Innovating in a world where winner takes all

A person who moves a mountain starts by taking away a small stone, according to a Chinese saying. This applies to the asset management industry today, say Amin Rajan and Kevin Pleiter

Innovation

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In his keynote address at last year's Monaco Fund Forum, Robert Kapito, the president of BlackRock, cited two numbers that sum up what is wrong with innovation in global asset management today.

In 2012, there were some 70,000 share classes in the fund universe, yet only 185 accounted for all inflows. In other words, all new money went into less than 1% of share classes. The year was not untypical. This conjures up an image of an industry that has a scattergun approach to innovation.

But the reality is different, according to our new study Upping The Innovation Game In A Winner Takes All World*.

It shows that the 2008 crisis represented a watershed. Since then, more asset managers have begun to improve their innovation processes. In particular, they are trying to emulate innovation tools used by some of the most dynamic companies in the world – like Apple, Johnson & Johnson and Toyota – to deliver better outcomes.

Attitudinal change is discernible. More asset managers no longer see innovation as a blind exercise in following the market leaders or engaging in competitor leapfrogging. Rather, they see it as a means of achieving client needs.

Financial markets thrive on greed and fear and prevailing market sentiment plays a big role in deciding the success or failure of any new product. In the past six years, market volatility has killed off many good – and bad – products through waves of panic buying and selling.

However, the dominant tendency in the asset industry has been to ride prevailing market sentiment and rely on expert marketing to sell new products. In other words, product push has always been a powerful driver of innovation, for two reasons.

First, it reflects the feast-and-famine mentality on the part of individual investors (south-west corner in figure 1). Second, unlike cars and computers, asset products do not have replicable outcomes and definable shelf life. Much depends upon the prevailing market environment.

In the 2008 crisis, investors lost $15trn (€11trn). Some 15 years of asset accumulation was wiped out in a 15-month span.

Hence, there has been a shift towards product pull that ensures that new products have a longer shelf life, higher performance persistency and are backed by a strong investment culture (north-east corner in figure 1).

Such product pull relies heavily on client engagement, on the one hand, and skills and processes that deliver robust products on the other.

Of course, product success depends on all four factors shown in the figure. In a cyclical industry, driven by greed and fear, it is unwise to ignore the power of any of them. But the ideal scenario puts more emphasis on product pull, whereas the daily reality shows that product push continues to have the upper hand.

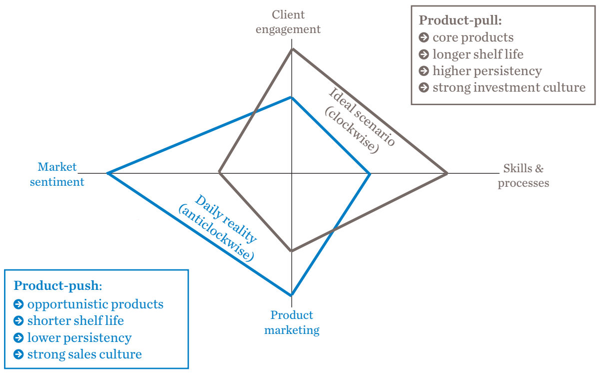
However, the winds of change have been evident since 2008. Indeed, the crisis was the trigger. The regulatory backlash on both sides of the Atlantic was also a factor. In the UK, for example, the Financial Conduct Authority (FCA) now enjoins asset managers to provide the thinking behind new products and the business case before granting regulatory approval.

Asset managers, as a result, have started to upgrade their innovation processes by emulating best practice from other industries. What Shell, the oil multinational, did back in the mid 1990s in the face of growing internal bureaucracy, has become a template.

As a part of its mid-1990s 'GameChanger' initiative, Shell introduced a fast-track process that invited all the staff – over 100,000 – to post new ideas on the corporate intranet. The ideas could be about products, processes or the business model. These were then evaluated by peers. Some were rejected, some were banked in the belief that their time had not come and the best ones were escalated.

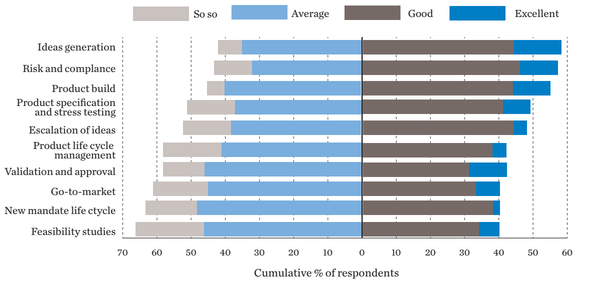
The ones that were escalated went through various hoops to deliver proof of concept before being turned into market products. The process was robust in evaluation, it also ensured that new ideas came from diverse sources, unlike in asset management where portfolio managers are usually in the driving seat.

1. Current approaches to innovation lack balance: greater emphasis is needed on skills, processes and client engagement



Source: CREATE-Research/Dassault Systèmes Survey 2013

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



Source: CREATE-Research/Dassault Systèmes Survey 2013

Variants of this process are appearing in asset management in the belief that it is impossible to deliver superior performance in today's deep liquid markets unless you do something different. The pre-crisis era is giving way to a new period of discipline.

Client engagement is becoming critical since most innovations are about customisation. In the institutional space, for example, asset managers are seeking to understand their clients' specific needs, solicit new ideas by tapping into their expertise, manage expectations on what can and can't be delivered in markets driven more by politics than economics, minimise 'wrong time' risks in buying and selling, highlight proactive buying opportunities and deliver bespoke research.

Our survey shows that asset managers are good at generating ideas but not so good at developing them. In other words, ideas generation is one thing, their execution quite another (figure 2).

Overall, only 3% rate their processes as 'excellent' and 43% rate them as 'good'. A further 54% think they are 'average' or 'so-so'. In interpreting this, it is worth bearing in mind three salient points.

First, 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.

Second, for some managers, these numbers reflect the classic innovator's dilemma – why rock the boat when a legacy book of assets is generating a steady revenue stream?

Third, for many managers, these numbers reflect transitional teething problems as they go from craft to industrialisation. While expanding their footprints, they had to shed their cottage industry character based on excessive individualism and embrace the new disciplines demanded by a mass market environment.

The report shows that as the industry has gone global, its star culture has been weakening but it still retains its glamour. Under it, innovations relied on personal chemistry and a magic inner circle of individuals much more than quality processes and reality checks.

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

These people have to balance between innovation and client needs, between business profits and franchise risk, between product push and value for money, and between the letter of the law and the spirit behind it.

Both the innovation process and the trade-offs it gives rise to require interpersonal collaboration on a scale that the asset industry is not used to. Yet, examples from other industries show that collaboration is the glue that holds together the infrastructure of innovation. As the world of investment has moved from calendar time to real time, no one can presume to have a monopoly of wisdom.

When asked whether such collaboration between various stakeholders in the innovation cycle can help to overcome factors that slow things down, over 80% replied 'definitely' or 'probably'. As asset managers have expanded their global footprints, collaboration has suffered due to the twin tyranny of time and space.

One option being considered is the digitisation of the innovation process that relies on the multiple functionalities of an IT platform. Digital tools aim to promote: the retention and enhancement of 'corporate memory', the generation and evaluation of new ideas, virtual team working across space and time, an integrated workflow document, and the minimisation of key-person risk.

Collaboration is key to minimising pain from the transition to a mass-market industry where scale, scope and reach will differentiate winners from losers. More importantly, it recognises the non-cognitive side of innovation.

After all, innovation is not a process of knowledge creation. Rather, it is a random explosion of energy born from dissatisfaction with the status quo. It exploits the law of increasing returns to ensure that ideas beget ideas and talent begets talent. It also needs to be replicable such that the process can be 'managed' to capture the resulting intellectual property, facilitate collaboration and drive to the right outcomes. All factors of production suffer from diminishing returns. The more one uses them, the less productive they become. Knowledge is an exception. Einstein's famous theory of relativity built on Newton's laws of gravity by adding fresh insights about speed of light, black holes and anti gravity. Most of Apple's products are built on established technologies. Toyota's first 'green car' used 30-year-old technology from Japanese bullet trains.

Global exemplar companies promote the law of increasing returns by paying attention to three traits of corporate culture that drive innovation:

- Serendipity: having strong convictions that promote what looks like chance discoveries. Alexander Fleming did not set out to discover penicillin, it came from a series of unconnected episodes.
- Failing forward: creating momentum with the learning derived from early failures. Scientists at Pfizer stumbled on Viagra while trying to invent a drug for a heart condition.
- Reinventing the wheel: recognising that most innovations are derivatives of the old. The person who invented the first wheel was clever but the one who invented the other three was a genius.

The central aim of collaboration is to unlock the tacit knowledge and latent energy trapped inside individuals. The role of top executives is critical in setting the tone.

Innovation means seeing what everyone has seen but thinking what nobody has thought. The requisite insights often come from interpersonal collaboration that not only ensures that ideas beget ideas but also that good ideas are taken to the finishing line via a credible process.

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