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Don't overdo the gloom and doom

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In these straitened times it would be easy for the asset and wealth management community, and those writing about its fortunes, to become downcast.

As capital markets slumped in the fourth quarter of 2007, investors behaved as they always do in turbulent times, running for the hills in undisguised panic.

According to Lipper Feri European investors withdrew a net €71bn (£55bn, $109bn) from the industry in the final three months of last year, once the commoditised, low-margin money markets sector is stripped out of the equation.

Factoring in market falls this translated into a €180bn slide in assets under management, a contraction of 4.2 per cent. Doubtless the data for the first quarter of 2008 will be equally soaked in red ink, and many parts of the European fund industry, particularly the southern extremities, were hardly in rude health even before the markets decided to go pop.

For an industry whose revenues are directly related to its assets, yet whose cost base is relatively fixed, this shrinkage of its asset base will flow straight to the bottom line. Investors have already realised this of course. Listed asset management houses across the European Union have seen their prices tumble, on average, by 25 per cent since the start of July, twice as much as the wider market. The falls in the US have not been as extreme, but performance is still nothing to write home about.

But there is a danger of overdoing the doom and gloom; the prospect of asset managers or private banks being battered so badly they end up being sold for a song, à la Bear Stearns, remains remote.

In the good times wealth management is a ludicrously lucrative business. According to McKinsey and Co, pre-tax profit margins across both the European asset management and private banking sectors hit 35 per cent in 2006, with the former generating record operating profits of €16bn. When markets are favourable even run-of-the-mill participants can sit back and watch their assets under management - and therefore revenues - rise by 10 per cent or so a year, even without generating net inflows. And all this from a refreshingly non-capital intensive industry.

Sure there are downturns, but they are rarely terminal. Ray Soudah, founder of Millenium Associates, a Swiss advisory firm, puts the current woes in perspective when he says the ratio of potential buyers to sellers in the wealth management sector has halved in the past three months from 100-to-1 to 50-to-1.

Within Switzerland alone there are "several dozen" potential buyers waiting in the wings, he asserts, and the only reason that the volume of transactions in the sector in the first quarter of the year has dipped below that seen in 2007, a record year, is because there is a "fundamental reluctance on the behalf of people to sell".

One potential source of willing sellers might be the full-service investment banks that are facing death by a thousand cuts as their liquidity evaporates amid the global credit desert.

But even here Mr Soudah sees little likelihood of a fire sale of private banking operations or wealth management arms. Indeed, he argues that wealth managers are now the "kings" of the banking firmament as their earnings help balance the write-downs and losses spreading like a rash across the rest of the operation.

"These guys have power, they are running the banks," he says. Indeed any sale of a bank's asset management arm would achieve little apart from monetising the goodwill on the balance sheet.

Being capital unintensive, a sale would do little to improve a bank's capital ratios, and might simply push share prices lower still. "If they sell their stock price will go down as they are selling future profits. I don't think in general they will do this unless they are in a real deep crisis. Then it becomes a survival mechanism," concludes Mr Soudah.

Indeed, despite the turbulence, the trend is still for investment banks to look to expand their wealth operations into new corners of the world; witness BNP Paribas's announcement last week that it is forming a new asset management joint venture in Saudi Arabia with the Saudi Investment Bank.

So what would it take for wealth management to really fall out of favour? Mr Soudah estimates that industry revenues might fall by 25 per cent this year, as a result of declining asset prices and negligible performance fees. Yet even this would merely push cost/income ratios from 65 to 87 per cent - a healthy figure in the best of times for some industries - assuming no cost-cutting whatsoever.

Mr Soudah believes we would need to see a full year of losses before most owners turn willing sellers. Assuming a year-end cost/income ratio of 87 per cent and zero net flows, even if asset prices fell a further 13 per cent in 2009, the median player would still be breaking even, again without cutting costs.

Thus, barring even darker scenarios than are already priced in, it would seem to be 2010 before owners throw in the towel en masse. This chimes with Mr Soudah's experiences in the last downturn when, after the equity market bubble burst in 2000 owners started to capitulate between the end of 2002 and the middle of 2003.

But a wave of selling never materialised. As soon as the market turned all was well in the world. Would-be sellers abandoned their putative disposals and got back to the business of milking their cash cows.

This market downturn has been sharper than in 2000, implying it might bottom out more quickly, despite the ructions in credit markets. Our front page story this week hinting at the first green shoots of recovery in commercial property, one of the first sectors to suffer this time around, suggests there will be no mass wave of sell-offs and job losses this time around either.

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