May 11, 2014 LOL Investment firms: Can you say what your strategy is?

As a lead into this week's topic—strategy—I will point out an important read on the fund industry appearing in The Economist (http://www.economist.com/news/briefing/21601500-books-and-music-investment-industry-being-squeezed-will-invest-food). At the very least I recommend making this piece available to your staff, as it summarizes nicely the challenges that all investment firms are facing…and why salaries and/or headcount may be shrinking. In a rather chilling statement, the article proclaims, "Like shoppers on a budget, investors are trading down from expensive brands to white-label goods. That may put many active managers out of a job." Warren Buffett himself, the hero of active management, is quoted in the piece: "My advice to the trustee [of my personal portfolio] could not be more simple: put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund." Ouch. From our own hero, this damning statement[i]! The body of the article goes into detail about fee pressure, smart beta alternatives and shrinking DB markets. Indeed, the writer expresses surprise that "commoditization of the fund-management industry has not happened sooner. After all, the first low-cost tracking fund, designed to mimic the performance of the S&P 500 index, was created more than 40 years ago. The slow transition is partly a result of how most funds are bought and sold: the commissions for brokers that made it attractive to push managed funds, and the fact that many people buy their investment products through banks."

All is not lost. The point is made that active managers will NOT disappear overnight. Hedge funds and private equity managers are cited as alternatives to traditional long-only investing. And three types of investors – the three largest – are still interested in the active managers: 1) sovereign wealth, 2) DB funds, and 3) high net worth individuals.

After throwing this bone to investment managers, the writer concludes "Life will be harder for traditional active-fund management companies…Investors of the world, unite! You have nothing to lose but your fund managers' fees." (Shhhhh…not so loud.)

Which leads directly into the meat of this week's LOL: strategy. Given the environment described in the Economist article, can you say what your strategy is!? (We use this language on purpose because a very fine article from HBR carries this title, available from Liz at Lseveryns@focusCgroup.com) FCG has been doing strategy retreats with investment firms for many years. Our experience is that few firms do strategy well. Rich Horwath, bestselling author of books on strategy, agrees with this view: "A survey of more than 2,000 global executives found that only 19 percent of managers said that their companies have a distinct process for developing strategy. For those firms that do have a process for strategy development, an alarming 67 percent of managers said that their organization is bad at developing strategy…Most managers know that [strategy] is important, but few do it effectively." Inquiring into why this is the case, Horwath discovered the top reasons for poor strategy are:

Strategy challenge	% of organizations citing each
1) Time	96%
2) Commitment (buy-in)	72%
3) Lack of priorities	60%
4) Status quo	56%
5) Not understanding what strategy is	48%

FCG's experience would support Horwath's findings. Many firms label their year-end budget planning as strategy. It is not. McKinsey reports that "A fresh strategic insight—something your company sees that no one else does—is one of the foundations of competitive advantage. It helps companies focus their resources on moves that separate them from the pack. Only 35 percent of 2,135 global executives believed their strategies rested on unique and powerful insights." Horwath developed his own assessment for strategy and has used it with over 500 companies. He writes, "The average score is 45 percent, a failing grade, indicating there are many rudderless companies out there that are strategically adrift." Ok, so Horwath is trying to sell his books and services; of course everyone is failing and **without** his magic elixir we're doomed…☺. But in truth we see his findings borne out in many investment firms. (So, now we can sell OUR magic elixir…) They are often great money managers (despite what The Economist says…) and very bright thinkers, but NOT strategic. Authors Birshan and Kan in an article about strategy write, "We are entering the age of the strategist. Rare is the company, though, where all members of the top team have well-developed strategic muscles." (Just last week, FCG did a leadership offsite with a hedge fund where the skill in shortest supply—by the firm's own self-assessment--was "strategic thinking.") Two separate studies on leaders and the most sought after skills cited strategic thinking as number one.

To help leaders develop their strategy skills, Horwath wrote a primer on strategy called, "Deep Dive." FCG uses it as our foundational book on doing strategy work. Now Horwath has written the sequel, "Elevate." Probably the most useful tool for leadership teams aspiring to do excellent strategy work is a common language. In this regard Horwath is good. He introduces nice distinctions and clarity which allow for productive strategy discussions. (FCG has seen strategy sessions devolve into time-sucking arguments over what words mean: milestone, tactic, objective, goal, outcome, mission, etc.) We adopted from Horwath's GOST formula which is simple and powerful:

Definition of Terms

Goal	Objective	Strategy	Tactic
What	What	How	How
General	Specific	General	Specific

- Goal = General statement of desired outcome: "Weight loss"
- Objective = Specific statement of desired outcome: "10 pounds"
- Strategy = General statement of HOW the goal will be achieved: "more exercise, healthier food choices"
- Tactics = Specific statements of HOW the goal will be achieved: "join the health club, eliminate sugar and wheat from diet"

As simple as these definitions are, they can streamline strategy discussions. So, to sum up so far:

1) Most investment firms do NOT allocate sufficient time to strategy work. (They mistake year-end budget planning for actual strategy.)
2) Most investment firms have not developed a framework—including clear language—for doing good strategy work. (They are overconfident about their ability to develop excellent strategies.)
3) The investment environment is increasingly demanding that firms actually have strategic business plans. ("[Commoditization] may put many active managers out of a job.")

So, what's to be done? Horwath suggests five key questions to ask when considering whether to change or re-assess your firm's strategy. For the investment firm, they look like this:

1) **Have our firm's goals been achieved or changed**? (Goals are what you are trying to achieve, and strategy is how you're going to get there.) If you have capped two investment funds because they've reached optimal size, then it's time to think about next steps. Or if your client base is disappearing—current situation for many traditional bond managers—you may need to change your goals.
2) **Have the clients' needs changed**? Clearly this is the challenge for many active managers. As The Economist article points out, clients are getting more sophisticated and driving harder deals. Clients now refer to the "fund of funds" model as the "fees on fees" business. In order to win in this space now, your value proposition needs to be much more sharply defined and clear to clients.

3) **Is there new value in the marketplace**? Truly innovative thinkers are reacting to the new environment with novel products. For example, Research Affiliates introduced their smart Beta product—the Fundamental Index—years ago. And it has grown rapidly into a powerhouse.
4) **Have competitors changed the perception of value in the market**? Again, the idea used to be that Beta was the default choice of passive investing. Now firms are producing their own smart beta strategies as alternatives to high cost active management.
5) **What is the condition of your capabilities**? Have you honestly, humbly assessed your firm's capabilities (i.e. the products/services you offer)? Relative to your competitors, have your capabilities strengthened or weakened? If they are stronger, leverage them. If they have lost ground, it may be time to revisit them and make them fully competitive or exit the market.

So, meet with the senior team and give these questions some serious consideration. Additionally, you might ask FCG's Michael Falk to join the conversation. Michael is our expert in combining strategy methods with deep investment expertise. With his background as a Chief Investment Officer and as a strategy consultant with FCG, he is uniquely qualified to think through your current strategy and decide what, if anything needs to be done. Meantime, we recommend both of Horwath's books and the article mentioned above: Can You Say What Your Strategy Is? (Amusing strategy trivia: Did you know that strategy guru Michael Porter—author of "Competitive Strategy"—ran a strategy consulting firm that went bankrupt!? It's true. "Those who can, do…" ☺)

Last week I wrote about "Flash Boys" which led me to mention a fine article about Integrity—having some –from the Rotman magazine (Canada's HBR). I was going to write about authors' Jensen (Harvard) and Erhard's (Landmark Forum founder) new paradigm for integrity when I discovered that they have a 60 page working paper that stands "behind" the short Rotman article. So, here is the link to the longer article if you want to skim it before my review next week. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1985594. It is quite fascinating. I look forward to thinking and writing about that all-important subject for our industry: integrity.

[i] Or simply a damned (?) statement – according to Michael Falk – as he reference Einstein's "Make everything as simple as possible, but not simpler." Falk, "Where's the client in that allocation, the portfolio diversification or the goal immunization?!"