McKinsey&Company

The Best of Times, The Worst of Times

North American Asset Management

Global Wealth & Asset Management Practice

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Introduction

Introduction

Despite buoyant capital markets and an unexpected regulatory pause, a pall fell over the North American asset management industry in 2016 as flows turned negative, a growing number of active managers underperformed their benchmarks, margins compressed, and aggregate industry profits retreated. Although 2017 has shown indications of an uptick in industry performance, a mood of pessimism continues to prevail. The inconvenient truth for asset managers is that strong secular trends—a moderation in long-term investment returns, an aging demographic shifting from an accumulation to withdrawal phase, the runoff of large pension funds, and pricing pressure driven by passive investments—are now firmly in control and will weigh on the industry for the next 20 years. Welcome to the new abnormal of asset management.

These secular trends are widening the gap between top and bottom performers. Today, the difference in profitability between the top- and bottom-quartile managers stands at a remarkable 42 percentage points. For the first time since the depths of the financial crisis in 2009, more funds closed or merged than were launched last year. Interestingly, and counter to some conventional wisdom that predicts an inexorable shift towards scale, our research finds winners and losers across institutions of all sizes. The greatest predictor of success has not been size, but focused execution to capture share in the most important pools of value in the industry. Many in the industry now predict, and we believe correctly, that these factors will drive a wave of consolidation. But consolidation will take a different form than many assume—instead of mega deals aimed at creating scale efficiencies, large and medium-sized firms alike will make targeted acquisitions to add capabilities, and struggling managers of all sizes will shutter due to their inability to meet the industry's rising bar.

These secular trends are not only affecting the industry's economics, they are contributing to a fundamental change to how value is distributed both across and within major asset classes. This redistribution has been steadily under way for a decade but is near a tipping point as two investing trends take root with clients: risk-based asset allocation that cuts across asset classes and factor investing that identifies additional drivers of value beyond the market capitalization-weighted indices of "standard" passive investing. These innovations are reinventing the very art and science of portfolio construction and the underlying drivers of product demand.

This is not all bad news for asset managers. A rising bar for the industry is causing underperforming rivals to fall by the wayside. A shift in investment paradigms is opening clients' minds to new innovations that cut across asset classes. This in turn is leading to a radical shift in how clients invest—for example, private equity now increasingly competes directly with public equities and credit with fixed income. Moreover, technology creates an unprecedented opportunity to improve both client experience and manager efficiency, which stands to create new sources of competitive advantage for firms that embrace technology in the right ways.

In short, asset managers with the right operating models and value propositions have a once-in-a-generation opportunity to drastically improve their competitive position, capturing additional clients, assets, and market share. For North American asset managers, it is truly the best of times and the worst of times.

This report draws on McKinsey's ongoing research into the asset management industry, including insights from McKinsey's 17th Global Asset Management Survey, which gathers benchmarking data from more than 300 asset managers—more than 100 from North America, representing $30 trillion (80 percent) of assets under management (AUM)—as well as McKinsey's annual Global Growth Cube data, which provides a granular breakdown of historical and forward-looking AUM, revenue, and net flow data for 42 regions and countries, 9 client segments, 15 asset classes, and 5 product vehicles.

State of the industry: A continuing phase shift

After a rough stretch in 2015, the macroeconomic and market environment picked up steam in 2016 and into 2017. An extended period of political and regulatory uncertainty came to somewhat of a pause after the US presidential election, corporate profits continued on an upward trajectory, volatility declined, and the equity markets powered ahead, with the S&P 500 delivering 10-percent returns for 2016 and over 16 percent by the end of October 2017. But while global AUM hit a record high of $75.8 trillion by the end of 2016, the industry's organic growth decelerated to 1.5 percent (from a postcrisis high of 3.6 percent in 2015). This deceleration was most pronounced in North America, the only major region where flows turned slightly negative (-0.4 percent), with outflows of $161 billion despite rising markets (Exhibit 1). The mood among professional ranks was distinctly gloomy.

This was a big change from the first decade of the century, particularly the recovery from the global financial crisis, when the North American asset management industry enjoyed a rosy period of AUM growth driven by rising markets and organic inflows. It was a rising tide that lifted all boats.

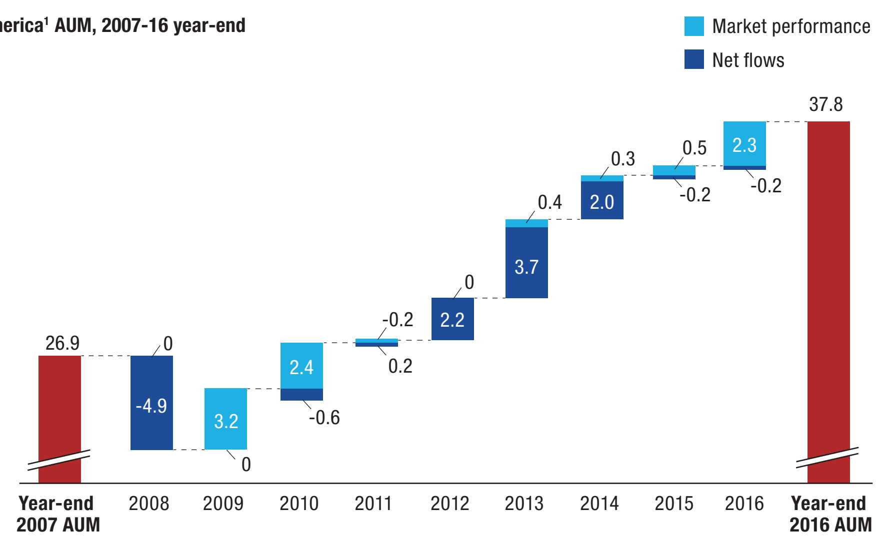
Over the past 18 months, a shift has occurred, ushering in a "new abnormal" for the industry where neither growth nor profitability can be taken for granted. North America remains the world's largest asset management market by far, accounting for about half of total AUM, but from 2012 to 2016 it accounted for only about 20 percent of flows. And 2016 was the first time in 20 years that industry revenues and markets were out of sync; ominously, profit margins declined for the second consecutive year even as markets powered ahead, characterized by a level of volatility that caused investors to stay on the sidelines (Exhibit 2, page 6).

Several familiar themes drove these results. Demographic shifts definitely played a role, as millions of baby boomers went from accumulating savings for retirement to repositioning their portfolios for retirement spending. Institutional market outflows continued gradually, as unfunded defined benefit liabilities continued to grow (a $63 billion increase by public

Exhibit 1

In 2016, North America experienced net outflows for the first time since 2011

North America[1] AUM, 2007-16 year-end
$ trillion



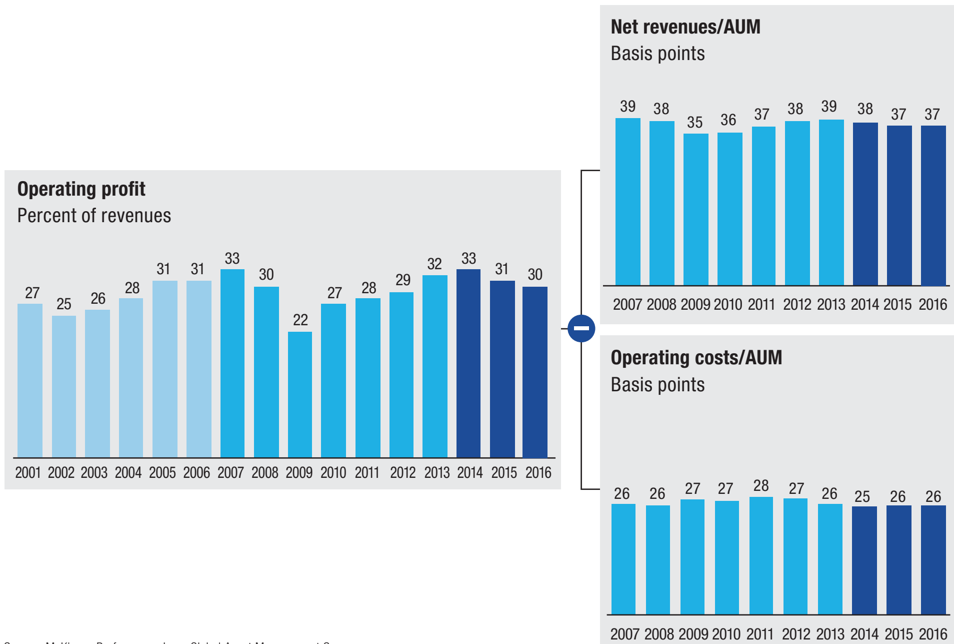
	2008	2009	2010	2011	2012	2013	2014	2015	2016
Net flows as percentage of beginning-of-year AUM	0.0	-0.1	-2.5	-0.8	0.1	1.2	0.9	1.5	-0.5

[1] United States and Canada

Source: McKinsey Performance Lens Global Growth Cube

Exhibit 2

Profit margins in North American asset management declined for the second year running

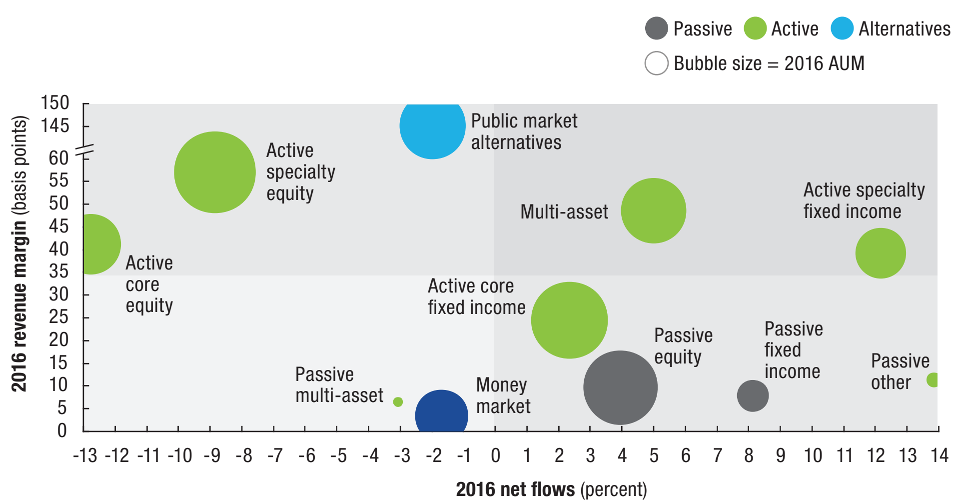


Source: McKinsey Performance Lens Global Asset Management Survey

Exhibit 3

The pullback from active was equities focused

North America net flow growth and revenue margin by asset class[1]



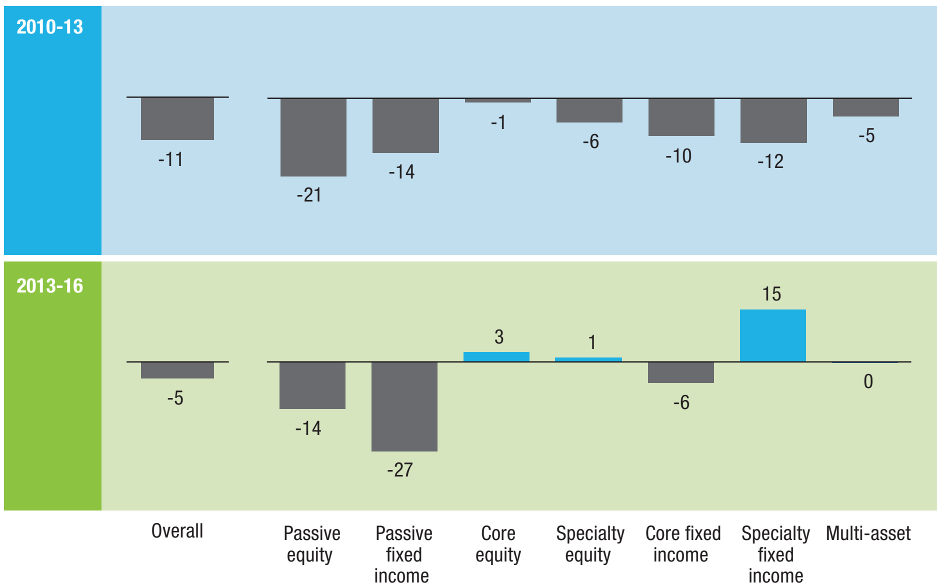
[1] Active core equity includes US large cap and yield/income equity; active core fixed income includes core, core plus, and municipal bonds; active specialty equity includes foreign, global, EM and US small/mid-cap; active specialty fixed income includes global, EM, high yield, TIPS, and unconstrained

Source: 2016 McKinsey Performance Lens Global Asset Management Survey and Global Growth Cube

Exhibit 4

Pricing pressure continued, but was concentrated in passive

Percentage change in revenue margin, US asset managers, 2010-16



Source: Strategic Insight Simfund MF

plans in 2016) and more plans were frozen and sponsors (particularly corporate ones) considered derisking measures, and in some cases wholesale pension risk transfer arrangements. Political and macroeconomic uncertainty caused investors to stay on the sidelines.

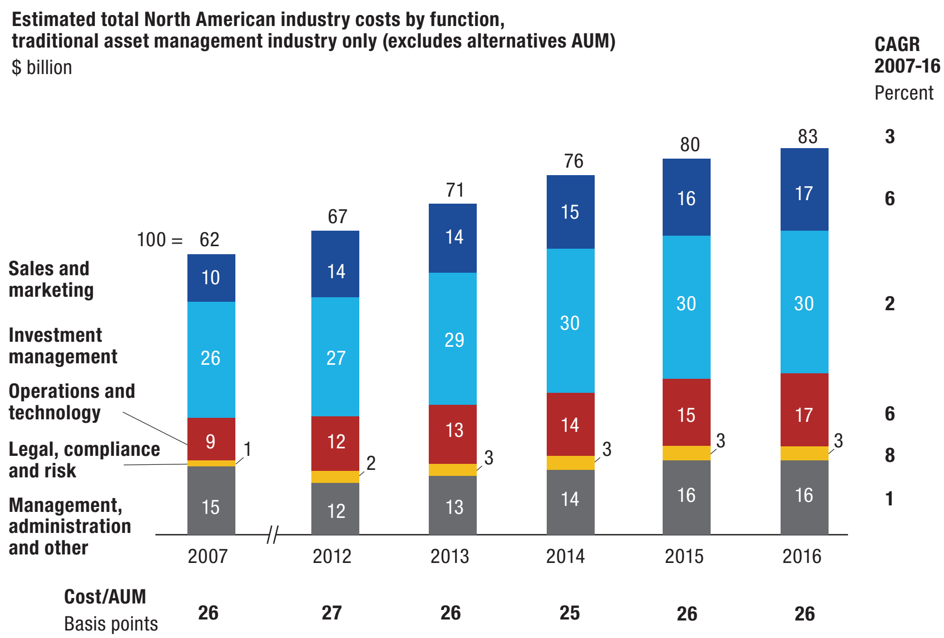
Ongoing shifts in product and pricing

In 2016, the continued shift towards passive investing was broad based, and reached a new high-water mark, particularly in equities (Exhibit 3). Specialty fixed income, multi-asset, and private markets were the only active categories that gained share in 2016. The cumulative impact of the product shifts has been considerable; over the past decade, passive equities have taken in $1.4 trillion of flows while active equities shed $1.1 trillion.

Although pricing pressure continued in 2016, it was slightly less intense than in recent years (Exhibit 4). From 2013 to 2016, revenue margins for mutual funds dropped a weighted average of 5 percent compared to a decline of 11 percent between 2010 and 2013. This slight moderation in pressure was caused by the concentration of pricing cuts in already low-priced passive categories as a number of major providers made aggressive moves to gain share. Also mitigating pricing pressure was a shift in favor of some higher-margin products (e.g., towards international equities in the core equity cat-

Exhibit 5

Costs continued to grow, with the highest percentage increases in distribution, O&T, and legal/compliance/risk



Source: McKinsey Performance Lens Global Growth Cube; McKinsey Performance Lens Global Benchmarking Survey

egory). Specialty fixed income, for example, was the biggest winner, boosting revenue margins by a healthy 15 percent from 2013 to 2016.

Product proliferation: Some early signs of a turning tide

Also notable in 2016 was the reversal of the product proliferation that took root during the industry's postcrisis recovery. As we pointed out in our previous report,[1] the industry embarked on a wave of product growth over the past five years in response to client demands for new types of exposures, particularly multi-asset strategies, smart beta, and income solutions. Where the industry has been less responsive is in culling smaller funds that had not found traction with clients. The result was a proliferation of "orphan funds" that created both operational complexity and a crowded field of funds chasing the same flows. Last year marked a turning point. For the first time since 2009, asset managers focused on rationalizing their product portfolios, resulting in 166 more funds being closed or merged than opened.

But we are in the early stages of this cull. In the US market alone, there are more than 11,000 funds—roughly 50 percent more than all the stock market listings for individual securities. In an age when retail intermediaries and institutional clients alike are gravitating towards "fewer but more strategic relationships" and product

[1] *Thriving in the New Abnormal*, McKinsey & Company, 2016.

platforms are curated with more precision, we expect this rationalization of products to continue. It may, in fact, accelerate as industry pressures drive managers to repackage their offerings into more efficient (and in some cases less profitable) vehicles such as separately managed accounts (SMAs), institutional share classes, and clean shares that place less of a tax on performance.

Costs remain stubbornly high

At the same time, costs have continued to increase at a steady pace (Exhibit 5). Despite the much-vaunted notion of leverage within the industry's operating model (put simply, a manager should be able to manage double the volume of assets without getting anywhere close to doubling costs), the average cost of managing a dollar of assets has remained remarkably constant at about 26 basis points despite a $10.9 trillion addition of AUM to the industry over the past ten years.

Since 2007, the North American industry's cost base has increased by $21 billion. Growth has been concentrated in three areas. Sales and marketing grew at an annual rate of 6 percent driven in a large part by a small-scale "arms race" in distribution over the past five years as managers expanded their sales forces to capture flows in a market that was growing and flowing. Operations and technology grew at a similar 6-percent rate as managers rushed to add new systems and processes to deal with an increasingly complex world of products (e.g., multi-asset strategies) and distribution (e.g., greater focus on CRM and digital marketing). Finally, legal and compliance spending ratcheted up at the fastest rate (about 8 percent per year) as asset managers dealt with the complexities of expanded product portfolios and diverse regulatory challenges, ranging from new fiduciary standards from the US Department of Labor and new MiFID 2 rules that demand transparency around research costs.

The industry snapshot at the end of 2016 was one of positive economic performance (about 30-percent operating margins) but with mounting challenges as a shift to passive, broader pricing pressures, and low levels of organic growth combined with stubbornly high operating costs to weigh down the industry's profitability. The second consecutive year of deteriorating operating margins even in the face of market growth (from 33 percent in 2014 to 30 percent in 2016) was perhaps the most powerful sign that the North American industry has reached a turning point. The all-too-familiar secular trends that we have discussed at length are coming to a head in a way that makes business as usual a losing approach.

Mind the gap: A widening performance spread and an impending shakeout

The dominant narrative for the asset management industry has been that we are entering the worst of times: low returns, lower flows, pricing pressure, performance challenges, a massive shift to passive, stubbornly increasing costs, and margin compression. A look at the aggregate performance of the North American asset management industry confirms this downbeat view.

However, while industry averages can provide a sense of broad direction, they can also mislead. In an intensely competitive talent-driven industry such as asset management, few firms are actually "average." By digging deeper, beneath the headline numbers, we can explore asset management dynamics at the level of individual managers.

What the numbers really say

Contrary to the conventional wisdom that all is doom and gloom across the industry, a deeper analysis identifies a massive spread in performance across the industry and a group of asset managers that is doing exceptionally well (Exhibit 6). According to McKinsey's proprietary benchmarking data of 100 managers in North America (covering 80 percent of AUM), in 2016, the top quartile of managers grew revenue at 5 percent, above the -2-percent average of the industry and enjoyed highly attractive operating margins at or above their historical highs.

> The increasing gap between the top and bottom of the industry suggests that a shakeout is all but inevitable. The question is how and at what pace this reshuffling of league tables will take place.

In other words, for some managers, it is actually the best of times. Clients are hungry for yield and open to innovation, shifts in asset allocation are setting an unprecedented amount of money into motion, lower-performing players are being eliminated, technology is creating new sources of competitive advantage, and trillions of dollars of unmanaged assets are up for grabs. In short, there is a massive opportunity to gain market share. Even in the severely challenged active equities space, top-performing managers are finding ways to thrive.

What makes averages even more misleading in this environment is that the performance gap between winners and losers is widening (Exhibit 7). Our proprietary benchmarking data shows that the gap has been creeping upwards for several years but is now accelerating as some asset managers adapt more nimbly to the new environment than others. Today the difference in operating margins between the top- and bottom-quartile managers stands at a remarkable 42 percentage points (51 percent versus 9 percent), compared to three years ago (51 percent versus 15 percent).

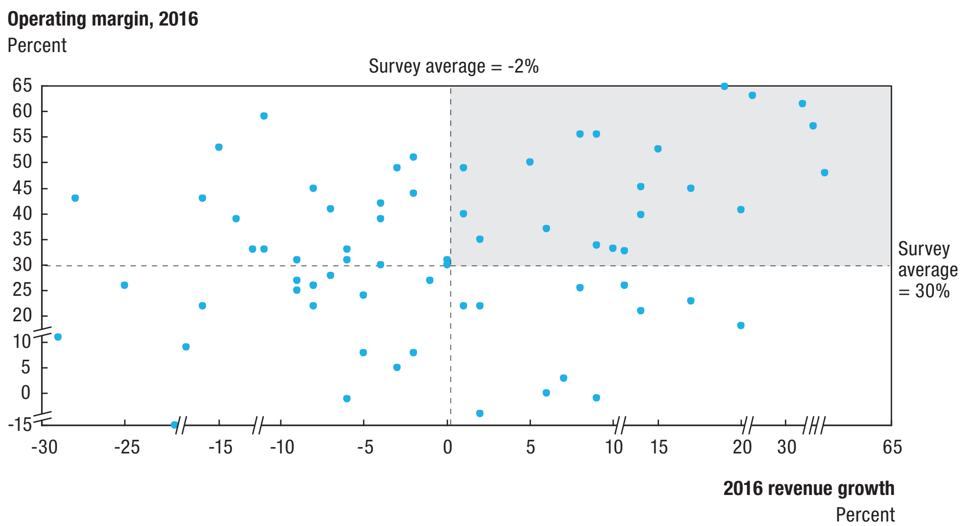
The increasing gap between the top and bottom of the industry—set against the challenging secular trends laid out in the last section—suggests that a shakeout is all but inevitable. The question is how and at what pace this reshuffling of industry league tables will take place.

Size is not destiny

What exactly will the contours of the shakeout look like? This is another area where we depart from the conventional wisdom. There is an argument taking root in the industry that the current environment is making it harder and harder to succeed as a smaller manager, and that we are moving to an era when the giants will take all. A related argument states that being medium sized is particularly perilous, the assumption being that many

Exhibit 6

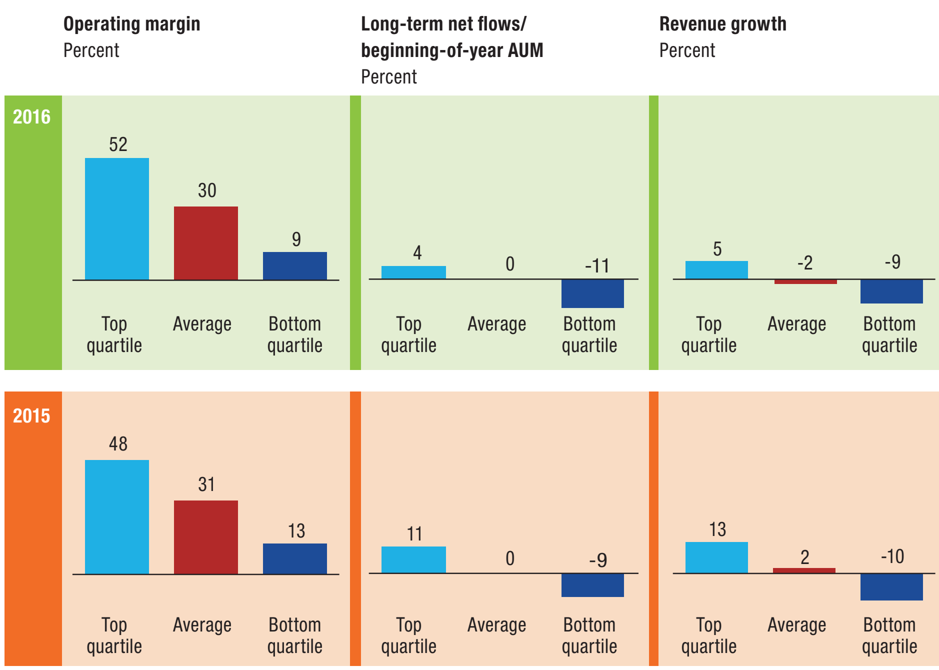
Top performers in North America sustained meaningful revenue growth at highly attractive operating margins



Source: McKinsey Performance Lens Global Asset Management Survey

Exhibit 7

Growth headwinds affected the entire North American industry, but the bottom quartile was hit particularly hard



Source: McKinsey Performance Lens Global Benchmarking Survey such firms are "stuck in the middle"—that is, they lack the scale to operate efficiently and are too broad to claim specialized status. And, once again, when you look at the averages, this outlook seems to have some merit. Medium-sized firms with $50 to $300 billion AUM suffered, on average, a 5-percent margin gap relative to large firms, and a 3-percent gap relative to smaller focused boutiques.

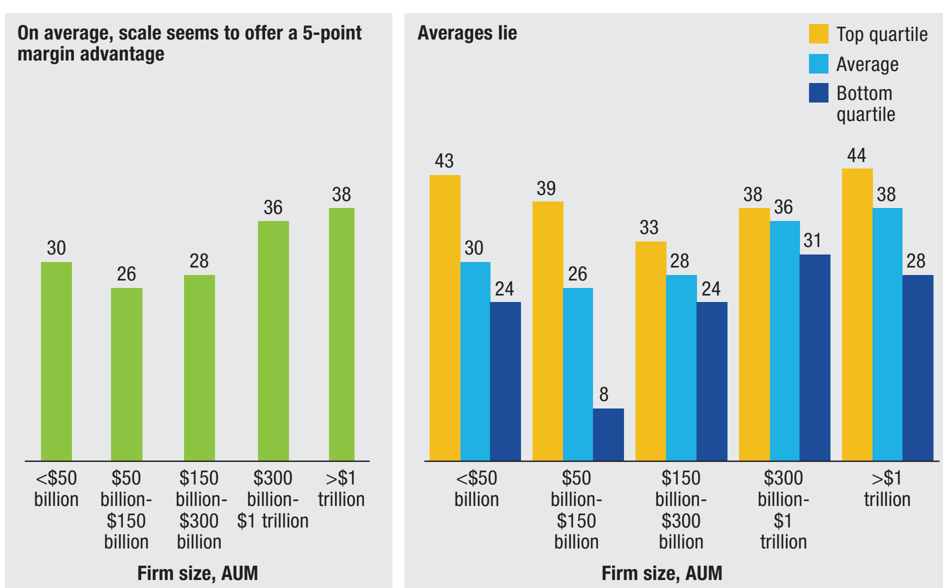
But our granular analysis shows clearly that size is not destiny (Exhibit 8). There were vast differences in performance within each size category, at a scale that dwarfed the differences across size categories. There were high-performing medium-sized firms, as well as large and small firms that struggled. For example, while the "average" asset managers with $50 million to $150 million in AUM had the lowest operating margins at 26 percent, the top quartile of managers in that group had margins of 39 percent, beating out most other managers of all sizes. Similarly, while the "average" small manager appeared to operate at a structural disadvantage to the biggest in the industry, the top-quartile performers in this size band were the best performers across the board.

If firm size was not a reliable predictor of success, which variables better forecast success? Our analysis of the over 2,000 metrics that we track on individual managers uncovered multiple routes to success. But what each leading firm had in common, was above-average "product

Exhibit 8

Size does not dictate success in North American asset management

Profit margin by firm size, AUM, 2016
Percent



Source: McKinsey Performance Lens Global Benchmarking Survey scale"—that is, the degree to which the individual firm scaled one or more major asset classes/strategy areas and then executed with focus. Specifically, profitability leaders drove close to 40 percent of their funds to a scale above $1 billion, compared to an average of 17 percent for the rest of the industry. Highly successful firms built the conviction to mobilize enterprisewide resources towards a focused set of well-defined growth priorities. This resource allocation was not just a question of dollars and headcount, but also included mindshare across every functional area of the firm. This dynamic was a predictable marker of success whether a firm was a focused, single-asset-class specialist or a broad-based multiproduct platform.

Some opportunistic mega deals will occur as larger financial institutions reshape their business portfolios. But the bulk of consolidation will result from more targeted acquisitions and lift-outs of individual teams.

Asset managers in the top right of the performance matrix—that is, those that lead in terms of both margin and growth—got there not just through focused execution in their areas of existing strength, but also through meaningful investments in new industry growth trends that sometimes threatened their areas of dominance. There was no shame in riding the coattails of emerging industry trends; in fact, it was essential to outperformance in many cases.

Meanwhile, the firms that struggled were those that resisted these trends, or took only token steps to build new capabilities. In many cases, they tried to play in multiple areas to hedge their bets, but lacked the conviction to invest in these businesses adequately or cull underperforming areas that diverted management attention and dragged on profitability.

Not the traditional M&A wave

Our third conclusion on the likely trajectory of the North American asset management industry is that consolidation will happen, but through a nontraditional set of channels. Conventional wisdom assumes that a new logic of scale is emerging across the board, that industry giants will take all, and that margin pressures will drive a search of economies of scale. Some go so far as to predict that the pursuit of pure scale will lead to massive consolidation through transformative mega deals.

We believe this logic of scale applies in some but not all parts of the industry; it is arguably well at work in the world of passive, but less clear in active and alternatives. To be sure, some mega deals will occur opportunistically as larger financial institutions continually reshape their business portfolios. But the bulk of consolidation will result from more targeted acquisitions and lift-outs of individual teams, undertaken to turbocharge the buildup of specialized capabilities in areas of industry growth (e.g., alternatives, multi-asset, ETFs). This process will be complemented by a second consolidating force—the shuttering of struggling managers unable to meet the industry's rising bar.

An evolving industry structure

In summary, we have reached four conclusions about how the industry structure will evolve in a world where performance gaps are rising between the best and the rest:

- *The coming shakeout is real.* In a highly fragmented industry, where the performance bar is rising and performance gap is widening, and where clients are demanding "fewer but more strategic relationships," poor performers will fall by the wayside. Many will simply close, not be acquired. A clearing out of the bottom tier is virtually assured.
- *M&A is not always (or even usually) the answer*. A wave of transformational M&A to save those firms that are "stuck in the middle" is unlikely. The notion that two underperforming managers can merge to become stronger is a myth based on the misguided pursuit of scale for scale's sake. In reality, the sum of two negative numbers is a larger negative number.
- *Transformative M&A is tough.* To be sure, the industry will see some large acquisitions. But instead of being driven by scale, these will more likely be opportunistic purchases made possible when forward-thinking institutions realign their own business portfolios. The reality is that transformative M&A at this scale is challenging. Few institutions have the integration skills or the wherewithal to radically restructure their operating model.
- *Capability-driven M&A will dominate.* To align with the industry's growth trends—to ride those coattails—companies need the right capabilities. Sometimes these can be built in-house, but many firms will opt to move faster by purchasing smaller or medium-sized firms with specialized capabilities.

An inconvenient truth: The great redistribution of value

The shifting of the product mix in North American asset management is well recognized. What is less understood is how this shift is changing the equation between assets and revenues. Also less appreciated are the trends that could accelerate the shift over the next few years. In this chapter, we explore these evolving demand-side drivers and examine how they are redistributing value across and within a number of "hot spots" in the industry.

Where's the money going?

Much attention has been focused on the massive flows into passive. Market share of passive has indeed grown materially, from 12 percent in 2010 to 18 percent in 2016. Yet, interestingly, passive's share of the industry revenues has remained constant at 3 percent as its growth has been accompanied by (and arguably driven by) aggressive price competition (Exhibit 9). All but the largest players have struggled to convert this significant asset growth into meaningful revenue and profit growth. Meanwhile, multi-asset strategies and alternatives have both grown in parallel, collectively grabbing an additional 7-percent share in AUM since 2010; due to their higher margins, this gain in assets has translated into a 9-percent revenue share gain. The big losers in this dynamic have been the traditional actively managed asset categories, which have ceded 9-percent share of the overall industry value pool (as measured by both assets and revenues).

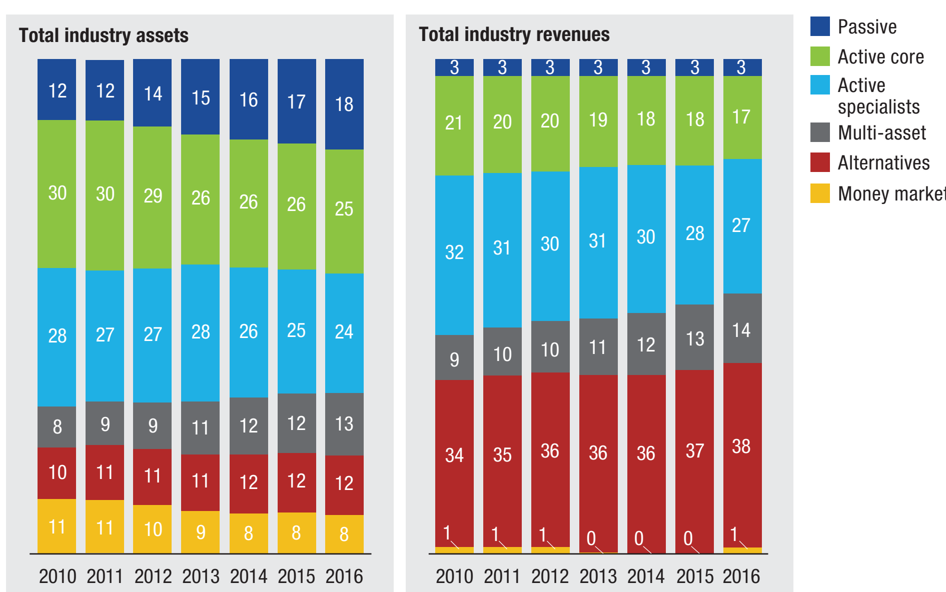
New orthodoxies will accelerate change

To date, this transition has occurred in a gradual and steady manner. However, we believe this shift in value pools is about to accelerate, as investors embrace two trends that have been steadily gaining credence and momentum (Exhibit 10, page 18). This philosophical change will alter the investing paradigm.

Exhibit 9

Passive's share of North American revenues has remained constant

North America assets and revenues, 2010-16
Percent



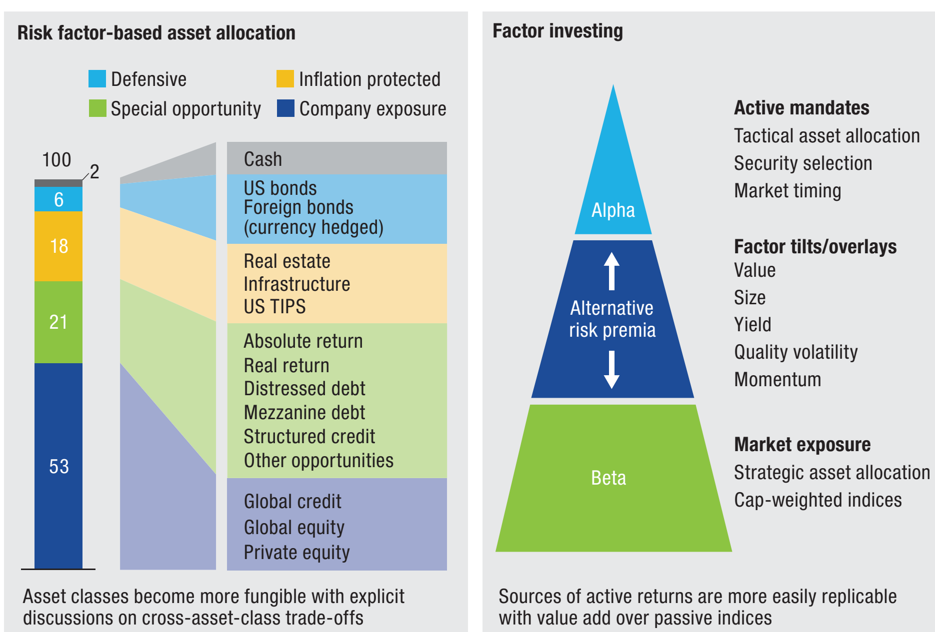
Source: 2016 McKinsey Performance Lens Global Asset Management Survey and Global Growth Cube

- *Risk-based portfolio construction.* Investors are increasingly recognizing the limitations of traditional asset allocation strategies, which use rigidly defined asset-class buckets and can mask underlying risk exposures. By reframing the portfolio construction process in terms of different types of risk exposures (e.g., corporate, interest rates, inflation) instead of types of asset classes, these new approaches are blurring the boundaries between asset classes, creating competition across previously distinct categories (e.g., private equity in the place of some public equities; and the use of multi-asset strategies instead of fixed income for some income generation).
- *Factor investing.* Factor investing seeks to go beyond broad market-capitalization-weighted indices like the S&P 500 or the Barclays Aggregate Bond Index to identify a more granular set of performance drivers, whether it be macroeconomic growth, currency fluctuations, momentum, or something else. Factors are the cornerstone of a passive investment strategy—so-called "smart beta"—that has been rapidly gaining traction with investors in recent years by providing a more finely calibrated set of portfolio building blocks.

Interestingly, factor-based investing challenges both active management (because a good portion of "alpha" is

Exhibit 10

Risk budgeting and factor investing gain followers



Source: APFC website; *Pensions & Investments*; McKinsey's 2011 Institutional Investor Benchmarking Initiative attributable to exposure to these factors rather security selection) as well as passive management (because classic passive management ignores these factors).

Together, these two ideas represent a revolutionary shift in investment orthodoxy with real implications on product demand. As they gain acceptance with a broad set of investors, asset classes will become increasingly fungible; meanwhile the bright line between active and passive investing will become increasingly blurred as smart beta utilizes both active and passive methods of investing. The net result will be an increased level of competition not just within individual asset classes, but also across them.

Three hot spots where the redistribution of value will play out with intensity

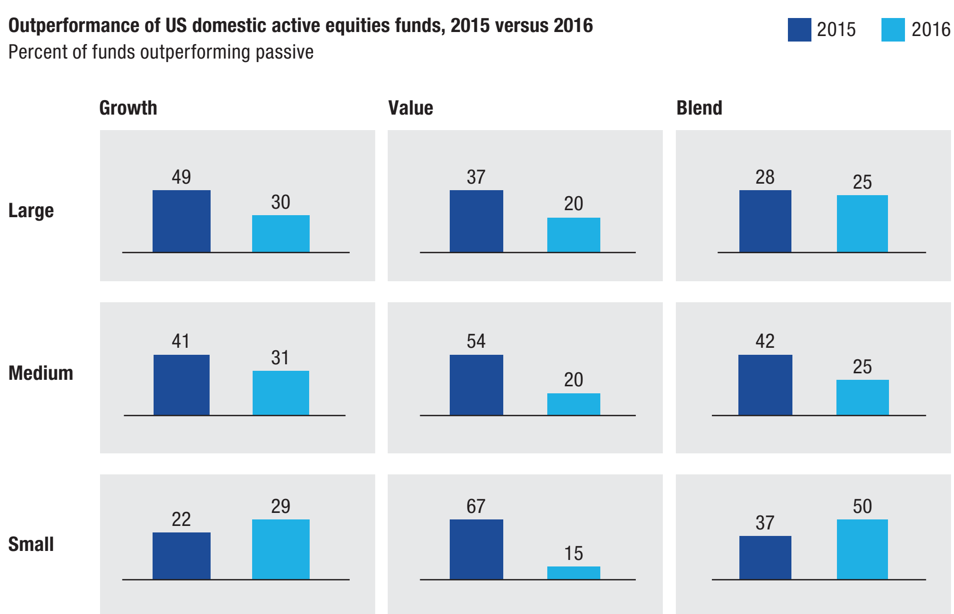
The redistribution of value is occurring and accelerating broadly across the industry and asset classes, but we have identified three areas where shifts are occurring with particular intensity, and where competitive dynamics and industry structure are likely to undergo important changes over the next five years:

Hot Spot 1: Traditional active strategies (particularly equities)

To put it bluntly, 2016 was a challenging year for traditional active investing, much worse than 2015, which itself was no banner year (Exhibit 11). The pain was

Exhibit 11

2016 was a challenging year for equities



Source: Morningstar

felt across almost every major active equity strategy. The number of large-growth funds outperforming passives fell from 49 percent in 2015 to 30 percent in 2016, the number of medium-sized-value funds outperforming dropped from 54 percent to 20 percent, and the number of small-value funds outperforming plummeted from 67 percent to 15 percent. Small-cap equity funds somewhat bucked the trend, with several categories improving their performance. And fixed income were the major outlier, with 76 percent of intermediate bond funds for example outperforming their passive equivalents, up from 29 percent in 2015.

Our research identified five enduring sources of value within active management over the 20-year period that undercut the gloomy prognoses commonly applied to the entire active management industry.

With this continued underperformance of traditionally managed active assets and clients' increasingly hardening attitudes towards certain classes of actively managed assets in mind, we conducted an in-depth study of value creation in active management using 20 years of granular North American performance data to better understand the facts on a through-the-cycle basis and gain a perspective on what the future might hold.

Our results pointed to a good news/bad new story.

First, the good news. Our research identified five enduring sources of value within active management over the 20-year period that undercut the gloomy prognoses commonly applied to the entire active management industry:

- *Institutional strategies.* More than 70 percent of these strategies outperformed passive equivalents by up to 100 basis points on a through-cycle basis. Several structural factors likely contributed to this outperformance: fee efficiency of vehicles and robust governance of institutional mandates.
- *Specialized active.* Specialized sub-asset classes (e.g., small cap, international, emerging markets) have generated long-term positive returns up to 200 basis points over passive. In this case, lower market efficiency (e.g., imperfect information, illiquidity) enabled managers with superior skill to generate sustained returns.
- *Top-performing managers.* Top-tier managers provided sustained added value even in mainstream asset classes, delivering more than 100 basis points over passive on average over the last ten years.
- *High-dispersion markets.* Macroenvironments mattered, but success was less tied to bull markets or bear markets and more to periods of volatility during which the price trajectories of individual securities varied significantly. In aggregate, active strategies

outperformed passive by 100 to 300 basis points in high-dispersion environments; this held true across both bull and bear market environments.

- *Quality manager selection.* Individual managers themselves go through periods of overperformance and underperformance, driven by a range of idiosyncratic factors. Manager selection matters; and our research suggests that the ability to make the right choices can create a 1.5-times multiplier over and above the performance of underlying funds.

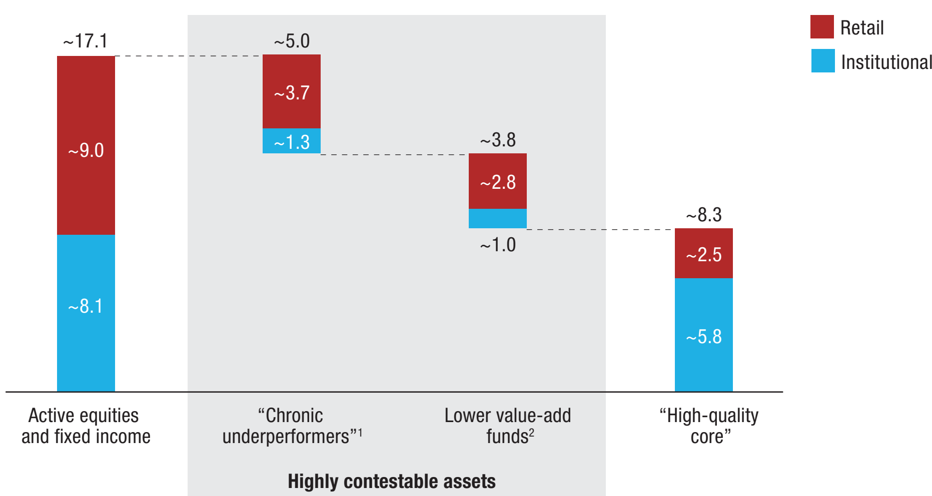
Now the bad news. There is some validity to the charges leveled by the harshest critics of active management. Portions of the industry have destroyed value for end investors over the past 20 years through chronic and consistent underperformance (Exhibit 12). The size of this asset pool is not insignificant. Of the $17.1 trillion of actively managed equities and fixed income in 2017, $5 trillion is managed by funds that have underperformed their benchmarks for four or more consecutive years. And another $3.8 trillion is managed by funds with such consistently paltry levels of outperformance that investors might reasonably ask: "Why bother?"

Based on these findings, we expect that the closing and merging of laggards, which picked up pace last year, will continue. This winnowing will result in a smaller, better-performing active industry.

Exhibit 12

A Darwinian moment for some active management segments?

Total traditionally managed active assets, equities and fixed income only, 2017
$ trillion



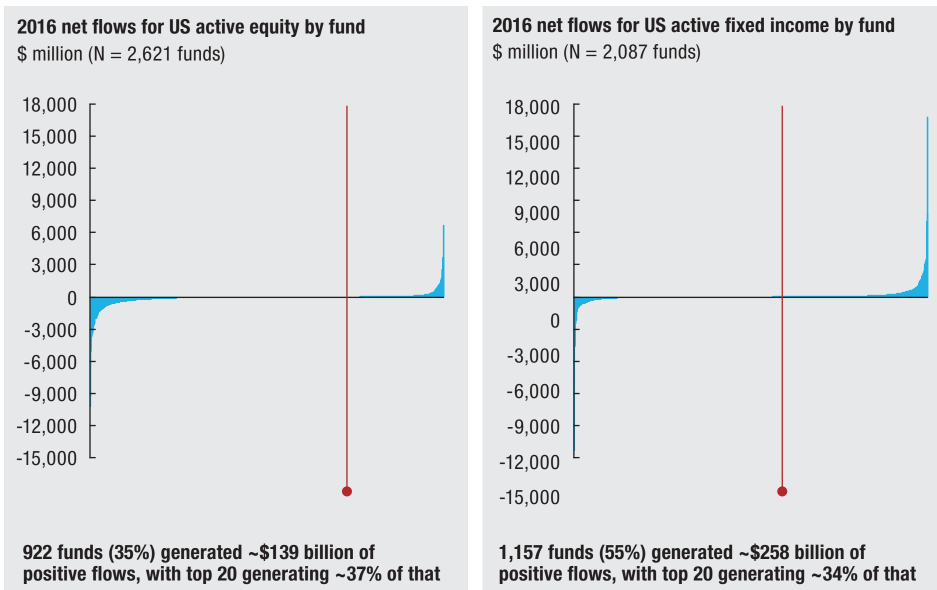
[1] Funds which had <-25 bps of excess return for 4 or more consecutive years in the period 1997-2016 in comparison to equivalent passive funds

[2] Includes assets of funds with negative excess returns and assets in categories with negative excess returns. Excludes funds which were marked as "chronic underperformers"

Source: McKinsey Global Asset Management Practice; eVestment; Simfund

Exhibit 13

Leaders in active have been winning new flows



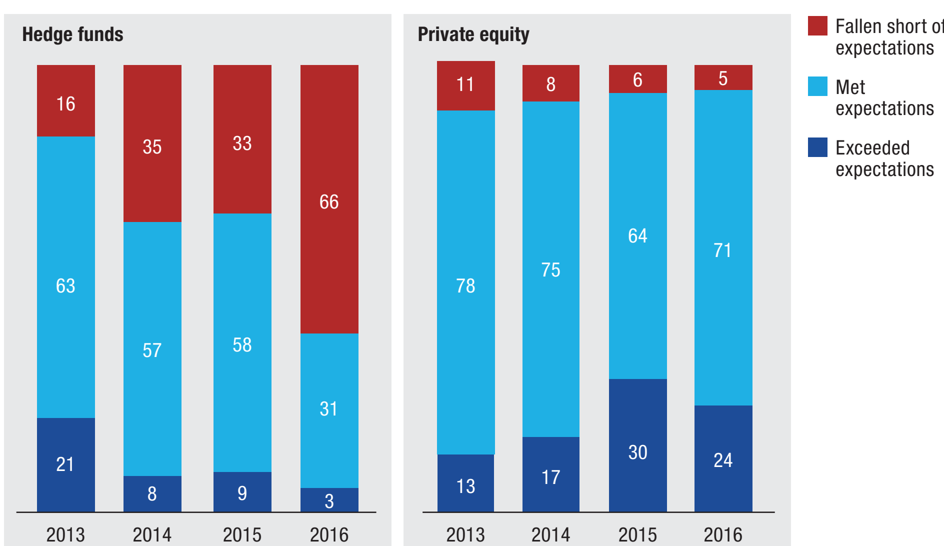
Source: Simfund

Exhibit 14

A value migration in alternatives as investors shift to the private markets

Institutional investor perceptions of alternative asset classes, 2013-16

Percent



Source: Preqin Investor Interviews, December 2013-16

But rumors of the death of active are greatly exaggerated. Indeed, this Darwinian moment for the active industry creates tremendous opportunity for high-performing managers that can deliver, and for those that restore value to their offerings through repricing and more efficient vehicles.

A granular look at industry averages for 2016 indicates that a move to quality, high-performing managers is already taking place (Exhibit 13). Amidst an overall picture of active outflows, the top active funds are actually enjoying great success. On the fixed-income side, for example, 55 percent of 1,157 funds generated about $258 billion of positive flow in 2016. The top 20 funds generated 34 percent of this total.

Hot Spot 2: A liquidity transformation within alternatives

Over the past several years, we have written extensively about the rise of alternative investments, driven by client needs (e.g., meeting pension liabilities) and a challenging external environment (e.g., low rates, low returns). By and large our expectations have played out correctly, with alternatives becoming a $7.5 trillion industry, accounting for approximately $2.3 trillion of new money entering the industry over the past five years.[2]

But that aggregate growth masks a meaningful shift within the alternatives category (Exhibit 14). "Alternatives" has always been somewhat of a misleading name for the breadth of strategies, styles, and risk-return profiles that the term encompasses. And the category's coherence is coming under further stress as a wide performance gap emerges between the public alternative market (that is, hedge funds) and private alternative markets, which is whetting investors' appetite for the latter.

And this "liquidity transformation" in favor of private markets is a logical response to performance. Since the global financial crisis in 2008 and 2009, the hedge fund industry has suffered from structural challenges in the form of low rates and seemingly unidirectional markets. In every year since 2009, a diversified portfolio of hedge funds has underperformed a standard 65-percent equities/35-percent fixed-income portfolio—and in a number of years by double-digit percentages. The converse has been true of the private markets, with private equity meaningfully outperforming the 65/35 portfolio over that same period.

Once the darling of the alternative investment category, the hedge fund industry is now facing existential questions as it seeks to position itself for a new environment. A number of large institutional investors have openly questioned the role of these strategies in their portfolios, either cutting back on capital allocations or in some cases removing the entire category from their investment programs. These factors, along with the closing of several large funds, led to a turning point in 2016. For the first time since the financial crisis, the hedge fund industry shrank in absolute terms, with outflows of $70 billion

[2] Inclusive of private markets fundraising.

and an uptick in fund closures (Exhibit 15). While aggregate flows have picked up again in 2017 and returns have bounced back, the industry has continued to face growth headwinds given skeptical investors with an ever broader range of alternatives. Industry leaders have been repositioning themselves in this new environment with a range of innovations ranging from significant investments in data, analytics, and technology to create new sources of investment advantage to paradigm shifts in pricing, with moves beyond the traditional 2/20 structure to 1/30 or even 0/20 to better position their propositions for low alpha environments.

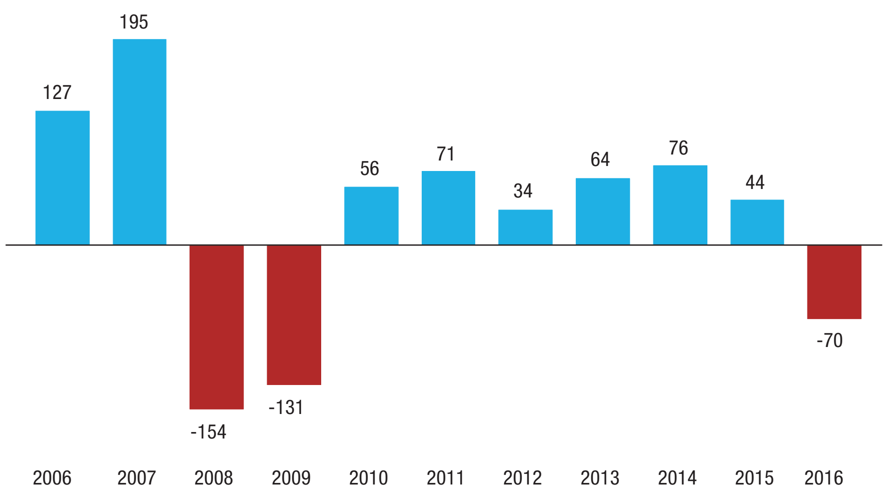
To be fair, the hedge fund industry has had to contend with a very diverse array of challenges: a tough macroenvironment (e.g., low rates, regulatory uncertainty, buoyant markets, and crowded trades); the rise of factor investing, which—because it granularly assesses value and risk factors—has spawned low-cost hedge fund replication strategies; and a business model that is difficult to scale because of an overreliance on a handful of skilled managers. These constraints can frustrate institutions that need to put massive amounts of capital to work.

Nevertheless, it is getting harder and harder to be a small investor in this space. Recently, the bulk of flows have gone to the largest firms, and this trend has continued through 2017. Thus, we believe industry consolidation—through acquisitions and closure—will pick up

Exhibit 15

2016 was a challenging year for the global hedge fund industry

Net flows into the global hedge fund industry
$ billion



Flows											
Percent	**11.4**	**13.3**	**-8.3**	**-9.3**	**3.5**	**3.7**	**1.7**	**2.8**	**2.9**	**1.5**	**-2.4**

Source: HFR

pace. Survivors will pursue greater institutionalization to better deliver quality investment products in a broader set of formats. The most successful hedge funds are already pursuing this strategy, enabling them to monetize their skills and intellectual capital through a broader range of channels.

Meanwhile, the outperformance in the private markets is hardly a secret and new money is rushing in. Private equity firms hauled in $626 billion globally in 2016, revisiting the highs set before the financial crisis. And—in contrast to the beleaguered hedge fund industry—a number of notable large investors have signaled the importance of their private-market programs and significantly upped their allocations. The surge in private-market demand is raising some red flags among market observers, who worry about future returns and if a bubble is forming. They point to high valuations, intense competition from strategic investors, and high levels of undeployed capital.

The world of private-market investing is indeed highly cyclical. But the surge in demand should be viewed in the context of the industry's significantly increased "surface area." Ten years ago, private markets referred almost exclusively to developed markets' private equity, but the category is now much more geographically diverse, encompassing all things illiquid, such as credit, real estate, and infrastructure. Also fueling growth in private markets are a wave of innovations among industry leaders, including: fundless-sponsor models that enable large-scale take-privates of companies; long-duration "core" funds that create patient capital; a greater willingness to play seamlessly across debt and equity; and innovations such as special-purpose acquisition companies (SPACS), which raise large pools of capital to pursue single investment themes.

The bottom line is that investors are growing increasingly comfortable with the category's illiquidity as a way to diversify risk exposure and add value. We expect that private-market alternatives will continue to attract a larger share of investments, and managers are likely to drive towards greater growth and scalability. We are also likely to see a growing number of firms that position themselves as multistrategy platforms—effectively becoming portals to access different investing alternatives and partners.

Hot Spot 3: The third act for ETFs

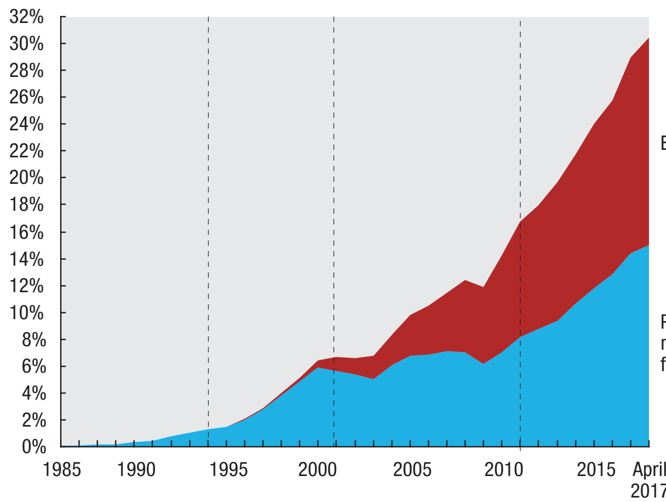
ETFs have continued their explosive growth, far exceeding any other major asset class/vehicle, even overtaking their passive equivalents in mutual funds and the active strategies that they began displacing over twenty years ago (Exhibit 16, page 26). There are now around 2,000 ETF products with increasingly precise exposures and themes.

The astounding growth—ETFs now control about 7 percent of all managed investment products—has been driven by intense retail demand for these low-cost, flexible investment instruments with intraday liquidity, particularly from their uptake in home office portfolios, the rise of the rep-as-port-

Exhibit 16

ETFs have almost overtaken their passive mutual fund equivalents

US market share of managed investment products[1]



CAGR
Percent

	1993-2000	2000-09	2009-16
ETFs	37	31	11
Passive mutual funds	27	7	11

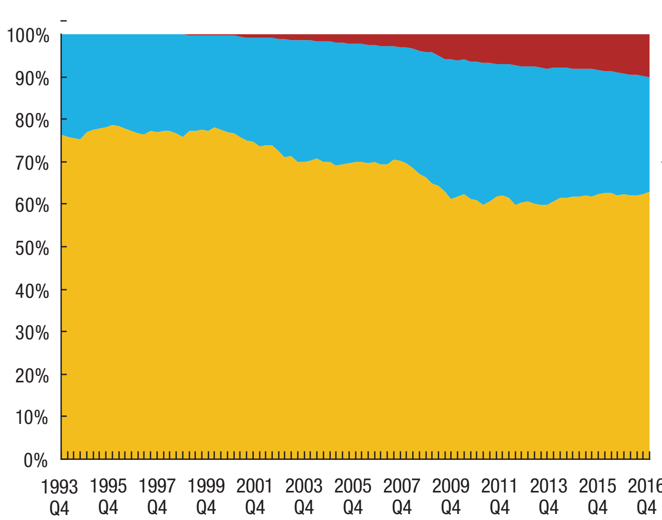
[1] Includes long-term open-end funds, money market funds, and ETFs

Source: Strategic Insight

Exhibit 17

ETFs are increasing the size of the asset management market

Individual stocks, long-term mutual funds, and ETFs – US household financial asset mix



Share year-end, 2007-16
Percent

	2007	2016	Change
ETFs	4	10	+6 % pts
Long-term mutual funds	29	27	-2 % pts
Corporate equity	67	63	-4 % pts

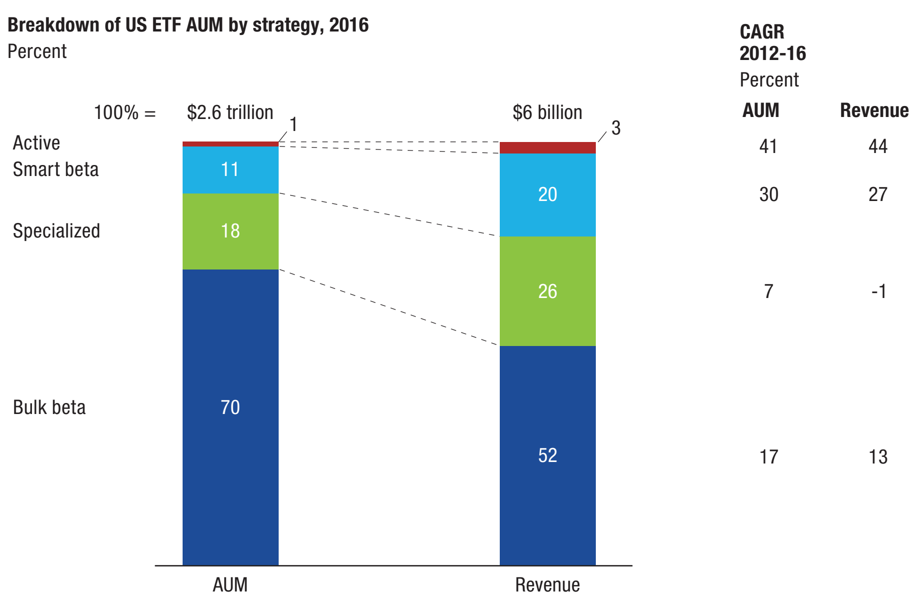
Source: Strategic Insight; Federal Reserve Flow of Funds; McKinsey Performance Lens folio-manager business model, and the fast-growing "robo-advice" platforms.

The growth of ETFs is often conflated with the inroads that low-cost passive investing has been making over active management. That's part of the story, but this angle obscures the true potential of ETFs. ETFs are not just grabbing share from active mutual funds, they are actually growing the total pie by winning new flows into asset management as a whole (Exhibit 17). Between 2007 and 2017, a full two-thirds of ETF growth (as a share of household financial assets) came from attracting assets once held as individual securities. In other words, ETFs are an investment "technology" that is growing the total asset management market and breaking free of the zero-sum game that is sometimes used to characterize the interplay between active and passive. We expect, for example, that fixed-income ETFs will grow rapidly, filling an acute liquidity and trading need caused by the pullback of traditional market makers, which are trimming their bond inventories and cutting back on activity given regulatory and capital challenges.

The ETF market has also been evolving in terms of what it delivers to investors. To be sure, most ETF demand continues to be in "bulk beta," the cheapest, most basic portfolio building blocks that track mainstream market-capitalization-weighted indices (Exhibit 18). The pricing of these products is so low that only the largest, most efficient managers have been able to win, and often with the help

Exhibit 18

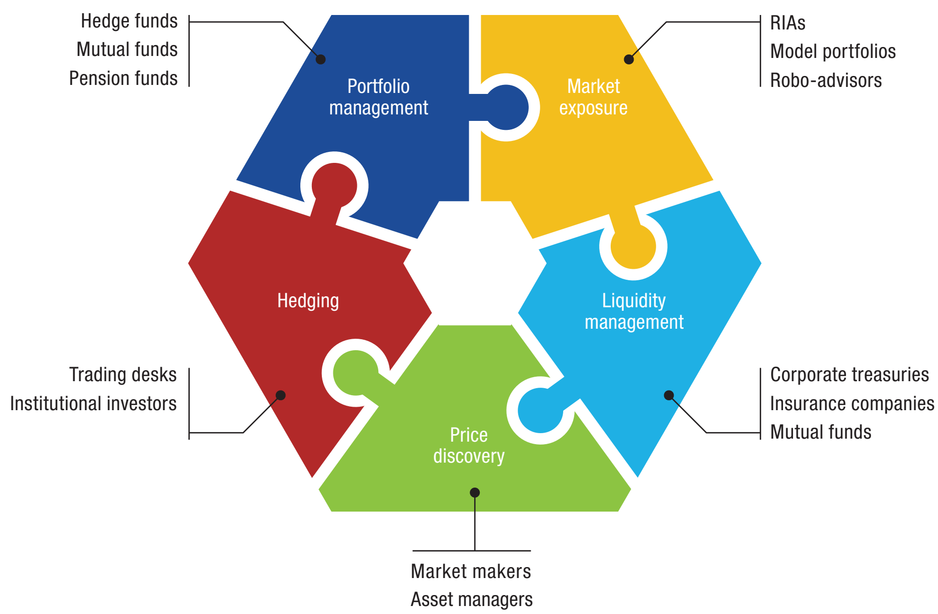
Bulk beta remains the mainstay of the ETF industry



Source: Simfund

Exhibit 19

New ETF use cases are emerging



Source: McKinsey analysis

of business models that deliver a set of ancillary revenue-generating services such as securities lending and product wrap fees. But, concurrently, the industry has been innovating, and investors are proving receptive to new products that come at slightly higher cost. Two categories in particular, active ETFs and smart beta, have been growing faster than bulk beta (though off a low base). Active ETFs and smart beta experienced compound annual AUM growth of 41 percent and 30 percent respectively from 2012 to 2016. Bulk beta, in contrast, grew at 17 percent over the same period.

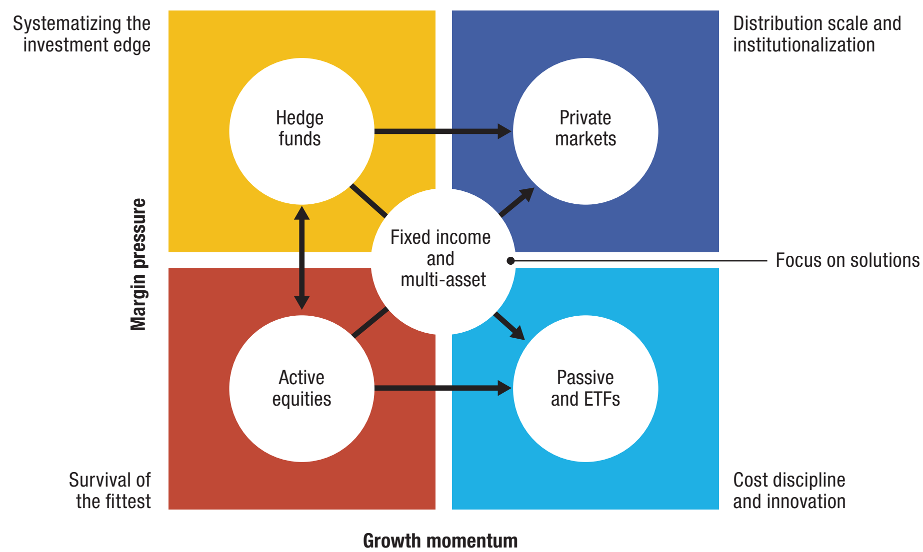
We expect that smart beta in particular will continue to be the focus of competition over the next few years as factor investing takes root in a greater way in the North American market. As more ETF managers move to leverage factor investing, competition will not just be about price, but also about innovation and execution. Indeed, the recent entry of several traditionally active managers into the smart beta ETF space is a signal of the nature of competition to come.

Given the robust demand across almost every part of the ETF market, our overall outlook for growth is strong. We expect the industry to continue its double-digit growth over the next several years, possibly becoming a $6 trillion market by 2021 (from $2.9 trillion in 2016).

Attaining this milestone will depend as much on innovation as it will on head-to-head market share gains against other in-

Exhibit 20

The industry game board is dynamic



Source: McKinsey analysis

vestment vehicles. Leading ETF providers need to broaden the use cases of their products to grow the overall size of the market (Exhibit 19). Already, institutions are putting ETFs to use for a wider range of needs: for example, to equitize cash holdings (ironically, sometimes within actively managed funds), to hedge exposures in difficult-to-access markets, for price discovery in thinly traded asset classes (e.g., corporate bonds), and even in corporate cash management.

Firms need to consider how to compete in this market. The scale economics of ETFs differ from more traditional funds, particularly in bulk beta, which is consolidating and may come down to three to four firms. Success will depend on combining operational efficiency (to withstand price pressures) with constant innovation (given the importance of first-mover advantage in new product areas as well as the ever-present threat of "fast followers").

New competitive dynamics

The three major shifts outlined above illustrate how the redistribution of value is occurring broadly across the industry and asset classes, creating fundamentally different pools of value and new competitive dynamics. The result is a highly variegated industry "game board," where margin and growth dynamics are exerting different pressures on different segments of the industry (Exhibit 20). This creates a highly varied set of imperatives. There is no one-size-fits-all prescription for success.

A tale of two cities

A tale of two

The observation that the North American asset management industry is at a pivotal moment is hardly novel. To say that the industry faces an unprecedented set of challenges is both so true and so accepted it has the ring of a cliché. In this report, we take this received wisdom as a starting point and cast an eye towards outcomes. And we argue that these outcomes for the industry come in the shape of a barbell. It is neither the best of times, nor the worst of times. It is both.

Asset managers need to seize on the realities of this new environment, one of the most fundamental of which is that the majority of trends discussed here are deeply secular rather than cyclical. They are not temporary fads that firms can ride out or adjust to with incremental changes. At the same time, asset managers need to approach the futurewith the dual mindset of both dealing decisively with new challenges but also seizing on the opportunities that this new environment affords.

> When firms focus too heavily on the downside, they risk missing some of the biggest, most exciting opportunities in the industry today.

Embracing both the best and the worst of times

We believe the industry has been too one-sided in its embrace of the "the worst of times" narrative. To be sure, there is real work to be done in restructuring business models and product portfolios to improve resilience to industry pressures. But far too many managers have simply positioned themselves in a defensive crouch, preparing for an extended fight to hold onto their narrow area of expertise and tightening their belts for a leaner future.

In many cases, this approach is certainly warranted (indeed it is far better than sticking one's head in the sand), but it is also incomplete. When firms focus too heavily on the downside, they risk missing some of the biggest, most exciting opportunities in the industry today.

Disruption is setting an unprecedented amount of money into motion, as clients shift assets in the hunt for yield. Industry consolidation will put large swathes of market share in play. New technologies are opening avenues to innovation across the asset management value chain and could help forward-thinking firms capture some of the trillions in unmanaged assets.

Two very different narratives are struggling for ascendance in today's asset management industry. In the dominant (and pessimistic) narrative, asset management is moving inexorably towards becoming a commodity industry, and asset managers are transitioning towards becoming cost managers. In the alternative narrative, asset managers can find new relevance by delivering solutions, and have a unique opportunity to position themselves as client-backed innovators. Deciding how to embrace and balance these competing narratives is quite literally a matter of choosing a firm's destiny.

Five priorities

In an industry undergoing significant change, there are multiple paths to success. Nonetheless, we believe that asset managers who are successful in repositioning their businesses for continued growth and profitability will embrace the following five priorities:

- *Rebalance and reallocate.* Every asset manager should review their current mix of businesses, evaluate their "natural" rate of growth given current industry trends, and aggressively reallocate resources to areas where they truly believe they can win. This is not to say that every asset manager should blindly follow the secular flows of funds in the market and abandon pockets with challenged growth prospects. What is required is a hard-nosed look at areas of competitive advantage and realistic prospects for market share gain, and a commitment of resources (or in some cases a deprioritization) that happens with conviction.

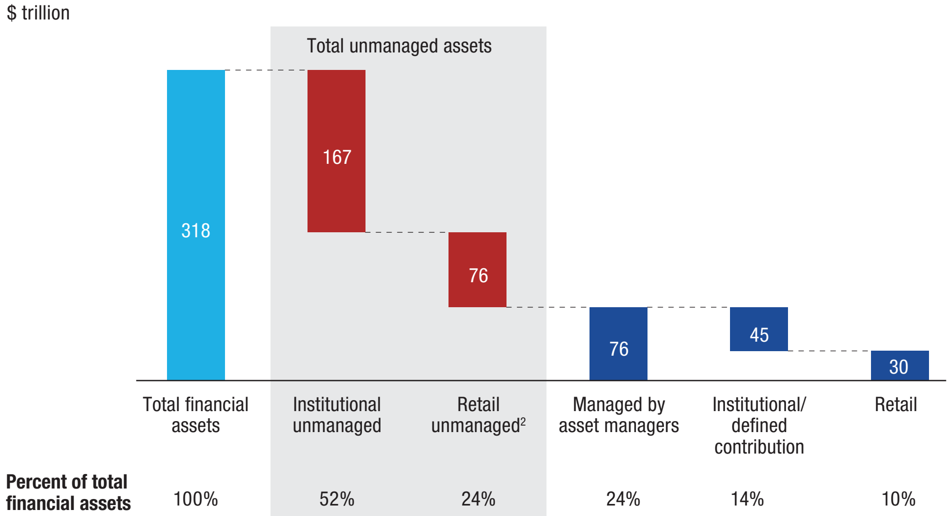
Recent advances in technology represent a unique opportunity (and arguably an obligation) to make fundamental improvements to the art of investing.

- *Retool the investment engine.* Investment outperformance has always been a challenging business, and perhaps more so now, given the greater efficiency of markets, the democratization of information access, and the intense state of competition. Despite these shifts, the investment process at many asset management firms has remained unchanged for the last two decades. We believe that recent advances in technology represent a unique opportunity (and arguably an obligation) to make fundamental improvements to the art of investing, whether that means finding new sources of alpha (e.g., using advanced analytics and nontraditional data sources), increasing the consistency of outcomes (e.g., using automation to flag behavioral biases), or creating a more scalable and efficient set of investment processes to lower costs (e.g., shared research utilities, common technology infrastructure).
- *Embrace a solutions mindset.* In a world where the boundaries between asset classes are becoming blurred, the notion of a "product" becomes a kind of anachronism. Client outcomes are what truly matter, and in an uncertain long-term market environment, outcomes such as income, liability management, inflation protection, and absolute return take on an added urgency. To become a solutions provider, managers must deeply understand client needs and how to marshal their resources and capabilities to deliver on those needs. They need to embed portfolio-driven advice, solutions-based selling, and outcome-oriented product development into the DNA of the firm.
- *Digitize operations to improve efficiencies.* As we pointed out earlier, the industry's costs have remained stubbornly high, with three areas (sales and marketing, operations and technology, and legal and compliance) driving a disproportionate amount of the increase. Up to now, most asset man-

Exhibit 21

Trillions of dollars in unmanaged assets are up for grabs

Breakdown of global[1] financial assets, year-end 2016
$ trillion



[1] Includes all countries from North America, Western Europe, Central and Eastern Europe, Gulf Cooperation Council, Africa, Developed and Emerging Asia, and Latin America
[2] Includes directly held securities and, newly included in 2017, cash and deposits
Source: McKinsey Performance Lens Global Growth Cube

agers have tried to rein in these costs without much success, while simultaneously holding onto the hope that by getting bigger they will get more profitable. But that has not panned out, due to the growing complexity within the industry. Once again, advances in technology and increased availability of data create an opportunity to fundamentally reshape the asset management operating model (e.g., digitization of client interfaces, advanced analytics to drive more leveraged sales models, automation to streamline processes). We believe that the generic asset management operating model requires a bit of shock therapy if firms are to achieve significant improvements in cost efficiencies and restore their operating leverage.

- *Innovating to win the war for unmanaged assets.* Most firms in the North American asset management industry are engaged in what amounts to hand-to-hand combat to defend their turf or make incremental gains into competitor territory. These battles will intensify as the combined pressures outlined in this report chip away at the size of the prize. While market share is certainly critical to near-term success, it can also induce a form of myopia. After all, asset managers are fighting day-to-day skirmishes over a fraction of the world's total assets—the 24 percent that is currently managed by third parties. Instead of devoting the entirety of their time and attention to this zero-sum game, we believe that asset managers should set their sights on the 66 percent of financial assets (about $72 trillion at the end of 2016) that are currently unmanaged; that is, assets held as bank deposits or individual securities or managed internally by institutions (Exhibit 21). These greenfields are a massive growth opportunity, but managers must look up from their daily battles to see the possibilities and begin testing innovations to unlock these assets.

This is a unique moment for the North American asset management industry. It is the best of times, but also the worst of times. We are at a moment of tremendous growth and innovation, but also entering a period of consolidation and retrenchment. The old dynamic of a rising tide lifting all boats has given way to a new dynamic where the winners will take a bigger share than ever before.

The greatest danger that most asset managers face in this tough, evolving environment is paying too much attention to the worst-of-times scenario. Those that become overly focused on surviving and keeping pace are likely to miss the enormous opportunities inherent in these challenging times.

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The Global Growth Cube is grounded in the understanding that asset growth, flows, and revenue trends vary greatly across the major regions of the world, reflecting fundamental differences in market maturity, industry structure, and regulatory frameworks.

To provide deep insights on where to compete and to help asset managers make effective strategic growth, resource allocation and product decisions, the Global Growth Cube dissects growth and revenue trends into over 4,000 microsegments across 44 regions and countries, 9 client segments, 15 asset classes, and 5 product vehicles.

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Now in its 16th year, the survey helps asset managers assess their operational effectiveness versus relevant peers and identifies actions to improve growth and profitability.

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