever. The one who invented the other three was a genius."*

*"Personal chemistry is often the spark that ignites creativity. In investing, everything is an art."*

*"Serendipity has been at the root of our best products. It happens when the business deploys all its capabilities."*

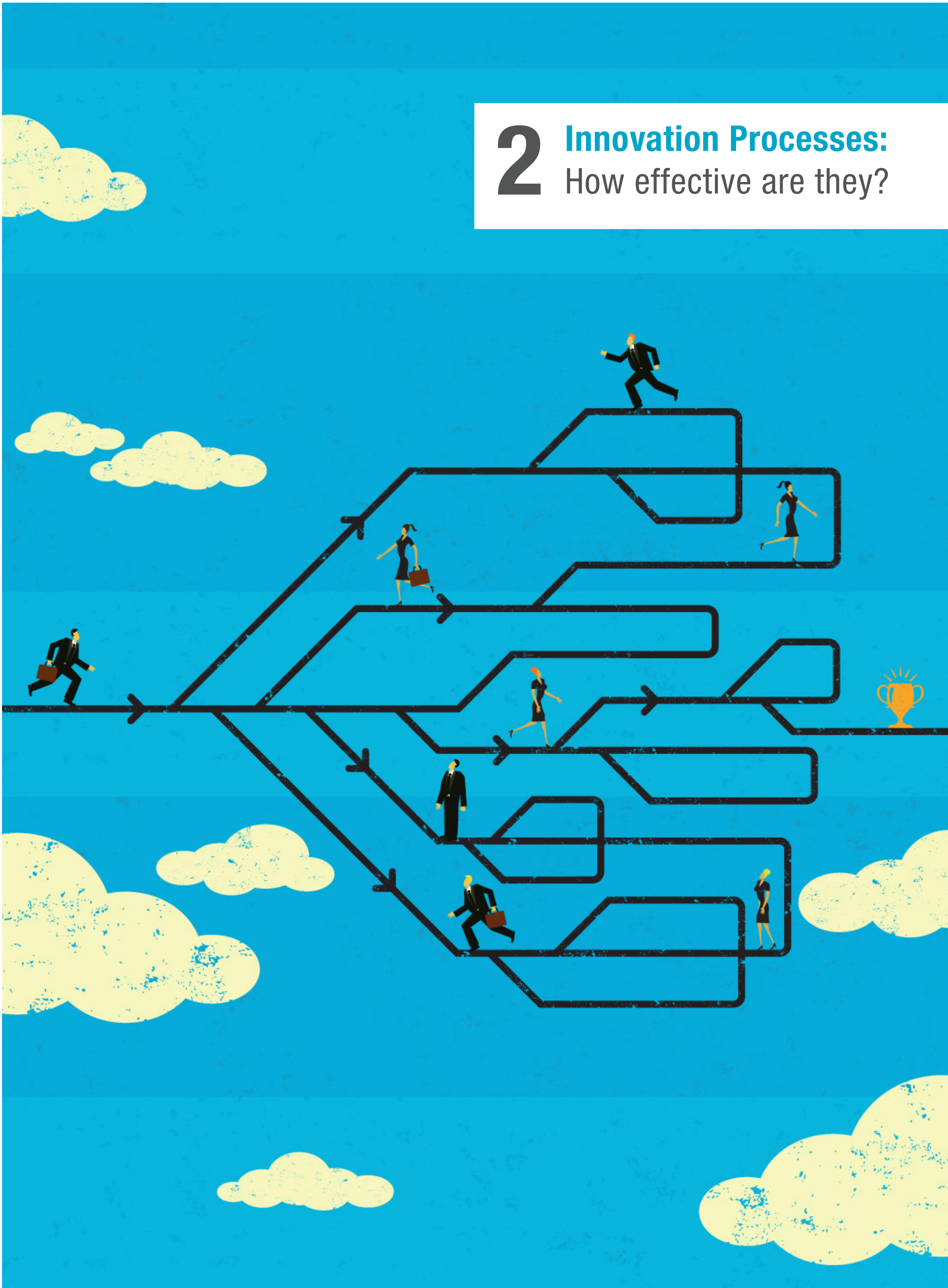
**Figure 1.6**

**How are global exemplar companies exploiting the law of increasing returns by ensuring that ideas breed new ideas?**




Source: CREATE-Research/Dassault Systèmes Survey 2013

# 2 Innovation Processes:
How effective are they?



# Overview

“We’re good at generating new ideas but not at taking them to the finishing line...”

*An interview quote*

## Issues

This section looks at innovation processes now in operation in our sample of asset managers. It covers three pertinent issues:

- what factors will drive product innovation over the next three years?
- what are the key sources of new ideas as well as their inhibitors?
- what does the scorecard look like on the effectiveness of various activities in the innovation processes?

## Key findings

**A. Drivers**
In order of importance, the key drivers of innovation are: the fall-out from new regulation, investors’ demand for blockbuster products, the switch from DB to DC plans, ageing populations, and the fall-out from market volatility.

Regulation will prove a double-edged sword. While promoting client interest, it will slow down innovation.

Other drivers will promote customised outcomes for clients that rely more on improving the inherent features of existing products than creating new ones. They will also ensure that new products seek to deliver a multiplicity of outcomes, as assets migrate from the accumulation to the decumulation phase of retirement.

**B. Sources**
In order of importance, five key sources of new ideas are: clients, investment professionals, sales and CRM professionals, product development teams and external fund distributors.

The centre of gravity in ideas generation, however, remains ill-defined on the whole.

In order of importance, the key inhibitors of new ideas are: the risk & compliance team, pension consultants, senior management and fund boards.

The role of these four entities has become ever more invidious in the wake of the crisis. They have to strike a balance between innovation and client needs; between momentum and intrinsic value.

**C. Effectiveness**
The identified drivers have fostered new disciplines. So far, these have ensured that the generation of new ideas is more effective than their execution.

Looking across the entire innovation value chain, managers rate themselves highly in activities such as ideas generation, risk & compliance, product build and product specification.

They rate themselves as low on feasibility studies, new mandate cycles, go-to-market, validation by product development committees and product lifecycle management.

Two key points emerge from our research.

First, innovation is no longer seen as a blind exercise in following the market leaders; but rather as a means to meet client needs. Attitudinal change is discernible.

Second, as a result, the innovation process is changing too: the informality of the pre-crisis era is gradually giving way to discipline and rigour.

# Customisation will dominate the next wave of innovation

**58%**

cite the switch from ‘products’ to ‘solutions’ as the most important driver of innovation.

**52%**

cite fall-out from new regulation as a significant driver of innovation.

**49%**

cite demand for blockbuster products as a significant driver of innovation.

Investors have learnt one enduring lesson from the losses inflicted by the two bear markets of the last decade: unlike cars and computers, investment products do not have a definable shelf life or replicable outcomes.

They are about managing money within a definable range of outcomes. Every position in the range is a matter of conviction, not guarantees. Actual returns can vary markedly from expected returns. Putting blind faith in *ex ante* performance numbers may also mean investing in products that cost too much and deliver too little.

Hence, asset managers are changing the focus of innovation: from chasing the next rainbow to identifying, understanding and delivering clients’ needs, including those that clients are not even aware of.

In any event, the shift has been inevitable due to the dual impact of the 2008 market losses and ageing populations. Under it, clients in all segments have been drawing a clear distinction between product alpha and solutions alpha: one is about beating the markets, the other about meeting investors’ pre-defined needs. Solutions alpha will remain the epicentre of innovation.

As Figure 2.1 shows, **58%** of our respondents have cited the switch from ‘products’ to ‘solutions’ as the most important driver of innovation over the next three years.

The latest examples of solutions cover liability-driven investing in the DB segment, lifecycle investing in the DC segment and advice-embedded investing in the mass market segment.

The other significant drivers of innovation include:

> fall-out from new regulation **(52%)**
> demand for blockbuster products **(49%)**
> switch from DB to DC plans **(43%)**
> ageing populations **(42%)**
> fall-out from increased volatility **(36%).**

The structured interviews in the aftermath of the survey revealed a number of salient points behind these numbers.

First, markets won’t be roaring back to life any time soon, while there is so much uncertainty owing to the unintended side-effects of the QE programmes on both sides of the Atlantic. So the next wave of innovations will most likely eschew the feast and famine mentality of the past (see client view on the facing page).

It will target balanced revenue streams for asset managers and customised outcomes for clients. That means improving the inherent features of existing products more than creating new ones.

**Interview quotes:**

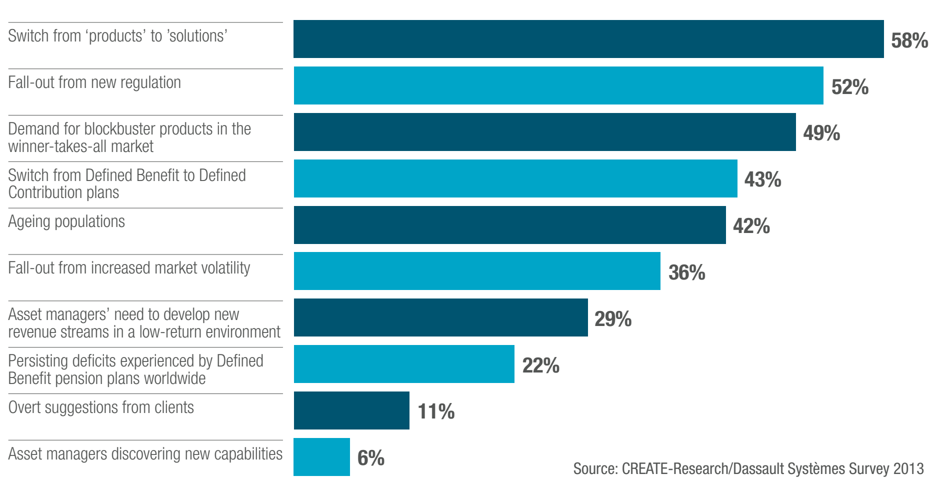
*“ESMA is squeezing our industry more than ever. Unless the industry ups the ante, we’ll have the regulation we deserve.”*

*“RDR in the UK and MiFiD in the EU will drive out mediocrity. On the flip side, they will reduce choice for investors.”*

*“Solvency II and new compensation rules for UCITs managers will cause a wave of shuttering of funds.”*

**Figure 2.1**

**Which factors will drive product innovation in global asset management over the next three years?**
(% of respondents)




Source: CREATE-Research/Dassault Systèmes Survey 2013

Second, regulation will prove a double-edged sword. New instruments such as the Retail Distribution Review (RDR) in the UK, Solvency II and MiFid II in the EU, and Dodd-Frank in the US will tackle the factors that have long conspired against client interests. RDR, for example, will require unusual rigour and transparency around the innovation process to minimise fads. On the flip side, by shifting the burden of proof, new regulation will doubtless slow down the innovation process in most asset houses and even block it in some.

Third, ageing populations will ensure that clients will pursue a multiplicity of goals as they head for their golden years. Regular income, inflation protection, low volatility bequest aspiration and catastrophe avoidance will feature high on their agenda. Customisation will directly correlate with age. Yet from time to time investors will also demand blockbuster products that can ride market waves or deliver specific investment themes.

Finally, the asset allocation approaches of clients have undergone a sea-change due to the crisis. Risk minimisation has become more important than return maximisation. Assets are allocated on the basis of risk factors more than return features. Portfolio construction and stock selection are no longer the be all and end all. In this era of rampant volatility, the quality of execution will differentiate winners from losers.

**Interview quotes:**

*"In the last decade, alpha was everywhere except in performance numbers."*

*"Far from being the mother of innovation, the 2008 crisis has ushered in a new era of customisation."*

*"Asset managers must not mistake activity for action, pace for progress."*

## View from the top...

*Crisis can be the mother of innovation: but not so in asset management. That is because innovation has had a bad press in the last decade.*

*For example, the funding crisis in the wake of the 2000-2002 bear market triggered new interest in the idea of absolute returns unrelated to market movements.*

*As alpha became the new mantra, too many products flooded onto the market without due regard for client needs. Many were neither tried nor tested, by time or events. Risk was stacked up like a wedding cake.*

*Many hedge funds, for example, were seen as running a Ferrari with a Citroen's brakes. Their replicators went a step further and promised to deliver the outsized returns of hedge funds at a fraction of the cost.*

*The gap between the cutting edge and the rest was massive. Almost all risk models failed to anticipate two of the four worst bear markets of the last 100 years that hit us over a span of seven years in the last decade. Most innovations enjoyed their 15 minutes of fame. Only savvy investors could make money out of them.*

*The 2008 crisis marked a watershed. Indiscriminately, it wiped out some US$15 trillion in asset values across all asset classes and geographies. Fifteen years of capital gains were wiped out in 15 months. Trust evaporated. Most of our clients can no longer spell it. Now, they agonise about every good idea in case it's a bad idea.*

*Hence, the pace of innovation has slowed down. Its scope is also changing. The focus has shifted from creating new things to doing old things better; from competitor leapfrogging in pursuit of me-too products to a serious rethink on product viability.*

*These shifts are manifested in the robustness of our innovation process, which generates new ideas, evaluates them and converts them into products that are fit for purpose. Implicit in it is the principle of 'best endeavour outcomes'. It enjoins us to adopt all the right cultural, structural and process tools to establish a clear line of sight between innovations and client needs.*

*This has become all the more important as ageing demographics are shifting clients' attention from products to solutions. The two bear markets of the last decade have taught them to avoid the 'sequence of returns' risks that can severely hurt their portfolios: after big losses, it has diminished their ability to catch up during subsequent years.*

*Regulators, too, have been reinforcing these shifts. Not only are they introducing new rules, they are also tightening up the enforcement of the existing rules. Regulators were accused of being asleep at the wheel before the crisis. Now they are going over the top by enforcing tighter fiduciary standards.*

*~ A global asset manager*

# Only a gold standard in client engagement will restore trust

**66%**

cite clients as a key source of new ideas.

**61%**

cite investment professionals as a key source of new ideas.

**55%**

cite sales and CRM professionals as a key source of new ideas.

If there was a recurring theme in our post-survey interviews, it was this: innovation is no longer about copycats. Rather, it is about creating products via robust processes that generate new ideas, evaluate them and then convert them into something that is fit for purpose. The prevailing market environment matters, too. Success is as much about *'when'* as *'what'* and *'how'*. Outcomes are thus influenced by the confluence of market conditions, product viability and client awareness of the conditions in which innovations work.

Hence, when asked to identify the key sources of new product ideas in their businesses, more than two in every four survey respondents identified five sources (Figure 2.2):

> clients **(cited by 66%)**
> investment professionals **(61%)**
> sales and CRM professionals **(55%)**
> product development teams **(43%)**
> external fund distributors **(41%).**

In most asset houses, the centre of gravity in innovation matters remains ill-defined, giving rise to petty turf wars, especially between investment professionals who understand the heartbeat of the markets and sales professionals who understand the heartbeat of the client. Under the evolving arrangements, the roles are taking a more discernible shape, however.

Investment professionals are increasingly taking a lead role in what are termed *core* products – those that seek to capture intrinsic value over a longer period by exploiting their insights into market dynamics.

In contrast, sales professionals are increasingly taking a lead role in *opportunistic* products – those that seek to capitalise on momentum or temporary price dislocation by exploiting their insights into client psychology.

Product development teams have two roles. The primary one is to capture new ideas from their investment and sales colleagues, evaluate them and take them to the finish line. Their secondary role is to generate new ideas in tandem with other colleagues.

**Interview quotes:**

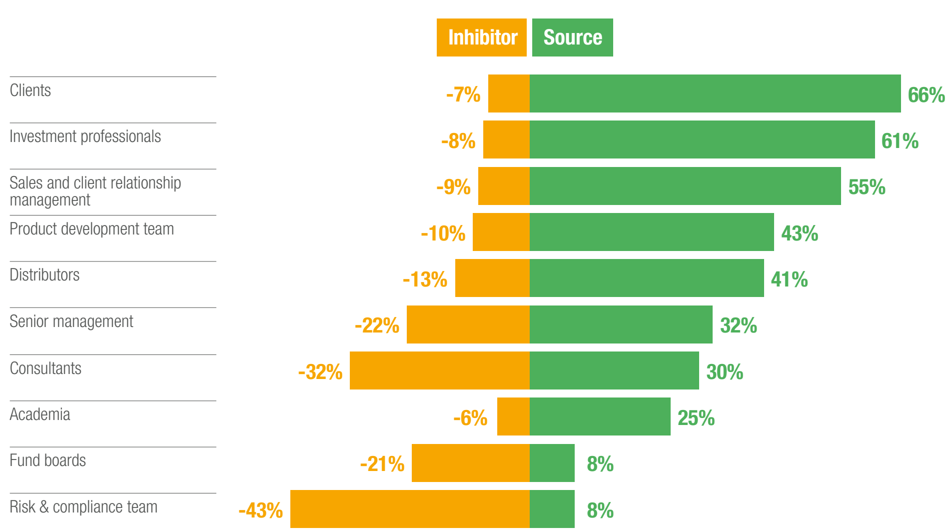
*"When a product is successful, its portfolio manager gets the credit. If it fails, marketing get the stick."*

*"Our Farmland Fund came out of ideas from clients who needed hedging assets in their LDI portfolio."*

*"I'm constantly amazed by how few asset managers know their clients' challenges and risk tolerances."*

**Figure 2.2**

**Which of the following are the most significant sources of new product ideas in your business? Which are the most significant inhibitors of new ideas?** (% of respondents)




Source: CREATE-Research/Dassault Systèmes Survey 2013

As for distributors, ever more of them are venturing into multi-asset class products that seek to deliver a multiplicity of outcomes (e.g. good returns, inflation protection, low volatility) – as part of solutions-driven investing. Their key role is in assembling different components that deliver targeted solutions; taking into account correlations between component assets.

So much for the sources of new ideas. Turning to the inhibitors of ideas, four stand out.

First, **43%** of respondents cite the risk & compliance team. This reflects increased scrutiny from external regulators. Second, **32%** cite consultants. This reflects more stringent due diligence and a demand for evidence-based investing. Third, **22%** cite senior management. This reflects increased emphasis on reputational risk in the wake of massive bear market losses. Finally, **21%** cite fund boards. This reflects a more stringent definition of their fiduciary role.

Thus, these inhibitors are not latter-day Luddites. Post-crisis, their roles have become ever more invidious. They have to walk a fine line between innovation and client needs; between business profits and franchise risk; between product-push and value for money; between the letter of regulation and the spirit of regulation.

**Interview quotes:**

*"Our best results have come from having asset managers as thinking partners rather than distant vendors."*

*"HNWI get a lot of airtime with their wealth managers. They are often the biggest risk takers."*

*"Engagement is about raising awareness, managing expectations and avoiding the wrong time risk."*

## View from the top...

*Investing is nuanced after three body blows in recent years: the 2000-2002 tech collapse, the 2008 credit crunch and the 2011 sovereign debt crisis.*

*Of the 20 biggest daily upswings in the S&P 500 since 1980, 10 have occurred in the last five years. Likewise, of the 20 biggest downswings, 13 have taken place in the last five years. This is a far cry from the heady days of the 1990s when the unrelenting chase for relative returns delivered double-digit performance year after year until the equity market crash in March 2000.*

*Since then, it is clear that the buy-and-hold strategy has not been working, as equities were outperformed by bonds; nor has the barbelling approach, as actual returns diverged markedly from expected returns for most asset classes; and nor has diversification, as the correlation between historically lowly correlated asset classes went through the roof due to excessive leverage.*

*We have also learnt that it is necessary but not sufficient to hire smart consultants and smart managers. What we do as investors also makes a big difference. That's why we are seeking deeper engagement with our asset managers.*

*Our engagement aims to help them to: understand our dreams and nightmares; solicit new ideas by tapping into our investment expertise; manage expectations in what can and can't be delivered when markets are moved more by politics than economics; minimise 'wrong time' risks in buying and selling; communicate bespoke research that addresses unique issues to clients; and highlight proactive buying opportunities in periods of big price dislocations.*

*In return, deeper engagement aims to help us as a pension plan to: seek a better alignment of interest via common beliefs and time horizons; obtain a second opinion on our asset allocation and correlation risks; gain deeper insights into what works at different stages of the market cycle; develop the mental agility to capitalise on periodic market dislocations; minimise behavioural biases and herd instincts provoked by periodic volatility; and understand the 'health warnings' that are usually lost in the fine print of legal agreements.*

*We were far removed from our asset managers, owing to disintermediation by consultants and wholesale fund buyers. We needed far more joined-up thinking via greater engagement of all parties in the investment value chain.*

*We now have a new form of engagement that is free of dogma and fads. It is based on the view that investment outcomes depend upon not only the intrinsic merits of a product but also on investors' own actions at different phases of the market cycle.*

*~ A Dutch pension plan*

# Thanks to new disciplines, ideas generation is one thing, their execution quite another

**58%**

cite ideas generation as 'good' or 'excellent'.

**66%**

cite feasibility studies as 'so-so' or 'average'.

**63%**

cite new mandate cycle as 'so-so' or 'average'.

Not long ago, when creating a new product, sales staff talked to their clients and then to their investment colleagues. Others usually arrived on the scene late in the day to add the finishing touches to the wrapper, sales channels and pricing. The crisis has challenged this amateurism.

First, clients and investment professionals play a central role in ideas generation and their initial screening. Second, other colleagues get involved much earlier, especially risk & compliance, due to regulatory pressures. Third, and most importantly, ideas that are selected for escalation are put through at least three hoops:

> ***evaluation,*** involving feasibility study and business case

> ***design,*** involving stress-testing, proof of concept and paper portfolios

> ***delivery,*** that calls for product launch, transition planning and marketing.

This is a far cry from when new launches relied on personal chemistry between a few people mainly accountable to themselves. The extra disciplines around go-to-market have had unintended consequences: more bureaucracy and long debates that often generate more heat than light. The generation of ideas has been easier than their execution. When asked to assess the effectiveness of various activities in their innovation process (Figure 2.3):

> **58%** rate themselves *'good'* or *'excellent'* in ideas generation

> **57%** do so in risk & compliance

> **55%** do so in product build

> **49%** do so in product specification, stress-testing and seed funding.

At the other extreme:

> **66%** rate themselves 'so-so' or 'average' in feasibility studies

> **63%** do so in new mandate cycles

> **61%** do so in go-to-market

> **58%** in validation and approval by product development committee

> **58%** in product lifecycle management

> **52%** in escalation of new ideas worth considering.

**Interview quotes:**

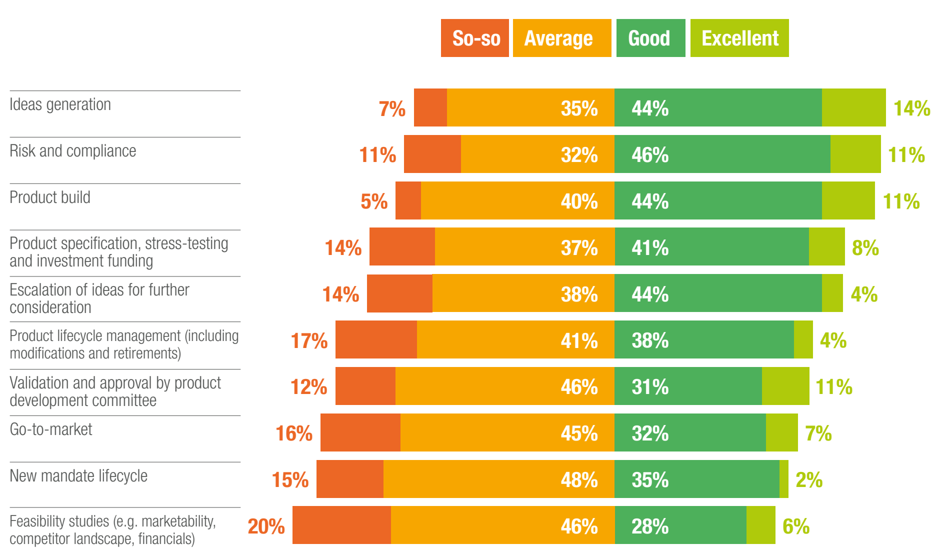
*"Risk & compliance get involved much earlier, so our innovation process is slower but more thorough."*

*"We're working on innovations that have a long shelf life. That takes time."*

*"No matter how good your process is, its outcomes depend on market sentiment that is hard to anticipate."*

**Figure 2.3**

**How would you rate the effectiveness of various activities in the innovation process in your business currently?** (% of respondents)




Source: CREATE-Research/Dassault Systèmes Survey 2013

Our post-survey interviews shed further light on these numbers. To start with, many asset houses now recognise that managerial skills alone cannot deliver good performance. Two other factors are just as important: the innovation process and the governance around it. Indeed, the success of the iconic Yale model is now attributed to governance, skills and execution equally.

Second, asset managers can no longer have a scattergun approach in the hope that one of their products will hit the bullseye. As in pharmaceuticals, innovation has turned into a costly exercise that has to weed out the 'dogs' from the 'stars'. Indeed, in good-practice asset houses a key metric of success is the 'kill' rate at three distinct phases: exploration, evaluation and design.

Third, the informality that came with the cottage industry image of asset management is giving way to systematisation – under the banner of 'treating customers fairly'. Some managers are struggling with the transition, especially those who feel disintermediated and see extra bureaucracy as yet another nail in their craft's coffin. Others are adapting to it, knowing that the old ways of doing things work only in a once-in-a-generation raging bull market.

**Interview quotes:**

*"Engagement is the key. Clients need to know why certain products work at certain market phases better than others."*

*"Good marketing only works for a short period, if your product doesn't meet the market need."*

*"We had a good China fund. But markets were unconvinced about China's growth story."*

## View from the top...

*In the past, too many new products were rushed out too often without much regard for their inherent value. That is not innovation. Innovation means creating new ideas that add value to clients via investment strategies that scale with greater predictability in outcomes.*

*Even today, the rhetoric of the investment world is solutions, but the reality is products. Investment is a cyclical business, driven by greed and fear. When one strategy goes out of fashion, the temptation is to do something different in the name of innovation, as has happened with alternatives in the last decade. In pursuit of higher fees, the speed at which many long-only asset managers switched from relative to absolute returns – via repackaging – was breathtaking.*

*That is because speed to market was seen as a key driver of success when style box investing required different products at different phases of the market cycle. Styles came and went out of fashion quickly – as did the opportunities associated with them. Few new products were stress-tested even via simple paper portfolios. Since the 2008 crisis, style box investing has gone into hibernation. Not only has the rate of innovation slowed down, but the processes underpinning it have also become more robust.*

*In this business, we capture a lot of new ideas. Thereafter they go through three distinct phases: evaluation, based on feasibility studies and a clear business case; design, based on proof of concept and paper portfolios; and delivery, based on product launch and seed money. The whole process is more rigorous than ever. The rigour has attracted bureaucracy and disciplines that were alien to us before 2008. At best, they slow things down. At worst, they raise more questions than answers. The bottom line is we're good at exploring new ideas but not so good at taking them to the finish line.*

*As an institutional manager, part of our problem is that we get engaged with trustees after the mandate, not before it, when the key decisions on asset allocations are made; and even then our contacts with them are mostly through consultants. That's because we sell products, not solutions.*

*We don't know enough about the circumstances of individual pension plans, their strategies and their funding levels to devise a solution. We're given a mandate within our area of expertise, with little guidance on how we fit into the wider picture. We find this worrying because we are one of the largest managers in the world, with broad capabilities. Yet we are pigeon-holed with very little contact with end-clients or the other managers serving them. The disintermediation of asset managers has ensured that innovations will always remain suboptimal.*

*In a sense, disintermediation suits us: we get greater operating leverage from selling products than solutions, since products are scalable across a number of clients, whereas solutions are customised. But we could create a lot more value if we had deeper relationships with our clients. The current crisis requires a more joined-up approach. That's not easy when people have long been used to working in silos.*

*~ A German asset manager*

# 3 Innovation Outcomes:
## How can they be improved?

# Overview

“Defined and governed innovation processes enable a higher degree of success.”

*An interview quote*

## Issues

This section looks at the outcomes of innovation processes. It covers three issues:

- What metrics are used to measure the success of the innovation processes in our sample of firms?
- What blockers have slowed things down and worked against optimal outcomes?
- How can increased interpersonal collaboration improve the outcomes?

## Key findings

**A. Metrics**
Two sets are used: outcome-based and input-based.

Four principal metrics in the first set include: total AuM raised by new products, feedback from clients, delivering the product’s value proposition and profit margins.

Four principal metrics in the second set include: the maintenance and improvement of the existing suite of products, speed to market, the quality of real-time collaboration between people involved in the innovation value chain, and the number of new ideas captured at the early stage.

Overall, the innovation dashboard is dominated by numbers on new inflows.

**B. Blockers**
Two sets have been identified: cultural and structural.

The principal blockers in the first set include: ‘permission’ culture, no ‘white space’ for free thinking, fear of failure, unhealthy tensions within innovation teams, ‘not invented here’ syndrome and ‘knowledge is power’ syndrome.

The principal blockers in the second set include: silo working, lack of tools that promote real-time collaboration, over-reliance on manual inputs causing errors and delays, and the absence of a central repository of all the relevant information.

Overall, things are slowed down by perceived bureaucracy and over-specialisation on the part of staff.

**C. Collaboration**
As in the world’s most innovative companies, so in asset management the centrality of tacit knowledge in the innovation process is now well recognised.

Such knowledge is expressed via creativity often sparked by interpersonal encounters. In this context, the digitisation of the innovation process is seen as one of the drivers because of its inherent benefits.

The principal benefits include: the retention and enhancement of corporate memory, the generation and evaluation of new ideas, real-time person-to-person collaboration, virtual team working across space and time, and a transparent audit trail.

Overall, digitisation is seen as minimising the ‘key person’ risk, offering better governance around innovation processes, providing a dashboard that gives a single version of the ‘truth’, and creating a repository of all product information – past, present and future.

# Data on new inflows dominate the innovation dashboard

**71%**

cite total AuM within a specific timeframe.

**67%**

cite feedback from clients.

**48%**

cite delivering what it says on the tin.

When asked to identify the metrics they use to assess the effectiveness of their innovation process, our respondents identified two sets.

The first set comprised outcome-based metrics. The top five amongst them are (Figure 3.1, upper panel):

- total AuM raised within a specific timeframe **(71%)**
- feedback from clients **(67%)**
- delivering what it says on the tin **(48%)**
- profit margins on new launches **(32%)**
- feedback from wholesale fund buyers **(30%).**

Thus financial numbers provide the litmus test for new launches. However, a noteworthy point about these numbers is that ever more asset managers are seeking client feedback through surveys, focus groups and *ad hoc* communication. Not only do they solicit new ideas or client perceptions, they also aim to raise awareness, manage expectations on what can and cannot be achieved, and offer proactive investment ideas.

But the latter is only possible in the institutional space: in the retail space, anything construed as advice is prohibited in many jurisdictions in Europe and North America.

Another noteworthy point is that less than **20%** of respondents cite two indicators that raise clients' comfort level: external seeding **(18%)** and co-investing by employees **(10%).**

At best, these numbers display a lack of confidence in new products on the part of people closely familiar with them. At worst, they indicate the hit-and-miss image of innovation, while conventional investment wisdom has been sidelined (see client view opposite).

**Interview quotes:**

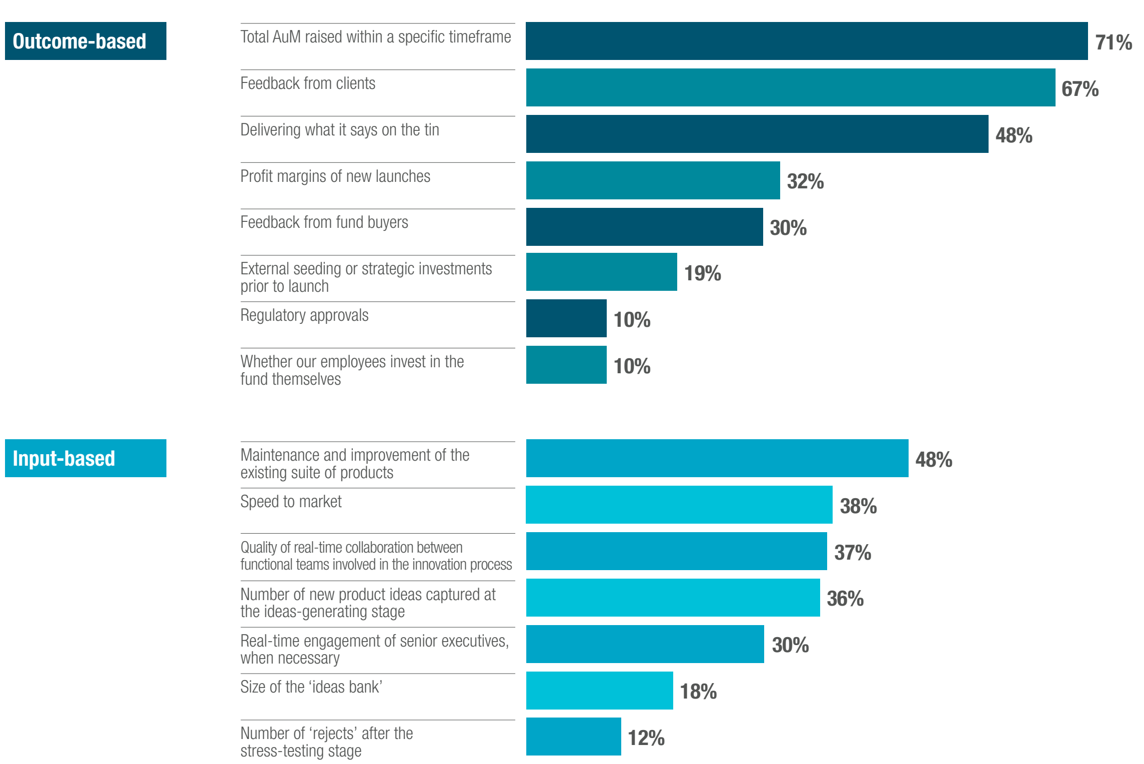
*"AuM is one measure of success. The other is the amount invested by the products' own portfolio managers."*

*"The 'kill' rate is a good yardstick. Products have to work intrinsically, commercially and operationally."*

*"Paradoxically, asset management is a people business. Yet so few firms have an ideas bank."*

**Figure 3.1**

**Which outcome-based and input-based metrics does your business normally use to assess the effectiveness of its innovation process?** (% of respondents)




Source: CREATE-Research/Dassault Systèmes Survey 2013

Turning to input-based metrics, these are less widely used. The top five include (Figure 3.1, lower panel):

> maintenance and improvements in the existing suite of products **(48%)**

> speed to market **(38%)**

> quality of real-time collaboration between the people involved in the innovation process **(37%)**

> number of new ideas captured at the early stage **(36%)**

> real-time engagement of senior executives, when necessary **(30%).**

Once again, two crucial areas receive far less scrutiny: the size of the 'ideas bank' **(18%)** and the number of 'rejects' at the stress-testing stage and thereafter **(12%).**

In global innovation exemplars such as Apple, 3M, Johnson & Johnson and Toyota, these two under-emphasised indicators are used as unambiguous proxies of process success. They reflect the breadth and depth of thinking built into the product design.

Let us take them in turn. The size of the ideas bank is an indicator of not only how many credible ideas are captured but also of how many of them will have legs when confronted by the harsh reality of market sentiment and client needs. Such ideas are revived when the time is ripe. They constitute a measure of 'corporate memory'.

Similarly, the number of rejects is seen as an indicator of not only how robust the innovation process is but also how far its outcomes run with the grain of client need and market sentiment.

A cyclical industry like asset management is driven as much by herd psychology as by intrinsic value. Chance and deft marketing can easily differentiate winners from losers in the short term.

But the persistency of success relies on robust innovation processes. At the least, they ensure product integrity. At most, they improve the chances of success.

**Interview quotes:**

*"Clients want new products when the old ones don't work. All we can do is to minimise product churn, not eliminate it."*

*"Wishing for a blockbuster product is like saying 'I'm going to be famous'."*

*"Eventually, the intrinsic value of a product is what decides its viability, not slick marketing."*

## View from the top...

*Timing is everything: over the last decade, the best returns have been achieved by those who were in the markets during five critical weeks. No wonder, because since 2000 the average holding period of a mutual fund has dropped from four years to one year in the US. The numbers are no different for pension plans. As investors have gone from euphoria to panic, many good products have struggled to survive. Opportunism is rife now more than ever, as conventional investment wisdom has been sidelined progressively since the 2000-2002 bear market.*

*Our clients in all segments believe that it is unwise to ignore the power of mean reversion, since intrinsic value always shows up in the end; but it is equally unwise to bank on it, in the light of the random bursts of risk-on/risk-off cycles of the past five years. They will continue until the debt crisis is over.*

*In the meantime, clients will want blockbuster products that now attract the lion's share of new inflows. Many of these do not have a long shelf life. They soon suffer from the curse of success: new inflows dumb down the returns. Investors then leave the money on the table and go after the next fad.*

*Such products run with the grain of prevailing market sentiment. They also thrive on high-pressure marketing. The role of these two factors cannot be underestimated. Both rely on clients' herd instinct. But they can also help clients if the underlying products are built to last. Two of our funds have done well despite unusual volatility. One of them is a risk parity quant fund that caught the market's attention and continues to deliver good returns despite fresh inflows. The other one is an absolute return fund that faced severe headwinds at the height of the sovereign debt crisis in 2011. We communicated a lot with our clients and contained the outflows to a minimum. Both these products went through a robust innovation process, including early stress-testing with our own seed capital. They blend the skills of our managers with rigorous processes and client engagement – the latter at the design phase and post-launch.*

*Innovation is a 20:80 game. Success depends on our skills and expertise, client engagement, marketing and market sentiment. You can't control the last factor but you can control the other three. We do that by ensuring that our innovation process addresses three questions: Will the new product deliver what it says on the tin? Is there a market for it? Can our support operations cope with it?*

*In the process, we deliver opportunistic products that enable our clients to ride a particular wave, if that's what they want. But we also deliver core products that belong to buy-and-hold portfolios, targeting persistency of returns. No one can guarantee investment outcomes. Look what happened to ultra-safe money market funds in 2009 when some of them 'broke the buck'. But by blending skills and processes, you can raise the chances of success.*

*~ A French asset manager*

# Perceived bureaucracy and specialisation slow things down

**58%**

cite silo working.

**55%**

cite 'permission' culture.

**51%**

cite absence of real-time collaboration tools.

When asked to identify the factors that slow things down in the innovation process and work against optimal outcomes, our respondents distinguished between cultural blockers and structural blockers.

Taking them in turn, more than one in three respondents identified the following cultural blockers (Figure 3.2, upper panel):

> 'permission' culture **(55%)**
> no 'white space' for free thinking **(45%)**
> fear of failure due to previous false starts **(42%)**
> unhealthy tensions within innovation teams **(42%)**
> 'not invented here' syndrome **(37%)**
> 'knowledge is power' syndrome **(36%).**

In the wake of the crisis, most fund managers have had to cut costs, improve efficiency and seek more accountability from their professionals. This has created a perception of extra bureaucracy – since most innovations have also faced a higher hurdle rate via a more compelling business case. Extra hassle has added to an increased sense of detachment. The new regulatory requirements have not helped in this respect.

Indeed, this increased parochialism is manifested in the structural blockers as well (Figure 3.2, lower panel):

> silo working **(58%)**
> absence of tools that promote real-time collaboration **(51%)**
> over-reliance on manual input that causes errors and delays in the innovation process **(45%)**
> absence of a central repository of all the relevant information **(37%)**
> limited process standardisation **(36%)**
> lack of seed money **(35%).**

**Interview quotes:**

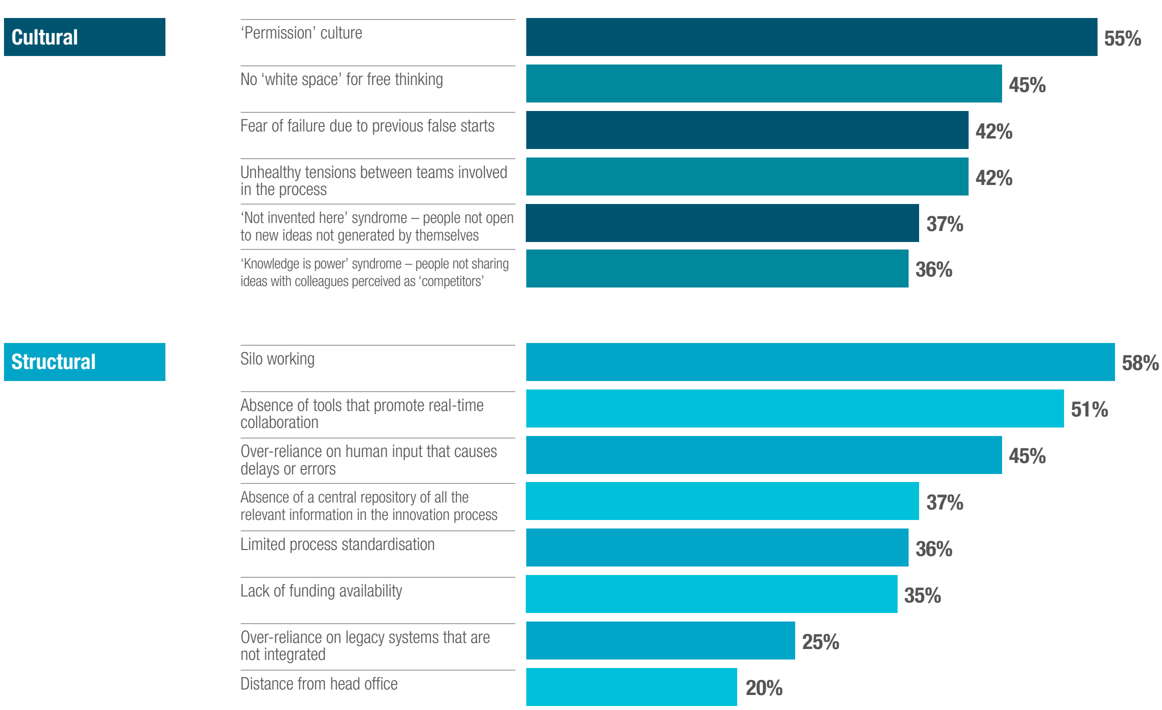
*"Career risk prevents people from thinking out of the box and putting their heads above the parapet."*

*"Senior executives vet every new idea. The rejection rate is high and the reasons often remain a mystery."*

*"Storytelling – 'investortainment' – is enormously powerful; as is peer review."*

**Figure 3.2**

**Which factors often slow things down and work against optimal outcomes?** (% of respondents)




Source: CREATE-Research/Dassault Systèmes Survey 2013

Behind these numbers lies an important observation. For a long time, asset management has been a craft business, with a strong culture of individualism backed by a reservoir of talent. Now as the industry has gone global via multiple channels, asset classes and client segments, the business is becoming industrialised. The recent cost disciplines have accelerated the process.

Disintermediation is one aspect of that industrialisation. The other is the need for process disciplines that are alien to a craft environment.

The result is an entrenched blame culture in which career risk and reputational risk have taken precedence over investment risk.

Some attribute these outcomes to active managers' inability to deliver their promise, especially since 2008. Finger-pointing is not confined to colleagues but also exists between asset managers and consultants.

Others see them as the birth pangs of a new order where talented people will either fit in with the more process-driven environment or strike out on their own.

Either way, the industry is gripped by winner-takes-all fever. It is healthy in the sense that clients are willing to vote with their feet in search of high returns. It is unhealthy in that they may be merely chasing the next rainbow.

Industrialisation cannot be rolled back. The best that asset managers can do is to make a virtue out of necessity by adopting processes that have the highest probability of delivering and sustaining the targeted outcomes.

**Interview quotes:**

*"You need innovators' DNA – always asking why? why? why? Our inquisitive culture is central to alpha generation."*

*"We've met the enemy and it is us."*

*"Our people are given a long leash in ideas generation but not in their execution. That has to change."*

## View from the top...

*We're a global house with a presence in over 15 fund markets. Until this decade, we had no mechanism for capturing and escalating new ideas, no capability maps, no tools of global connectivity and no global platforms for major activities.*

*Constantly glued to their screens or attending meetings, our investment professionals had little white space for free thinking. It made them defensive of their turf. We had so many false starts in the past that new initiatives often invited cynicism. Worst of all, we suffered from the classic innovator's dilemma: why rock the boat when we have such a big legacy book of assets earning a handsome fee year after year?*

*Then came a double whammy in 2010: our sister company – a private bank – switched to open architecture and our large insurance clients switched managers as they went overweight in fixed income. A number of changes had to be implemented. Their main thrust is directed at getting close to our clients and delivering innovations via customised solutions.*

*To develop and retain talented professionals, we have tried to create an infrastructure around empowerment whereby they can maximise their creative and tactical talents, and are surrounded by like-minded professionals who share the same goals and ideals. This is easier said than done, however. Talented people like to excel in their narrow area of specialisation. They also like autonomy, but not the accountability that goes with it. More autonomy has meant excessive individualism; more individualism has meant more 'key person' risk; more 'key person' risk has meant the constant upward repricing of skills; the repricing of skills has created an unbalanced approach to incentives. At any rate, the teamwork essential for a robust innovation process has proved hard to find. No doubt, these are teething problems; everybody here recognises that we can't go on doing the same old things and expect different outcomes.*

*To set the tone and example, senior executives have been obliged to widen and deepen their skillsets so as to do five things that are essential for an innovation culture: first, up the ante by raising the bar on performance, spotting opportunities and promoting a can-do mindset; second, become strategic by setting clear business goals, taking actions and doing a reality check; third, lead the leaders by influencing senior colleagues at all locations and creating an environment of mutual trust; fourth, motivate staff by clarifying the goals, getting buy-in, seeking new ideas, walking the talk and listening actively; and finally, deliver results by articulating a realistic value proposition for clients, orienting all staff towards its delivery and implementing meritocratic incentives.*

*Changing through crisis is painful. But we needed a burning platform before we could change our DNA. Our biggest challenge has been to get across the idea that strong leadership does not mean bureaucracy. The role of leaders is to strike a balance between autonomy and accountability, between effort and performance. This requires exceptional tact, empathy and diplomacy, as the 'key person' risk is always lurking in the background.*

*~ A Scandinavian asset manager*

# The new innovation processes need a collaborative culture

**59%**

cite retention or enhancement of corporate memory.

**54%**

cite generation and evaluation of new ideas.

**31%**

cite minimisation of 'key person' risk.

Post-Lehman crisis, asset managers have been upping the ante on their innovation process and the role of tacit knowledge in it.

Unlike explicit knowledge, tacit knowledge cannot be communicated in oral, written or image form. Being highly personalised, it resides in the individual in the form of accumulated insights, intuitions and experiences.

Unlike explicit knowledge, it cannot be codified in a formal body of learning. Creativity is the channel through which it emerges, often as a random explosion of energy born of frustration with the status quo. Creativity, in turn, thrives on interpersonal encounters where ideas breed new ideas.

As cost and regulatory pressures have intensified, asset managers have been enjoined to seek smarter ways of promoting interpersonal collaboration. This aims to promote creativity on the one hand, and efficiency in the innovation process on the other. One of the ways being considered is digitisation of the innovation process via a multi-functionality IT platform.

When asked to identify the ways in which digital tools that permit interpersonal collaboration can help, at least three in ten respondents cited the following (Figure 3.3):

- retention/enhancement of corporate memory **(59%)**
- generation and evaluation of new ideas **(54%)**
- real-time person-to-person collaboration **(51%)**
- virtual team working across space and time **(48%)**
- a transparent audit trail of all key decisions **(43%)**
- online availability of all the relevant data **(37%)**
- integrated work flow and document management **(33%)**
- minimisation of 'key person' risk **(31%)**
- a repository of the latest data on markets, products, clients and regulation **(31%).**

**Interview quotes:**

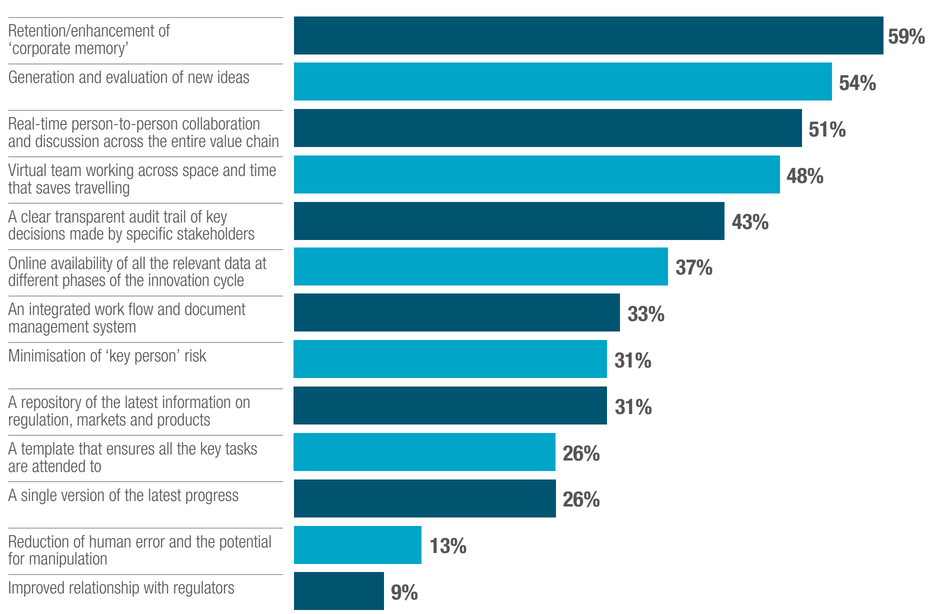
*"Our regulators enjoin us to document everything. Digitisation is a step in the right direction."*

*"We have a product pipeline report on an Excel spreadsheet. But nothing is digitised."*

*"We need to improve our 'hit' rate so as to help other products in our line-up."*

**Figure 3.3**

**In what ways can digital tools help with the various innovation-related activities in your business?**
(% of respondents)




Source: CREATE-Research/Dassault Systèmes Survey 2013

Behind these numbers lie three salient points.

To start with, as the war for talent has intensified, asset managers have been keen to enhance their corporate memory while minimising the 'key person' risk. This is done by adopting processes and work methods that ensure that ideas breed new ideas, and individual learning is converted into organisational learning. In this respect, the asset industry is beginning to emulate some of the world's most innovative companies, which have adopted digital tools that aim to promote new ideas, capture them, evaluate them, reject some of them, 'bank' others and escalate the rest. Across the entire innovation value chain, collaboration is seen as the magic bullet.

Furthermore, digital tools are also viewed as providing the necessary checks and balances to minimise human error, provide a to-do checklist and hasten line speed, while preventing things from falling through the cracks. In the past, staff turnover, human error and lack of an audit trail have been the main causes of process inefficiency. When essential staff left, so did a part of the corporate memory. Many asset houses have no documented records or folklore around past product failures or successes. The tendency to reinvent the wheel is all too pervasive; and fails to take into account that success is about inventing the other three wheels as well.

Finally, digital tools are seen as providing a real-time dashboard that enables senior managers and everyone in the innovation value chain to get updates on product development. It also provides a real-time snapshot on the status of all products: past, present and future. In global houses, especially, having real-time information has improved time to market as well as the governance around it.

**Interview quotes:**

*"Good products often travel on their own. Investors are always drawn to a good offering."*

*"We have a structural source of alpha. It is embedded in our ideas-seeking culture."*

*"Investing is an art based on insights and intuitions. The real edge comes from capturing them."*

## View from the top...

*Most critiques of the Yale model do not understand it. They think it's all about being overweight in alternatives and nothing about the underpinning structures and processes. So when private equities and hedge funds crashed in the 2008 crisis, the model lost its star quality when examined solely through the prism of asset allocation.*

*What's less well known is that the model's success came from a mix of factors that also led to its rapid recovery after the crisis. First, it has clear investment beliefs that shape its short-, medium- and long-term goals. Second, it puts a strong emphasis on governance and skillsets that enable it to go into risky asset classes, exploit the prime mover advantage, have a clear exit strategy and give delegated authority to full-time professionals to exploit periodic price anomalies. Third, its asset allocation has clear outcome-based aims backed by a strong risk framework and vehicle-agnostic delivery. Finally, the model is just as strong on execution as it is on ideas. It captures new ideas and turns them into credible investment theses after robust testing.*

*This model is alive and well because its investment beliefs are not static. Instead, they are an essential part of adaptive learning resulting from doing things in a fast-changing environment. Such experiential learning can result from positive experiences. But negative experiences may be an even better teacher. For example, in the pharmaceutical industry, new discoveries mostly stem from 'failing forward': using the learning from past failures to progress forward. Thus, asset allocation is just the tip of the iceberg in the model. It is supported by many moving parts that rely on tacit knowledge created by brainstorming. This kind of knowledge is different from the explicit knowledge that is transmissible via language or images.*

*In contrast, tacit knowledge is personal, context-specific and hard to formalise and communicate – in oral or written form – because it comprises insights, hunches and intuitions born of experience or through a restless dissatisfaction with the status quo. Brain experts believe that what we speak and write every day is less than 1% of what we know. The rest lies fallow in us, until it is invoked by contexts, situations and encounters. A successful innovation process aims to capture tacit knowledge via greater collaboration, so that ideas breed new ideas. Tacit knowledge is an essential part of corporate memory. Explicit knowledge about markets, customers and regulation is important, too. But, being widely available, it does not give a competitive edge.*

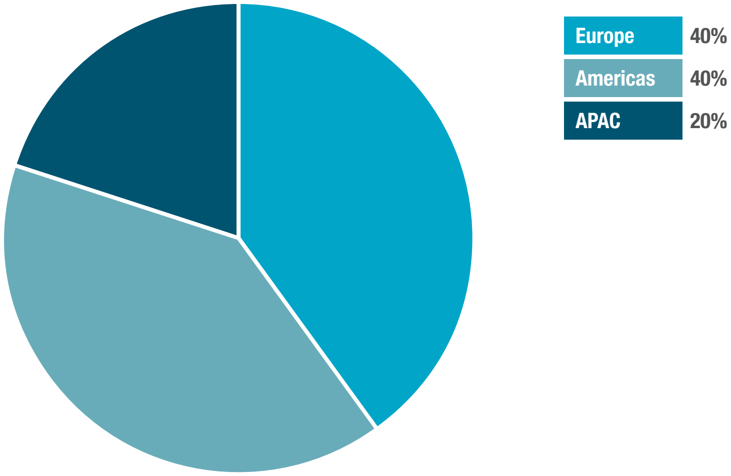
*Our innovation process relies on our corporate memory operating at three levels: know-what, know-how and know-when. The first is about mapping what the business knows; the second is about commercialising it; and the third is about developing insights into market cycles and their timing dynamic. We also use IT-based tools to enhance this capability across space and time. Over time, we shall be using collaborative tools such as crowdsourcing and social websites to turn individual insights into organisational memory.*

*~ A US asset manager*

## As with previous CREATE-Research reports, our research relied on a global survey bolstered by structured interviews.

Over 223 asset managers, pension plans and pension consultants participated in the survey. The survey was followed by 53 in-depth interviews with senior executives from a cross-section of survey respondents. All data presented in the report emanates from either the survey or the interviews.

**Respondents across the globe** (% of respondents)




Source: CREATE-Research/Dassault Systèmes Survey 2013

CREATE-Research is an independent thinktank specialising in strategic change and the newly emerging models in global asset management.

It undertakes major research assignments from prominent financial institutions and global companies. It works closely with senior decisionmakers in reputable organisations across Europe and the US. Its work is disseminated through high-profile reports and events that attract wide attention in the media.

Further information can be found at **create-research-uk.com**

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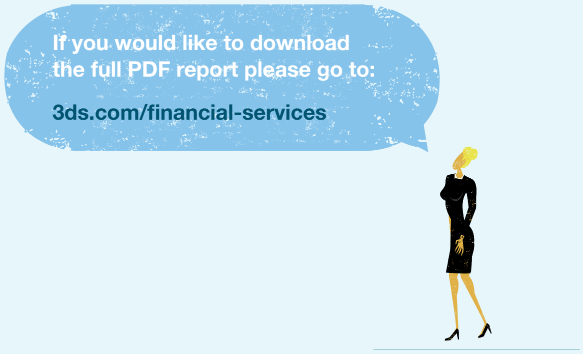
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