

Investing in product management

Product management is an important element in funds management but what does it mean for asset managers, why does it matter and how do you do it right? **ANDREW BAKER** provides some answers.

After the investment and distribution teams, the product team will often be one of the larger groups of professionals in an asset management firm. A big asset manager with a long product line can spend a lot of money on the product management task.

Product management has a direct impact on the investor experience. After all, most investors gain access to an investment capability via a managed investment product, such as a unit trust, superannuation fund, PST, or other structure.

Therefore, the product needs to be an effective and robust conduit of the capability being sought. Less well appreciated is how good product management can protect a firm and add value to an investment capability. Incompetent product management can rain down catastrophe on a firm—and its customers.

In fact, there is remarkably little research on product management in the asset management industry. A flick through any JASSA issue will confirm the industry's almost total focus on the nature and effectiveness of investment capabilities.

This is akin to reviewing a car based purely on its engine, while forgetting to check, for example, that it is actually lashed to the chassis. For a few, primarily institutional, investors, it's possible to buy just the engine. But for the vast majority of investors, it's the whole package that matters.

So what are your product managers doing? What, perhaps, should they be doing?

What is product management?

Product management was first developed by Procter & Gamble more than 70 years ago.¹ By 1931 the company had created an approach by which different products were managed by dedicated groups of people. This approach improved focus through more specialised marketing strategies for each product, with the aim of achieving a more efficient use of resources and improved profitability.

The product is a key element in any overall market offering.² Managing it involves decisions regarding:

- Features and quality
- Services attached to the product
- Price.

These, after all, are the basic criteria by which a customer will consider a product's benefits. Other important decisions in a meaningful product plan³ relate to the need being addressed, the market for the solution, revenue potential, branding, communications, labelling and packaging.

What makes a good product manager in the financial services industry? Research of product managers working for banks identified the following desirable characteristics:⁴

1. They give full-time attention to their product/market activities.
2. They consider and plan for all of the activities within the organisation which will affect their products.

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- 3.They coordinate the many different functional activities throughout the banking organisation by acting as a resource to the department heads who actually implement the plans of the product management group.
- 4.They are marketing specialists whose most valuable qualification is their marketing experience and insight.

But asset management products, despite also being financial services, pose quite different problems from consumer or banking products.

Like banking, asset management products are predominantly services. They are mainly intangible; one of few tangible elements is the end of quarter account balance. But there is a key difference. The quality of consumer products, and even banking products, can be standardised. The quality of asset management products, however, is often extremely variable and quality control is difficult.

In fact, if we defined quality as the

ability to create (hopefully positive) alpha, this must be one of very few industries where there is serious dispute as to whether it is possible to deliver quality at all.

The characteristics seen as desirable in bank product management are also applicable to asset management. Few could argue that the above points are not also important in asset management products.

But the variability in quality suggests that the most valuable qualifications of the asset management product manager are more likely to be depth of understanding of investment markets, and what measures can be taken to manage product quality and mitigate business risk. Marketing experience in itself is of limited value if you cannot control quality.

Models of product management

Observations suggest that Australian asset management firms tend to adopt one of four product management models. (See Table 1.)

There is no “right” model of product management. What is important is that a firm’s situation and objectives are matched with a product management model which fits them.

A technical model, for instance, will probably not suit a firm that is looking for its product managers to be a source of innovation. A champion model is more likely to deliver innovation but also controversy. A consumer marketing model may be best suited to firms which also control distribution, or situations where a firm has broken through with gatekeepers and there is an opportunity to rapidly gain market share. It does not suit most entry or re-entry situations where the task at hand is to secure gatekeeper support.

Adoption of a model will also be influenced by a firm’s history and experience with products. A firm which has typically enjoyed investment success and has no significant product problems will probably lean towards a consumer marketing model to leverage that success. On the other hand, a firm which has experienced problems with investment processes or failures in product structures may move towards a champion model which can act as a check and balance on the investment team and create more robust products.

Protecting the business

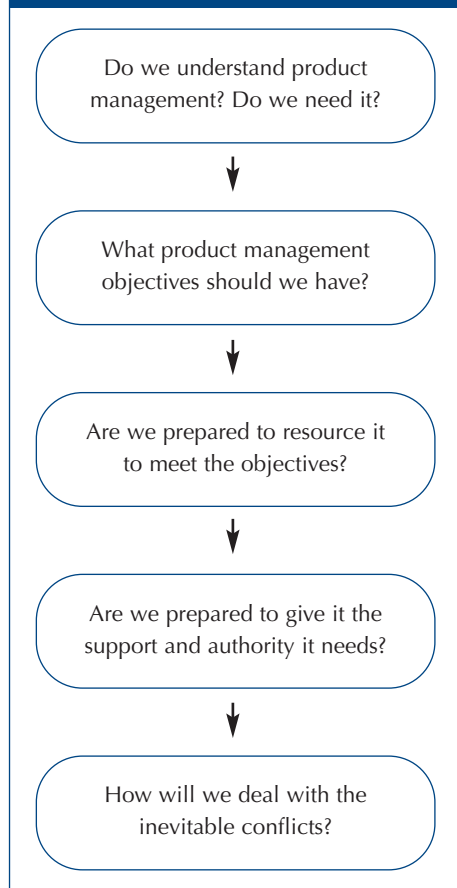
A high-quality product team is one of the most important ways an asset management firm can protect its shareholders, employees and customers.

Compare it with your local fire brigade unit:

- You can choose not to have one, but in the event of a fire there is a risk that you will not have the skills to control it.
- It’s expensive to kit out, but if you don’t spend on good people and equipment it will be useless when you need it most.
- A good unit knows which direction the problems are likely to come from, works on prevention, and is aware of the latest developments. A bad unit ends up spending all its time fighting fires because it never gets on top of

TABLE 1 MODELS OF PRODUCT MANAGEMENT

Model	Product Management Focus	Incidence	Difficulty	Resourcing
Project-based	Not a major focus for the firm No full-time product managers. Project teams manage issues on a one-off basis.	Rare	Low	Low
Technical	Stay out of regulatory trouble Compliance with the regulatory environment, issue of offer documents, technical support.	Frequent, especially in banks and insurers	Low	Medium–high
Consumer	Support distribution Deploy consumer marketing and communication competencies to increase sales.	Frequent, especially in asset managers with distribution, or strong performance which has overcome barriers to entry	Medium	Medium–high
Champion	Own and drive the product business Combine investment, project and marketing competencies to protect and grow the business.	Rare	High	High

**FIGURE 1 PRODUCT MANAGEMENT
ISSUES**

the underlying problems, let alone making advances.

Effective product management protects against catastrophic failures and sets a course towards improvement and development. It's that simple, and that important.

As a general rule, the more sophisticated a firm and its products, the more important effective product management becomes.

While incompetent investment management will certainly put a firm out of business, it will usually take some years, and the losses to customers are generally moderate. Incompetent product management can destroy a firm in a day and wipe out customers' investments.

A poor Australian equities investment process might subtract an average 5% pa from the benchmark return. The market usually loses patience after three years of such results, perhaps a maximum of five. So the firm may

eventually fail and customers might lose returns of up to 25% over 5 years. This is bad, but it is relative—if the market has performed at 5% pa or better the customer still walks away with their original capital or more, and of course the firm may be able to correct the situation before it becomes terminal.

But apparently simple investment products are capable of producing very strange, and very adverse, outcomes.

This is particularly the case when you combine products with illiquid investments and/or gearing, either direct or indirect. The unlisted property trust debacle of the early 1990s is the best, but unhappily not the only, example of a fundamentally flawed product which wiped out many customers' investments and destroyed or damaged the firms associated with the product.

Although flirting with danger clearly invites disaster, it is also entirely possible for, say, a relatively simple unit trust to become insolvent despite having fully liquid investments and no gearing.

Investment products are a complex interplay of investment characteristics, tax consequences, income and capital accounts, liquidity, gearing and investor movement in and out. The investment component, while a critical input, is just one.

Mastering this swirling mix of alphas, betas, tracking errors, information ratios, derivatives, franking, capital gains, distributions, net inflows and so on is no small achievement—but an essential one for the product manager.

What's the upside?

Products are a major intersection in an asset management firm. It's where the different competencies of a firm meet to produce—and maintain—the offer to the customer.

The upside is that when this intersection functions efficiently, it enhances and adds value to the flow of ideas and information from different competency groups. The different competencies and cultures of the firm merge smoothly to create a compelling competitive proposition, rather than colliding and diffusing the capabilities of the firm.

In particular, the products group can act as a vital bridge between the investment team and the rest of the firm. Investment teams usually have a very distinct culture and language, and communications between investment and non-investment groups can be fraught.

Good product groups with a range of competencies have the ability—and credibility—to communicate and work effectively with both investment and non-investment teams. They may make mistakes as they push boundaries, but they learn from their own and others' mistakes. When they work well, product groups are an important source of leadership, can be electrifying places to work, and roles in the group are seen as highly desirable.

This opens the way to idea generation, innovation, and the ability to execute—all of which are essential regardless of whether a firm is pursuing a differentiation strategy based around product innovation, or a cost-based strategy based around process innovation.

How to go about it

Asking the right questions at the start is critical. When product management teams struggle to meet their objectives, the reasons include:⁵

- Responsibility for getting things done but no line authority;
- Insufficient experience, which damages the credibility of both individuals and the process;
- Lack of senior management support;
- Lack of commitment to appropriate resourcing;
- Inability to resolve conflict with other groups and create a productive environment.

These issues need to be addressed for any product management model to work effectively. Without it, product managers will not get the stakeholder support necessary to achieve their objectives.

This suggests that a firm's senior management needs to ask the questions listed in Figure 1.

Having made a decision that a product management competency is required, there must be clarity of objectives. What outputs are required? Offer document production? Competitor research? Pricing? Market research? Product enhancement and development? Marketing? Cross-functional coordination? As will become evident during such an exercise, the scope of the product management team can be the widest in the firm.

Another important decision is about what really matters. What outputs are key competitive advantages and therefore have to be industry-leading? What is not key and can perhaps therefore be industry average?

These decisions should be a reflection of the firm's overall objectives (in terms of profitability, revenue growth, market share defence, build/rebuild etc) and competitive context. But it is also a philosophical question—often ignored—with major implications for the brand. What do we want our products to say about us as a firm?

Having established product management objectives, a firm needs to resource up and allocate those resources accordingly. For example, there is no point in selecting a champion model unless you are prepared to make a serious headcount and financial commitment. Inadequate resourcing of a champion model, for instance, will see it fail or be discredited.

If the resources are simply not

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available, it is better for a firm to accept that a limited technical model may be the only realistic choice, and to be prepared to sacrifice the potentially substantial additional gains in the short term.

You can always scale up over time. In fact, starting with a champion model in a single product line, bedding it down, and then migrating it across other lines, can be a more attractive strategy than attempting to introduce it across all lines at once.

Support and authority are important. Formal support and authority can be given so that product managers do not face ridiculously uneven negotiations when dealing with senior stakeholders. But formal authority often gets only formal cooperation—what you really want is active buy-in.

One way in which this can be addressed is the recruitment process. If you staff product management with highly competent, experienced and motivated people, product management will earn authority rather than having to demand it.

Another is by creating shared goals. While there should be individual goals

tied into the firm's key objectives, you can encourage beneficial behaviours by making product managers responsible for the quality of inputs to and overall market success of their products. Shared goals force product managers out into the other functional areas of the firm to support their objectives, understand how they can be achieved, and what they can do to reduce the risk of goals not being achieved.

Effective product management creates inevitable conflicts. Product decisions involve tradeoffs and highlight sensitive issues of control and power. Professional careers and livelihoods get tied up with the success or failure of specific products.

Given that products are a major intersection of the firm, most forms of change—new products and many day-to-day product management decisions—impact most areas of the firm and can generally only be implemented with active cross-functional support and cooperation. The potential for conflict here is limitless.

Conflict in itself is not a bad thing. An absence of conflict—or groupthink—usually means that hard questions are not being asked or debated, which can result in disastrous decisions. But high levels of conflict and a lack of methods to resolve conflict are counter-productive.

Conflict must be expected, and in fact welcomed, but the firm needs to be able to manage it so that it adds to the quality of decisions. For this reason,



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product management is typically far more effective if it is accompanied by a project and stakeholder management methodology.

In-house or outsourced?

Product management is an activity almost always performed within the firm. But does this always make sense?

Product management can be a substantial undertaking. A quality product management team is expensive. High-quality product professionals with a range of competencies are exceptionally hard to find, especially if a more intensive model of product management such as the champion model is desired.

The pool of talent is small and recruiting from the larger pool in consumer industries has usually been unsuccessful. Such individuals face steep learning curves in getting to grips with investments and may face difficulties in the change from dealing with tangible products where quality can be strictly controlled to an intangible service where quality control is extremely difficult. Frustrations can arise from the constraints of a heavily regulated financial services environment.

A product team can represent a significant fixed cost for an asset management firm—a potential mismatch with volatile variable revenues. This can still make sense for large firms with large numbers of complex products because they should be able to generate some economies of scale or scope.

But for smaller firms, especially boutiques and new ventures, such a commitment probably does not make sense.

At first glance they may have less need for product management as their products are generally limited in number and type.

Yet their products may be no less sophisticated, and often more so, and investor expectations of product robustness are unlikely to be scaled down to cater to the more limited resources of a small firm.

Therefore smaller firms still usually have a need for product management, but it may not make financial sense to develop this capability internally.

Given the flourishing of boutiques and new ventures following the consolidation of the middle ground in Australian asset management, there may be scope for an innovative outsourcing solution.

Case study—split capital investment trusts in the UK

UK investment trusts are akin to Australian listed investment companies (LICs)—closed-end investment companies. Traditionally they invest

in a diversified portfolio of blue chip shares. There are more than 300 such trusts, some with long and distinguished records of delivering through bull and bear markets. They trade at a market price which fluctuates around net tangible assets, but typically have low management charges and are transaction friendly for small investors.

However, by 2002, several UK investment trusts had become insolvent and others sustained massive losses for many of their investors. A number

TABLE 2 SITUATION GIVEN DIFFERING RETURN SCENARIOS

Example 1—equal income and growth units

	Amount	Price	Units
Income units	100	1.00	100
Growth units	100	1.00	100
Total	200		200

Average returns

Income return	4%		
Growth return	6%		
Income units	108	1.08	
Growth units	112	1.12	
Total	220		

Bull market

Income return	4%		
Growth return	20%		
Income units	108	1.08	
Growth units	140	1.40	
Total	248		

Bear market

Income return	4%		
Growth return	−20%		
Income units	108	1.08	
Growth units	60	0.60	
Total	168		

Severe bear market

Income return	4%		
Growth return	−40%		
Income units	108	1.08	
Growth units	20	0.20	
Total	128		

Example 2—unequal income and growth units

	Amount	Price	Units
Income units	100	1.00	100
Growth units	50	1.00	50
Total	150		150

Average returns

Income return	4%		
Growth return	6%		
Income units	106	1.06	
Growth units	59	1.18	
Total	165		

Income return	4%		
Growth return	20%		
Income units	106	1.06	
Growth units	80	1.60	
Total	186		

Income return	4%		
Growth return	−20%		
Income units	106	1.06	
Growth units	20	0.40	
Total	126		

Income return	4%		
Growth return	−40%		
Income units	106	1.06	
Growth units	−10	−0.20	
Total	96		

of asset management firms were subjected to regulatory investigation and parliamentary criticism, resulting in severe damage to brand and business values.

The road to catastrophe was marked by a series of decisions which steadily accumulated risk. Each decision in itself was not inherently foolish. But the resulting accumulation of risks gradually yet fundamentally changed the nature of these trusts and left them extremely vulnerable to even modestly adverse market conditions:

- Split capital trusts were introduced in 1965. This development enhanced the investment trust concept by usually making it fixed term (say 10 years) and splitting it into income and growth units.
- The intention was to cater to investors with different preferences for income and growth. Although specifics varied from one trust to another, income unit investors often received all the income return of the trust, and a pre-determined capital value (often the original entry price) at the end of the fixed term, assuming that the trust's assets were sufficient to repay this amount. Growth unit investors received no income, but received all the capital growth return of the trust, after the ultimate repayment of the capital owed to income unitholders.
- This structure introduced a new risk into investment trusts—structural gearing. Consider the following simplified examples:

Example 1 assumes that \$100 each of income and growth units are issued, a total of \$200. An average blue chip equity portfolio return might be 10%, composed of 4% income and 6% growth. Income unitholders receive all the income, 4% on the \$200 portfolio, and receive a return of 8% on their \$100. Growth unitholders receive all the growth, 6% on \$200, and receive a return of 12% on their \$100.

- So far so good. But income and

growth returns are not always similar. Income returns tend to be relatively stable while growth returns fluctuate dramatically from year to year. So in Example 1, the income unitholders always receive 8%, but the growth unitholders might receive anything from +40% in a bull market year to -80% in a severe bear market year. A growth return of -50% or worse will wipe out the growth units, at least temporarily.

- The first type of structural gearing should therefore be clear. In Example 1, there is effectively 100% gearing of each type of return for the different unitholders.
- However, a second layer of gearing occurs if the split trust does not issue equal numbers of units of each type but entitlements remain the same.

Example 2 examines a situation where because of uneven demand, the trust issues \$100 of income units but only \$50 of growth units. In this case, the gearing of the income unitholders is reduced to 50%—they receive a 6% return for a 4% income return. The growth unitholders' gearing is now 200%—they receive an 18% return for a 6% growth return.

- Growth unitholders therefore face very elevated risks, the degree of which may not be clear at the time of investment. Income units are not as safe as they appear either. In the severe bear market scenario of Example 2, the growth units have a theoretical value of -\$10. In reality, the growth units will be valued at \$0, and the negative equity will be charged to the income units, reducing their value to \$96.

We are therefore dealing with a potentially highly leveraged structure, which can produce unusual and unexpected outcomes. This suggests that a particularly prudent approach to investing and risk management would have been appropriate. Unfortunately the risks already present were then multiplied through a series of extraordinary decisions:

- Some trusts took out bank loans to financially gear the trust.
- A new type of unit became popular—zero-dividend preference shares. Comparable to a zero-coupon bond, these promised a pre-set return (assuming the trust had assets to cover it at maturity), and were popular with families saving for school fees. Although technically

TABLE 3 GEARED UP SITUATION

Example 3	Amount	Price	Units	Rate
Borrowings	100			5%
Zeros	100	1.00	100	7%
Income units	100	1.00	100	
Growth units	100	1.00	100	
Total	400		300	

Severe bear market

			Reallocate Growth losses	Reallocate Income losses
Income return	4%			
Growth return	-60%			
Borrowings	105		105	105
Zeros	107	1.07	107	71
Income units	111	1.11	-36	0
Growth units	-147	-1.47	0	0
Total	176		176	176

preference shares, these were essentially another form of borrowing.

- Trusts specialising in more volatile (and currency exposed) asset classes such as Asian equities and technology shares started to appear.
- Trusts started to cross-invest—for example, a split trust might invest in the income or growth units of another trust.

Therefore, not only was the gearing mounting, but the likelihood of large positive and negative returns from the underlying assets was also increasing.

In Example 3 we have bank borrowings of \$100, and \$100 each in zeros, income and growth units, for total assets of \$400. But cross-investment means that bear market losses are now much higher, here assumed to be –60% rather than the –40% of the previous examples. Under such conditions, the outcomes are devastating:

- The \$100 in growth units is wiped out and they have equity of –\$147. The negative equity is then allocated against the income units.
- This in turn wipes out the \$100 in income units plus their income return, and there is still negative equity of –\$36 left over. This is allocated against the \$100 in zeros, reducing their capital value to \$71.
- We have now destroyed the investments of two thirds of the investors in the trust, including 100% of the “less risky” income units, and inflicted large losses on apparently “safe” zeros. And of course there is the risk of breach of borrowing covenants and the lender taking control and liquidating to protect their position—thus crystallising investors’ losses.

This example seems extreme but unfortunately, it is pretty much what thousands of UK investors have recently experienced.

While significant losses in bear market conditions are typical, the

extent of the split capital trust disaster was entirely avoidable. Split trusts are not necessarily a flawed product development design, but they can be very unstable. They demanded exceptionally close attention from product managers.

In such circumstances, introducing financial gearing via loans, further structural gearing via zeros, and increasingly volatile asset portfolios was extremely dangerous and inconsistent with the implicit promise of investments with labels such as income units and zero dividend preference shares. Cross investment into the leveraged units of other split trusts was simply playing with fire.

Effective product management should have prevented such decisions being taken. As to why it failed, we can only make educated guesses:

- Managers simply failed to understand the true risk of their products and how that risk was escalating over time.
- Managers failed to appreciate the extent of investment market losses possible. After many years of positive double digit returns, it’s easy to anchor on such information as remaining applicable—especially when managers are new.
- Managers ignored warning signs. We tend to seek confirmation of what we are doing unless we specifically look for disconfirmation.
- The business may have had powerful supporters—after all, it promised much higher assets under management and therefore revenues—who overruled the concerns of product managers when raised.

The most depressing aspect of this episode is that in many ways it replicated the unlisted property trust disaster that damaged the Australian asset management industry in the early 1990s. Some elements of our home-grown disaster were different—it involved illiquid assets and open rather than closed trusts—but other elements

were identical, in particular the combination of structural gearing of split capital trusts, uneven units on issue, and financial gearing.

FOOTNOTES

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