

Roland Berger

Focus

May 2017

The ant or the grasshopper?
Tomorrow's asset management industry



Management summary

The pace of change in the asset management industry is accelerating. While the industry will continue to grow overall, the gap between winners and losers will widen. Those whose business models do not uphold a competitive advantage will fall further and further behind.

While structural dynamics ensure continued growth in the industry, cyclicality is intensifying, requiring companies to understand their own cyclicality and take measures to reduce it.

Diversification may be valuable for investors, but it can present serious issues for asset managers if not kept under control. The new environment will push asset managers to focus on their strengths; excessive diversification will neither drive revenue growth nor protect profitability.

Actively managed products will always have a market. The debate, therefore, should not be about active versus passive but about creating a product offering which matches client needs and expectations and is priced accordingly. Until asset managers better prepare themselves for the market's cyclicality, any rotation in product performance will continue to come at their own expense – historical positioning will not bail them out in times of downturn.

Identifying and focusing on the sweet spots of growth while radically addressing the cost base by eliminating areas with low visibility or differentiation will be crucial. Products are sold, not bought. The importance of marketing, communication and client visibility is increasing at a time when distribution channels are radically changing and widening. With the switch from a promise of future returns to the cost savings around product choices, intermediaries have a new role to play in this new environment.

Differentiation initiated by digitalization and technological advancement will become increasingly visible. To stay ahead of the curve, asset managers must embrace FinTech as an opportunity, and not only see its rise as a threat.

The favorable curve of today's market may delay strategic reviews and restructuring, but it does not inherently protect asset managers from future challenges – which will only continue to grow. Asset managers should take advantage of the tailwinds now to prepare for survival during the inevitable downturns – and ultimately to prepare for future success.

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Prepare now, win later

The challenging – and much-changed – asset management industry requires a new approach

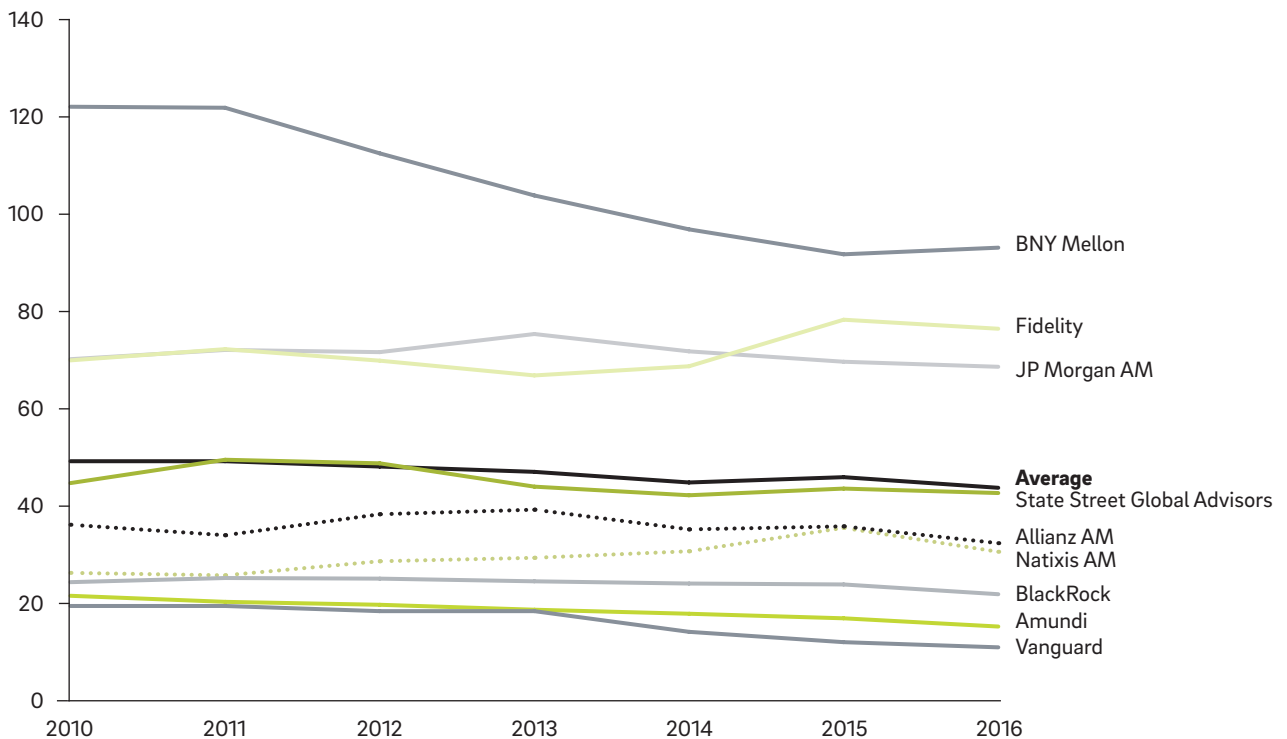
New and renewed regulatory frameworks like MiFID II. Shifts toward passive products. Rising price transparency. The emergence of robo-advisors. The ever-growing accumulation of digitalization requirements from consumers. These and many other challenges currently facing the asset management industry may paint an apocalyptic picture of its future, especially if viewed in light of dropping revenue margins. → **A** But there is a more positive outlook, one that sees market players taking on the

challenges and using them to reach new levels of success. This more confident viewpoint is backed by two factors: one, stable profit margins, and two, strong signals of volume growth in the industry.

Despite the pressure on revenue margins, the industry is still benefiting from high average profits. Since 2010, the average profit margin of the top 6 asset managers has been stable at around 13 bps → **B**, though indeed the disparities between players remain significant.

A: Revenue margins are dropping.

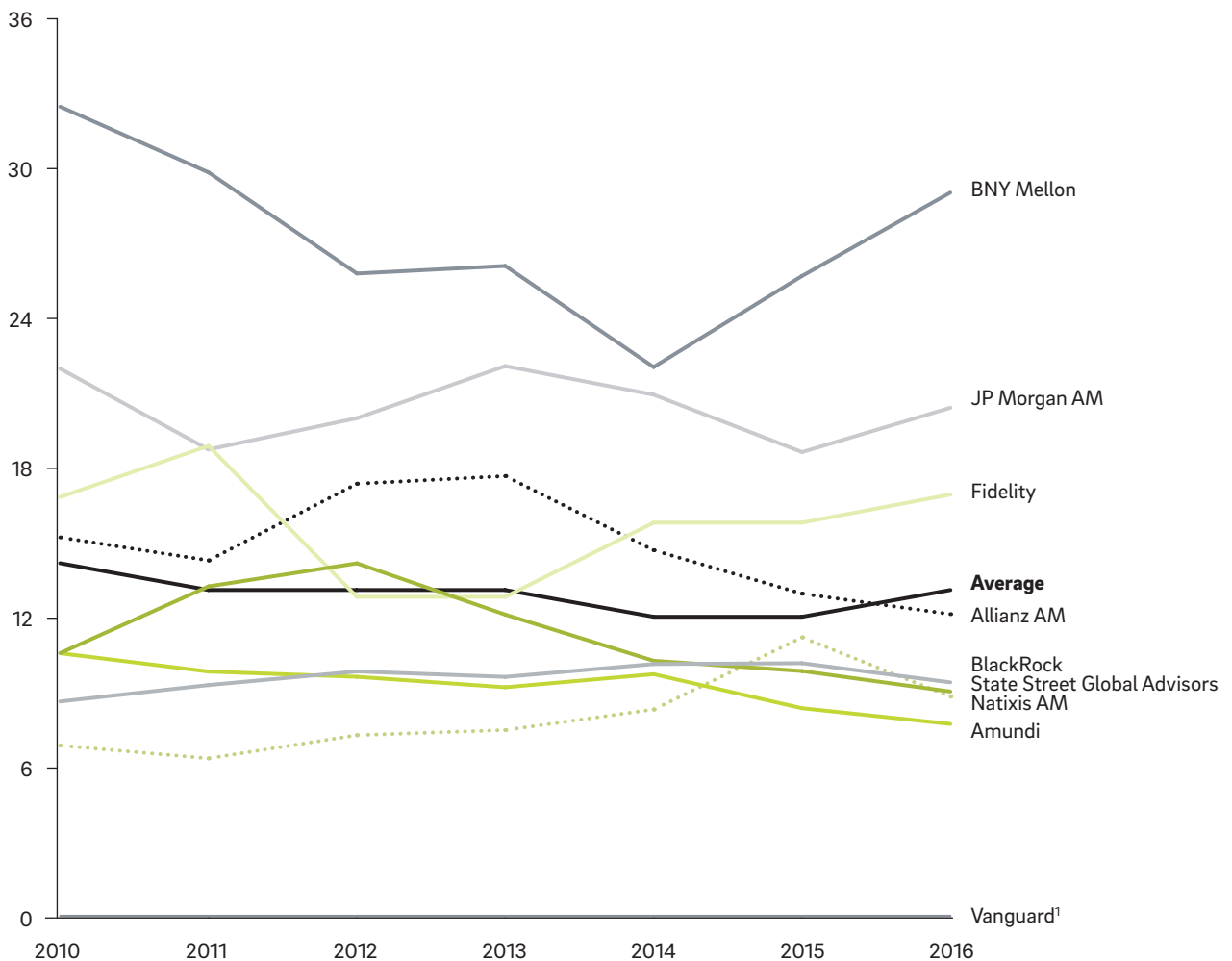
Net revenues as share of AuM for selected asset managers [bps].



Source: Annual reports

B: The average profit margin of the top 6 asset managers has been stable at around 13 bps, though disparities between players remain significant.

Profits as share of AuM for selected asset managers [bps].



¹ Vanguard is not publicly listed and is owned by its clients. Since all profits are put into lowering client fees, Vanguard makes virtually no profit as a result

Source: Annual reports

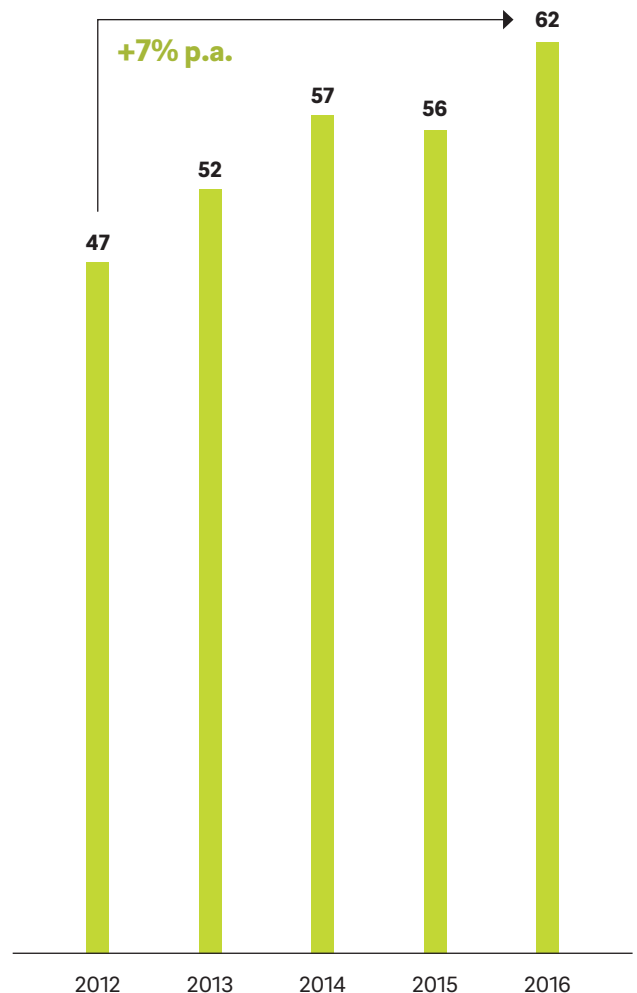
The industry is also benefiting from two strong growth drivers of volume. For one, the emergence of a new middle class in many parts of the world means a new and large group of potential savers. Two, as the population ages around the world, retirement savings are gaining urgency. As a result, global AuM has grown approximately 7% per annum since 2012.¹ → C Regardless of how the market develops over the coming years, these factors will only continue to gain strength.

To seize this growth and protect themselves from the rapidly changing environment, asset management players must temper their inner Weiss, in other words their eagerness to fixate on those attractive profits – which regulators like the FCA are wary of – and the advantages of scale that the consolidating industry now offers. Ultimately, the determining factor for success and survival will have less to do with size and almost everything to do with competitive advantage. Without value-adding product offerings and distribution channels, large players will struggle to keep up with the new demands of the industry. And without market visibility, smaller players may not be able to even survive. Today's industry is a game of ant and grasshopper: those who work hard now will reap the benefits later.

1. As the industry grows more cyclical, asset managers must assess their own cyclicity and find ways to counter it

The asset management industry is a growth industry, but it is also cyclical. In order to protect the business model, asset managers should fully understand their own cyclicity and how it impacts the business. How to then respond – and make changes to the business –

C: Global AuM has grown approximately 7% per annum since 2012.
Global AuM [USD tn].



Source: IPE research

¹Note that the average annual growth rate in USD terms of 7% is much less than the average growth rate in EUR (12%) due to the strong appreciation of the USD in 2012-2016.

depends on where the company falls in terms of its level of exposure to the market's cyclicality. Every company will find it has its own unique tipping point; understanding where that might be means determining where the revenue dependencies lie:

- > Existing business
- > Net new business
- > Segment, product and client rotation
- > Market and currency movements
- > Non-organic growth

Big and exposed

For good reason, the industry focuses on sales: these are products that are sold, not bought. But there is an inverted correlation between AuM and the organic growth rate; sizeable AuM does not in and of itself facilitate the generation of new business. While certainly influenced by local particulars, net growth rates typically stay in the lower single digits; generating 3% annual net organic revenue growth is a significant challenge for a USD 500 bn diversified asset manager. Out of the top 10 AuM firms, only four achieved over 3% growth last year. Given the historical cost-level increases of 2-3% per annum, for many large managers, especially those with broad product suites and distribution channels, organic revenue and profit growth actually relies almost solely on market and currency movements. The bigger the company gets, the more cyclical its profits will become; the company's size will wash out any real impact of organic growth. → [D](#)

It's in the asset mix

The next downturn will come; this is inevitable. And while the asset manager does not control market and currency movements, the company's asset mix (and requisite cost structure) can reduce their impact. The ongoing upward pressure on costs is of course partially driven by general inflation, but also by the need to invest in

IT platforms and marketing simply to respond to additional or different client needs and a more challenging competitive environment.

For many larger managers, future success will depend on cost savings and complexity reductions, but costs and complexity will remain sticky unless changes to the business model or the product range are implemented. Cost management and investment programs should be influenced by the cyclicality of the revenues and its sources. Strong cost discipline and complexity reductions when markets are favorable will pay dividends; investing during a down cycle will prepare for an upturn. With regulatory pressures structurally pushing up a number of cost factors, cost management and investment programs take on even greater importance.

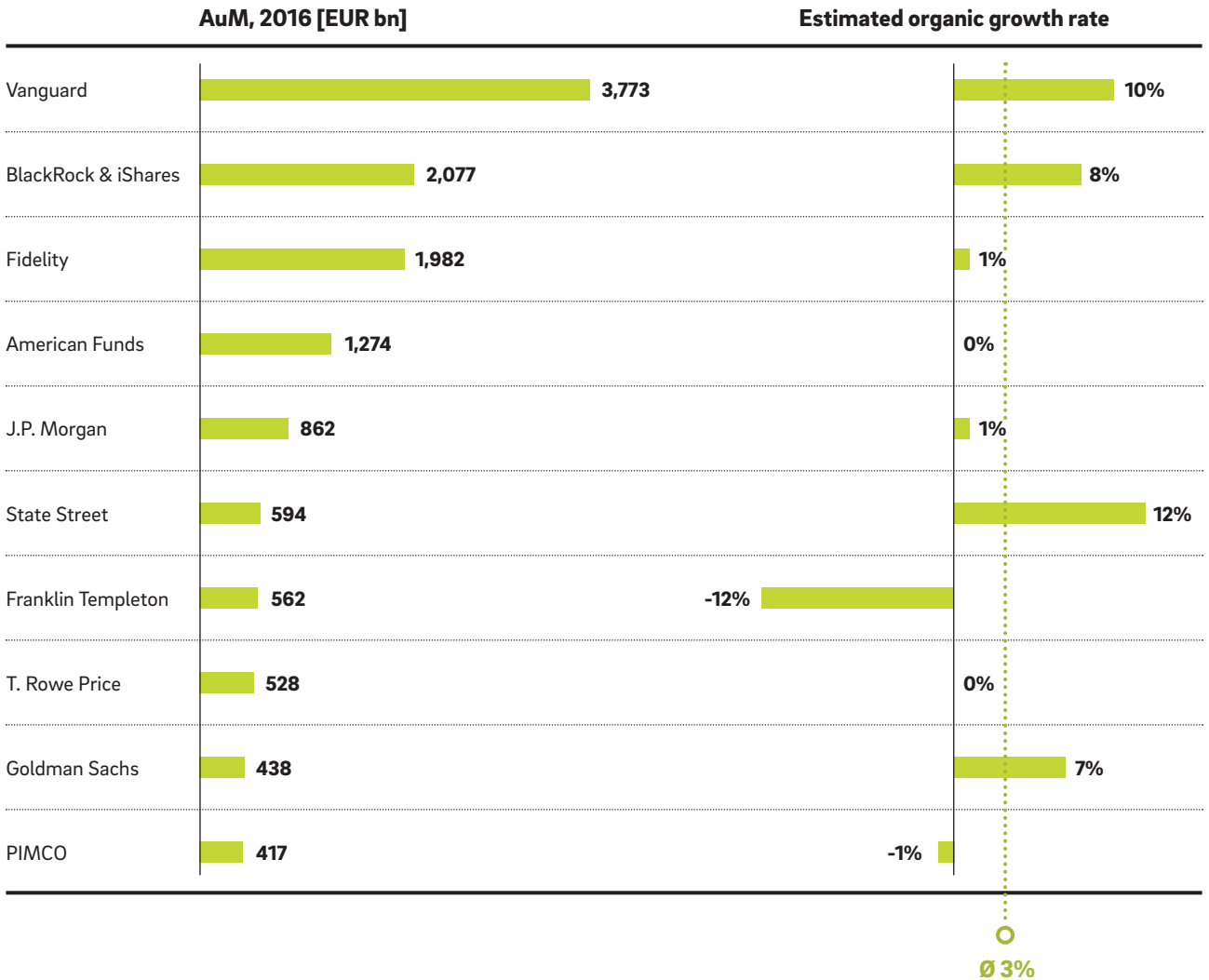
The consolidation in this highly fragmented industry will continue, in many cases driven by cost efficiencies. Non-organic growth can be an important component in cost management through scale advantages, as well as in fueling revenues and providing new avenues of growth – but stay alert: when there is considerable overlap between products and distribution channels, integration and synergy measures can prove challenging.

2. Finding the sweet spot: Diversification may not actually contribute to the long-term value and growth of the asset manager

The industry correctly assumes that over the long term, diversification contributes to the value and growth of investment portfolios. But this same assumption cannot be applied to the industry as a whole, or to its individual players. Unbridled diversification significantly damages the outlook for large asset managers, in particular those where clients are not captive and do not entrust the asset manager with most or all assets.

D: Only a few asset managers realize organic growth beyond 3%.

AuM and estimated organic growth rate of largest fund firms, 2016 [USD bn].



Source: Morningstar

Diversify...and bust?

Nonetheless, many asset managers are diversifying their number of asset classes and products. Their moves in this direction are driven by several factors:

- > Creeping diversification from existing asset classes
- > Good retail access and the desire to provide solutions across the full range of the potential market
- > The aim to expand the revenue base and reduce sensitivity to particular asset classes
- > Client demand and a company's unwillingness to adopt a third-party model

But in doing so, asset managers are putting not only revenue and P&L at risk, but also their structural positioning. Many active funds underperform the benchmarks they are set against. Extensive product diversification neither improves the probability of strong performance of individual products, nor of the portfolio's performance as a whole. On the contrary, it reduces the share of asset classes which will do well compared to their benchmark or, more importantly, peers. The result is often a long trail of products with poor performance records, low AuM and limited ability to reverse the trend.

Some diversification adds to revenues and stability, but if performance does not match targets and offers insufficient or no value, any gains in client access will rapidly erode. Clients will respond with their own diversification tendencies, with limited to no loyalty to products which are not first-quartile in their product groups or which are otherwise irrelevant to their circumstances.

Active fund diversification also has potentially significant implications for organizational costs which go well beyond the direct costs related to the investment team, affecting each division of the business chain from management to operations. There will be some rotation in the underlying product performance but overall this ro-

tation will have to carry the full weight of the increased overall cost structure, offsetting any operating leverage the diversification could provide.

Lifecycle management

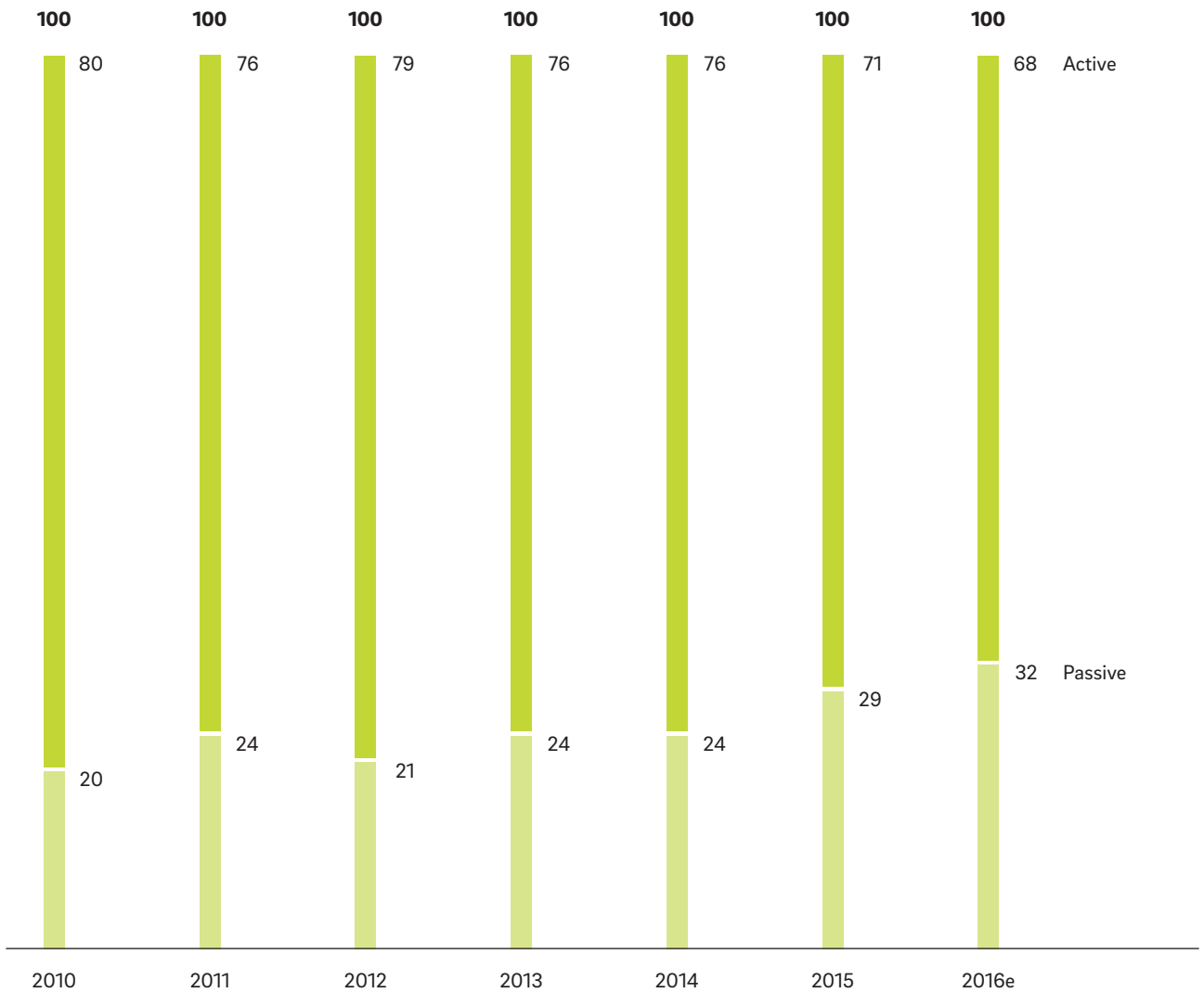
Asset managers, of course, can alleviate diversification tendencies by periodically reviewing the performance of their product portfolios. Product lifecycles can signal overall portfolio health, and close review at the product level will pinpoint those products that do not add value for clients, or for the company.

To make any meaningful shifts in the product strategy, however, top-down decision-making will play a key role. Most asset managers will find it difficult to cut their product portfolios using a bottom-up approach, as business units will often have the arguments in hand to keep certain products; even the smallest products generate revenues, if ultimately negative profit. A bird's eye view of the situation will be necessary to make fundamental, sustainable change.

Active vs. passive – the false dichotomy

There is too much emphasis on active versus passive funds. The industry is simply transitioning from an environment where the large majority of funds were active (or at least marketed and priced as such) to an environment where client needs are best served by open access to passive funds and smart beta-related funds, active funds and investment solutions. The share of passively managed funds increased from ~20% in 2010 to ~32% in 2016. → **E** This new reality inevitably comes at the expense of active managers. The average expense ratio of an active fund is 77 bps, where the average passive fund only charges 17 bps → **F** – in other words, the active asset manager charges close to 60 bps in additional expenses. However, passive funds will never outperform their benchmark, and this will sustain continued demand for active funds.

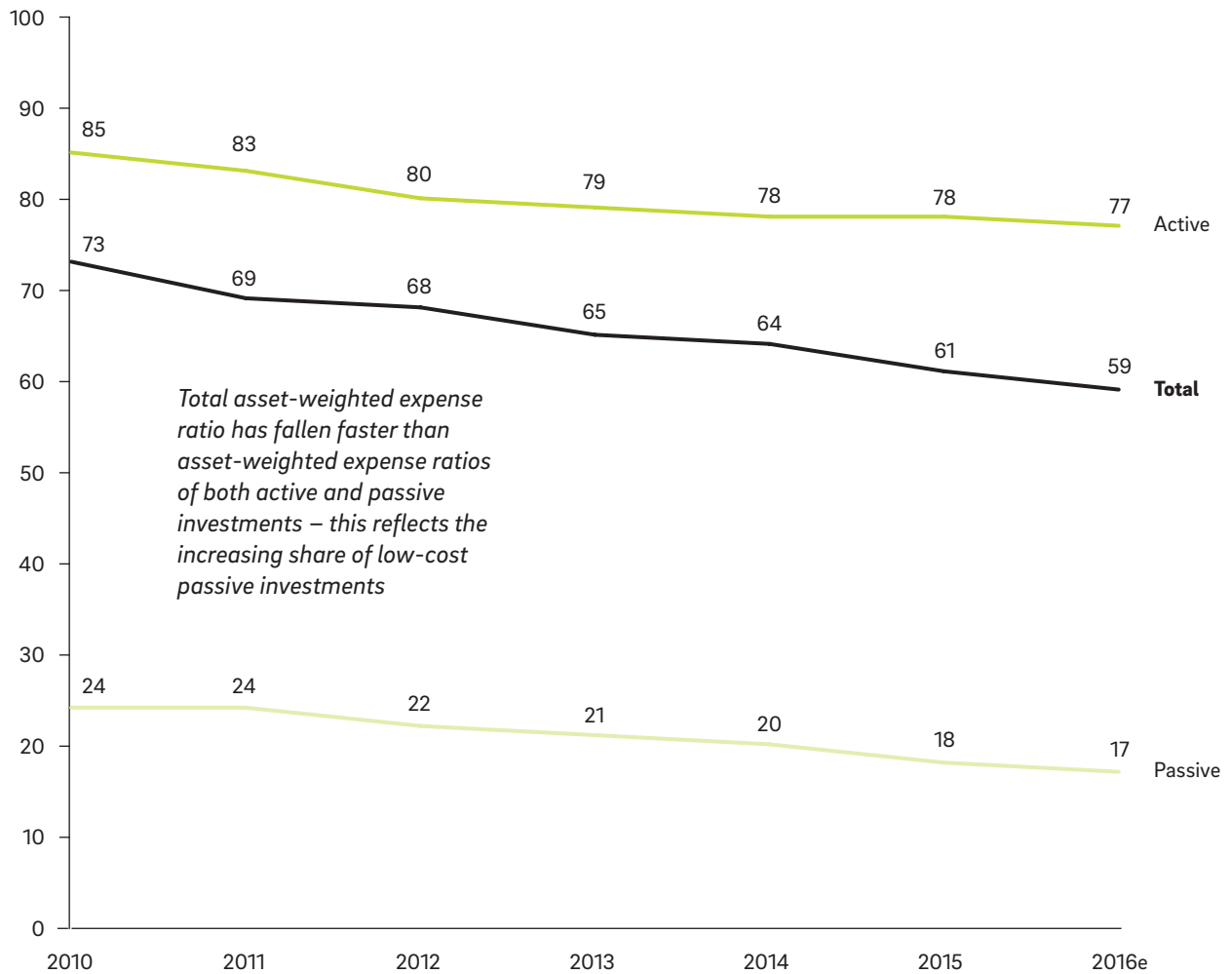
E: The share of passively managed funds increased from ~20% in 2010 to ~32% in 2016.
 Distribution of active and passive funds [%].



Source: Morningstar

F: Active asset managers charge close to 60 bps in additional expenses compared to passive asset managers.

Expense ratios [%].



All eyes on alpha


Active asset managers in this new reality, however, will have to prove that they have the structure, skillset and approach that will reward their clients with additional alpha. In an environment where intermediaries are paid by clients rather than through retrocessions, and where intermediaries cannot guarantee performance for their clients, asset managers can prove their added value by offering their clients attractively priced mutual funds. This focus on cost comparison is also pushed by the regulatory environment. While this is justified to prevent some of the past excesses, it accelerates the need for active asset managers to prove their alpha worth.

The issue for active asset managers is not to fight the trend toward passive funds, but to provide funds with a realistic expectation of generating significant alpha or to provide thematic access that cannot be delivered through passive management. Asset managers will not only have to limit the number of active products, but also dedicate the required resources to increase the chances of sustainable alpha; this will include ensuring that enough risk is allowed or required to be taken.

Offering portfolio solutions is an intrinsic part of selling alpha. Such solutions can create new revenue opportunities by using products as a tool rather than an outcome. Smart beta products can also be an excellent way for asset managers to fill the gap between pure passive funds and active funds, adding interesting products to their offering which can be managed in a cost-effective way.

The rise of ETFs

One additional trend affecting active funds that cannot go unmentioned is the rise of exchange-traded funds, or ETFs. In a number of cases, ETFs are now dominating market trading. Shares in Apple, the world's biggest and most heavily traded company, turn over more

than USD 3 bn each day, while the biggest ETF, State Street's SPDR S&P 500, trades more than USD 14 bn each day. Since 2006, the volume of ETFs has grown by ~20% per annum. →  While there are drawbacks, the technology behind ETFs yields several benefits for investors, including:

- > Possibility to trade at any time of the trading day
- > Facility to increase exposure or hedge
- > Lowering fund costs
- > In certain jurisdictions, fiscal benefits

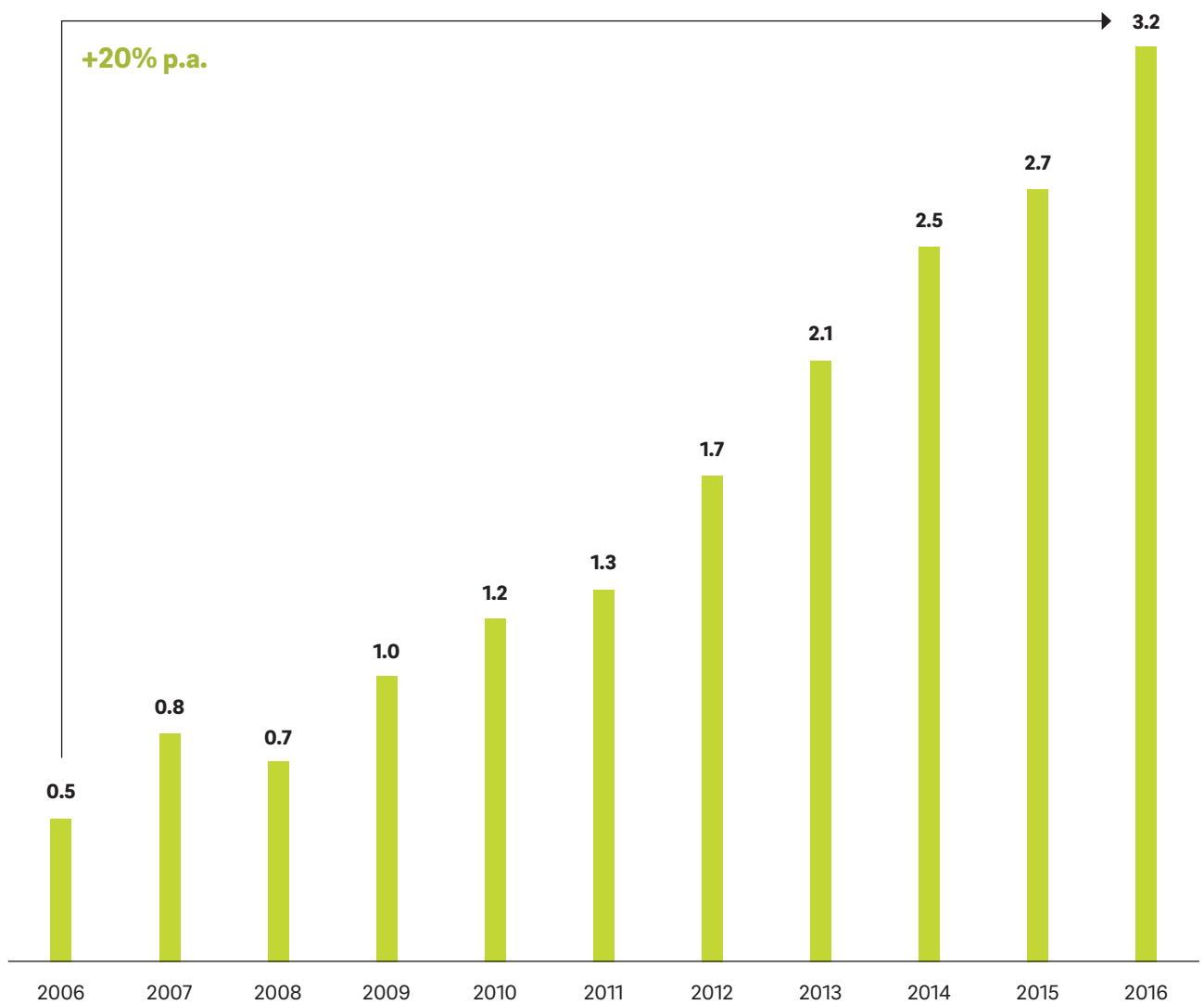
But while there is little reason to doubt that a new equilibrium will be found between active funds and ETFs, creating a full-scale ETF business unit will be challenging for most asset managers. The dominance of the top 2 ETF providers requires a scale unmatched by most competition.

Nurturing competitive advantage

Consultants, advisors, and institutional, wholesale and retail clients no longer believe that one asset management company can excel at everything. Some asset managers may have the benefit of a strong brand, but that means little if their alpha performance is hardly better than average. The asset manager's profile may naturally point in the direction of focus: the asset manager of a global bank is expected to focus on multi-assets and income-related activities; the European asset manager is expected to at least offer quality European products.

Simply put, all asset managers need to determine what their competitive advantage is, nurture it, and do whatever they need to do to keep it. But as industries evolve and mature, players need to ensure that their competitive edge is the result of internal skills rather than external factors. For many, their advantages are related to privileged client access or brand name rather than a particular skill.

G: Since 2006, the volume of ETFs has grown by ~20% per annum.
Global ETF asset development [EUR tn].



The value of third-party funds

Asset managers of passive and smart beta funds who believe that their client base requires a full offering could also consider the use of third-party funds. These funds could be used for areas where they will not be able to reach the required performance standards or where the investment is not warranted. Considering the huge choice in available funds, the selection of the right third-party funds is also a differentiating skill. Any reputational risks and liabilities associated with third-party funds – fueled by the Madoff story – are now adequately addressed by the regulatory environment.

Multi-asset space

Another major opportunity for asset managers is the broad multi-asset space. This is a space where the value of services lies less in alpha generation than in the asset allocation itself (asset classes, currency and geographical exposure).

The changing needs of the client base will continue to open opportunities for adapted products that leverage these skillsets. Understanding the needs of the different client groups and identifying the optimal ways to address them will continue to provide further growth opportunities for the industry overall.

3. Outstanding marketing and digital excellence are decisive factors in asset management success

Excellence full-frontal

Marketing will continue to play a crucial role in this industry, as new funds often collect more funds than old ones and large funds often collect more than small ones. Excellent performance is not enough to generate revenues. Clients need to know about it and understand it. Many asset managers must strengthen their capabilities when it comes to selling their positioning, their

performance and their competitive advantage to their different client bases, whether final or intermediaries, and they must better understand what drives the selection process.

The digital key

Digitalization is crucial for asset managers, not only with regard to their interface with the external world but also as an essential way to improve internal processes and reach the required operating and cost efficiency. Ultimately, it also serves as a potential revenue generator.

FinTechs are less of a threat to asset managers than they may seem. The innovation they bring is a tremendous break, both on the product and the distribution sides. Certainly, the rise of FinTechs means new competitors which could erode client and revenue base, but asset managers who embrace digitalization and integrate the possibilities into their own workings will no doubt benefit from their new – or renewed – digital excellence.

In the same vein, robo-advisory is capable of more than client profiling and linking this to investment models. The current debate around robo-advisors unfortunately focuses on only part of the equation. Identifying the risk profile of a client is not that difficult; well-designed questions can identify their risk appetite and fit this in an investment model. The real opportunity behind the robo-advisor lies in the ability to link client profiles with much more sophisticated, more dynamic asset allocation models. This means new prospects for the more traditional lifecycle products with static allocations, but also for asset managers in leveraging their accumulated knowledge.

4. The tailwinds in the industry are a signal that it is time for asset managers to prepare for survival – and success

The asset management industry is on the cusp of a major change. Increasing costs and margin pressure, intensifying cyclicality, and strong regulatory pressure (e.g. the arrival of MiFID II in the EU in 2018) are the final nails in the coffin of yesterday's industry. Positive profit and growth indicators may have dampened the signs of the oncoming transformation, but they are also precisely the reason that now is the time for asset managers to address any issues and reposition their companies for the future.

5. CEO agenda

In order to be ready for the coming changes, asset managers must take a step back and analyze their situation with care and diligence. In this section we outline a CEO agenda – the issues that the top managers of the asset management industry should prioritize going forward.

We make four key recommendations:

- 1. Define your competitive advantage and tailor the offering**
- 2. Create a competitive cost level throughout the cycle**
- 3. Reinforce marketing efforts**
- 4. Embrace digitalization**

In each of these priority areas, a number of essential questions need to be addressed.

Defining the competitive advantage and tailoring the offering involves calibrating the asset manager's proposition to also maximize the value for clients. The key questions here are:

- > What are the core investment offerings with a distinct added value for the client base? What distinct competencies form the basis for this added value? Do these offerings show actual outperformance to prove this added value?
- > What clients and markets would benefit from this specific added value and should therefore be served?
- > What products in the current offering provide no or limited added value to clients? How could these products be phased out? Could clients be better served via superior third-party alternatives?
- > What is required to develop and sustain the competitive advantage and required competencies in the future? Is there a benefit from pursuing inorganic growth opportunities?

Ensuring competitive cost levels throughout the cycle involves an optimized, flexible cost level. The key questions to be addressed are:

- > What is the cyclicality of the company? What measures can be taken to reduce it?
- > What is the minimal cost level that can be carried by the asset manager throughout the cycle?
- > How can sustainable cost reductions be realized? How can the cost base be made more variable?
- > How can the asset manager create flexibility for future investments?

Strengthening marketing efforts requires a clear view of the target clients and their purchasing criteria.

- > Who are the target clients? What are their purchasing criteria?
- > How can the identified competitive advantage and added value be better communicated to this target audience?
- > What marketing tools are most effective in doing so?

Embracing digitalization across the value chain calls for a forward-looking perspective.

- > What are the key digital developments in the industry? How will these affect the asset management landscape and value chain in 5-10 years?
- > What digital developments provide an opportunity? How can these opportunities be prioritized? How could the prioritized opportunities be leveraged, e.g. via partnerships with FinTechs, corporate start-ups or alliances with incubators?
- > What digital developments should be considered a threat? Which of these threats are hyped, and which of them are real? What should be done to mitigate such threats and turn them into opportunities?

The execution of this CEO agenda will lead to different roadmaps for different asset managers. For some this will mean further exploiting the clear competitive advantage of their companies, and for others it means identifying and focusing on their own unique strengths. And some will participate in the consolidation game. Regardless of the roadmap used, key priorities across the industry will continue to be cost control throughout the cycle, a focused offering, outstanding marketing and the adoption of digitalization. With the global economy and financial markets picking up again, the outlook can be very bright for those asset managers ready for the future.

Our four key recommendations:

1. Define your competitive advantage and tailor the offering
2. Create a competitive cost level throughout the cycle
3. Reinforce marketing efforts
4. Embrace digitalization

Imprint

WE WELCOME YOUR QUESTIONS, COMMENTS AND SUGGESTIONS

AUTHORS

Mark de Jonge

Senior Partner, Netherlands
+ 31 20 7960-658
mark.dejonge@rolandberger.com

Sjors van der Zee

Principal, Netherlands
+ 31 20 7960-600
sjors.vanderzee@rolandberger.com

Vincent Camerlynck

Senior Advisor, UK

FURTHER CONTACTS

Knut Storholm

Senior Partner, Bahrain
+971 4 446-4080
knut.storholm@rolandberger.com

Markus Strietzel

Senior Partner, Germany
+49 211 4389-2244
markus.strietzel@rolandberger.com

Robert Buess

Partner, Switzerland
+41 43 336-8620
robert.buess@rolandberger.com

Alain Lecouedic

Partner, Hong Kong
+852 3757 9488
alain.lecouedic@rolandberger.com

Thierry Quesnel

Senior Partner, France
+33 1 70 39 42 75
thierry.quesnel@rolandberger.com

Philippe Chassat

Partner, Singapore
+65 6597-4560
philippe.chassat@rolandberger.com

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Publisher

ROLAND BERGER GMBH

Sederanger 1

80538 Munich

Germany

+49 89 9230-0