Asset management

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Asset management is the investment of financial assets by a third party. Financial assets under management (AUM) are categorised according to asset classes: equities, bonds and alternatives such as property, currency and commodities. Equities represent an ownership interest in another corporation, including a share of the profits as a dividend and a claim in the event of bankruptcy. Bonds represent an obligation to re-pay a loan and, normally, a coupon. Alternatives include a wide range of tradeable assets where the asset manager expects to earn a profit.

There are two main investment strategies: active and passive management. Under active management, there is often greater flexibility in the investment mandate. Passive management or index-tracking funds are more closely aligned to a benchmark, which usually reflects the market capitalization of a broad set of constituent assets in a sector or country. Passive management took off after the 1970s and had a 13 per cent share at the end of 2005 (Pastor and Stambaugh, 2012, p. 759). Both active and passive strategies encompass a variety of investment objectives such as yield or growth maximization, tax avoidance and socially responsible investment. Funds are also segregated by asset class, country and industry sector. Lastly, funds often incorporate derivatives such that a Brazilian equity fund might be denominated in US dollars.

The quantitative techniques of asset management have their origins in a broad body of theoretical work (Markowitz, 1952; Modigliani and Miller, 1958; Merton, 1972; Black and Scholes, 1973). These techniques are used to construct a fund from a combination of derivatives, risky assets and a risk-free asset, usually a government bond. By synthetically matching the risk and return characteristics of third-party benchmarks, managers distance themselves from the investment decision. These decisions are retained by the investor, who in turn might rely on investment advisors, benchmark and performance data.

Quantitative techniques also introduce new problems. They extrapolate return and risk from historical data, ignoring Knightian uncertainty and assuming a normal distribution of returns despite contrary evidence (see Mandelbrot, 1963). The use of derivatives introduces counterparty risk as well as profit opportunities for other financial actors. Index-tracking ignores Roll’s critique that the benchmark is hypothetical and unobservable (Roll, 1978); an index-tracking fund can miss out on profit opportunities or anomalies unless a specialized benchmark is used. Assets that have a lower volatility (called “beta”) than the benchmark have been shown to outperform; currency markets have shown long-term profit opportunities (carry trade); and the existence of high net worth financial actors is another persistent anomaly.

Asset management is concentrated in relatively few, global firms that are geographically concentrated. In 2012, global AUM were 120 billion US dollars or 170 per cent of gross world product. Around two-thirds are long-term investments managed by pension, insurance and mutual funds. The remainder are managed on behalf of wealthy individuals and sovereigns in private wealth, sovereign wealth, private equity and hedge funds. Almost half are US firms, and clusters exist in global financial centres such as New York and London (TheCityUK, 2012, p. 4). This concentrates equity ownership interests. Tracing ownership connections between transnational corporations (TNCs) shows that "nearly 4/10 of the control over the economic value of TNCs in the world is held […] by a group of 147 TNCs in the core" (Vitali et al., 2011, p. 4). The top fifteen TNCs are either fund managers or combined fund managers and investment banks.

There has been an observed tendency for smaller funds to disappear due to the selective culling of underperforming funds (Elton et al., 1996) as well as mergers and acquisitions. In Europe, the single market has enabled further consolidation. The intention of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directives, which began in 1985, was to create a single market for asset managers across Europe; it also created problems in cross-border regulation and opportunities for regulatory arbitrage. The UCITS *cause célèbre* was Bernard Madoff's asset management firm, revealed in 2008 as a massive Ponzi scheme. The firm had been UCTS registered in Luxembourg and was responsible for "the largest investor fraud ever committed by an individual" (Weber and Gruenewald, 2009, p. 1). In Luxembourg, local regulations permitted custody of the non-existent assets in the United States without direct surveillance.

Asset management is therefore of concern to central bankers and regulators from several perspectives: financial stability, competition policy, and the on-going possibilities of fraud and collusion.

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