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Achieving digital alpha in asset management

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Even as financial institutions globally have begun the shift to competing in the digital economy, asset managers generally have remained digital laggards. Despite sustained asset growth, revenue pressures driven by increased competition, the shift to lower-fee passive investments, and the need to comply with new regulations have forced asset managers to focus on cost management. Only a handful of firms are creating value (what we call digital alpha) through greater investments in digitizing their operations and technology functions. These asset managers are streamlining systems to reduce long-term costs, but are also realizing incremental revenues and improving investment performance, according to McKinsey's annual Performance Lens Global Asset Management Survey for 2017. The correlation between digital leadership and improved overall performance is no accident: McKinsey's view is that to succeed, asset managers must be digital leaders.

Of the 300 firms in our global survey, roughly 20 belong to this select group of asset managers creating digital alpha (see sidebar on methodology). They share three characteristics: First, they have erased the traditional boundaries between their operations and technology groups, combining their budgets and development strategies. Second, they have focused both on reducing costs in legacy areas while simultaneously investing new data, digital capabilities, and talent. Third, they have made their operations and technology capabilities central to their competitive strategies, describing their digital strategies as creating, and not only enabling, value.

Operations and technology costs

In North America, operations and technology costs for asset managers have grown twice as fast as total expenses in the last ten years, roughly doubling in amount (Exhibit 1, page 4).

Increasing complexity—of financial markets, investment techniques, products and distribution, and regulation—has led to the expansion of support systems in many directions.

Many firms have tried to manage complexity by expanding and patching their legacy platforms, leaving them with processes, governance, and skills that bear higher long-term costs and are not optimized for growth in a digital era. The result is outsized growth in operations and technology spending. While overall costs for North American asset managers have declined by 1 basis point since 2007, the share of operations and technology spending has increased from 15 percentage points of the total to 20, placing it on a par with the costs of sales and marketing and general firm overhead.

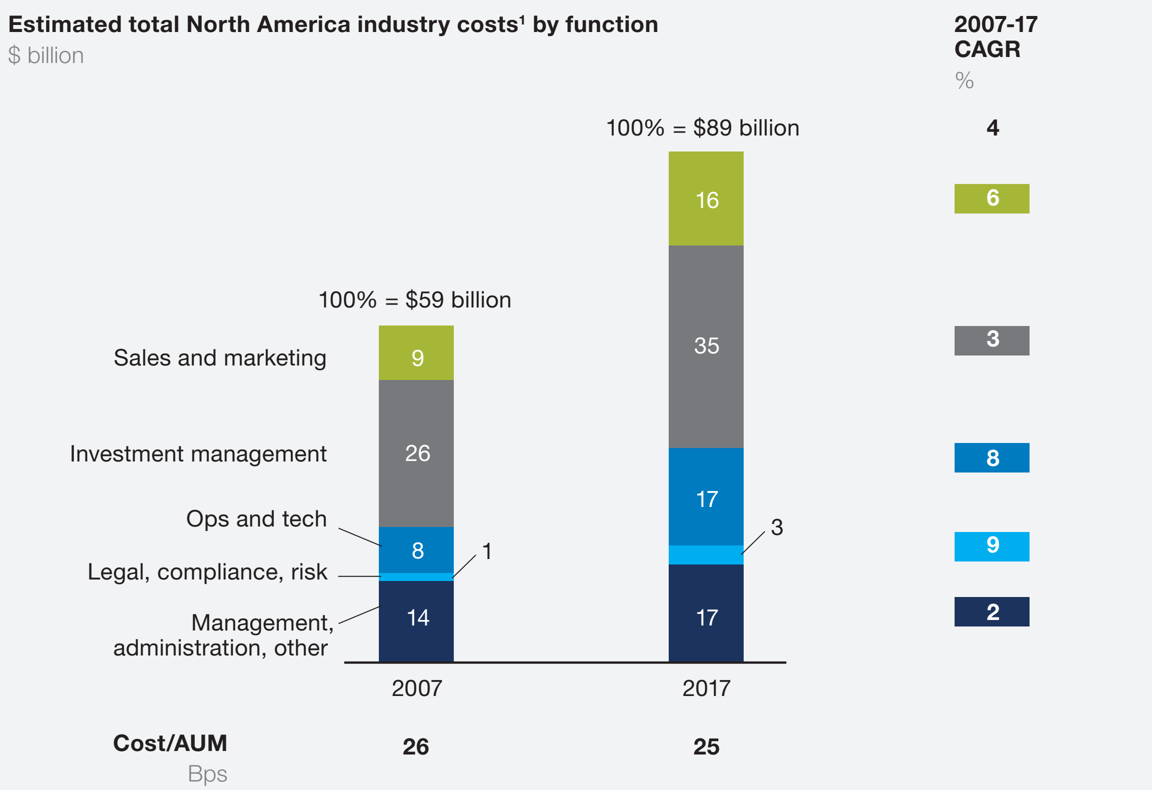
What leaders generating digital alpha have in common

McKinsey's Performance Lens Global Asset Management Survey for 2017 includes an exhaustive study of operations and technology benchmarks, supplemented by interviews with more than 30 heads of operations, technology, and data at asset managers around the world. The research indicates that firms generating digital alpha share three sets of operations and technology characteristics. The first is a close partnership between the operations and technology functions, eliminating a traditional and increasingly artificial boundary. Digitally advanced asset managers combine their operations and technology budgets and talent, and develop and execute joint strategies—such as client journeys—that span the two functions. The combined teams also sponsor major new initiatives, such as natural language processing to automate investment mandate governance.

Second, digital leaders are establishing two-speed technology strategies. On the one hand, they are aggressively attacking cost and

Exhibit 1

O&T costs for traditional North American asset managers are growing twice as fast as overall industry costs.



Source: McKinsey

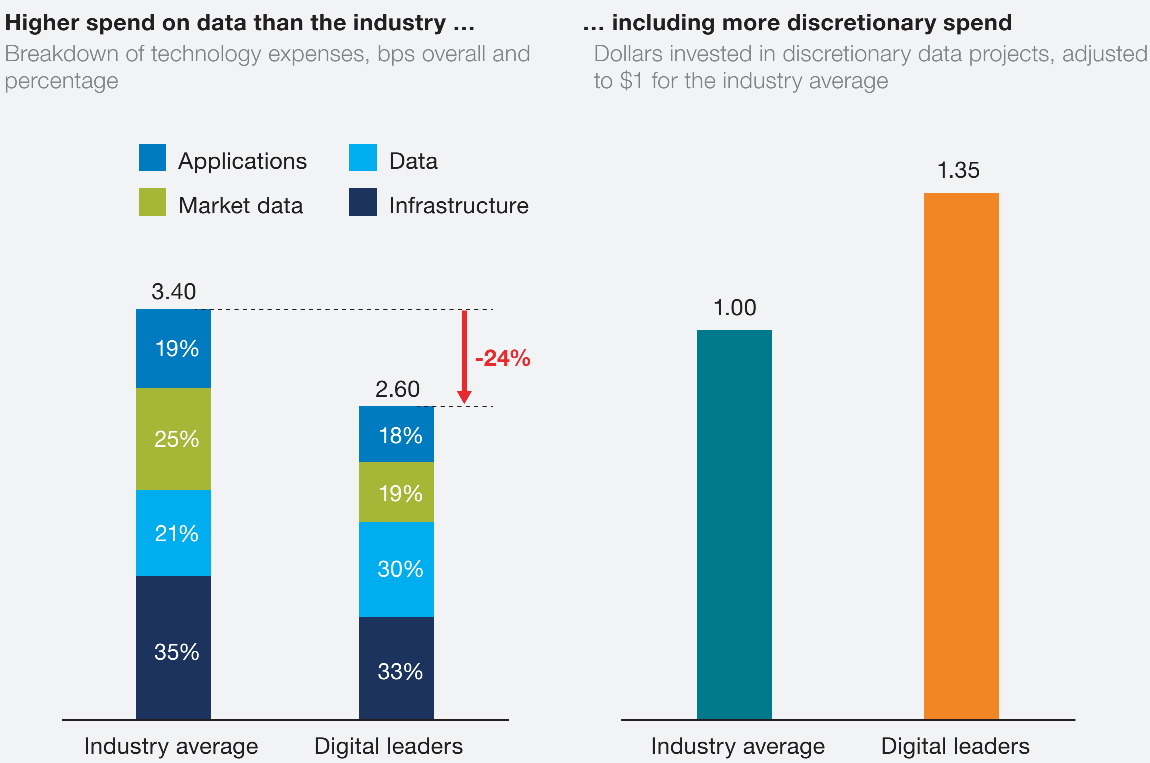
technical debt by streamlining their legacy architecture, eliminating duplicative applications, and sunsetting outdated systems. In parallel, however, they are also investing in next-generation technical capabilities (e.g., private cloud, data lakes, bots and automation) and operating models (e.g., agile application development and maintenance).

Third, digitally advanced asset managers have placed their operations and technology capabilities at the heart of their strategic differentiation. In practice, this means: appointing COOs/CTOs to the management executive committee; seeking new board members who bring expertise in operations and technology; creating new digital and data roles; and investing in talent development to more effectively leverage digital capabilities.

While digital leaders are spending less on operations and technology overall, they are out-investing competitors in data and analytics—30 percent of technology expenses versus 21 percent for the survey average. Moreover, they devote a greater share of their overall discretionary investment spending to data-related projects—35 percent more than the sample average (Exhibit 2).

Exhibit 2

Digital leaders in asset management are characterized by heavy investments in data.



Source: McKinsey

Transforming the client experience

How does an advanced digital approach translate to greater client experience? One answer is by reimagining and automating core business processes to emphasize sales and service, while reducing the cost of non-client-facing operations.

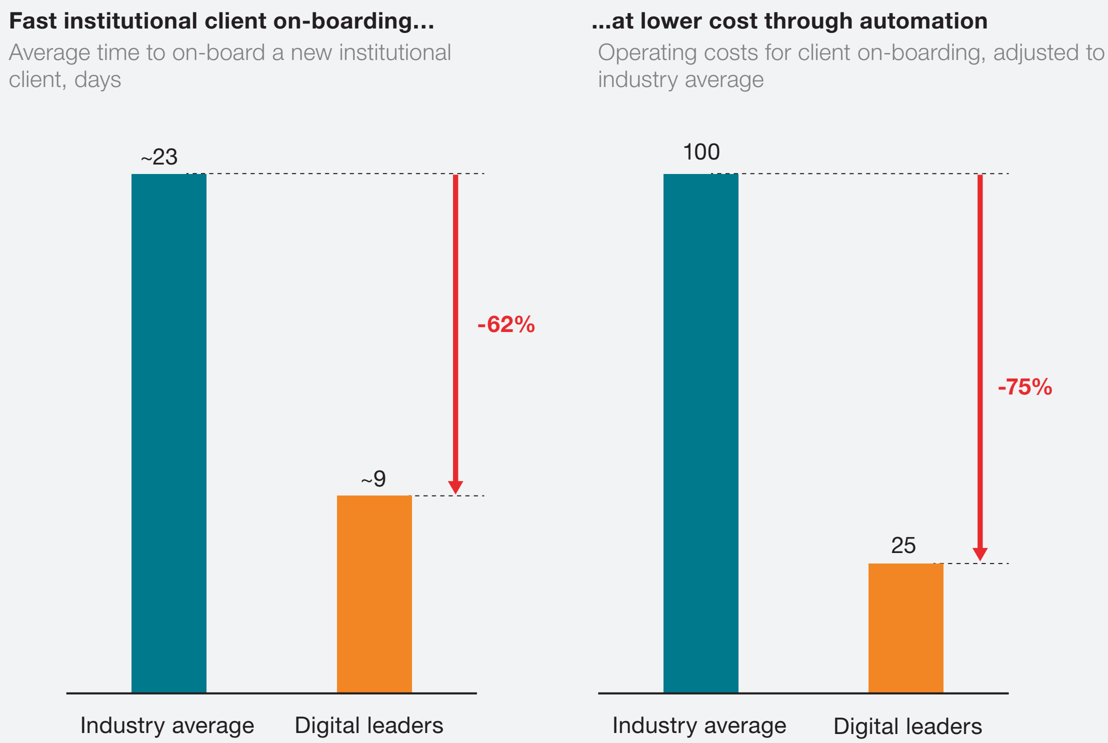
Onboarding of new institutional clients is traditionally cumbersome and highly manual for both clients and managers, leading to high costs. An executive at one asset manager described how a lack of accountability resulted in an onboarding process involving almost 300 employees being copied on e-mails. All digital leaders in the survey are transforming their client onboarding processes, leading to far more rapid cycle times and dramatically lower costs (Exhibit 3).

Redesigning the onboarding journey does more than lower costs: funding new accounts more quickly engages clients and can enhance managers' revenues by accelerating the recognition of fees.

Institutional asset managers are using new analytics tools to transform the client experience and improve AUM retention. Portfolio managers are making faster and better-informed investment decisions through position, performance, and

Exhibit 3

Digital leaders in asset management are transforming the client-onboarding journey.



Source: McKinsey

attribution reporting integrated with clients' risk management and accounting systems.

Retail-oriented firms have built propensity models to help their wholesalers provide financial advisors with analytic tools such as "next product to sell" predictors, which can improve wholesaler productivity, while maintaining or even lowering the costs of distribution.

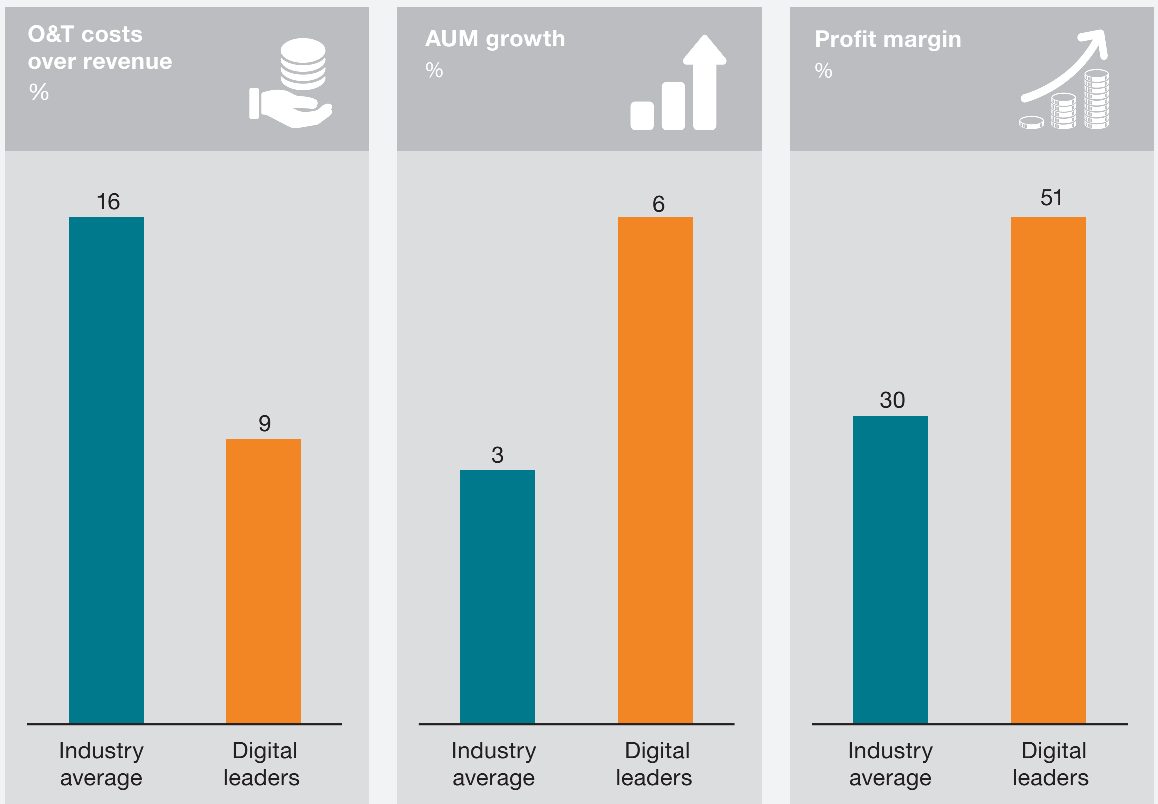
Improving investment insights

Digital leaders also realize benefits in the investment process. Some have automated their investment management agreements with natural language processing, ensuring rapid compliance with client guidelines and allowing portfolio managers to establish positions more quickly. Firms also have invested in analytics that assess portfolio managers' actions in advance of trades, and help to counteract behavioral bias in investment decisions. The payoff on the latter investment has been substantial, adding 100 to 200 basis points to portfolio returns.

Additionally, every firm in our digital leadership group maintains an investment book of record, which compiles security positions across portfolios to provide a timely and accurate view of market exposure, eliminating the need for manual reconciliations and speeding up the investment process.

Exhibit 4

Digital leaders in asset management are outperforming peers.



Source: McKinsey

Digital leaders in asset management are rethinking their footprint and sourcing strategies for the middle and back offices; rationalizing commoditized and low-value activities; while keeping talent focused on the highest-value strategic differentiators. For some, this has meant opening low-cost locations as well as outsourcing.

Delivering superior financial performance

The 20 or so asset management firms that we identified as digital leaders also reported stronger financial performance than the full sample. In 2017, their operations and technology costs were far below the group average, at 9 percent of revenues versus 16 percent, and they realized growth in AUM of 6 percent, double the 3 percent average. Moreover, profit margins were far higher, at 51 percent, versus 30 percent for the full survey group (Exhibit 4).

The survey results show a strong association between firms' digital strategies and growth, efficiency, and profitability. This correlation may not be causation: asset management is a complex business, and markets and investment decisions can have a stronger impact on performance than how firms organize their operations and technology.

Methodology

To identify asset managers generating digital alpha, we looked for firms that were in the top decile in each of the following three dimensions:

Architecture: Firms with a streamlined application landscape (e.g., focused set of vendors across the value chain), high infrastructure and application stability, and strong cybersecurity protocols

Analytics: Firms with an integrated data strategy, actively using algorithms and advanced analytics (e.g., machine learning) to improve investment performance, strengthen product distribution and client relationship management, optimize operations, or manage talent

Activities: Firms that have been focused on reducing cost and improving efficiency through automation, user experience, and client/associate journey redesign

These digital leaders are diverse in terms of geography, client channels, asset-class focus, and size, but are linked by three crucial financial outcomes: superior growth in assets under management (AUM), lower overall operations and technology costs, and higher profitability—earning margins of 51 percent as a group, versus 30 percent for the survey average.

However, operations and technology are a meaningful component of costs, and a streamlined operating model provides a foundation for higher profitability. Moreover, in a business so dependent on markets, and an environment where investment alpha has become unpredictable and difficult to achieve, every basis point of profitability matters.

Becoming a digital leader in asset management

The journey to digital leadership in asset management can take years, depending on a firm's starting point. While none of the COOs interviewed during our research felt they had completed their digital transformation, they observed that they were already reaping the benefits of the journey. Aspiring firms need to keep the following imperatives foremost in mind:

- **Tone from the top: Co-opt the CEO and CIO.** Each of the digital leaders we spoke to talked about how both the CEO and the CIO had prioritized these initiatives within the organization. Securing the support of the CIO is crucial to ensuring that the digital strategy receives the sustained investments needed to be successful. None of the leaders believed that a grassroots approach would have delivered the same outcomes, even if given a longer runway.

- **Make the first "at bat" count: Take a journey approach.** To convince skeptics in the organization (often, portfolio managers and relationship managers), many leaders spoke about the importance of having a signature initiative that would engage many parts of the organization and illustrate a significant change between the old and new worlds. For instance, while trade operations can often involve significant costs and inefficiencies, several leaders pointed out that these were often “invisible” to portfolio managers. To win support, they picked end-to-end journeys that were very visible (e.g., institutional client on-boarding or client reporting) to begin with. Rethinking the entire client (or associate) journey means involving virtually every part of the organization, and demonstrating a tangible difference in the experience as a result.

- **Keep scale in mind throughout: Build agile, cross-functional teams with dedicated product owners from the business side**.The digital leaders in our research focus on building flexible and re-usable technology that enables them to scale capabilities quickly. While the term agile is overused, all the leaders spoke about two themes in their approach: first, a deliberate effort to build capabilities within their teams (e.g., introduction of agile academies and coaches to bring concepts to life); and second, the creation of cross-functional teams with active participation from investments, distribution, and the support functions. A single product owner was assigned—often from investments or distribution—to avoid the historic challenge of sponsorship abandonment.

The chief operating officer of a $1 trillion asset manager told us: “For my 40 years in the business, my job has been operational delivery. Now it has become business transformation and value creation for my firm, and I’ve never been more energized by the task ahead.”

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While asset managers generally remain further back on the S curve of digital disruption relative to other financial services firms, some institutions are already building new digital capabilities and harvesting the rewards. They are outperforming the industry in asset growth, operating efficiency, and profitability. Yet, as asset managers know only too well, sources of alpha rapidly erode without continued innovation. The question for executives therefore is not whether to invest in new digital capabilities, but how to do so in the most effective way possible

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