

Viewpoints

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'To Do' List Is Getting Longer

By Mohamed El-Erian

Today's financial crisis is producing ever higher unemployment, investment losses, and home foreclosures. People now recognize that the unthinkable is thinkable, be it in the banking system or in the real economy. Yet some major structural changes, that are about to play out, have not as yet attracted sufficient attention – including the upcoming shrinkage and consolidation of the industry that provides investment management services to individuals, companies, pensions, and governments around the world.

Two distinct yet inter-related drivers are at work. First, collateral damage from the largely self-inflicted war within the banking system which, as I noted in an earlier FT column, is gradually transforming banks into “utilities”. Second, the desire by governments to impose a peace by de-risking and re-regulating finance, lest today's crisis morphs again – and this time into a global depression that would negate the progress that the world has made in the last ten years to improve living standards and alleviate poverty.

These factors will inadvertently result in a major but uneven shrinkage of the investment management industry during 2009 and 2010. This unintended consequence will be felt most intensely in the levered (or “alternative”) space dominated by hedge funds and private equity firms. But it will spread well beyond that to traditional investment managers, particularly in the equity space and among those that are part of declining banking conglomerates.

The alternative sector faces a perfect storm. These once prominent pools of capital are finding it harder to secure financing lines from banks. It is also proving harder for them to raise longer-term funds through bond issuance and initial public offerings.

The alternative sector's reputation has been harmed by the restrictions (or “gates”) that some have placed on investors seeking to pull money out. Meanwhile, poor investment performance for some, and asset value erosion for many more, have shrunk collections from management and incentive fees. It would come as no surprise if at least half of the entities in this space were to disappear in the next two years, either through mergers or failures.

Traditional investment managers are not immune to this rash of institutional shrinkage and consolidation. For some, the collapse in worldwide equity prices over the last 15 months has already shaved off about half of their operating revenues, rendering their current cost structure overwhelming and threatening the retention of talented staff. They are also seeing assets walk out the door as some investors try to counter the gates in the alternative space by using traditional investment managers as a cash

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machine. Moreover, some firms with weak institutional parents now find themselves regarded as "non-core" and subject to disposition.

What does that mean for investors? The implications go well beyond another phase of pressure on asset prices. As difficult as it already is, it is no longer sufficient for investors just to come up with the right asset allocation and responsive risk management; they must also undertake more rigorous assessment of investment managers to ensure investment and business models are sustainable.

To do so, investors should look for firms that remain profitable and, equally importantly, are playing defensively upfront so that they can play offensively later in a sustainable fashion. They should also look for firms that are positioning their business to take advantage of some major strategic and human resource opportunities that will arise as others stumble.

Understandably, few investors will welcome the news that the "to do list" is getting even longer. They already face considerable challenges on account of the turbulent financial landscape. Yet there is no alternative than to recognize the unprecedented changes impacting many firms' business, and not just investment models. Meeting these challenges forcefully is certainly not easy; and it is not risk free. But the alternative of not doing so is potentially very costly.

The writer, chief executive officer and co-chief investment officer of PIMCO, is author of ["When Markets Collide: Investment Strategies for the Age of Global Economic Change"](#) (McGraw Hill). 2008 FT/Goldman Sachs business book of the year.

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