

July 2006

# 2005 Business Benchmarking Survey: Long-Term Incentive Alignment Drives Success

- **We surveyed 20 large asset management firms.** We collected a wide range of financial, performance, and ownership information to quantify the key drivers of success.
- **Asset management remains a profitable and growing business.** Firms in our sample had median revenue growth of 12% and median pretax operating margins of over 27%.
- **Scale is not the Holy Grail.** We found little correlation between assets under management and profitability.
- **Focused firms are more profitable.** Managers that had greater distribution channel focus or greater asset class focus had higher pretax operating margins than firms that served multiple channels or managed multiple asset classes.
- **Long-term incentive alignment drives success.** We believe that a “chain of significant relationships” connects incentive alignment with greater profitability:
  - Incentive alignment has a strong relationship with investment performance.
  - Investment performance is correlated with net asset flow.
  - Net asset flow has a strong relationship with profitability.
- **Strong incentive alignment significantly impacts operating margins.** We developed a multi-factor model to explain firm profitability. Based on our model, we believe that strong incentive alignment improves operating profit margins by nearly 10 percentage points.

## WHAT DRIVES ASSET MANAGEMENT SUCCESS?

As advisors to the asset management industry over the past twenty years, we are constantly asking ourselves: “What are the key ingredients to a successful asset management firm?” Based on our observations and experience working with managers, we have developed a set of principles that we believe contribute to success. These principles are embodied in our definition of the Complete Firm: a firm with a balanced excellence in investments, distribution, and business management. (See our whitepapers “*Success in Investment Management: Building and Managing the Complete Firm*” and “*Success in Investment Management: Three Years Later.*”) Because asset management businesses are human capital intensive, they face unique challenges in creating and sustaining the cultural conditions for success. However, we have observed that some companies are consistently able to grow faster and maintain greater profitability than their peers. Our hypothesis is that their success is tied to a strong investment culture, organizational stability, and good investment performance. This benchmarking survey serves as a starting point to better understand and quantify these relationships.

## RESEARCH METHODOLOGY

Our 2005 Study included 20 large, mature asset management companies. Our research sample represented over \$6.5 trillion in assets under management, had significant representation in the retail and institutional distribution channels, and was diversified across asset classes. The managers in the survey ranged in size from \$30 billion and to over \$1 trillion in assets under management. The median assets under management and revenues were \$206 billion and \$868 million, respectively (see Exhibit 1).

From each participant, we collected over 100 data points and analyzed more than 50 measures related to firm profitability (see Exhibit 2), including assets under management, sources of revenues, ownership structure, compensation expenses, and operational expenses. Our data also included firm focus (by distribution channel and asset class), investment performance, and growth of assets and revenue. In addition to benchmarking financial performance and productivity for each participant, our objective was to explore and identify the key factors that contribute to firm growth and profitability.

Exhibit 1

**2005 Survey Participants: Key Statistics**

Characteristics	Median	25th Percentile	75th Percentile
Assets Under Management (\$B)	206	98	396
Revenue (\$M)	868	576	1,415
Operating Profit (\$M)	244	158	421
Operating Margin	27.3%	20.5%	33.9%
Number of Employees	1,522	703	2,256

**SOURCE:** 2005 CQA McLagan Asset Management Pay & Business Benchmarking Study

## Exhibit 2

### Select Data and Measures

Assets Under Management	Base Salary	Total Expenses by Department
Total Net Asset Flow	Cash Incentives	Revenue per Employee
Asset and Revenue Growth	Total Cash Compensation	Revenue per Professional
Investment Performance Rank	Total Long-Term Incentives	Profit per Employee
CQA Performance Quality	Total Compensation	Profit per Professional
Operating Profit Margin	& Benefits Expense	Employee Equity Ownership
Implied Fees	Compensation & Benefits by Department	Marketing & Development Expense

SOURCE: 2005 CQA McLagan Asset Management Pay & Business Benchmarking Study

We conducted regression analysis to assess the relationship between each of these key measures and profitability. We also created a wide range of sample subsets based on common characteristics, such as investment performance, compensation levels, and marketing and development expense, to measure and understand their relationship with profitability.

## ASSET MANAGEMENT REMAINS A PROFITABLE GROWTH BUSINESS

The median manager in our sample had operating profit margins of nearly 28% and pretax operating profits of \$868 million. Despite the capital market challenges the industry has faced since 2000, asset management remains an attractive business. Even the asset managers in the lowest quartile of profitability had margins approaching 21% and earned profits of \$158 million. The median year-over-year growth in revenues was 13%, and top and bottom quartile growth rates ranged between 26% and 7%, respectively.

## SCALE IS NOT THE HOLY GRAIL

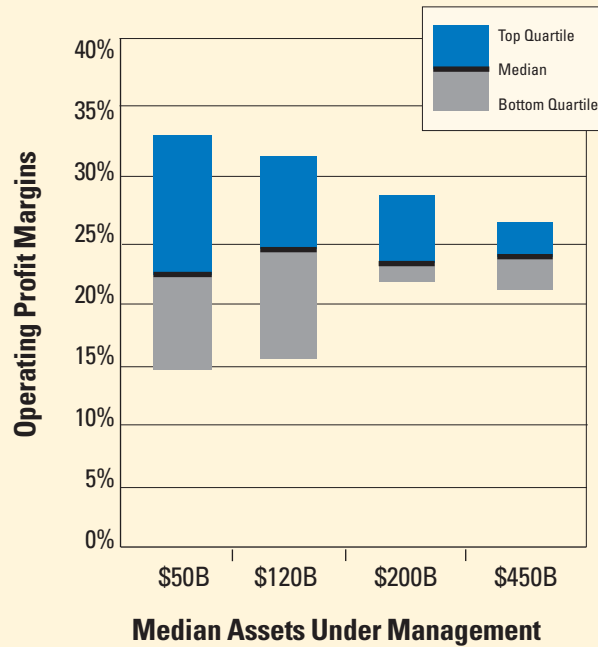
The survey results show little evidence of economies of scale. While absolute profits went up with greater assets under management, we observed no relationship between greater assets under management and greater profit margins (see Exhibit 3). As firms diversify their businesses across products, distribution channels, and geography, diseconomies appear to arise from the increased complexity of communicating, training, and retaining professionals. We found that expenses increased at the same rate as assets and revenues. However, the survey results also indicate that some asset

management businesses, such as single capability boutique managers and quantitative managers that have a focused expertise, do appear to benefit from economies of scale. These businesses, which are not typically organizationally complex, benefit from leveraging a single investment platform or capability.

Based on our research, we conclude that success in asset management is not dependent purely on growing assets under management. If asset growth increases organizational complexity, greater asset levels can actually reduce profitability.

Exhibit 3

**Little Evidence that Profitability Increases with Assets**



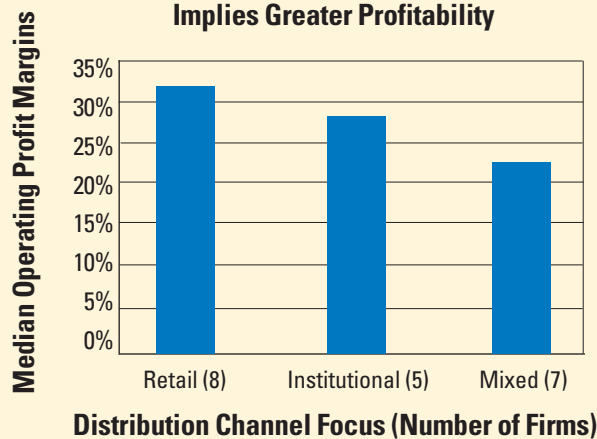
SOURCE: 2005 CQA McLagan Asset Management Pay & Business Benchmarking Study

**FOCUSED FIRMS ARE MORE PROFITABLE**

We categorized our sample by distribution channel focus and also by asset class focus. In each case, we found that firms with greater focus had higher profitability. We defined distribution focus as having greater than 70% of assets sourced from a single distribution channel, such as institutional or retail. If less than 70% of a firm's assets were sourced from a single channel, we categorized it as mixed.

Exhibit 4

**Greater Distribution Channel Focus Implies Greater Profitability**



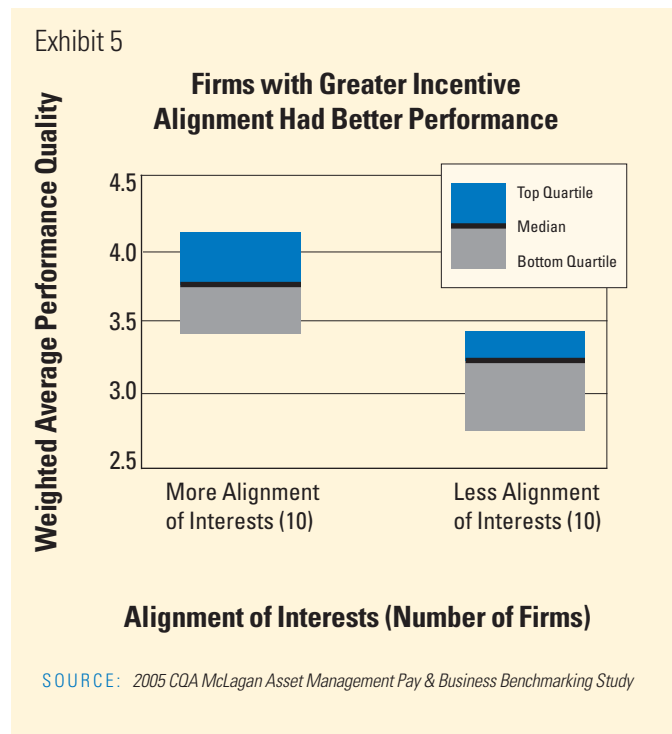
SOURCE: 2005 CQA McLagan Asset Management Pay & Business Benchmarking Study

Interestingly, the firms with channel focus had significantly higher operating profit margins than firms classified as mixed. Operating profit margins were approximately 10 percentage points higher for retail focused firms and 5 percentage points higher for institutionally focused firms (see Exhibit 4).

We also examined the asset class focus of the companies in our sample. Asset class focus is defined as managing more than 70% of assets in a single asset class, such as equity, fixed income, or index. Firms with less than 70% of their assets in a single asset class were classified as multi-asset. Firms categorized as index had the greatest profitability, despite the relatively low fees of index and enhanced index products. However, this is a case where the market leaders all enjoy significant economies of scale. Operating margins for firms with an equity focus were nearly 10 percentage points higher than for firms categorized as multi-class. Fixed income focused firms also had higher operating profit margins than firms categorized as multi-class.

## INCENTIVE ALIGNMENT HAS A STRONG RELATIONSHIP WITH INVESTMENT PERFORMANCE

Firms with greater long-term incentives had significantly higher asset weighted investment performance quality than firms with less long-term incentives (see Exhibit 5). We measured long-term incentives three ways: (1) the percentage of the asset management business that was owned by employees; (2) the number of employees who participated in the equity ownership; and (3) the prominence of long-term compensation as a percentage of total compensation. Based on these three measures, we categorized firms into two groups: (1) those with more long-term incentives; and (2) those with less long-term incentives.



We measured investment performance quality using CQA's measure of investment product performance. It incorporates performance, risk-adjusted performance, and risk and style consistency each relative to an appropriate set of peer products. A score between 1 and 5 was assigned to each participating manager's products and we calculated an overall asset-weighted score for each firm.

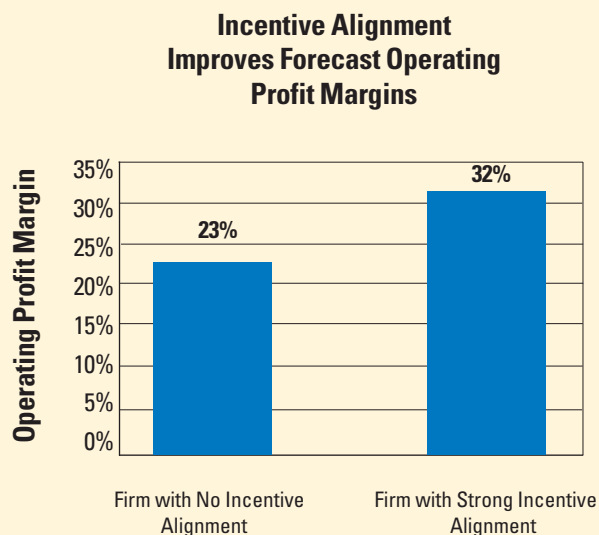
## INVESTMENT PERFORMANCE IS CORRELATED WITH NET ASSET FLOW

Firms with stronger investment performance had a significantly higher 12-month net asset flow, in both dollar value as well as a percentage of total assets under management. A number of firms with medium or low performance experienced negative flows during the year, but outflows were of a greater magnitude for firms with the lowest performance. Firms categorized with the highest performance had a median 12-month net asset flow of over \$10 billion compared with a median of \$2 billion for the middle category and outflows of \$2 billion for the lowest performance category.

## STRONG INCENTIVE ALIGNMENT HAS AN IMPORTANT IMPACT ON FIRM PROFITABILITY

Based on our research, we created a multi-factor model to explain asset manager profitability. The model had three types of drivers, including: (1) asset class focus; (2) investment performance; and (3) long-term incentive alignment. Our model explained over 80% of the differences in operating profit margin across the firms in our sample. To quantify the impact that strong long-term incentive alignment can have, we created two hypothetical firms with identical characteristics except for incentive alignment. Putting our assumptions into our model, we found the forecast operating profit margin improved by nearly 10 percentage points (see Exhibit 6).

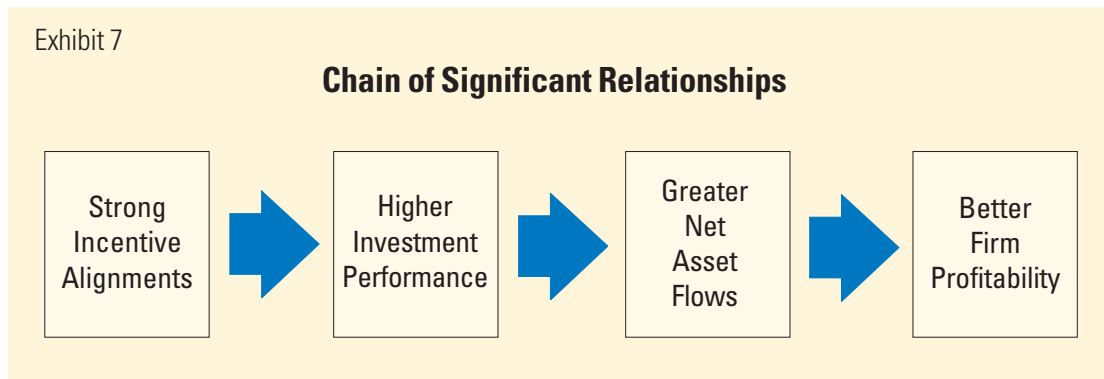
Exhibit 6



SOURCE: 2005 CQA McLagan Asset Management Pay & Business Benchmarking Study

## CONCLUSION: A “CHAIN OF SIGNIFICANT RELATIONSHIPS” DRIVES PROFITABILITY

We believe that strong incentive alignment is the anchor of a “chain of significant relationships” that ends with greater growth and profitability (see Exhibit 7). We found a significant relationship between long-term incentives and higher investment performance, between investment performance and net asset flow, and between net asset flow, revenue growth, and higher firm profitability.



Delivering strong investment performance is still the most important factor in explaining firm profitability. Our research suggests that strong long-term incentive alignment is also important because it contributes to the conditions that we believe drive investment performance. This supports our long-standing view that firm culture and stability are important to asset management success. We believe that strong long-term incentive alignment increases firm stability through a greater ability to attract and retain professionals. And finally, we have seen a direct set of relationships linking strong long-term incentive alignment with greater firm profitability.

We look forward to further testing our conclusions as we expand our survey in the coming years.

## HOW CAN YOUR FIRM PARTICIPATE IN 2006?

Casey, Quirk & Associates and McLagan Partners hope that you find these summary comments to be useful and interesting. As part of our *2006 Asset Management Pay & Business Benchmarking Study*, we will be exploring these and other related issues in much greater detail. To get the full benefit of our 2006 research, we would like your firm to participate in the 2006 Study. That is, in addition to the topics referenced in this paper, the *2006 Asset Management Pay & Business Benchmarking Study* will provide you with broader information and insight about, for example, your Firm's:

- Operating expenses and operating margins relative to the competition. For every dollar of revenues, how much is spent on staff/people, G&A, marketing, and other types of expenses?
- Bonus funding rates relative to pre-bonus profit. Adjusting for cash bonuses, commissions, long-term incentives, and other types of incentives, is the "number" 35%, 38%, 40%, or more?
- Relative staffing levels by function and in aggregate. For every 100 employees, how many legal and compliance, HR, operations, and finance professionals are there? How does your firm compare?
- Relative compensation spending levels by function. For every dollar spent on people, how much is consumed by investments, sales, administration, and top management?
- Effective payout rates for investment professionals. How much are investment professionals paid as a percentage of the revenues that they manage?

If you would like to participate or learn more about the *2006 Asset Management Pay & Business Benchmarking Study*, please contact Adam Barnett at McLagan Partners (abarnett@mclagan.com; 203-602-1200) or Jeb Doggett at Casey, Quirk & Associates (j.doggett@cqallc.com; 203-899-3034).

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## 2005 BUSINESS BENCHMARKING SURVEY

Long-Term Incentive Alignment Drives  
Success



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Casey, Quirk & Associates (CQA) provides management consulting services exclusively to investment management firms. CQA specializes in developing business strategy, enhancing investment practices, and crafting distribution plans. CQA draws on 35 years of experience in delivering value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to create change within organizations.

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## **McLAGAN** P A R T N E R S

McLagan Partners (McLagan) provides compensation consulting and performance benchmarking services to asset management organizations. McLagan's services for asset management organizations include:

- 1 Compensation Surveys: McLagan's pay surveys are the "gold standard" in the asset management industry. Over 300 firms participate annually, including 90 of the top 100 firms.
- 1 Customized Research: McLagan completes customized, client-initiated studies about competitive pay levels, performance levels, and pay and business practices.
- 1 Incentive Plan Design: McLagan helps asset management organizations design annual and long-term incentive plans and sales commission plans.
- 1 Pay Advisory: McLagan provides guidance about pay-related issues to senior management teams and boards of directors.

More information about McLagan Partners is available at [www.mclagan.com](http://www.mclagan.com).

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