Survival of the Fittest:

Defining Future Leaders in Asset Management

The operating environment for asset management firms worldwide (outside China) **will continue to pose challenges:**

- The industry's annual organic growth will slow to <1% by 2021
- Annual revenue growth will fall to 2.9% from 6.0%
- Median profit margins will drop to 28% from 34%

Four catalysts are driving secular industry change, driven by growing demand for outcome-oriented portfolios:

- **New buyer demands** emphasizing different value propositions for asset managers
- **Skepticism regarding active management** fueling growth for old and new betas
- **Disruptive technologies** slashing distribution costs and reinventing the consumer experience
- **Fiduciary-driven regulation** reorienting advice delivery and product pricing

Nevertheless, **one-third of asset managers worldwide** are still growing faster than the currently oversupplied marketplace, using any of four competitive advantages to differentiate themselves:

- Innovative product development
- Strong, positive brand recognition
- Distinct customer experience and engagement
- Data about customers and markets

Effective asset managers will make **five bold changes** to transform their businesses into powerful, efficient competitors:

1. **Optimize resource allocations** from outmoded businesses to new growth initiatives
2. **Streamline operations** for efficiency and onboarding new skills and technologies through M&A
3. **Differentiate investments** with a broader array of active capabilities and strong product development processes
4. **Digitize distribution** to reduce costs and more directly engage the client
5. **Build a unique consumer-oriented brand**

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CaseyQuirk
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Casey Quirk helps clients develop broad business growth strategies, improve investment/product appeal and growth prospects, evaluate new market and product opportunities, and enhance incentive alignment structures. Our unparalleled industry knowledge and experience, detailed proprietary data, and global network of relationships make Casey Quirk a leading advisor to the owners and senior executives of investment management firms in the world.

Introduction

Asset management executives worldwide have long been the beneficiaries of a lucrative and benign operating environment. The resulting broad growth rewarded many asset managers, even those with functional deficiencies in strategic plans and operating models. Now, however, the industry faces a reckoning driven by two primary factors:

- **Costs:** Shrinking expectations for capital market returns and slowing organic growth have combined to reveal the industry is not as scalable as previously believed, with expected fixed cost increases now outpacing likely future revenue growth. Asset management executives are reviewing how they allocate costs among current and future business lines.
- **Consumers:** As individuals, rather than institutions, begin to provide the industry's future growth, asset management increasingly looks like other consumer businesses—dramatically changing buying demands, desire for a strong customer experience, and fee sensitivity.

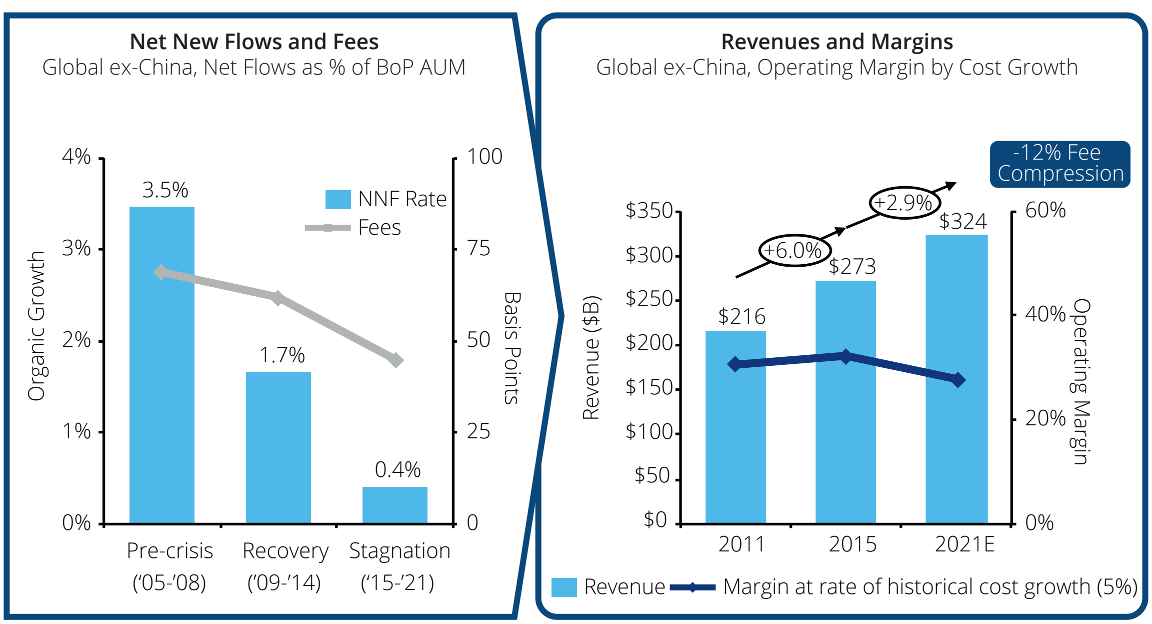
A select group of firms have created operating models that are growing faster than rivals. Few have done so using conventional business strategies, or simply competing with rivals based on relative investment performance. Effective players are transforming their value propositions, service offers, and operating models. Bold strategic changes, not incremental shifts, will characterize the firms that continue to thrive. These firms will pull away from the pack, forcing similar-looking rivals to consolidate for survival.

Environment: Four Catalysts Shaping Industry Economics

Asset management's historically healthy economics are deteriorating. Annual revenue growth will fall by half before 2021. If investment firms continue to maintain their long-term proclivity to increase costs by 5% each year, aggregate earnings will shrink in absolute and relative terms.

Exhibit 1

Global Asset Management Industry Economics



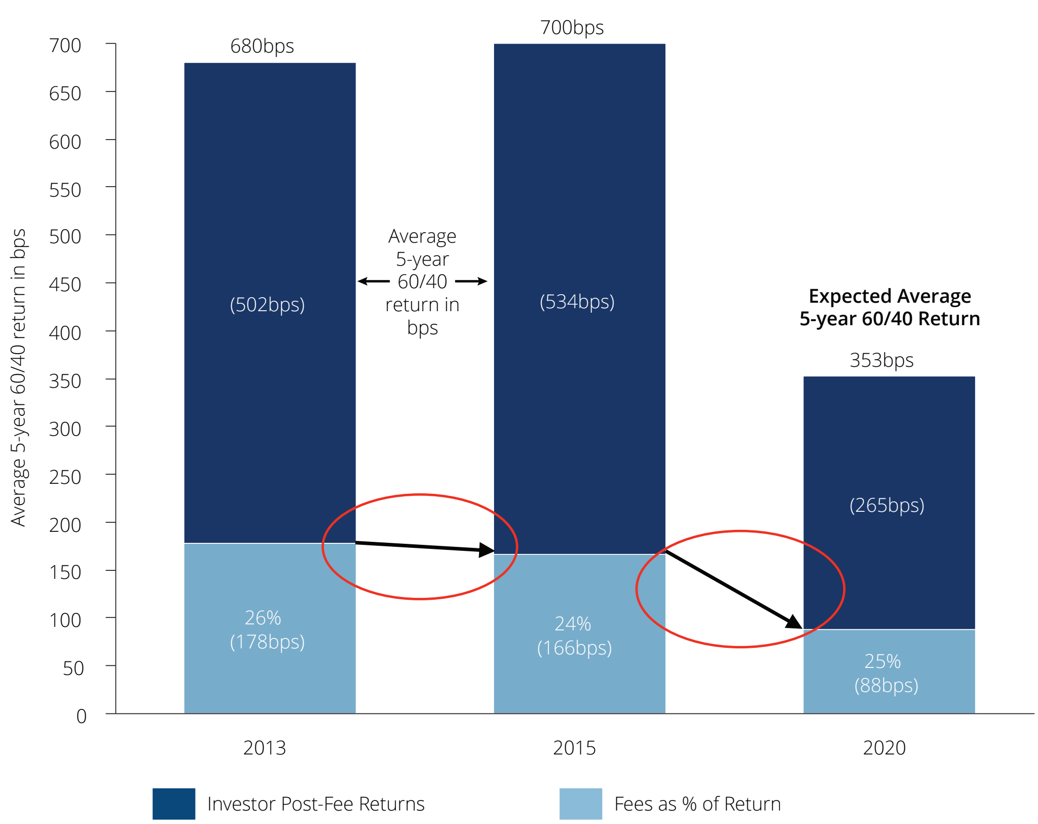
Sources: Casey Quirk/Institutional Investor Institute/McLagan Performance Intelligence, Casey Quirk Global Demand Model, Casey Quirk Analysis

Long-term headwinds continue to strengthen:

- **Dwindling market returns:** Falling expectations for long-term GDP growth, the continued prevalence of low or negative interest rates in much of the world, and a benign outlook on inflation all will combine to slice expected market returns—historically, the inertia behind revenue growth for asset managers.
- **Shrinking organic growth:** Less new money will enter the hands of professional asset managers as pension systems worldwide return funds to retirees, sovereign funds deploy capital to stimulate growth, and more asset owners worldwide elect to manage their own money.
- **Fee compression:** Aggregate fee rates in asset management are plummeting, due to four factors: increased indexing; more head-to-head competition encouraging higher discounting in an oversupplied market; disruption from new technologies that slash the cost of distribution; and increased scrutiny where fees comprise a widening portion of slimmer capital market returns. By 2020, the expected average all-in advice and portfolio management costs for a US retail investor will need to shrink if investors expect to maintain roughly consistent yields on their investments.

Exhibit 2

Investor Fees as Proportion of Expected Returns



Sources: Casey Quirk Advisor Database, Casey Quirk Global Demand Model, *Investment News*, Casey Quirk Analysis. Return estimates aggregate projections from J.P. Morgan, AQR, BlackRock, and Goldman Sachs

China is the sole exception. The world's second-largest asset management marketplace will grow as fast as the rest of the world combined. Thick fees for asset management products and services should remain steady, buttressing the marketplace's revenue and profit potential—although more so for domestic players than foreign entrants, at least for now.

Better capital markets returns could improve marketplace conditions—but only incrementally. Pressure on asset management earnings also stems from four secular catalysts that are reshaping the industry's economics.

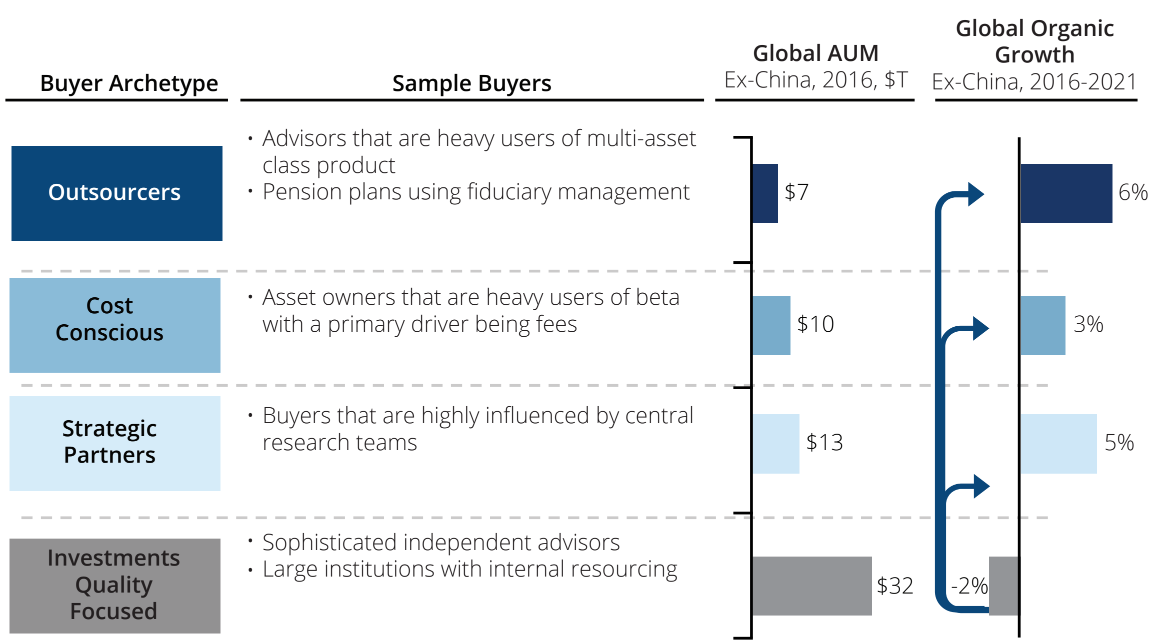
Catalyst 1: New Buyer Demands

The demands of large, conservative institutional investors historically set the pace for innovation in asset management. Sophisticated asset owners designed their own portfolios of specialist investment firms, selecting vendors based on investment quality, generally measured by an asset manager's ability to outperform benchmarks. Going forward, however, individuals will drive the majority of future growth. These clients value different attributes of the investment firms they select, including the ability to deliver outcomes, support for more holistic financial planning advice, and—like any consumer industry—value for money.

A majority of asset managers have business models built solely around a value proposition of investment quality, based on outperformance, distinct philosophies and well-articulated processes. Yet during the past five years, investors who represent their traditional customers already have shrunk by $1.8 trillion. During the next five years, outflows from these traditional buyers will amount to nearly another $4 trillion.

Exhibit 3

New Buyer Demands in the Global Asset Management Industry



Source: Casey Quirk Analysis

Instead, organic growth likely will center in three emerging types of buyers, many of which are served by far fewer competitors or those with outmoded business models:

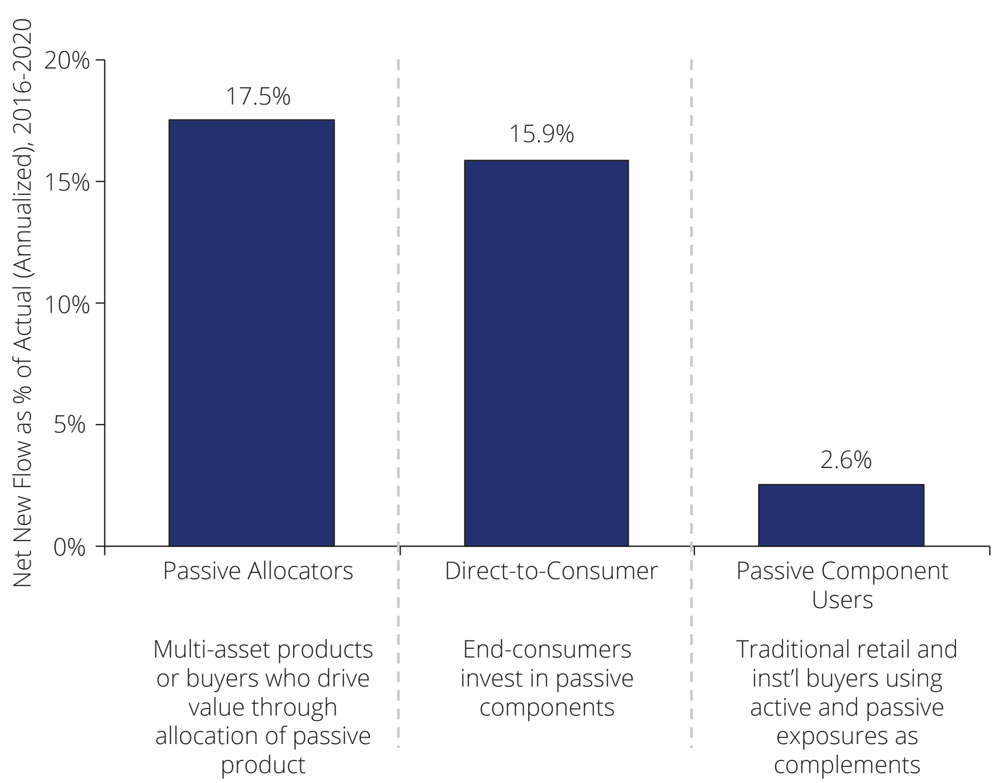
- **Outsourcers,** including intermediaries, advisors and small institutions that seek to outsource the complicated business of outcome provision to asset managers, and often turn over their entire portfolio to a multi-asset provider.
- **Strategic partners,** including buyers such as institutional investor consortia, large wealth managers and broker/dealers who centralize decision making within business units acting as gatekeepers and professional buyers. These buyers often seek to consolidate relationships with a smaller number of larger asset managers, selected just as much for brand credibility and engagement model as they are for investment quality.
- **Cost-conscious:** A growing portion of buyers may be amenable to trading uncertain future upside for certain current discounts. Fiduciary regulation and the growing debate about the value of active asset management will accelerate the growth of this buyer cohort.

Catalyst 2: Active Management Skepticism

During the next five years, 43% of the industry's net new assets will find their way into passively managed portfolios. Several forces fuel this skepticism, including the relatively unimpressive performance of active managers net of fees in recent years; wider information availability, which makes alpha increasingly elusive; and increasing press scrutiny regarding value for money in asset management.

Exhibit 4

Sources of Future Passive Investments



Some of the flow into passively managed products still will come from traditional portfolio construction: using a large passive core to match benchmark performance, while spending fees on smaller actively managed satellites to beat the index. But the investors most suited to this approach are institutions with shrinking asset bases. In fact, the highest index product growth will come from two pools of individual investors:

- **Direct investors** who purchase exchange-traded funds (ETFs) either without advice or through an automated advice offer (so-called robo-advice).
- **Beta allocators,** a growing group of investors served by intermediaries that allocate portfolios actively across a wide range of betas, both traditional (benchmark-driven) and "smart" (mostly factor-driven). These buyers will reward more of their fee budget to the active allocation, and less to the underlying instruments viewed mostly as components.

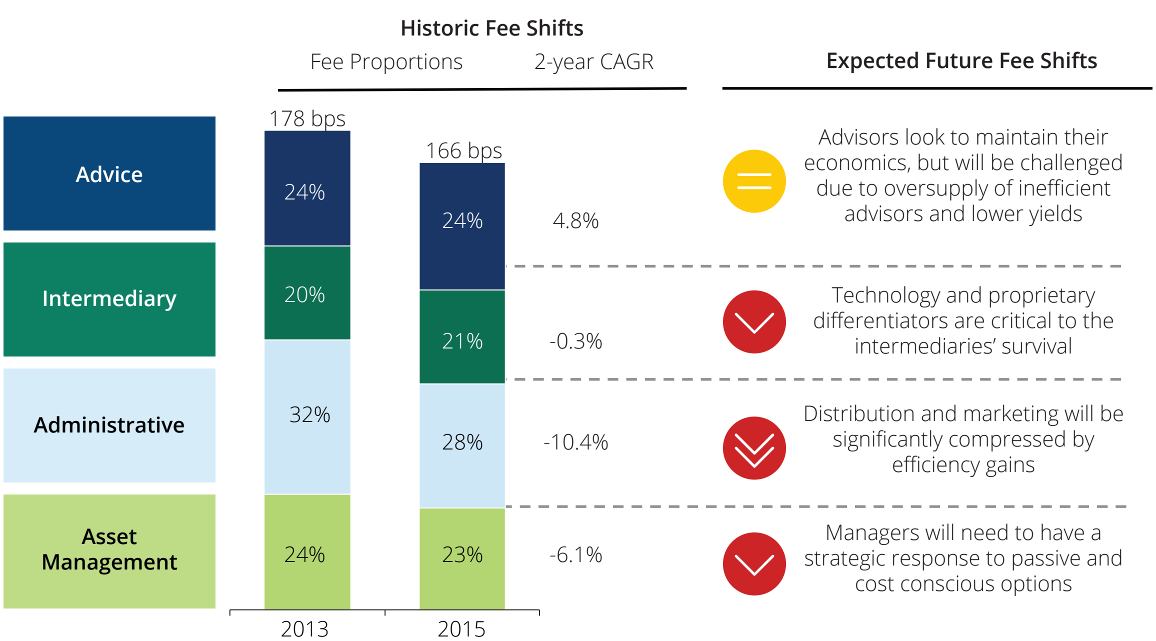
Increasingly, buyers will argue that active asset management remains essential but has been monetized incorrectly. They will more highly value active allocation across multiple asset classes and exposures, rather than only security selection within a single asset class. Managers will look for new methods to monetize their allocation skills, while opening conversations about alternative approaches to pricing their legacy investment strategies.

Catalyst 3: Disruptive Technology

While many asset management CFOs say technology is a top strategic priority, few can articulate how it can reshape their business. But disruptive technologies already have changed the asset management industry's value chain. Robo-advice has dominated discussions, but a wide variety of technology improvements are reducing the cost of distribution industrywide. Better data management has streamlined fund sales, and advances in automation of accounting and client management are making distribution more efficient.

Exhibit 5

US and European Individual Investor Fee Budget



Note: Expected returns reflect capital market assumptions on a 60% global equity, 40% global fixed income portfolio.
Sources: Casey Quirk Advisor Database, Casey Quirk Global Demand Model, *Investment News,* Morningstar, Casey Quirk Analysis

New technologies are impacting multiple aspects of the industry's traditional service offer. Examples include:

- **Automated advice,** which encourages a more direct end-user engagement and changes the overall customer experience
- **Enterprise data management,** including cloud technology and less structured, network-driven databases, allowing firms to use data more effectively in decision-making
- **Improved analytics,** allowing more effective segmentation and more predictive capabilities
- **Blockchain** and similar technologies that remove redundant layers in overly complex series of transactions

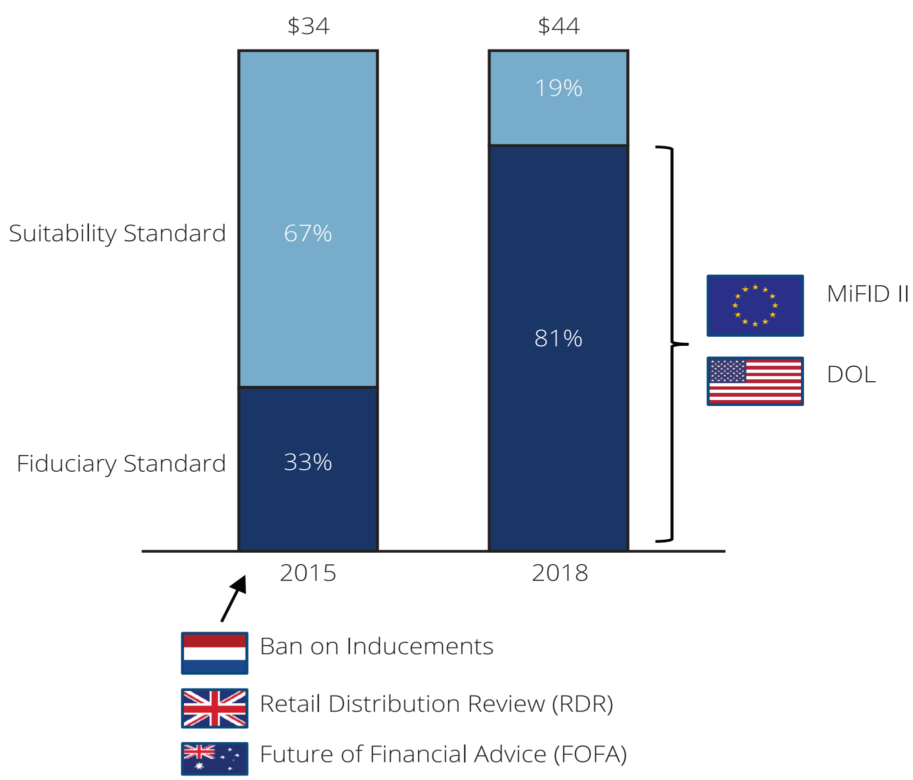
As technology and regulation work together to streamline delivery costs, particularly in retail fund management, asset managers seeking to recover lost margin will need to fight on two fronts—against intermediaries and advisors who claim they are adding more value for the consumer, and the relentless fee pressure applied by shrinking capital market returns. Some managers will accept lower marginal fees to stay in business; only those that differentiate themselves should retain pricing power. Traditional value propositions might no longer be capable weapons in this battle.

Catalyst 4: Fiduciary-Based Regulation

As asset management becomes a consumer industry during an era of rising populism, governments already are strengthening investor protection regulation across the globe. Within two years, if fully enacted, implementation of just two regulatory programs—the Fiduciary Rule of the US Department of Labor and the European Union's Markets in Financial Instruments Directive (MiFID)—will triple the assets in individual portfolios worldwide subject to stricter fiduciary standards.

Exhibit 6

Assets in Advice-Regulated Markets (AUM, US$T)



Sources: Casey Quirk Analysis

Rising standards for delivering financial advice will have several repercussions for asset managers, many of which could contribute to rising costs of regulatory compliance:

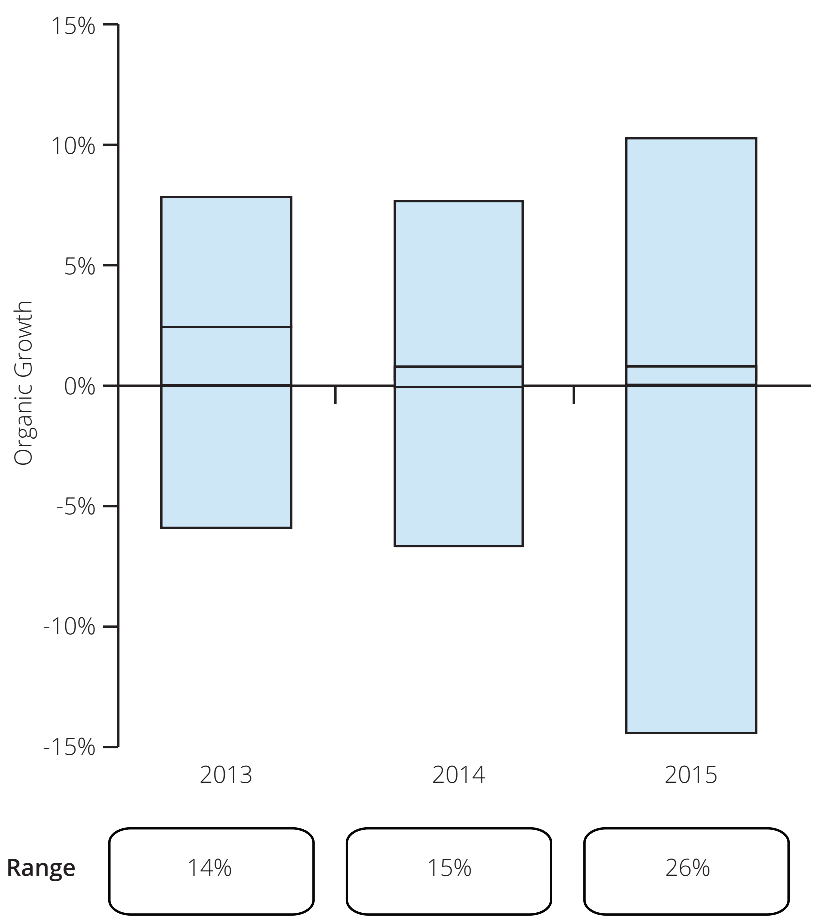
- A **growing risk of regulatory sanction or litigation** may encourage intermediaries to merge into bigger balance sheets as a defense, concentrating distribution power in fewer hands.
- The **number of fund vendors and funds** provided by intermediaries **may shrink** in order to encourage simplicity and transparency for advisors.
- **Smaller advisors and intermediaries may outsource** more heavily regulated portfolio advice, creating opportunities for asset managers and other vendors.
- **New pricing schemes** may emerge to align industry economics more closely with regulator expectations: there will be growing discussion about shifting from *ad valorem*, asset-based fees to flat fees based on the degree of customization and automation.

Playing to Win: Five Ways to Reinvent Asset Managers

These four catalysts continue to fuel ever-stronger challenges for the asset management industry at an accelerating rate. In 2015, however, after discounting capital markets growth, nearly half the industry's vendors shrank in terms of organic expansion. The gap between faster-growing and faster-shrinking firms widened dramatically.

Exhibit 7

Asset Managers by Organic Growth Rates



Source: Casey Quirk/Institutional Investor/McLagan Performance Intelligence

Yet a group of market leaders, including businesses of multiple shapes and sizes, are growing faster and more competitive. Their investment results vary, but they share four specific competitive advantages that many of their weaker rivals lack:

- A **broader investment toolkit,** one that has transitioned from legacy benchmark-oriented products to highly demanded, actively managed capabilities
- A **strong brand** with well-regarded fiduciary and consumer attributes built on trust, investment leadership, and an ability to regularly meet investor expectations about outcomes
- A **customer experience and engagement model** that positions the asset management organization's value as more than simply product provision, by offering value-added services that inform the investor
- **Data** about customers and markets that fuel proprietary analytics, as the industry divides into two camps of competitors: those with access to information about clients and markets, and those forced to buy that intelligence

Firms that possess these four characteristics did not simply inherit them, nor secure them through incremental changes to existing operations. Today's faster-growing asset managers invested in multi-year programs to upgrade capabilities, overhaul their business models, re-educate their leadership and re-orient their businesses for a new operating environment. Five strategic changes drove their transformation:

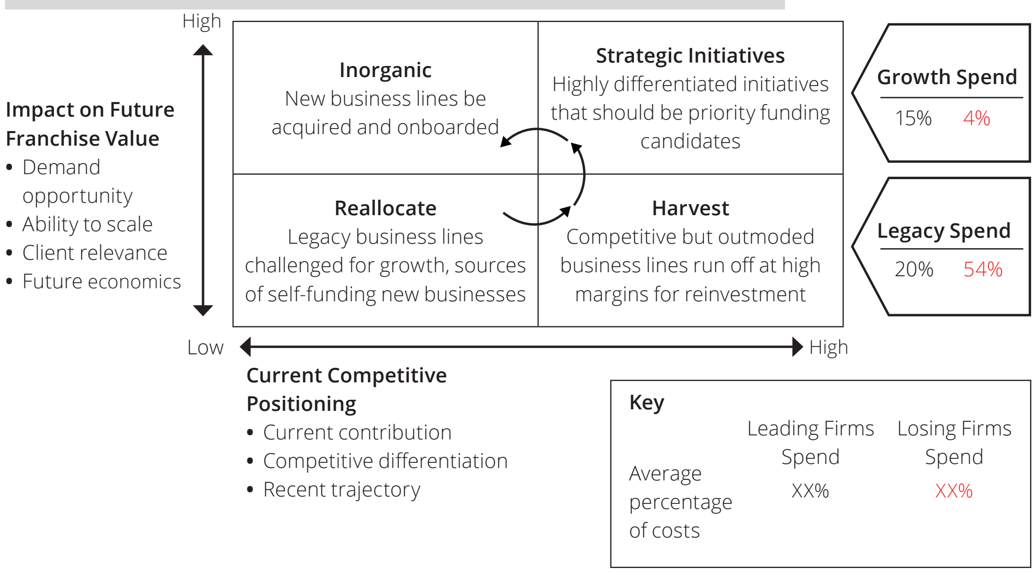
Strategic Change 1: Optimize Resource Allocations

Historically, like their counterparts in other highly profitable industries, asset management leaders (perhaps understandably) have managed their firms as a well-diversified portfolio rather than a focused set of business lines. However, as margin pressure rises, the explicit and implicit cost of operating an array of sub-scale businesses will weaken efficiency. A widening number of initiatives means any effective one is less impactful on the overall business—but the option cost of maintaining all these businesses becomes more visible as revenues recede.

Competitive asset management businesses make hard choices. They focus investments, as well as management time, on business lines, that significantly impact future franchise value and possess competitive advantage. In turn, they pivot away from legacy business lines that currently may be significant, but in which they do not see strong organic growth, lack the ability to compete, or both. The most competitive firms will reallocate operating capital aggressively from outmoded business lines—even suffering short-term revenue impact as a result—in order to reinvest in organic or inorganic growth initiatives.

Exhibit 8

Resource Allocation Framework



Note: Expenses exclude costs in business support functions and other unclassified business lines.
Source: Casey Quirk

Leading managers already exhibit a discipline for growth-oriented capital allocation. High-growth firms already allocate roughly half their costs to growth initiatives, even if it means curtailing or shuttering some legacy business lines. Slower-growing firms still spend 90% of their costs on clients or capabilities where they are likely losing market share of a shrinking customer segment or investment capability. Effective capital reallocation may become a significant results strategy for asset managers worldwide.

Strategic Change 2: Streamline Operations

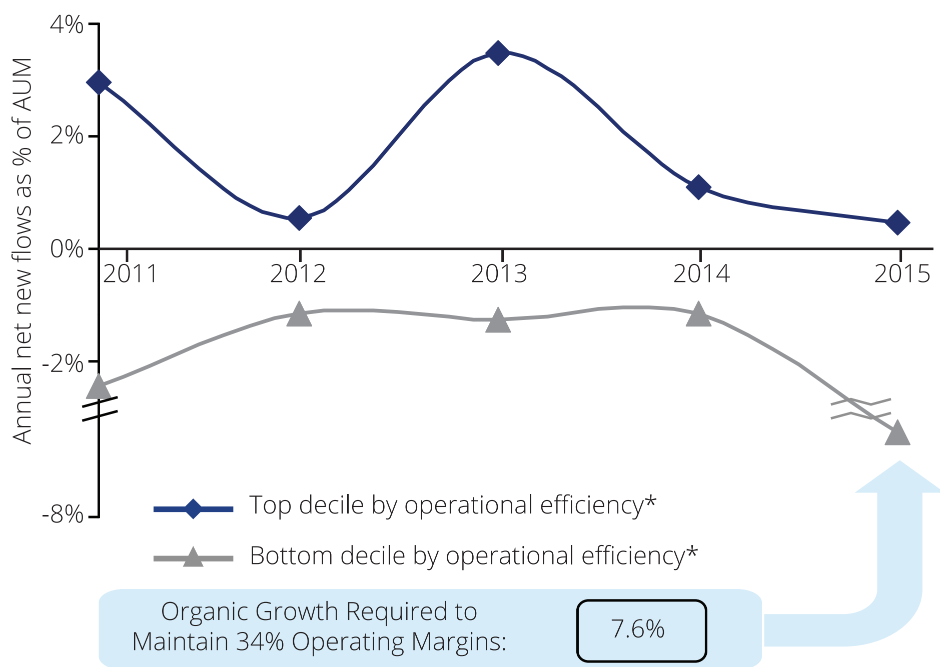
Cost allocation is one method of effectively competing in asset management; the quality of costs, however, is equally important. Asset management is a notoriously inefficient industry:

- Data infrastructure is poor, outmoded and disjointed, often on multiple legacy systems (both proprietary and third-party) inherited through serial acquisitions
- Risk management, both for portfolios and the enterprise, often lacks requisite attention or investment
- Onboarding processes for new acquisitions, in a time when transformation strategies should require firms to buy new capabilities, are often poorly designed and untracked
- Despite being a well-paid industry, incentives remain short-term and unaligned with important success metrics that reflect strategic goals
- Outsourcing decisions are tactical, as many asset managers select technology vendors based solely on cost, ignoring repercussions on long-term strategy and competitive advantage

Operational efficiency will separate more and less successful rivals in asset management. As owners seek to retain thick margins, efficient platforms will find more capital to re-invest for growth, while laggards will get stuck in a spiral of cutting essential services. Firms that papered over sloppy processes or jury-rigged technology will no longer be able to grow their way out of their deficiencies. Firms with bottom-decile operating efficiency need to expand nearly five times faster than the industry in order to maintain current median margins, while their more efficient counterparts have built themselves a better starting point for growth.

Exhibit 9

Asset Managers' Organic Growth by Operational Efficiency, 2011-2015



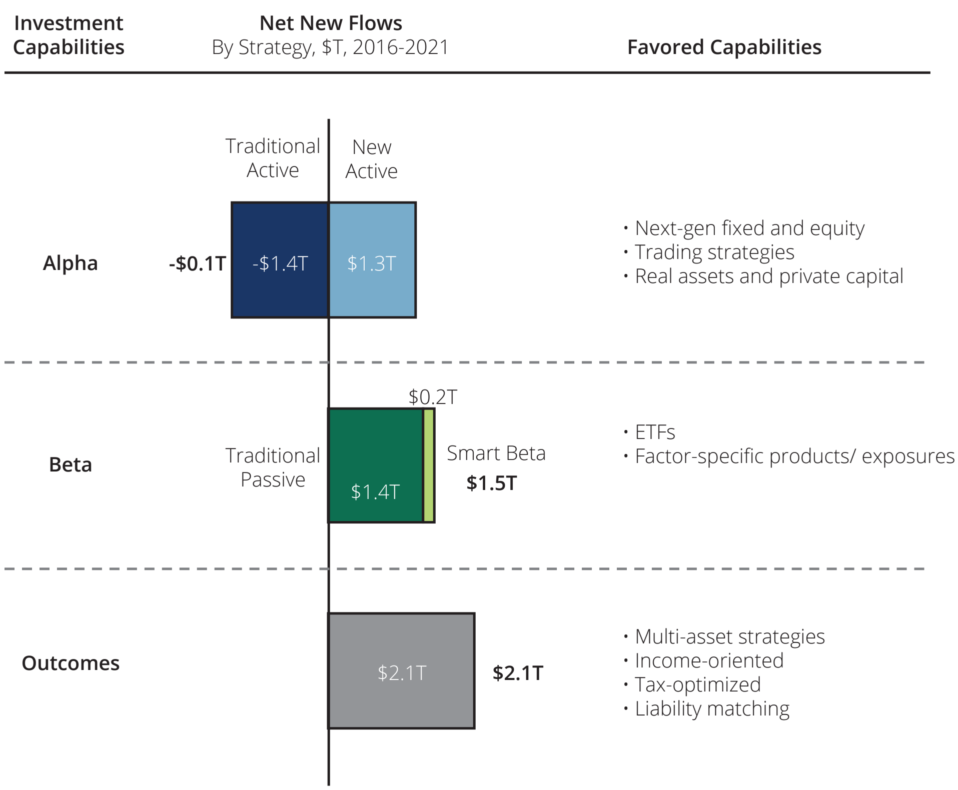
Note: Operational efficiency = operational expenses/revenue
Source: Casey Quirk/Institutional Investor/McLagan Performance Intelligence

Strategic Change 3: Differentiate Investment Capabilities

As investors focus on outcomes, their demands for investment capabilities are changing substantially. A high proportion of net new flows during the next five years will focus on outcome-oriented portfolios: multi-asset, multi-strategy, and designed around cash flow objectives. Nearly $1.5 trillion will flow into beta-oriented components, as described earlier. And traditional alpha-seeking portfolios will rotate from benchmark-oriented strategies into more highly active, less liquid, non-correlated offers.

Exhibit 10

Net New Flows (ex-China) by Investment Capability, 2016-21



Source: Casey Quirk Global Demand Model

Asset managers will pivot from legacy to new capabilities in multiple ways. Inorganic development will become more prevalent, as larger asset managers seek to speed up their transformation and secure differentiated, high-demand talent before their competitors can do so. Organically, a common thread of effective investment innovation will be a well-designed product development and management function that orchestrates this transition. Stronger product development processes share a number of specific characteristics, including:

- **Documented process,** less dependent on specific talent and more dependent on a data-driven method of identifying and securing new capabilities
- **Strong governance,** often reporting to neither investments nor distribution but directly to the CEO
- **Balanced control and creativity,** encouraging creative ideation but holding new product sponsors to tight metrics and timeframes
- **Cross-functional,** involving inputs from both investments and distribution, as well as operations officers
- **Well-funded,** to permit effective competition for the purchase of truly competitive capabilities
- **"No sacred cows" policy,** accepting few excuses for maintaining outmoded investment capabilities, even if they continue to generate revenue passively

Strategic Change 4: Digitize Distribution

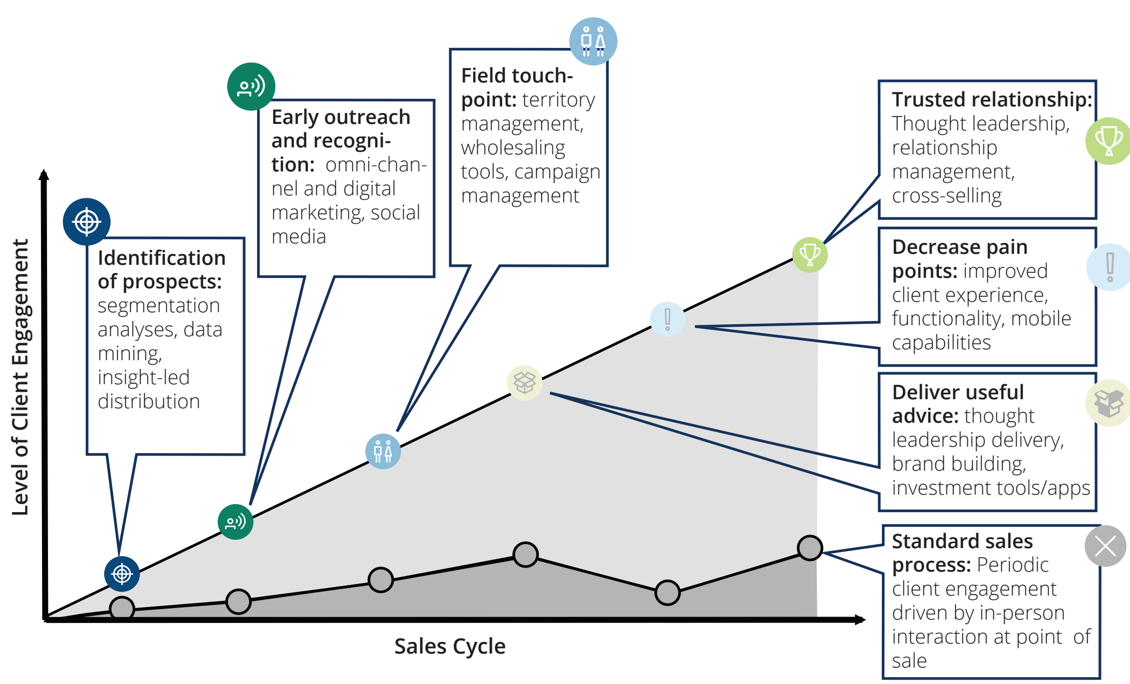
Technology is reducing the delivery costs for both advice and asset management products. The longer-term impact of such technology, however, centers on the user experience. Digital solutions will play a role in improving the engagement experience with intermediaries—and eventually end-users—of asset management products. Asset managers that invest in these technologies ultimately may control more of the value chain, improving client persistency and overall economics.

Human-driven distribution of asset management products is impactful, but inconsistent in a world of just-in-time client demands. The customer experience will become unrefined and sporadic as sales and service officers work to balance interactions and transactions across thousands of customers with varying levels of potential, customized needs and sales cycles of differing lengths. Increasingly, more effective asset managers can use technology to increase the probability of acquiring or retaining business. This should manifest in several ways:

- **Insight-led distribution:** Using data mining techniques to parse advisor and client information gleaned from intermediary relationships to build detailed segmentation analyses and develop proprietary predictive analytics
- **Digital marketing:** Developing digital strategies, including social media and video, to promote omni-channel marketing campaigns customized for targets
- **Field management:** Automating various existing functions of internal sales support desks, including arming wholesalers with digital-enabled CRM and other internal information systems
- **Investment information delivery:** Creating tools for advisors and end-users, allowing them to integrate manager insights and tools at important decision points
- **Customer experience:** Promoting more consistent and customized interactions with advisors or end-users through multiple media, including mobile and social
- **Data acquisition and capture:** Building large data sets on customers and markets that can inform future product and service offers.

Exhibit 11

Technology Impact on the Client Sales and Servicing Cycle



Source: Casey Quirk

More innovative asset managers will look to further transform their business models in one of two ways:

- **Direct distribution:** One defense against a compressing value chain involves owning more of it. Proximity to the end-investor provides greater influence over pricing. Regulation has created a catalyst for asset managers to develop ways to serve low balance clients orphaned by traditional advice providers. But the more interesting direct-distribution strategies will come from asset managers that seek to build custom portfolio solutions for wealthy individuals. Technology will make both approaches more feasible. Such strategies raise significant regulatory and channel-conflict issues, but both are manageable by firms that make focused investments in extending their capabilities along the value chain.
- **New business lines:** Some of the more recent purchases of automated advice technology and robo-advisors are less about direct distribution than about creating platforms that encourage a deeper relationship with intermediaries. These asset manager-led propositions will begin to compete with turnkey asset management platforms (TAMPs) to support advice delivery. Such strategies will encourage more open-architecture offers, but those with allocation skills and strong brands will find this approach an effective way of further monetizing their intellectual property.

More than half of the strategic investments that leading asset managers will make during the next five years may focus on financial technology rather than only investment capabilities. Compensation for talent with technology skills also will rise.

Strategic Change 5: Build a Consumer-Oriented Fiduciary Brand

As individual investors demand more customized outcomes based on each of their individual cash flow needs, customer satisfaction about outcome delivery will become as important as relative benchmark performance. As a result, the industry will take on more attributes of traditional consumer-driven industries where products are difficult to compare empirically—making brand more important as a decision driver for customers. Many asset managers traditionally have subordinated marketing to sales in terms of both seniority and compensation, but the faster-growing asset managers increasingly are investing in better-funded, separately staffed marketing functions tightly linked to sales organizations.

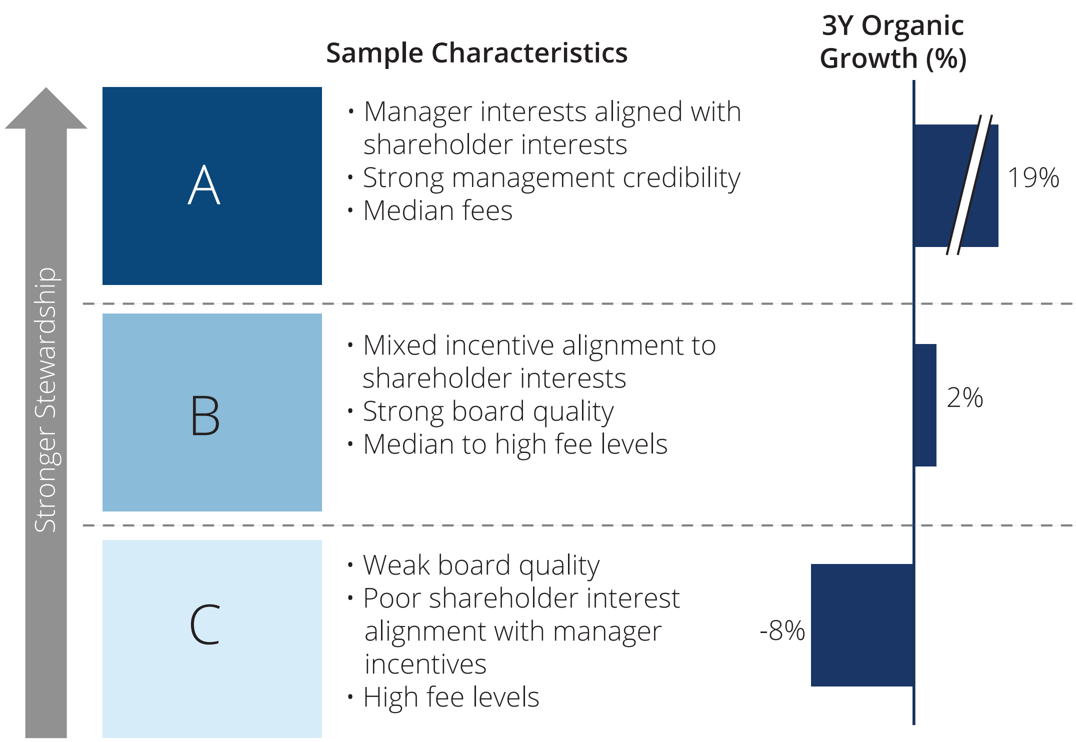
Investment leadership—characterized as results, however measured—will remain a critical component of leading asset management brands, but other attributes could become equally important, including:

- **Trust,** particularly given recent political focus on scandals across financial services sectors
- **Strong alignment of interests** with the customer, particularly around fees and incentives
- **Reliable executive management,** emphasizing experience and continuity of leadership
- **Innovation,** underscoring differentiated investment capabilities unavailable anywhere else
- **Fair pricing,** appealing to buyers focused on value for money
- **Transparency,** in line with regulatory initiatives to prevent hidden fees and conflicts of interest

Already, firms receiving high marks from third parties regarding leadership quality, customer alignment and fair pricing are seeing significant organic growth compared to those receiving lower ratings.

Exhibit 12

Net New Flows by Morningstar Stewardship Rating, 2013-15



Sources: Morningstar, eVestment, Casey Quirk Analysis

Conclusion

For decades, strong organic growth and high margins have encouraged complacency in business innovation for asset management firms worldwide, encouraging a wide proliferation of similar-looking vendors who grew without much fear from competition. As the operating environment becomes less forgiving, the penalty for poorly planned strategy will become more severe. Rather than simply enduring lower but still sizable margins, weaker asset managers that cling to legacy business models will likely suffer shrinking revenues, budget cuts, and even losses. The minority of today's firms that continue to increase their franchise value over time will look different than peers, and adopt more innovative strategies for achievements. It is quite likely that the business models of future leaders in asset management may share innovative characteristics, potentially including:

- **Service-oriented pricing models** that emphasize value added beyond investment performance, and measure fees in terms of meeting customer goals
- **Less intermediated distribution,** including asset management businesses that own more of the value chain, directly engage the client, and resurrect the investment counsel model from which the industry began in the 1970s
- **Focused portfolios of competitive advantages,** which favor capabilities and engagement models that meet evolving buyer needs, rather than simply service shrinking legacy clients
- **Prioritized clients** targeted through analytics, leveraging client tiering and segmentation frameworks
- **Single-brand strategies,** abandoning multiple-brand models that worked for sophisticated institutions with unified global, cross-client brands that represent desired consumer attributes

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by Deloitte.

Casey Quirk helps clients develop broad business growth strategies, improve investment/product appeal and growth prospects, evaluate new market and product opportunities, and enhance incentive alignment structures. Our unparalleled industry knowledge and experience, detailed proprietary data, and global network of relationships make Casey Quirk a leading advisor to the owners and senior executives of investment management firms in the world.

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