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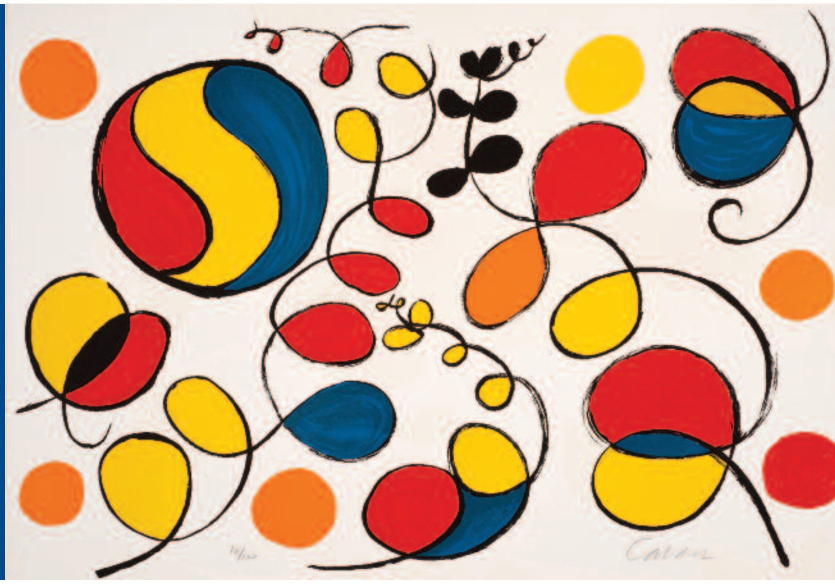

# Navigating the Shifting Terrain of North American Asset Management

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# Introduction

Introduction

The North American asset management industry is in a robust state of health, as measured by assets under management, revenues and profits. However, the route forward for individual firms is less certain than it might appear based on the positive momentum of the past five years. Fundamental shifts in client demand, product innovation, distribution, technology and regulation are reshaping the terrain of the industry and will require asset managers to rethink their traditional operating models. The industry is at an inflection point on a number of these dimensions, and the next five years represent a once-in-a-generation opportunity for North American asset management firms to position themselves for lasting success.

Assets under management (AUM) for North American firms reached an all-time high of $31 trillion in 2014, with revenues and profits growing at a double-digit clip to $111 billion and $37 billion respectively. Most impressively, the industry's operating margins reached 33 percent, an 11-percentage-point improvement from the lows of 2009. These gains appear to have been preserved even into the volatile markets of 2015, and the capital markets continue to look favorably on the asset management industry, with valuations and multiples pegged at a meaningful premium to other financial services sectors.

The positive momentum of the industry has been propelled by a set of powerful global cyclical and secular trends. A multi-year boom in asset prices has served as a rising tide for the entire industry, but meaningful net new flows have resulted from a structural shift to managed assets (away from deposits and direct holdings of stocks and bonds), the rise of new pools of capital (e.g., defined contribution [DC] pensions, insurance general accounts, high-net-worth investors and sovereign wealth funds), a shift in portfolio construction practices toward "bar-belled" portfolios that balance conservative and high-risk investments, and opportunities created by increased regulations on banks.

This benign, growth-friendly environment has not benefited all managers equally. There will always be leaders and laggards in any industry, but the performance gap—measured in net flows, revenue growth and operating margins—between top- and bottom-performing firms has been significant in North America, which raises the question of what the leaders are doing differently. The most distinguishing factor common to winning firms is their ability to identify and compete in the "sweet spots" at the intersection of industry tailwinds and their intrinsic strengths as an organization.

This report lays out five key questions that leadership teams will need to address:

1. **How should asset managers respond to the passive investments revolution?** The passive revolution is proceeding apace, with passive products accounting for over 100 percent of industry net flows since 2009. A closer look at this trend, however, reveals that while the surge in passives is real, rumors of the demise of active management have been somewhat exaggerated. The full story includes the parallel development of more specialized active strategies such as alternatives and multi-asset solutions, which have attracted $1.6 trillion of flows since 2009. Perhaps the most salient implication of the surge of passives has been an increased demand for transparency into the true returns and value add of strategies. The passive revolution continues to make headway, however, as product innovations such as smart beta take advantage of passive building blocks to deliver sophisticated outcomes. Firms need to decide where to compete and how to win across the active-passive spectrum and redesign their investment processes to deliver superior results. Active firms, in particular, will need to develop a sharper and more nuanced

framing of their value propositions that encompasses, for example, not only their profile of returns, but their approach to managing risk.

2. **What are the best approaches to serving a fragmenting client base through an expanding array of distribution channels?** The distribution landscape continues to diversify from the traditional platforms to include an array of smaller firms (e.g., registered investment advisers [RIAs]) as well as more direct channels, including a new set of technology-enabled models. The fragmentation of the client base has been exacerbated by managers seeking a foothold in high-potential emerging markets. Distribution tailored to deliver the uniformity and scale required by traditional platforms will come under increasing pressure. McKinsey believes managers should be thinking ahead to "Distribution 2.0"—a set of new data- and technology-enhanced sales models amplified by force multipliers like powerful branding and marketing. Firms will also need to make deliberate choices about where to focus by geography and segment and ensure that their distribution approaches are both scalable and fit for purpose for the next generation of investors and intermediaries.

3. **How should asset managers drive innovation with advances in data and technology?** Successful asset managers have long relied on technology for the essential "plumbing" that connects the investment ecosystem. But increased availability of data, coupled with quantum leaps in analytic approaches and processing power, opens up new possibilities for managers to gain a competitive edge in their investment management and distribution processes. For example, leading firms have already begun mining open source data for investable insights that can be used to deliver alpha. Leaders are also leveraging data and technology to improve distribution, by translating data on financial advisor behavior to precisely target on-the-ground retail distribution forces. The biggest hurdle—at least to start—will be attracting top talent in these new areas in an era in which competition for that talent is at an all-time high, both within and outside the asset management industry.

4. **What are the keys to creating and sustaining operating leverage?** The rising markets of the past five years have masked a multitude of cost increases and operational complexities across almost every functional area in asset management. As a result, the underlying cost base of the North American industry has risen in tandem with its revenues, seemingly disproving the asset management business model's promise of operating leverage and leaving the industry's profitability susceptible to a market downturn. Asset managers will need to focus on retooling their operating models for efficiency, simplicity and scalability to ensure that the growth that they gain in the coming years proves to be profitable.

5. **How should asset managers deal with the rising tide of regulation?** Over the past five years, the asset management industry has remained a secondary focus for regulators, as attention has fallen disproportionately on the balance-sheet-dependent financial institutions that were at the center of the financial crisis. It would be naïve to expect this state of affairs to continue indefinitely, and a wave of regulations, focusing on fee transparency, product neutrality, fiduciary standards and even market stability and fund liquidity, is gathering on the horizon. Regulation will invariably be part of the "new normal." But history has shown that regulation can be a powerful driver of innovation and growth (witness the rise of target-date funds). McKinsey believes that asset managers will need to take a proactive approach to regulation that goes beyond compliance to seeking out opportunities that arise from regulatory discontinuities. Success will require more than just increased regulatory awareness. Firms will need to make a holistic shift to a more client-centric and fiduciary mindset.

> A review of the leading firms in five years will show that they made definitive choices about their position on the passive-active axis and demonstrated clear value add in their investment strategies.

While it is difficult to make five-year predictions for an industry, McKinsey believes that the forces at work in North American asset management will change the terms of success for individual firms. A review of the leading firms in five years will show that they made definitive choices about their position on the passive-active axis and demonstrated clear value add in their investment strategies. They will have reinvented their distribution models to ensure scalability in a fragmented landscape, and used data and technology for competitive advantage in their core investment and distribution capabilities. They will have redesigned and streamlined their operating models for greater efficiency and scalability and made tough choices about where they can be sustainably profitable, and where they should scale back. They will also have made a virtue out of the necessity of new regulations and discovered opportunities for growth.

This report draws on McKinsey's Performance Lens research on asset management, including the annual McKinsey Global Asset Management Survey, which gathers benchmarking data from more than 300 asset managers—more than 100 from North America, representing $26 trillion (roughly 75 percent) of AUM—and the annual Global Growth Cube, which provides a granular breakdown of historical and forward-looking AUM, revenue and net flows data for 44 regions and countries, 9 client segments, 12 asset classes and 5 vehicles.

# Strong Performance And a Positive Outlook In North American Asset Management

The global asset management industry has been on a robust trajectory since the beginning of 2009, with assets, revenues and profitability all at record highs. During this time, the industry has added $28 trillion in AUM, double the growth in new assets between 2005 and 2009.

This sustained wave of growth has been propelled largely by the continued upward momentum of financial markets and asset prices. Of the $28 trillion in AUM added since the start of 2009, net new flows contributed $4.5 trillion, or about 16 percent of asset growth. That said, net flows have been accelerating over the past few years, with growth rates of about 3.6 percent in 2014 (Exhibit 1), driven in large part by retail investors.

There was a strong resurgence of developed market investors as a source of flows in 2014, and that momentum has continued into the first half of 2015. In a marked reversal of the emerging-market-led growth of the prior five years, North America and other developed markets accounted for almost 70 percent of total global flows in 2014 (Exhibit 2, page 8).

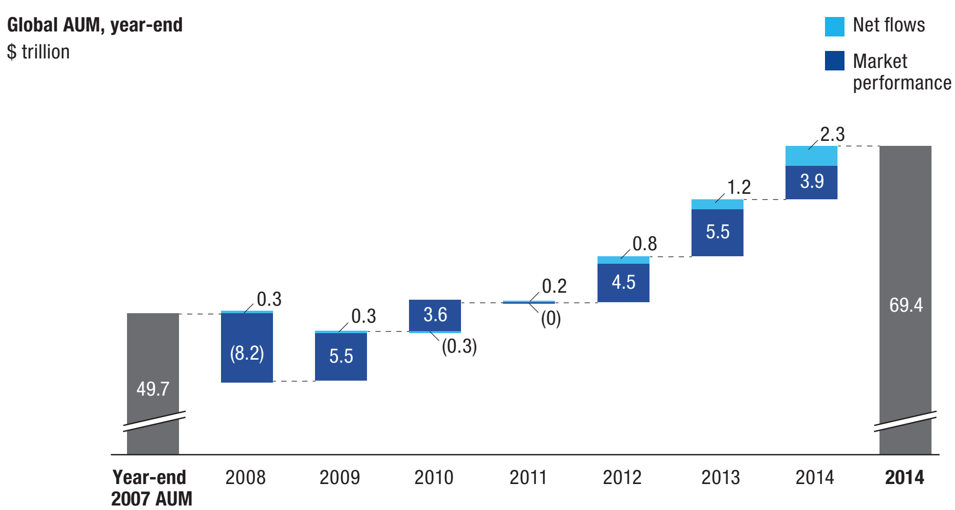
The North American asset management market continued the steady growth that began in 2009, contributing significantly to global growth of assets, revenues and profits. In 2014, North American AUM rose 11 percent to a record $31 trillion, revenues grew 10 percent to $111 billion, and profits climbed 12 percent to $37 billion. Most notably, the industry's operating margins peaked at 33 percent, a dramatic 11-percentage-point improvement over the 2009 low (Exhibit 3, page 8).

The North American asset management industry's steady upward climb since 2009, not just in assets but also in revenues, profits and margins, was more than a cyclical phenomenon. Beyond the positive momentum of the markets, a set of secular shifts have been gradually, but definitively, changing the texture of the industry and creating new opportunities for asset managers.

**An ongoing structural shift to managed assets.** Over the past 10 years, individual investors in North America have migrated assets from the banking system and from direct holdings of stocks and bonds into professionally managed investment funds as the range of funds, flexibility of underlying strategies, and breadth of client needs have

Exhibit 1

Net flows in global asset management have been accelerating in the last few years



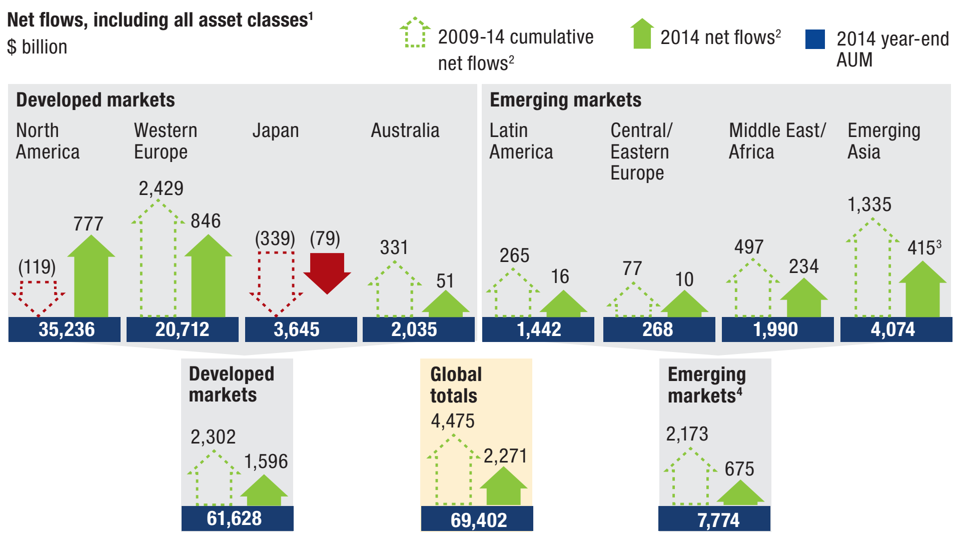

| Net flows as percentage of beginning-of-year AUM[1] | 0.5 | (0.7) | 0.8 | 0.3 | 1.6 | 2.1 | 3.6 |
|---|---|---|---|---|---|---|---|

[1] Excludes private equity flows

Source: 2015 McKinsey Performance Lens Global Asset Management Survey

Exhibit 2

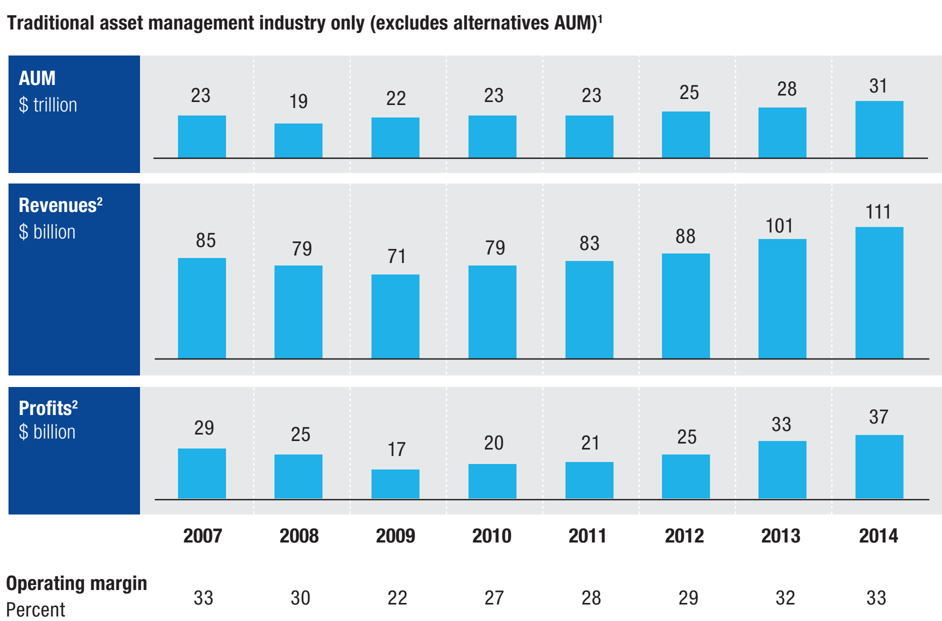
## North America and other developed markets accounted for 70% of flows in 2014




[1] Excludes private equity fund-raising
[2] Arrows for net flows not to scale
[3] Includes $300 billion in 2014 net money market flows from China
[4] Includes CEE, Emerging Asia, Middle East and Africa and LatAm; includes money market and alternatives
Source: McKinsey Performance Lens Global Growth Cube

Exhibit 3

## North American asset management operating margin has improved dramatically since 2009




[1] Includes third-party AUM only (excludes general account assets)
[2] Calculated based on overall industry margins for traditional asset managers
Source: 2015 McKinsey Performance Lens Global Asset Management Survey and McKinsey Performance Lens Global Growth Cube

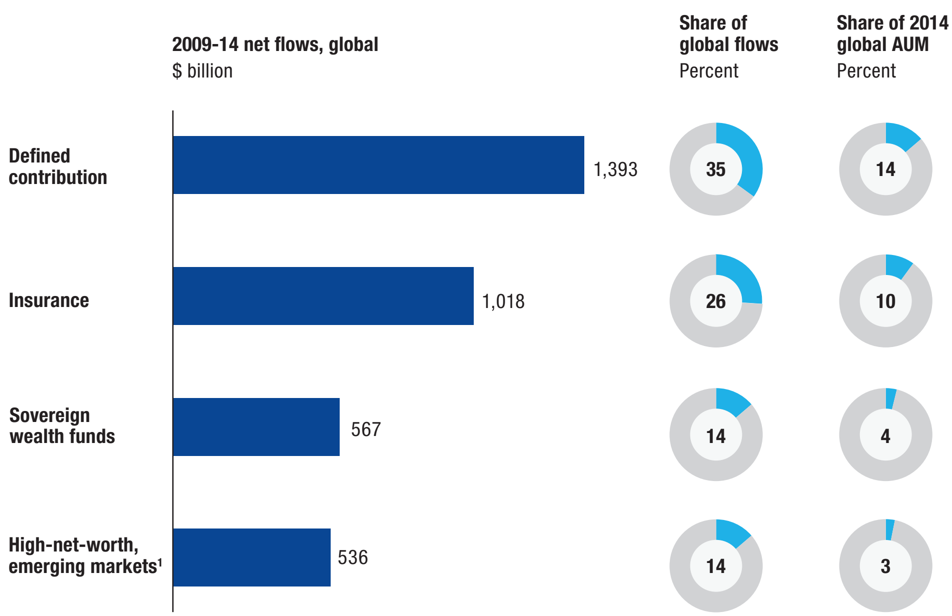
expanded. In 2014, asset managers accounted for 37 percent of North American financial assets, compared to 35 percent in 2007.

**The emergence of new pools of capital.** Four investor groups have now fully come of age, accounting for 89 percent of global net flows between 2009 and 2014: DC pension systems, insurance general accounts, sovereign wealth funds and high-net-worth investors in emerging markets (primarily Asia) (Exhibit 4). The result has been an expansion of assets to be managed and clients to be served, and North American asset managers have captured a large share of this opportunity both locally and abroad.

**Continuing evolution in asset allocation practices.** Institutions and retail intermediaries alike are increasingly demanding specialized exposures (e.g., emerging markets, high yield), diversification (e.g., alternatives), and solutions-based products (e.g., target-date funds, tactical asset allocation funds, multi-asset income funds). North American asset managers have responded with a wave of product innovation to meet these needs. Between 2009 and 2014, the three categories listed above accounted for over 60 percent of new assets and 90 percent of new revenues, and have been part of an overall product mix shift that helped the industry sustain healthy revenue margins, even in the

Exhibit 4

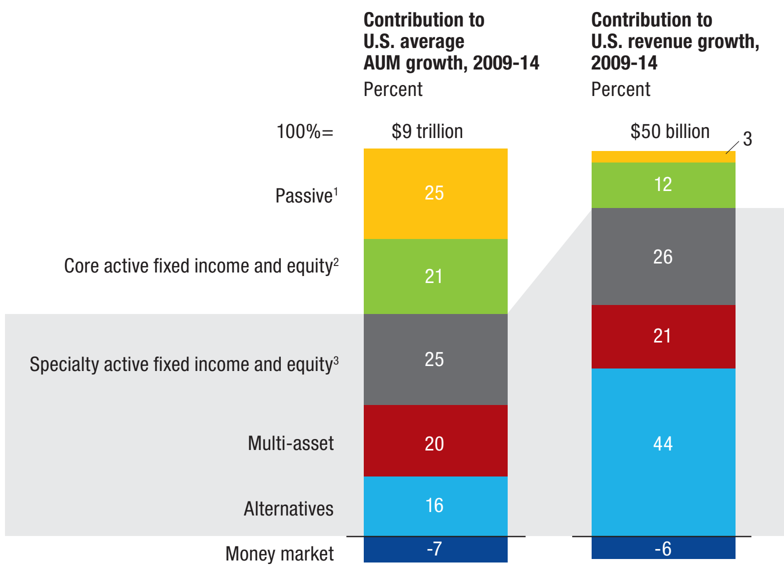
Four investor groups have accounted for 89% of global net flows since 2009




[1] Retail flows in emerging markets, including CEE, LatAm, Asia-exc. Japan, GCC and African countries
Source: McKinsey Performance Lens Global Growth Cube

Exhibit 5

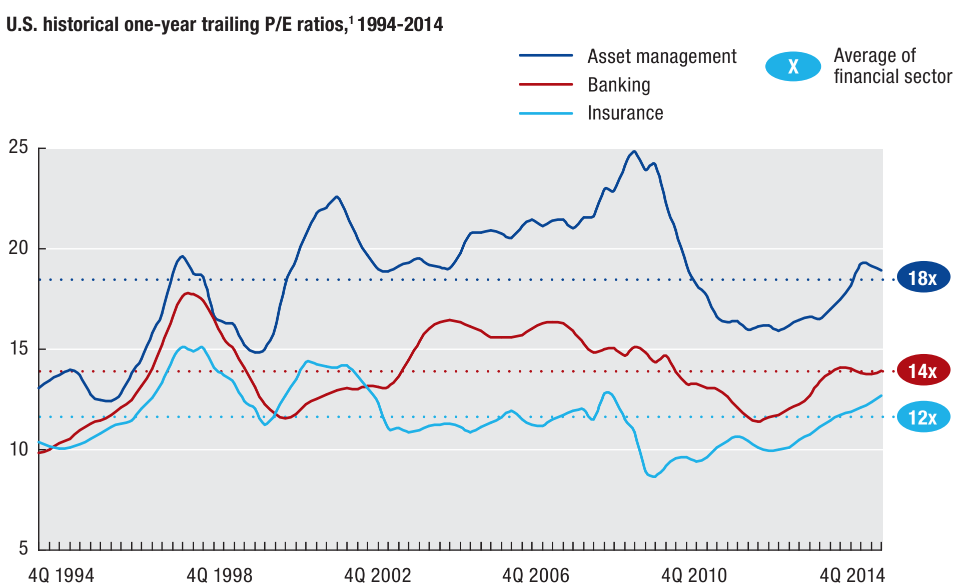
Three asset classes have accounted for more than 60% of new assets and 90% of new revenues in the U.S. since 2009




[1] Excludes passive assets held in multi-asset strategies
[2] Includes large cap, income/yield and unconstrained equity strategies, as well as core/core+, bank loans, long duration, short duration, and tax-exempt fixed-income strategies
[3] Includes mid/small cap, global/international and EM equity strategies, as well as high-yield, TIPS, flexible, global/international and EM fixed-income strategies
Source: 2015 McKinsey Performance Lens Global Asset Management Survey and McKinsey Performance Lens Global Growth Cube

Exhibit 6

U.S. asset managers trade at a consistent premium compared to banks and insurers




[1] Median price-to-earnings ratio after extraordinary items at quarter end; number of firms varies each quarter
Source: McKinsey Global Asset Management Practice; SNL Financial

face of a steady growth of passive assets (Exhibit 5).

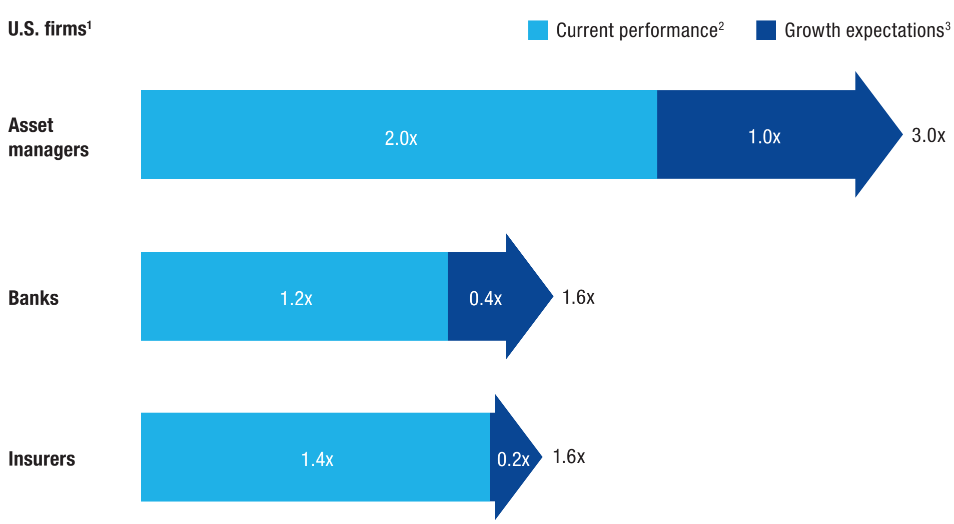
**Opportunities arising from banking regulation.** Post-crisis regulation has required banks to fortify their capital bases, leading many balance-sheet-driven firms in the financial system to scale back or exit certain areas of their traditional lending and capital markets activity. Asset managers are starting to fill the voids created by this retreat, with burgeoning growth in credit products, such as direct lending to middle-market companies, as well as efforts to develop origination, syndication and crossing platforms to facilitate the trading of illiquid securities.

As a result of these shifts, the outlook for the North American asset management industry is robust, particularly in the context of the broader financial services industry. Capital markets have maintained a positive view of the quality of asset management earnings, with publicly held asset managers trading at a consistent premium to banks and insurers (Exhibit 6).

These higher valuations reflect the strong growth outlook for the asset management industry. A simple decomposition of 2015 price-to-book ratios in the U.S. indicates that up to one-third of current capital market valuation for the asset management industry as a whole is based on prospects for future growth over and above current earnings. In contrast, for banks and insurers, valuations are driven almost entirely by current earnings, with equity investors giving little credit to future growth (Exhibit 7). The

Exhibit 7

## Up to one-third of capital market valuation for U.S. asset managers is based on expectations for growth




[1] Common equity including goodwill for asset management; tangible equity excluding goodwill for banks; tangible equity excluding goodwill and AOCI for insurance

[2] Includes growth and profitability improvement

[3] Based on net income estimates for full-year 2015

Source: McKinsey Global Asset Management Practice; Bloomberg asset management industry has excelled not just in past performance, but also with future prospects.

However, it is worth noting that compared with broader U.S. equity market valuations, which are close to pre-crisis peaks, asset manager valuations have moderated over the previous decade. This may reflect an awareness in the capital markets of the structural challenges that asset managers will face in designing new products, maintaining their revenues and holding down costs in the coming years.

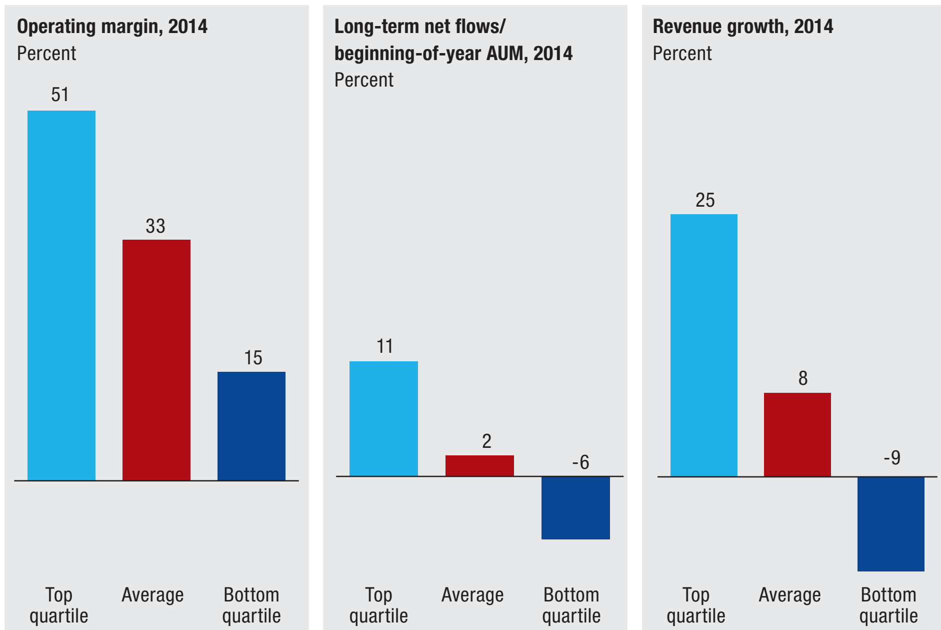
# Five Critical Challenges Asset Managers Must Address

The rising tide of the markets has lifted all boats in the North American asset management industry, but it has not closed the gap between the top and bottom performers. Some firms are far better positioned to capitalize on the opportunities created by the benign investment environment. In 2014, firms in the top quartile outperformed those in the bottom quartile by 17 percentage points in net flows, 34 percentage points in revenue growth, and 36 percentage points in operating margin (Exhibit 8, page 14).

This performance variation cannot be attributed to simple factors like size, specific asset class capabilities, client segment focus or even ownership structure. Nor can the performance disparity be explained solely by differences in investment performance. (Previous McKinsey research has

Exhibit 8

## The gap between top- and bottom-quartile North American asset managers was significant in 2014




Source: 2015 McKinsey Performance Lens Global Asset Management Survey

shown that investment performance, while necessary for success, accounts for at most one-third of the variation in growth across the asset management industry.[1]) In the end, what sets top performers apart is the ability to identify and compete in the sweet spots that lay at the intersection of individual firm strengths and broader industry tailwinds, and, importantly, a willingness to invest with conviction in these efforts.

McKinsey expects that as the North American asset management industry evolves, this ability to "pick the right spots" will continue to be what distinguishes leading firms from also-rans. However, those "spots" are moving targets and will require new operational capabilities. There are five critical areas that asset management leaders need to address with conviction as they redesign their operating models for success in the years ahead.

### 1. Responding to the passive revolution

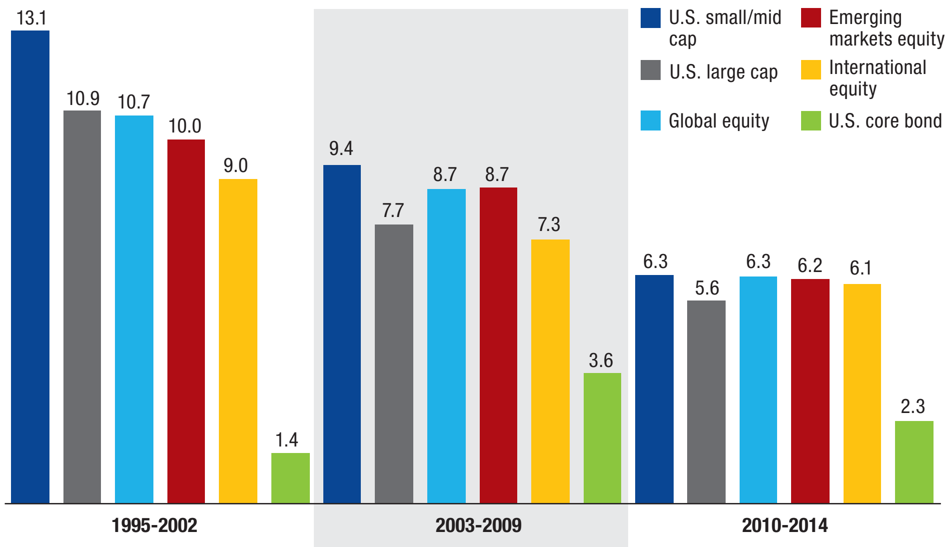
The passive revolution continues to advance aggressively. Passives accounted for 16 percent of the North American market in 2014, up from 12 percent at the end of 2009. More dramatically, between 2009 and 2014, passive strategies captured $593 billion of net flows into the asset management industry, while all other strategies combined experienced $712 billion in outflows. This shift has

[1] ***Searching for Profitable Growth in Asset Management: It's About More Than Investment Alpha***, McKinsey & Company, October 2013.

Exhibit 9

The ability of active managers to deliver excess returns has steadily decreased across almost all major strategies

**Average annual spread between top- and bottom-quartile returns for all U.S. actively managed strategies using same preferred benchmark,[1] 1995-2014**




[1] Benchmarks used: U.S. large cap – S&P 500; U.S. small/mid cap – Russell 2000; global equity – MSCI World; international equity – MSCI EAFE; emerging markets equity – MSCI EM; U.S. core bond – Barclays US Aggregate

Source: McKinsey Global Asset Management Practice; eVestment

spurred some soul-searching on the part of active-only managers on the longer-term positioning of their franchises.

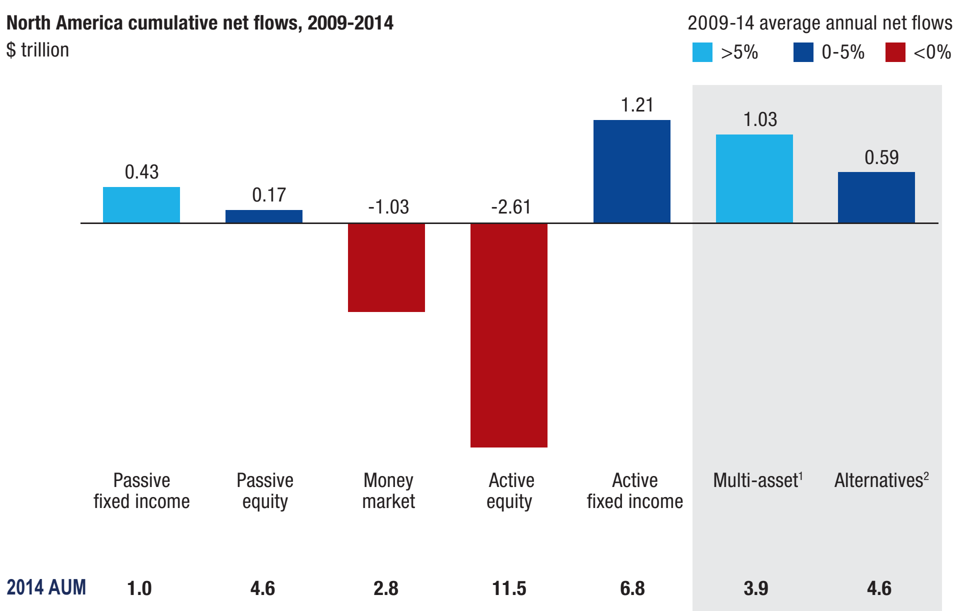
The market's shift to passive investments is related in part to investment performance. Over the last 20 years, the degree to which active managers have been able to deliver superior returns has steadily decreased across almost all major strategies. In U.S. large-cap equities, for example, the gap between top- and bottom-quartile manager performance declined, from almost 11 percent from 1995 to 2002 to 5.6 percent between 2010 and 2014 (Exhibit 9). This narrowing distribution of returns can be attributed to several factors, including a more rapid flow of information leading to higher-quality research, increased efficiency of markets, and heightened competition among a growing number of skilled portfolio managers. The steady rise of markets over the past few years has also done active managers few favors as beta has come to dominate alpha as a source of returns. In addition, active managers have had to contend with a meaningful degree of cash drag in a world with near-zero yields.

Based on the headlines, the passive investments revolution appears to be an unstoppable force that threatens to upend the asset management industry and transform its economics. The reality is more nuanced. There is indeed meaningful room for continued passive growth, but the facts suggest that rumors of the imminent death of active management are at least somewhat exaggerated.

A closer look reveals that collateral damage from the passive revolution has fallen disproportionately on "plain vanilla" active product segments, in particular the world of active equities, which in North America has suffered $2.6 trillion of outflows between 2009 and 2014. To be sure, a good portion of these assets were displaced outright by lower-cost passive equity mandates. But many analyses fail to account for a parallel development on the other end of the product "barbell": the demand for more specialized strategies within the world of active management, in particular alternatives and multi-asset solutions, which garnered $1.6 trillion of flows in the same period (Exhibit 10). These strategies, many of which aim to create value across benchmarks and asset classes, have become the new focus for alpha generation, with many even using passive building blocks to construct strategies that ultimately have a high active content in cross-benchmark allocation and to deliver what some have termed "specialized beta." While security selection within mature, highly-liquid asset markets and within the confines of narrow benchmarks is becoming increasingly efficient and commoditized by passive investing, many investors, both retail and institutional, are seeking

Exhibit 10

## Specialized strategies within the world of active management received $1.6 trillion of flows between 2009 and 2014




[1] Includes actively managed target-date funds
[2] Includes retail alternatives
Source: McKinsey Performance Lens Global Growth Cube

exposure to more specialized markets and believe in the potential for value creation across benchmarks. These strategies—in many but not all cases "unconstrained" or multi-asset-class—are attracting attention and flows across segments. The challenge for asset managers will be to show that they can create value beyond a passive allocation strategy, particularly as these new product markets mature and competition increases.

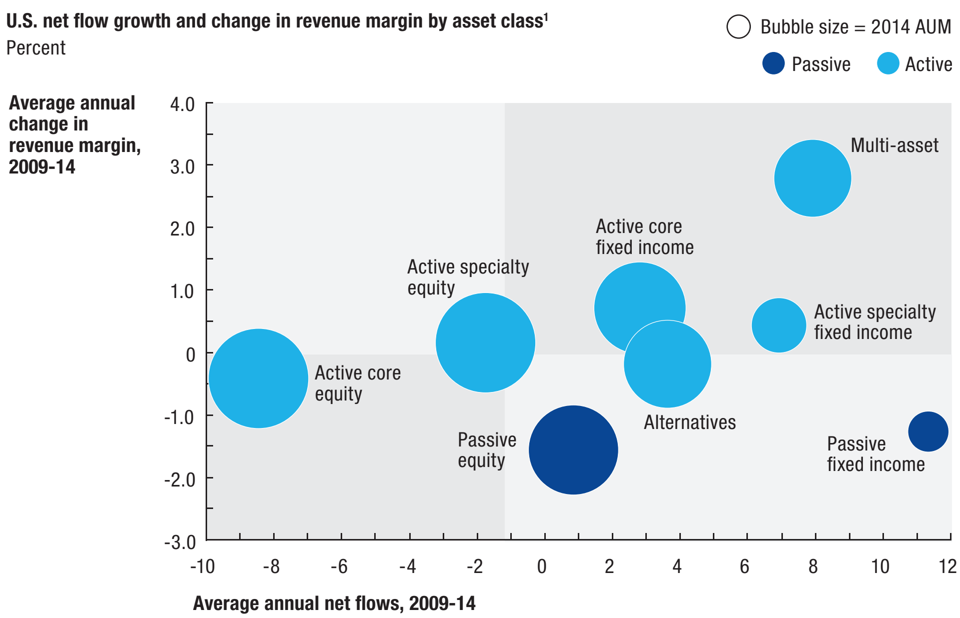
Growth in passive investments has been significant in terms of asset flows, but the associated revenue represents a relatively small portion of the industry's overall revenue pool. For example, despite accounting for over 100 percent of industry net flows over the past six years, passive investments accounted for just 3 percent of new U.S. industry revenues. This fact raises a deeper concern about the potential for passive products to commoditize the market and exert downward pressure on pricing across the board.

A granular view of the market is instructive (Exhibit 11). An analysis of major product categories by both net flows and changes in revenue margins reveals several interesting insights. The most significant price compression took place within the world of passive products; passive equity and fixed-income revenue margins both declined by an average of about 2 percent over the period. The next-biggest pricing impact was (unsurprisingly) in ac-

Exhibit 11

## In the U.S., the most significant margin compression took place in passives

**U.S. net flow growth and change in revenue margin by asset class[1]**
Percent




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

Source: 2015 McKinsey Performance Lens Global Asset Management Survey and McKinsey Performance Lens Global Growth Cube tive core equities, the very products that were being displaced by passive.

Most interestingly, average pricing actually increased moderately in a number of high-demand categories, like multi-asset solutions and specialty fixed income; some of this was due to mix shifts and new product innovation, but, by and large, these categories sustained their margins because investors continued to value what the categories delivered to their portfolios. If anything, it appears that the use of low-cost passive instruments may have increased some investors' "budget" for more specialized strategies.

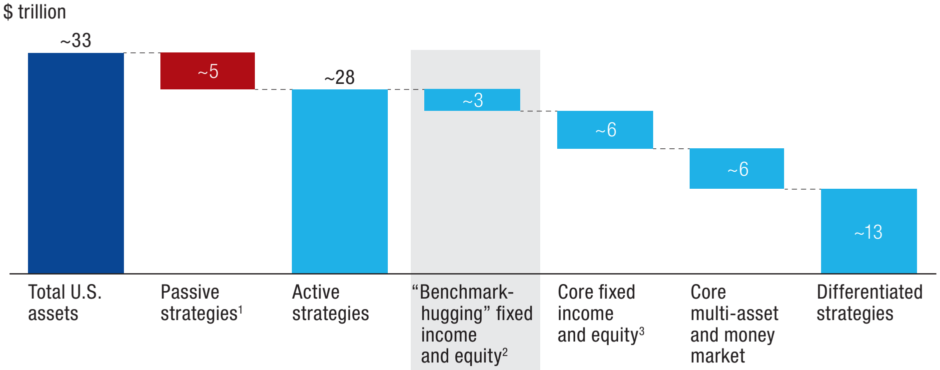
In the end, strategies that lack differentiation are a magnet for passive disintermediation. It is not so much individual asset classes that are susceptible to displacement, but rather individual asset managers who fail to differentiate themselves from the benchmark. An analysis suggests that about 10 percent of the active industry could fall into this "benchmark-hugging" category, and is thus a prime target for disintermediation in the near term. This slice of the market offers immediate room for growth for passive managers, but not enough to forecast the overthrow of the active regime (Exhibit 12).

This is not to say that the rest of the industry is immune from the passive investments challenge, as passive players continue to innovate with their products.

Exhibit 12

## About 10% of U.S. managed assets fall into the "benchmark-hugging" category

**U.S. asset management market, 2014**
$ trillion




| | Passive strategies[1] | Active strategies | "Benchmark-hugging" fixed income and equity[2] | Core fixed income and equity[3] | Core multi-asset and money market | Differentiated strategies |
|---|---|---|---|---|---|---|
| **Share of total** Percent | **~17** | **~83** | **9-11** | **~17** | **~18** | **~39** |
| **Examples** | | | Active strategies that track benchmark | Large-cap equity<br>Core fixed income | Balanced<br>Target date<br>Money market | Alternatives<br>Specialty fixed income and equity |

[1] Excludes passive multi-asset and target date

[2] Includes actively managed strategies whose returns were within 100-350 bps of preferred benchmark (depending on sub-asset class) in at least three-quarters of the past 10 years

[3] Excludes "benchmark-hugging" strategies

Source: McKinsey Global Asset Management Practice; eVestment; Simfund

A nuance often lost in the passive-active dynamic is the blurring of boundaries between the two categories, embodied by the rise of "smart beta" and factor-based strategies that claim to deliver superior, index-beating returns with a superior risk profile at a lower cost and with greater predictability than active management. Many sophisticated investors and their intermediaries are in the midst of exploring and experimenting with the use cases of such strategies in their portfolios.

It is also important to note that the growth of passive investments itself faces challenges. Investors recognize that most of the growth in passives has taken place during an unusual period of rising markets and low volatility. The resilience of passives in the face of cyclical change and a shifting macroeconomic environment is open to question. Recent events—specifically the "flash crash" in the prices of a small number of ETFs during the stock market decline in August 2015—have also caused some to question the premise of passives being a "safe" and highly flexible strategy. While most of the ETFs that failed on August 24th were small and had limited liquidity, a few large ETFs experienced significant variances in prices relative to their indices, spurring debate among market participants and regulators on the resilience of this broader set of vehicles during a crisis.

Looking forward, it will be critical for asset managers to go beyond the simple active/passive dichotomy and develop a clear position on where they will compete and how they will stand out in an environment where investor preferences are likely to be in flux. Active managers, in particular, will need to develop a far sharper and more nuanced articulation of their value proposition to their clients, not only in terms of the uniqueness and durability of their "edge" in generating alpha, but extending to their ability to manage risks, liquidity and volatility to deliver superior results across a range of market conditions. Key actions that asset managers will need to consider include redesigning the active investment process (and associated investor incentives), accelerating the development of specialized active products and multi-asset solutions, and entering the more specialized segments of the passive market (including hybrid strategies that leverage passive building blocks) to balance growth and revenue potential.

## 2. Serving a fragmenting client base across an expanding array of distribution channels

Asset management has been transitioning from its traditional business-to-business model to one that is business-to-business-to-consumer across its most important growth segments. In North America, changes in governmental and corporate policies on retirement have shifted the client nexus from defined benefit (DB) pension plans with thousands of participants to millions of individual households making their own investment decisions through DC plans or dispersed financial intermediaries. These shifts alone have made the retail segment a critical source of new asset flows, which in turn creates a new set of distribution challenges.

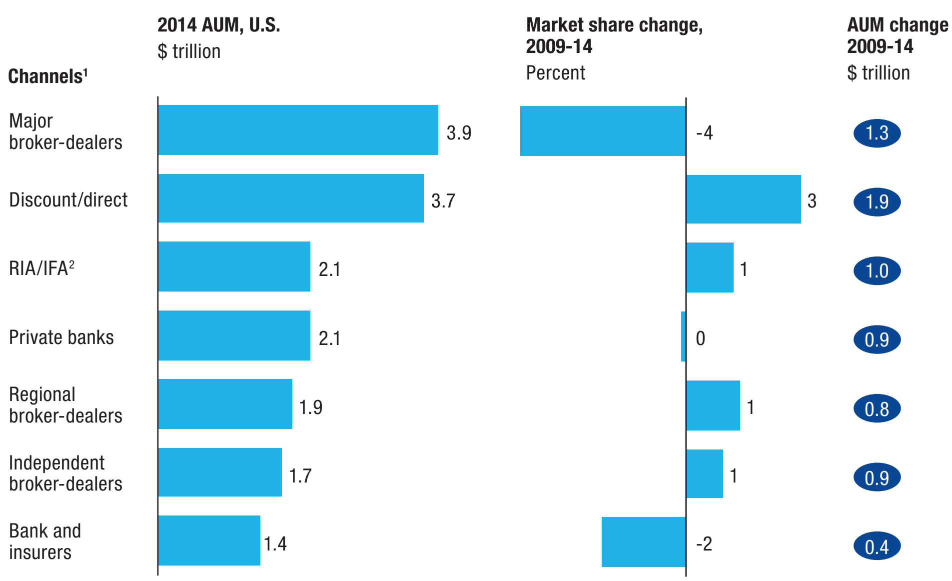
In North America, the retail distribution landscape has been clearly evolving, with a diverse and growing set of constituents. A significant portion of retail assets continues to be managed on the large traditional platforms and through major broker-dealers, but two other channels—RIAs and direct/discount brokerages—have been gaining momentum. A number of factors are driving this growth, including the trend of breakaway advisors seeking greater autonomy, client disillusionment with the commission-based brokerage model, and the emergence of younger investors who are drawn to the simplicity and immediacy of technology-enabled direct channels.

Collectively, RIAs and discount and direct investment channels took about 4 percent of the U.S. retail market between the beginning of 2009 and 2014, and many expect that momentum to continue through 2020 (Exhibit 13).

Asset managers selling through large brokerage firms have traditionally designed their distribution models with a focus on uniformity and scale. In recent years, many firms have bolstered their coverage of the large distributor home offices that oversee the selection of asset managers for recommended lists and the positioning of individual funds into asset alloca-

Exhibit 13

RIAs and discount and direct investment channels have been growing share in U.S. retail




[1] Includes SMAs, OEFs, CEFs, VAs; excludes money market funds, fixed annuities, limited partnerships and collective investment trusts

[2] Includes IFAs, dual-registered, and ETF strategists

Source: McKinsey Performance Lens Growth Cube; Strategic Insight; Investment Company Institute tion models. Now, the diversification of the retail client base is undercutting the scalability of these models, not only because of the challenges of geographical reach (e.g., the dispersion of major RIAs outside traditional money centers), but also because asset managers must meet the needs of diverse groups of advisors and satisfy the preferences of multiple subsets of end-investors.

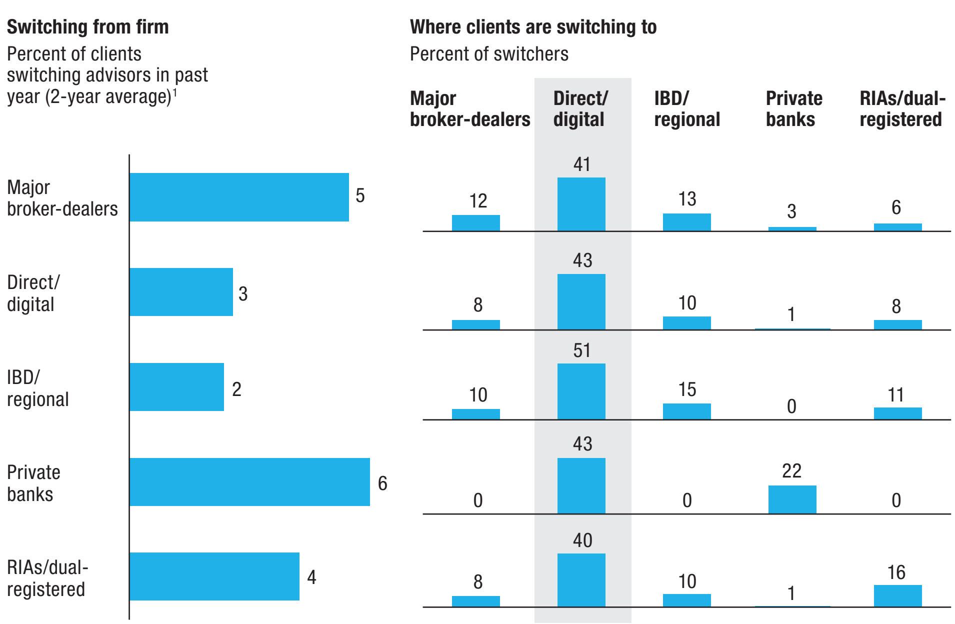
The growth of direct and discount channels—particularly those using digital interfaces—will further increase the complexity of the distribution landscape. A segment of the client base will inevitably become increasingly comfortable with more commoditized forms of advice (e.g., on asset allocation), which will make brand recognition and clear product value propositions paramount. Distribution, in this paradigm, becomes as much about marketing as it is about the traditional levers of sales.

Direct models will continue to gain share as an important channel in North American asset management. Even as the intermediary channels within wealth management continue to be distinguished by relatively sticky client relationships, McKinsey research shows that when consumers in the U.S. do switch providers, the direct and digital channels prove highly compelling (Exhibit 14).

The challenges of fragmentation will be felt all the more acutely as North Ameri-

Exhibit 14

When U.S. retail clients switch providers, a significant percentage move to direct/digital channels




[1] 2014; N=10,114 respondents with $100,000 or more in investable assets (aged 30-75 years old)

Source: McKinsey Wealth Management Practice Affluent Consumer Insights Survey (ACIS) can asset managers seek to expand into fast-growth emerging markets. These efforts will bring their own challenges: multiple languages, regulatory regimes, jurisdictions, competitive dynamics and distribution relationships, all of which challenge the scalability of a traditional one-size-fits-all sales model.

Advances in data analytics and technology have the potential to transform investment processes, making new sources of insight available to portfolio managers and freeing up research bandwidth from routine tasks.

These changes in the retail client base give asset managers opportunities to grow share in new and underpenetrated markets or segments; but they also present a degree of operational complexity that can put pressure on profitability. The increased diversity in retail channels will force managers to choose thoughtfully where to focus by geography and segment. Firms will need to continue to innovate in distribution and build scalability into their product platforms to balance the demands of greater specialization with the ability to generate profitable growth.

The diversification of retail channels will also require a shift in how firms think about client value. Instead of taking a purely sales-focused view of the market (e.g., metrics based on gross sales and redemptions), firms will need to consider the net present value of client segments, which can vary widely by channel when factors like client acquisition costs and asset churn are taken into account.

### 3. Leveraging advances in data and technology to drive innovation

Asset management is a data-centric industry, with technology-enabled “plumbing” that facilitates information flows across internal functions, as well as externally to clients and other market participants. Recent technological advances have significantly enhanced risk-related analytics, improved trade execution and helped firms address increased compliance and regulatory complexity within capital markets.

Over the next five years, data and technology will continue to play a critical role in core asset management functions. Now, however, industry leaders will begin to aggressively adopt analytical approaches and technologies (and talent) from outside the industry to reinvent the core activities of investing and distribution.

On the investment front, a step change in the availability of non-traditional data and processing power, as well as rapid advances in new techniques of semantic analysis and machine-learning, will give asset managers an unprecedented ability to mine terabytes of unstructured data for signals, patterns and relationships, with the potential to yield investable insights. Tools and technologies that were once the sole preserve of "black box" quantitative investment firms are now increasingly available to traditional investors.

Advances in data analytics and technology have the potential to transform investment processes, making new sources of insight available to portfolio managers (e.g., real-time insights via web-scraping) and freeing up research bandwidth from routine tasks (e.g., searching multiple pages of regulatory filings and annual reports). Asset management firms are experimenting with these capabilities to build an edge in delivering alpha, and industry leaders are likely to turn them into a source of competitive advantage.

Distribution is another area ripe for disruption through data and technology (Exhibit 15). For example, with the unprecedented availability of data on financial advisor behavior (some of it newly available from large distributors for a fee), leading firms are beginning to use advanced analytics to more precisely target on-the-ground retail distribution forces. Leaders in the industry will develop next-generation, technology-enabled wholesaling models aimed at drastically increasing sales return on investment.

The true elephant in the room in terms of data and technology is the question of talent. Firms seeking to take the lead in analytics, data-mining and technology-based portfolio insights will need to develop new value propositions to attract

Exhibit 15

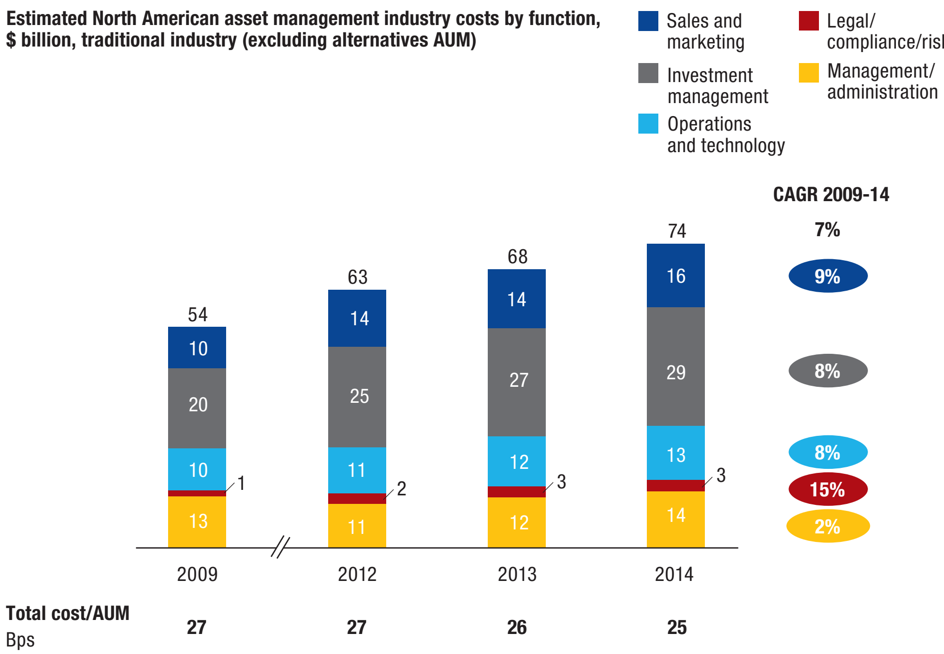
## Advanced analytics can transform distribution in a number of ways

| | |
|---|---|
| **Enhanced prospecting** | Predicting which advisors will outperform their current segments; prioritizing outreach to advisors based on potential to improve prospecting efficiency |
| **Defensive intelligence** | Identifying and addressing advisors likely to redeem/underperform, and prioritizing informed sales conversations to stem outflows from at-risk advisors |
| **Personalized marketing** | Focusing marketing messages and sales conversations on products advisors are most likely to purchase/redeem, based on common product associations<br>Delivering segment-specific marketing materials and sales conversations that address the key considerations within individual advisors' investment processes |
| **Smart salesforce reallocation** | Prioritizing advisors based on future potential and alignment to firm value proposition.<br>Using attitudinal and behavioral segmentation to improve success rates among advisors |
| **Optimized sales coverage** | Serving advisors with their preferred format and frequency of interaction, and delivering the optimal level of service while conserving salesforce resources<br>Aligning salesforce with advisor segments they are best positioned to serve, by matching strengths with the capabilities advisor segments value most |
| **Targeted campaigns** | Targeting efforts when key competitor products are underperforming or experiencing a PM change |

Source: McKinsey Global Asset Management Practice

Exhibit 16

The cost base of the North American asset management industry has risen almost as quickly as revenues




Source: 2015 McKinsey Performance Lens Global Asset Management Survey and McKinsey Performance Lens Global Growth Cube

employees from outside the industry with a more diverse array of skills and talents. They will not be alone, as firms across many industries are seeking to build an edge in digital talent.

### 4. Creating and sustaining operating leverage

Conventional wisdom holds that asset management is an industry with significant operating leverage. A doubling of AUM in a particular fund, according to this view, should not require anything close to a doubling of the underlying costs of management.

Recently, however, operating leverage has been in short supply. The underlying cost base of the North American asset management industry has risen almost as fast as revenues. From 2009 to 2014, North American asset managers[2] added a collective $20 billion to their cost base, amounting to an annualized 7 percent increase in costs, versus an annualized 7 percent increase in overall AUM and an annualized 9 percent increase in revenues. While operating margins have improved, costs as a proportion of AUM have ranged between 25 to 27 basis points over the past few years (Exhibit 16).

Some of the rising costs are variable—for instance, performance-related compensation. But a large portion of the industry's incremental costs stems from the increas-

[2] Includes traditional assets only (excludes alternatives).

ing complexity of operating models. As firms bring a more sophisticated range of products to market, enter new geographic markets with distinct requirements around product vehicles, and scale up in legal and compliance resources to meet regulatory demands, their operating models become more complex to keep pace. In addition, a significant chunk of industry costs (an increase of $6 billion compared to 2009) has gone into the sales and marketing arms race, with some firms ramping up sales resources in the face of resurgent flows.

> The efficiency and scalability of an asset manager's operating model will be the critical determinant of whether the growth it captures is sustainable and, perhaps more important, profitable.

Growth in the industry's cost base has important implications for financial performance and strength. As discussed earlier, a majority of the industry's growth has come from market appreciation—the kind of growth that should not have a meaningful impact on costs. If costs continue to increase in parallel with the markets, the gains in assets, revenues and profitability of the past several years could be vulnerable to a market downturn, or just to a pause in the upward climb in asset prices managers have enjoyed for several years.

The efficiency and scalability of an asset manager's operating model will be the critical determinant of whether the growth it captures is sustainable and, perhaps more important, profitable. A sound operating model is one that is designed to carry out a firm's strategy. Building such a model will demand a consistent set of choices across client focus, product platforms, geographic footprint and a firm's operational spine. In the coming years, McKinsey expects new operating model components to include: greater use of remote and digital sales channels, both independently and as a complement to traditional sales forces; a dedicated focus on scalability of product platforms (including ruthless product prioritization and leveraging of cross-border funds to penetrate smaller markets); optimization of geographic footprints; and greater use of outsourced operational and technology resources that effectively "variable-ize" important spend categories.

### 5. Finding opportunities in the rising tide of regulation

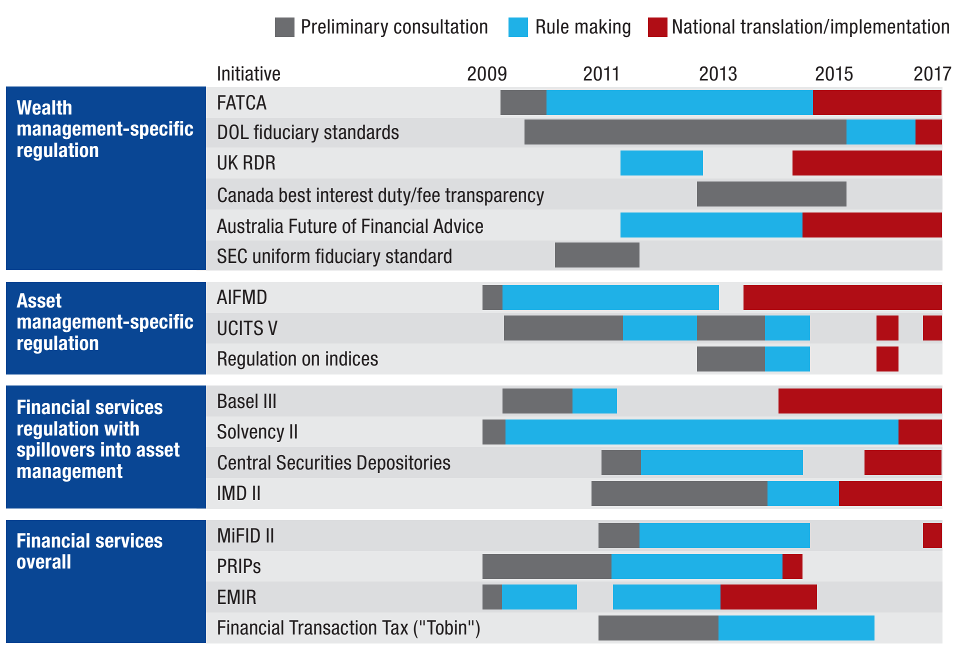
Success in asset management is always subject to the realities of regulation. History has shown that regulation can be both a constraint and an opportunity. Perhaps the best example is the rise of target-date funds, a product with approximately $1.1 trillion in AUM in the U.S., which is expected to generate $600 billion to $700 billion in cumulative net flows in DC alone over the next six years (albeit with moderate yields and concentrated among a few managers). One of the major drivers of the growth in target-date funds was the Department of Labor's regulation regarding Qualified Default Investment Alternatives in 2007, which created a privileged position for investment funds that balanced long-term appreciation and capital preservation through a mix of equity and fixed-income investments and that were managed in a way that took account of the employee's age or retirement date. Managers that moved quickly on this opportunity realized tremendous benefits, as over $400 billion of net new assets flowed into DC target-date funds over the past six years.

To date, the asset management industry has remained a secondary focus for regulators, as added scrutiny and new rules have fallen mainly on balance-sheet-dependent financial institutions that played a more prominent role in the global financial crisis. But the next wave of global financial services regulation is on the horizon, and much of it will impact the asset management industry in both direct and indirect ways (Exhibit 17).

The near-term focus of asset management regulation will likely center on the retail side of the business, given the resurgence of retail flows into the market and broader secular shifts (e.g., the move from DB to DC) that are making the current generation of retail investors the first

Exhibit 17

## The next wave of financial services regulation will have direct and indirect impacts on asset management




Source: McKinsey Global Asset Management Practice to fully own the risks of their retirement. Regulators seem to be focusing on four key areas: transparency in pricing, distributor incentives (e.g., commissions and revenue-sharing), open architecture in key platforms, and a unified set of fiduciary standards in asset and wealth managers' relationships with individual investors. Fund liquidity requirements and broader questions around the implications on market stability of large funds operating in more specialized market segments are also likely to be longer-term areas of focus.

If enacted in their most stringent forms, new regulations could have far-reaching effects on the economics of the asset management industry. For example, the U.S. Department of Labor's proposal to extend fiduciary standards to advice provided to retirement savers could significantly limit the advice that wealth managers will be able to provide to individual investors. Implications could range from incentivizing managers to guide investors into low-cost passive products ("conflict-free" investments) to shifts in retirement plan product line-ups and the DC asset mix, with more assets remaining in employers' retirement plans and fewer rolling over into IRA accounts. On the macro front, more severe regulatory scenarios on fund liquidity could create new sources of "cash drag" on active investment vehicles, further increasing the challenge of competing against passive. Similarly, broader market liquidity guidelines could constrain the growth of passive vehicles in less mainstream markets.

To position themselves for success over the next five years, asset managers will need to significantly step up their regulatory approach. This means going beyond a reactive, compliance-driven approach to rethinking business models and product lineups in order to take advantage of opportunities created by regulatory discontinuities. For many, it will also require a fundamental shift to a more client-centric and fiduciary mindset, which leading firms will embed deeply within their cultures.

■ ■ ■

There is no single best response to the five critical challenges described in this report—and there are many answers that could be "wrong," that is, sub-optimal. The urgent task for North American asset managers is to fully understand the scope and nature of the challenges they face, make clear choices concerning their place in the active/passive spectrum, their approach to distribution, data and technology, operating models, and regulation, and invest with commitment in their chosen path.

# Imperatives for Asset Managers

The core driver of success in asset management may be unchanged: winning firms choose the right spots and play to their own strengths. However, the means of achieving this will evolve in a significant way over the next five years. A winning strategy for 2020 will address a mix of longer-term secular forces (e.g., demographic shifts in developed markets, the rise of emerging markets), medium-term industry trends (e.g., the concurrent rise of alternative and passive investments), and fundamental discontinuities that will create both challenges and opportunities in the near term (e.g., technology and regulation).

Given this confluence of changes across multiple time horizons, asset managers aspiring to industry leadership owe it to themselves and their stakeholders to take a structured approach to building strategic alignment within their organizations to prepare for success in 2020.

Trying to be all things to all people is rarely a winning strategy, and firms are best served by choosing a limited number of areas—say, three to five—where they aspire to be distinctive.

In McKinsey's view, five core steps are essential to the development of a long-term strategy grounded in industry realities and implemented through a set of highly practical initiatives:

- *Agree on aspirations and strategic vision.* As a first step, leadership teams should come to a consensus about their view of the future of the industry with respect to regulation, the evolution of client needs and changes in distribution, and compare this vision with their firm's current path. How well-positioned is the firm to succeed in three years, if no significant changes are made? What are the aspirations for success in the market of the future, and how will success be defined?
- *Assess strengths against market opportunities.* Leadership teams should take a clear-eyed look at which of their core strengths distinguish them in the marketplace, and which capabilities can be developed into strengths in the future. Which market opportunities will be most compelling, and how do these opportunities line up against the firm's current strengths? What new capabilities should the firm incubate and develop, and what implications would these have for the firm's core value proposition?
- *Develop and prioritize future scenarios.* Leadership teams should consider possible market, macro and regulatory scenarios, and their implications for the current business portfolio and firm performance. That is, for each scenario, how does the firm's mix of geographic footprint, product and solution set, target clients and investment skills line up? Where are the biggest opportunities for breakout growth, and are there outcomes that would represent unacceptable risks to the franchise?
- *Make tough choices and trade-offs through resource reallocation.* Leadership teams must make deliberate choices regarding the specific product and segment areas where they will focus. Trying to be all things to all people is rarely a winning strategy, and firms are best served by choosing a limited number of areas—say, three to five—where they aspire to be distinctive. These decisions must be supported by aggressive reallocation of resources. In keeping with the principles of zero-based budgeting, firms should challenge themselves by asking whether they would be allocating resources the same way if they were rebuilding from the ground up.

- *Develop a holistic operating plan that bridges operating platform, governance and culture.* Key questions to consider include: What are the implications of our new strategy for our operating model and talent requirements? How do our current organizational structure and culture need to evolve to meet the demands of our new strategy? Deciding on near-, medium- and long-term priorities must be a focus, along with a strategic roadmap and a clear timeline for making change happen.

Meaningful changes in strategic positioning and operating model will be required for all asset managers aiming for industry leadership in 2020, but there are also several elements of continuity that are critical to building an enduring and thriving firm.

Meaningful changes in strategic positioning and operating model will be required for asset managers aiming for industry leadership in 2020, but there are also several elements of continuity that are critical to building an enduring and thriving firm. A relentless pursuit of excellence in three areas will continue to be fundamental to the success of any firm:

- *Robust investment processes that drive performance.* Leading firms ensure that the design and functioning of their investment engine and its underlying processes are rooted in sources of competitive advantage and that they can deliver for clients in a reliable and repeatable way. Performance matters, but so does consistency.
- *Client-centric sales and servicing capabilities.* Leading asset managers can mobilize across all functions and geographies to meet a set of well-articulated client needs. Success factors include clarity in terms of roles and processes and, just as important, ensuring that the entire organization shares a consistent and appropriate fiduciary mindset.
- *Strength in leadership and talent development.* Asset management has always been a talent-based industry, but leading firms go beyond the classic paradigm of "attracting and retaining" talent to nurturing that talent to reach their full potential. This capability will become even more important in the increasingly globalized asset management landscape of 2020, and leading firms will focus particularly on developing well-rounded cross-functional business leaders.

The North American asset management industry has had a very strong run over the past five years, and the next five will offer continued opportunities for success. However, even the leading firms of today will not be able to coast their way to future performance. Shifts in product preferences, distribution channels, industry regulation and the role of technology are changing the terms of success. Winning firms of tomorrow will recognize the impact of these shifts, and will take the first steps in redesigning their business and operating models for a new industry landscape.

**Pooneh Baghai**

**Onur Erzan**

**Ju-Hon Kwek**

**Fabrice Morin**

*The authors would like to thank Owen Jones, Joseph Lai and Nancy Szmolyan for their contributions to this report.*

## About McKinsey & Company

McKinsey & Company is a management consulting firm that helps many of the world's leading corporations and organizations address their strategic challenges, from reorganizing for long-term growth to improving business performance and maximizing profitability. For more than 85 years, the firm's primary objective has been to serve as an organization's most trusted external advisor on critical issues facing senior management. With consultants in more than 50 countries around the globe, McKinsey advises clients on strategic, operational, organizational and technological issues.

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To learn more about McKinsey & Company's specialized expertise and capabilities related to the asset management industry, or for additional information about this report, please contact:

**Pooneh Baghai**
Director, New York & Toronto
pooneh_baghai@mckinsey.com

**Pierre-Ignace Bernard**
Director, Paris
pierre-ignace_bernard@mckinsey.com

**Onur Erzan**
Director, New York
onur_erzan@mckinsey.com

**Jonathan Harris**
Director, London
jonathan_harris@mckinsey.com

**Martin Huber**
Director, Cologne
martin_huber@mckinsey.com

**Philipp Koch**
Director, Munich
philipp_koch@mckinsey.com

**Alok Kshirsagar**
Director, Mumbai
alok_kshirsagar@mckinsey.com

**Enrico Lucchinetti**
Director, Milan
enrico_lucchinetti@mckinsey.com

**Joe Ngai**
Director, Hong Kong
joseph_luc_ngai@mckinsey.com

**Frédéric Vandenberghe**
Director, Brussels
frederic_vandenberghe@mckinsey.com

**Robert Byrne**
Principal, San Francisco
robert_byrne@mckinsey.com

**Gemma D'Auria**
Principal, Dubai
gemma_dauria@mckinsey.com

**Nick Hoffman**
Principal, London
nick_hoffman@mckinsey.com

**Daniel Gourvitch**
Principal, New York
daniel_gourvitch@mckinsey.com

**Fumiaki Katsuki**
Principal, Tokyo
fumiaki_katsuki@mckinsey.com

**Ju-Hon Kwek**
Principal, New York
ju-hon_kwek@mckinsey.com

**Sebastien Lacroix**
Principal, Paris
sebastien_lacroix@mckinsey.com

**Rogerio Mascarenhas**
Principal, Sao Paulo
rogerio_mascarenhas@mckinsey.com

**Fabrice Morin**
Principal, Montreal
fabrice_morin@mckinsey.com

**Matteo Pacca**
Principal, Paris
matteo_pacca@mckinsey.com

**Sofia Santos**
Principal, Sao Paulo
sofia_santos@mckinsey.com

**Jill Zucker**
Principal, New York
jill_zucker@mckinsey.com

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*Searching for Profitable Growth in Asset Management: It's About More Than Investment Alpha*
**October 2013**

*Defined Contribution Plan Administration: Strategies for Growth in the Challenging Recordkeeping Market*
**April 2013**

# About the Research for This Report

This report is based in part on insights gleaned from McKinsey's "Performance Lens" proprietary knowledge suite, which provides a granular perspective on growth and profitability in the asset management industry.

### Global Growth Cube

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 micro-segments across 44 regions and countries, nine client segments, 12 asset classes, and five product vehicles.

### Global Asset Management Survey

The Global Asset Management Survey is the leading survey of its kind in asset management, with unrivaled coverage (over 300 participants representing 60% of AUM globally and over 100 participants and 75% of AUM in North America), data quality and depth (8,000 business performance benchmarks), and the longest track record in the industry.

Now in its 14th year, the survey helps asset managers assess their operational effectiveness versus relevant peers and identifies actions to improve growth and profitability.

### Sales Alpha

McKinsey's Sales Alpha methodology measures the value-add of sales and marketing (adjusting for investment performance), utilizing a factor analysis of over 10,000 retail and institutional products.

This tool conducts detailed fund-level analyses of gross sales, redemptions and net flow metrics that are aggregated at the channel and company level to help asset managers identify specific opportunities to improve distribution effectiveness and stimulate faster growth.

### Alternatives Survey

McKinsey's bi-annual Alternatives Survey provides detailed insights into alternatives usage of institutional investors by client segment and sub-asset class. In 2013, over 300 institutions, representing a broad range of segments and sizes and collectively managing $2.7 trillion in AUM, took part in the survey.

Additional information regarding McKinsey's proprietary knowledge of the asset management industry is available at www.mckinseyperformancelens.com, or by email at performancelens@mckinsey.com.

Performance Lens
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Financial Services Practice
November 2015

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