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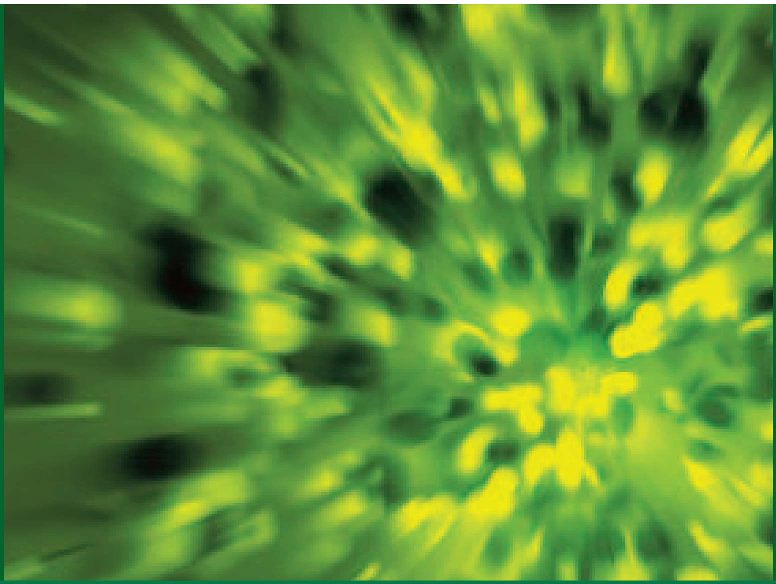

The Asset Management Industry: Outcomes Are the New Alpha

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Introduction

Against a backdrop of renewed market turmoil and ongoing flare-ups in the euro-zone, the North American asset management industry once again displayed a Teflon-like ability to generate robust profits, as evidenced by the results of McKinsey's most recent benchmarking survey. Yet while the average firm delivered 28 percent margins (and the top third 46 percent margins), growth proved elusive to all but the few whose business models and pursuit of major growth trends – including solutions – enabled them to gain share.

Indeed, for all its profitability, the North American asset management industry as a whole has been virtually incapable of attracting new money from its clients over the past four years. Market appreciation is now the lifeblood of the industry – an unstable foundation on which to move forward. Profit levels, meanwhile, remain a full 20 percent below the pre-crisis highs of 2007, with the earnings gap between winning and losing firms growing wider and not explained by differences in scale.

At the same time, the market's growth expectations for asset managers remain exceptionally high: 30 percent of the market value of asset managers is based on expected future profit growth. And therein lies the most difficult challenge for many firms. New McKinsey research reveals that growth opportunities exist, but they continue to be highly concentrated and are now shifting rapidly from the relative performance game that has dominated the industry for decades to three key categories: passive products, outcome-oriented solutions and alternatives. Moreover, since 2007, a handful of focused asset managers have been capturing a highly disproportionate share of flows within each of these fast-growing categories – anywhere from 60 percent to 100 percent for the top 10 firms alone — but with few winning across more than one category. For the remaining firms, the implications are clear: growth remains the greatest priority, and it is increasingly hard to come by.

Traditional means to achieve growth – namely beating a benchmark – are no longer proving sufficient and account for just over one-third of the average asset manager's growth. More critical now is meeting a changing set of client needs, which increasingly means shifting from alpha to outcomes. This report takes an in-depth look at the drivers of the outcome-oriented solutions opportunity and early competitor moves and lays out a series of questions for management teams hoping to capitalize on this growth category.

This report draws on McKinsey's annual benchmarking of North American asset managers, which surveyed more than 100 firms representing $15 trillion (or 65 percent) of assets under management (AUM). (The North American survey is part of a global McKinsey effort that encompassed more than 300 asset managers with $25 trillion in AUM.) In addition, McKinsey conducted dozens of interviews with industry leaders on the topic of solutions. This research revealed the following:

- While overall profitability has been strong for most firms through the cycle (28 percent on average and 46 percent for the top third), deeper structural issues remain. Despite a recovery in assets and revenues, profits remain more than 20 percent below pre-crisis levels, due to increased costs, reduced productivity and lower pricing. And the variance in profitability among firms was not explained by size but rather by focus and operating discipline.
- Net flows have been stagnant across the industry but are now highly concentrated in three areas: passive products, solutions and alternatives, with more than $1.3 trillion flowing into these categories from 2008 to mid-2012. At the opposite end of the spectrum, $400 billion has flowed out of relative return equity funds over the same time frame.
- Within each of the three key growth areas, fewer than 10 players are capturing the majority of the industry's net flows, but there are virtually no triathletes. The vast majority of preeminent players within each category are dominant in that category alone; only a quarter are dominant in two categories; and only one firm is dominant in all three.
- Focused business models – for example, global specialists or retirement specialists – have gained share at the expense of generalist firms that

have spread their bets, often in an unfocused way, and failed to win in any of the big three growth categories.

- Solutions are not only a significant growth opportunity; they have the potential to change the nature of the industry from alpha to outcomes. Retail solutions alone have grown 25 percent annually for the past five years, and McKinsey expects assets to double to $2 trillion within the next five. Institutional investors, particularly sponsors of defined benefit (DB) pensions, are also actively seeking outcome-oriented solutions as they attempt to cope with worsening plan deficits and liability management.
- Most asset management firms have lofty ambitions when it comes to solutions. Eighty percent of firms recently surveyed by McKinsey list solutions as a top three growth priority, and the average firm anticipates that solutions will account for more than one-quarter of flows and 15 percent of profits by 2015. Yet most face capability, credibility and organizational challenges in delivering solutions effectively and have not yet internalized the changes that will turn their ambition into flows.
- Every management team that aspires to leadership in solutions should consider a set of five questions to determine if its optimism about solutions is justified and, if so, the nature of changes required.

The search for growth will be an industry-wide priority. Some firms will find it in alternatives and a fortunate few in passive (see McKinsey's recent reports, *The Mainstreaming of Alternative Investments* and *The Second Act Begins for ETFs*). A number of innovators will find opportunity in the movement toward outcome-oriented solutions. Beyond significant growth – from retail clients that move past their "target date" and institutions looking to match liabilities – solutions have the potential to change the way in which products are designed, money is managed and firms are organized. While leaders of firms are optimistic, the magnitude of change required is as significant as the potential for growth.

The Industry Today: Enviable Profits, Woeful Flows

When it comes to profitability, the U.S. asset management industry continues to be the envy of the financial services sector, with returns and expected profit growth far outstripping those of banking and insurance. In McKinsey's most recent benchmarking survey, average profit margins crept up to 28 percent — enough to match the industry's 10-year average. Profits as a percentage of AUM, meanwhile, remained unchanged at 9 basis points.

A widening profit gap not explained by scale

Averages can hide as much as they reveal. In this case, the overall industry's return to more normal levels of profitability in 2011 is concealing a widening profit gap between individual winners and losers. McKinsey research shows that the top one-third of asset managers earned an average margin of 46 percent in 2011, a disparity that was more pronounced than that of the previous year (Exhibit 1, page 6).

Contrary to conventional wisdom, the profit discrepancy among industry players was not attributable to differences in firms' overall scale (Exhibit 2, page 6). Rather, the variance is a direct consequence of the decisions firms have made in such crucial areas as business model, product scale, operating discipline and targeting of growth opportunities.

Profits remain well below pre-crisis highs

Despite average AUM almost returning to pre-crisis levels in 2011, overall industry profit pools nonetheless remained 20 percent below 2007 highs

Exhibit 1

Profitability has improved slightly to 28%, but with a widening gap between top-tier and average firms

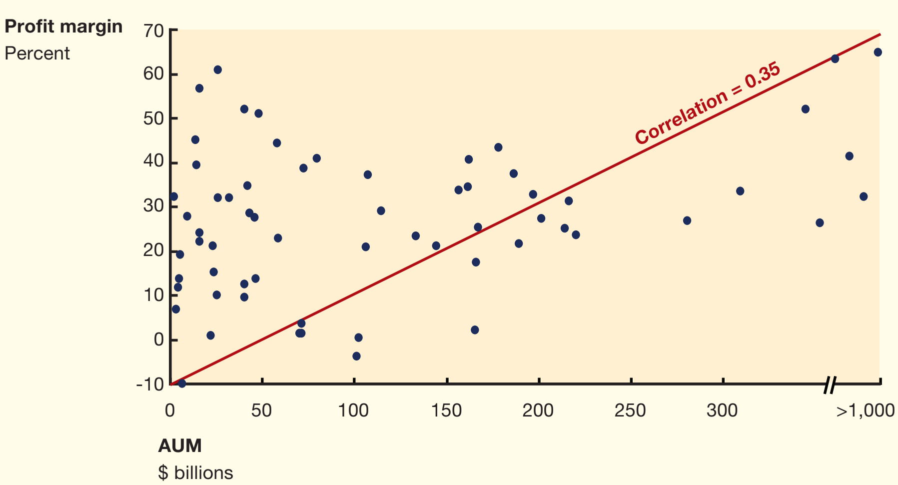
Pre-tax profit margin for asset managers in the survey
Percent of revenues

Source: 2012 McKinsey North American Asset Management Benchmarking Survey

Exhibit 2

Variance in profitability among firms is not explained by overall scale

Pre-tax operating margins versus AUM for North American asset managers

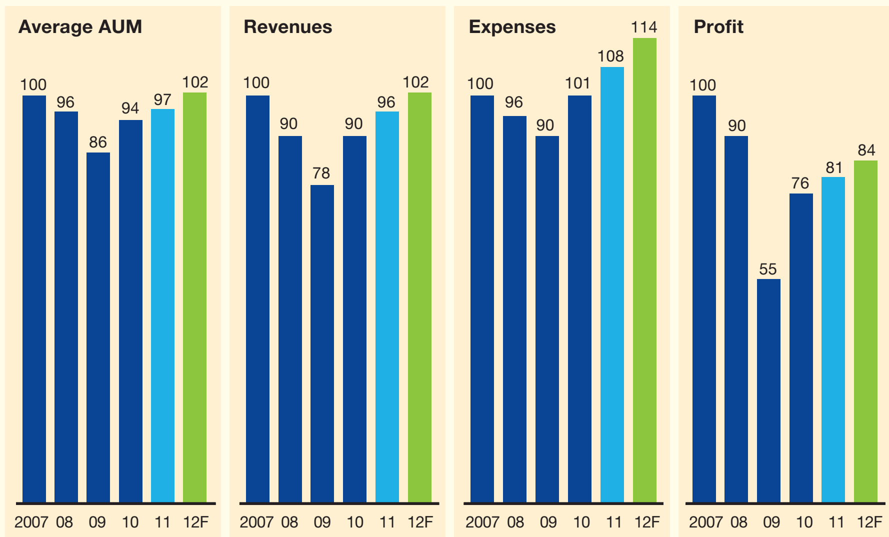


Source: 2012 McKinsey North American Asset Management Benchmarking Survey

Exhibit 3

Operating profits remain 20% below 2007 peak levels

100 = 2007 results indexed



Source: 2012 McKinsey North American Asset Management Benchmarking Survey

(Exhibit 3). This was largely due to escalating costs, reduced productivity and lower pricing. Even when assets peaked in early 2011, overall profit levels remained badly depressed relative to 2007. Here again, the current recovery lags when compared to the last market cycle that began in 2002, when the rebound in industry profit margins was considerably sharper.

The second half of 2011 saw the worst equity flows since the market's huge sell-off in 2008 through early 2009. Core asset classes/vehicles in particular have been under pressure, with lower-priced passive investments taking market share from actively managed funds. Moreover, McKinsey research shows that most retail asset managers believe distributors are poised to capture an increasing share of asset management revenues over the coming years. With market turbulence persisting into 2012, asset managers have reason to be cautious about their growth prospects. And indeed, most expect minimal profit improvement for 2012.

Pricing pressures continue

Revenue yields (net revenues over AUM) nudged up slightly in 2011, but this was due to shifts in mix rather than improved pricing power. In retail asset management, net revenue yields increased to 48 bps in 2011. That is still nowhere close to the 59 bps earned early in the last market cycle, and this year's increase masks continually declining prices on several core asset classes over the past five years.

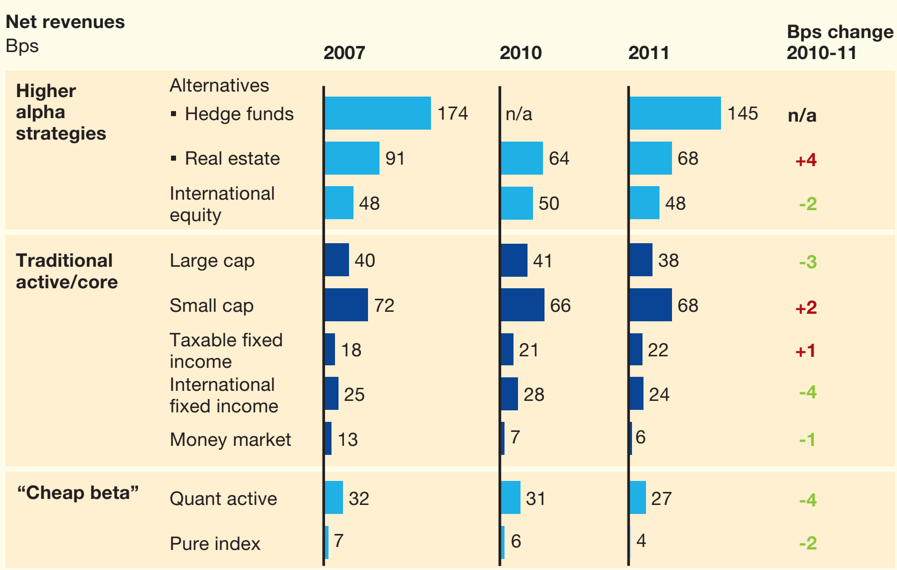
On the institutional side, average net revenue yields were 36 bps in 2011. While overall yields benefited from a slight shift toward alternative products, institutional prices have been flat or declined since 2007 in all core or traditional asset classes except taxable fixed income (Exhibit 4). Asset classes that saw the most significant price declines in 2011 were quantitative active and international fixed income, both of which dropped by 4 bps in 2011, followed by large-cap funds, which declined by 3 bps. Looking forward, McKinsey expects prices in institutional to remain flat, driven by the continuing funding challenges of pension sponsors.

Asset managers' costs inched higher

In most industries, increased pricing pressure typically serves as a spur to rein in costs. That does not appear to be the case in the asset manage-

Exhibit 4

Prices for most institutional products continued to decline



Note: Not all asset classes listed

Source: 2012 McKinsey North American Asset Management Benchmarking Survey

ment business. Average costs (excluding revenue sharing and transfer agency expenses) over AUM increased by one bp in 2011 to 28 bps. And firms, on average, experienced negative operating leverage, as costs increased faster than revenues (Exhibit 5). Costs swelled by 7 percent in absolute terms in 2011, with the fastest increases coming in sales and marketing and operations. Investment management costs, which account for one-third of the typical asset manager's cost base, rose by 7 percent due mainly to higher compensation expenses. Looking ahead, a major structural challenge for asset managers is that costs have continued to grow faster than both assets and revenues every year since the financial crisis.

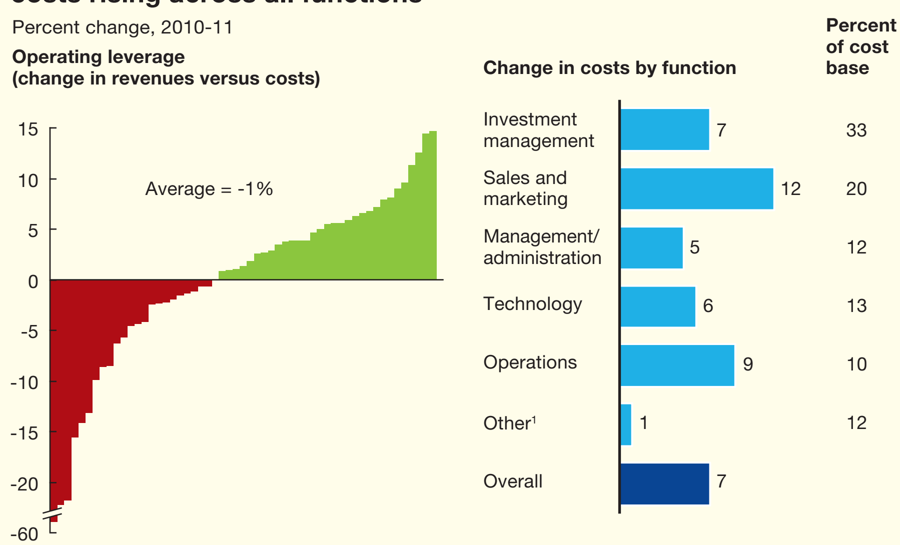
A dwindling ability to gather assets

In recent years, the performance of the U.S. asset management business has painted a rather contradictory picture. The most lucrative industry in the financial services sector has been virtually incapable of collecting new money from its clients, despite significant increases in personal savings rates.

Exhibit 5

Many asset managers experienced negative operating leverage, with costs rising across all functions

Percent change, 2010-11



[1] Includes occupancy, legal, non-sales-related T&E, and other general expenses (e.g., insurance, temp)

Source: 2012 McKinsey Asset Management Benchmarking Survey

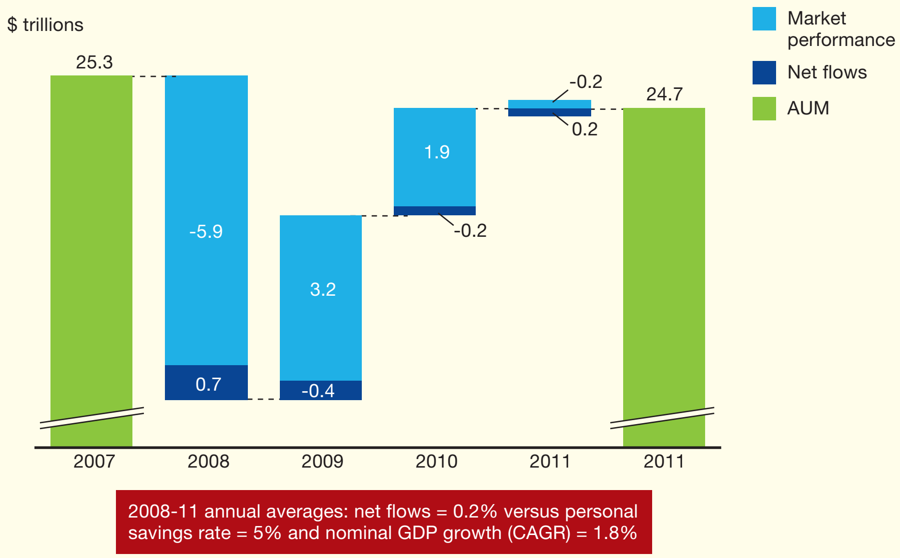
The situation in 2011 was no exception. While profit margins rose, growth in AUM nonetheless came to a standstill, as tailwinds from market appreciation lost strength (Exhibit 6). And net inflows increased to a paltry 1 percent in 2011, half the growth rate of the overall economy. Market appreciation is now the lifeblood of the industry — clearly, an unstable foundation on which to move forward.

Without question, the financial crisis and ongoing market turmoil have shaken investor confidence and are contributing to the industry's poor flow performance – in North America and globally. Still, the current state of affairs is a far cry from the recovery cycle that began in 2002, after the market had suffered a similarly devastating collapse. Then, growth in net flows in North America ranged from 3 percent to 5 percent, helping to fuel the industry's rebound.

Beyond market turbulence, another factor is at play: the continuing encroachment of new competitors into traditional asset manager turf. A host of outside players, including insurance companies, investment banks, hedge funds and private equity firms are now playing much broader roles for retail and institutional investors alike. Many insurers, for instance, are now gearing

Exhibit 6

Market performance is accounting for virtually all asset growth in the U.S.



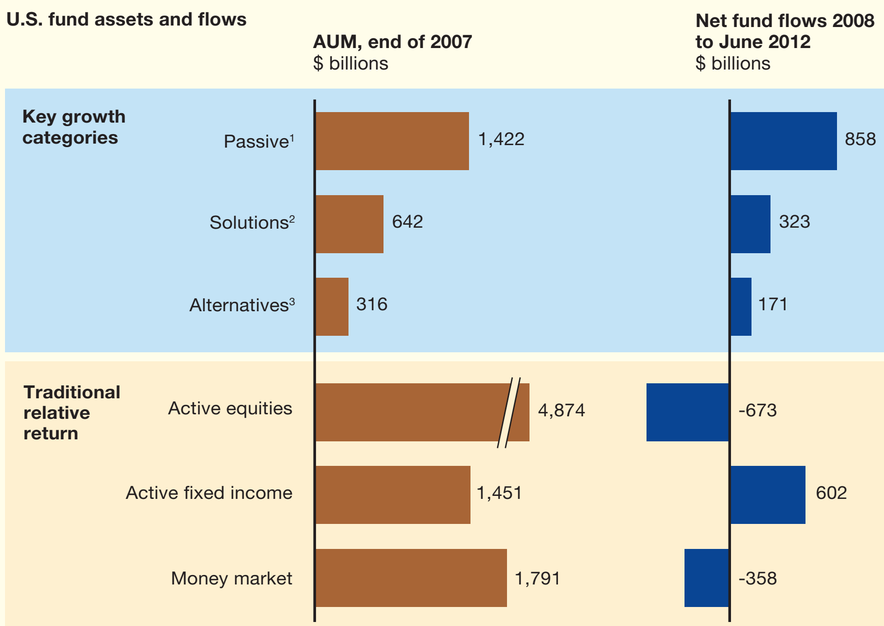
Source: McKinsey Global Asset Management Database up to take aim at the assets of the 70 million-plus baby boomers headed for retirement, with new principal-protection and risk-mitigation products. Ongoing financial turmoil and market volatility have led many investors to temporarily de-risk their portfolios. While the extent to which they will ultimately re-risk remains to be seen, these new investment vehicles have the potential to be significant competitors for future flows.

Concentrating Growth, With a Handful of Winning Firms Pulling Away

There is little question that the asset management industry's historic emphasis on relative performance has served the majority of players well over the years. But that is rapidly changing. Industry flows are increasingly moving away from traditional relative return funds and toward three growth areas: passive products, solutions and alternatives. More than $1.3 trillion flowed into these categories from 2008 to mid-2012 — a stark contrast to the $670 billion in outflows from relative return equity funds over that same time frame (Exhibit 7, page 14). And while relative return fixed income funds did garner positive flows in the wake of the financial crisis (as investors de-risked their portfolios), money is likely to start rotating out of this category as economic conditions and investor confidence improve and as low interest rates and retirement trends magnify the need for returns. Passive products, solutions and alternatives should be the primary beneficiaries.

Exhibit 7

Net flows are shifting away from traditional relative return equity funds, while fixed income has benefited from the financial crisis



[1] Includes index and ETFs

[2] Includes target date/risk, tax managed, inflation protected bonds (TIPS), principal protected & 529 college savings (all in single funds or fund of funds)

[3] Includes 130/30, long-short, market neutral, leveraged, inverse/dedicated short bias, real estate, commodities and precious metals, natural resources and energy, options arbitrage, absolute return, volatility, multi-alternative and miscellaneous trading strategies including currency trading

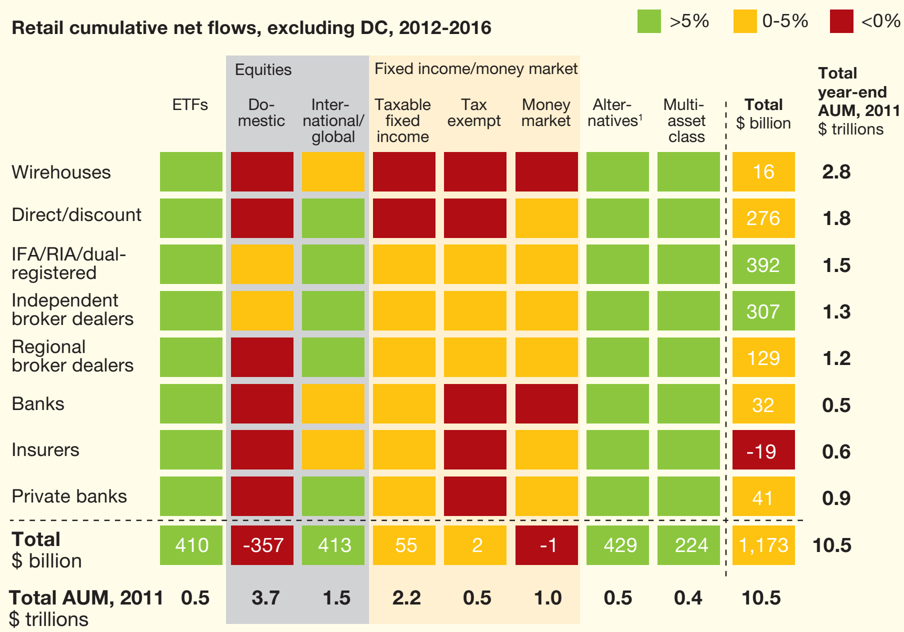
Source: Strategic Insight Simfund

The drivers of the shift away from relative return to passive products, solutions and alternatives are both powerful and multifaceted. Within the passive category, ETFs have democratized access to an array of asset classes and strategies, such as commodities and foreign currencies, that were once too expensive and impractical for retail and small institutional investors to own. They are also revolutionizing the way retail advisors work with clients, replacing the stock-picking advisor of the past with the "ETF asset allocator" of today. ETFs have been the most consistent growth category in the industry over the past decade, and that growth should continue, due in large part to a new preference for ETFs among fee-based, independent advisors, who constitute one of the fastest-growing channels within retail. McKinsey estimates that by 2015 more than $1.6 trillion of new money will flow into ETF products.

Exhibit 8

Retail flows will likely continue to be concentrated in ETFs, alternatives and multi-asset solutions, and in the independent channel

Annual net flows 2012-16
Percent of year-end 2011 AUM



[1] Excludes ETF assets

Source: Cerulli Associates; Strategic Insight; Investment Company Institute; EBRI; Federal Reserve Flow of Funds; LIMRA; Benefits Canada: *Pensions & Investments*; McKinsey analysis and estimates

Ongoing market turmoil has made alternatives — including hedge funds, private equity and structured products — appealing to both individual and institutional investors. Products that incorporate hedging and volatility management are particularly attractive to individual investors and have been strong performers within the retail channel in recent years, where they now account for almost 10 percent of total U.S. retail fund assets. Over the next four years, retail alternatives should collect more than $400 billion in net new flows (Exhibit 8).

Solutions, broadly defined as products engineered to help clients address specific opportunities or needs, have quickly gained traction in the asset management industry. A host of structural and cyclical forces are driving the growth of solutions, including poor market performance through the financial crisis, prolonged low interest rates, global monetary easing and high volatility in equity markets. Playing a particularly strong role in the increasing demand for solutions are two major shifts in the needs of institutional and retail clients. First, many sponsors of DB pensions are now actively seeking outcome-oriented solutions in lieu of relative return products, as they attempt to de-risk their plans and smooth out the impact of DB pensions on corporate cash flow and earnings.

On the retail front, some 70 percent of all investable assets within the next five years will be controlled by retirees and near-retirees who are reaching their "target dates." As a result, they are increasingly seeking out solutions like income generation and principal protection. In the retirement market, for example, flows into defined contribution (DC) will likely be almost exclusively concentrated among providers of solutions products, particularly target-date funds. These firms should gain over $1 trillion in assets over the next five years, with net new contributions into DC almost fully offsetting outflows from retiree rollovers.

Winners are emerging within each critical growth category

Just as growth is highly concentrated in passive products, solutions and alternatives, so too are the firms that have been able to capitalize on these opportunities. Within each of the three key growth categories, just 10 industry players have captured anywhere from 59 percent to 100 percent of net fund flows from 2008 through mid-2012 (Exhibit 9). Combined, these firms have garnered practically all of the net fund flows accruing to the asset management industry over the past few years.

That said, few firms are winning across multiple growth categories. Indeed, only one firm in the funds universe holds a top 10 flow position in all three categories. The vast majority of preeminent players in each crucial growth category have targeted specific trends and are dominant in that area alone.

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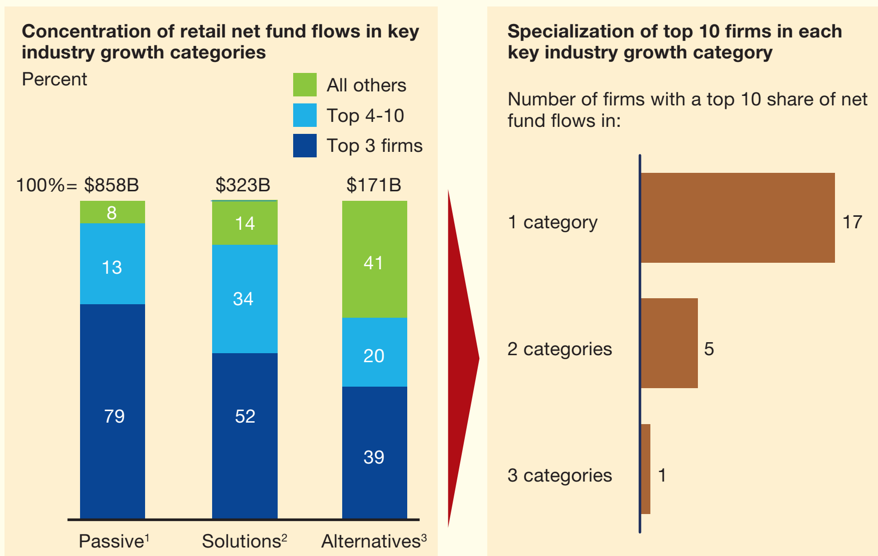
Business model — not investment performance or size – is the main driver of growth for winning firms

So who are the winning firms in each of the three crucial growth categories? Many are smaller, focused competitors who use their scale and expertise in specific investment strategies to drive distinctive performance and flows.

Exhibit 9

Winners are emerging in each of the key growth categories, with few firms winning across multiple categories



[1] Includes index and ETFs

[2] Includes target date/risk, tax managed, Treasury Inflation-Protected Securities (TIPS), flexible funds, principal protected & 529 college savings, single funds and fund of funds

[3] Includes 130/30, long-short, market neutral, leveraged, inverse/dedicated short bias, real estate, commodities and precious metals, natural resources and energy, options arbitrage, absolute return, volatility, multi-alternative and miscellaneous trading strategies including currency trading

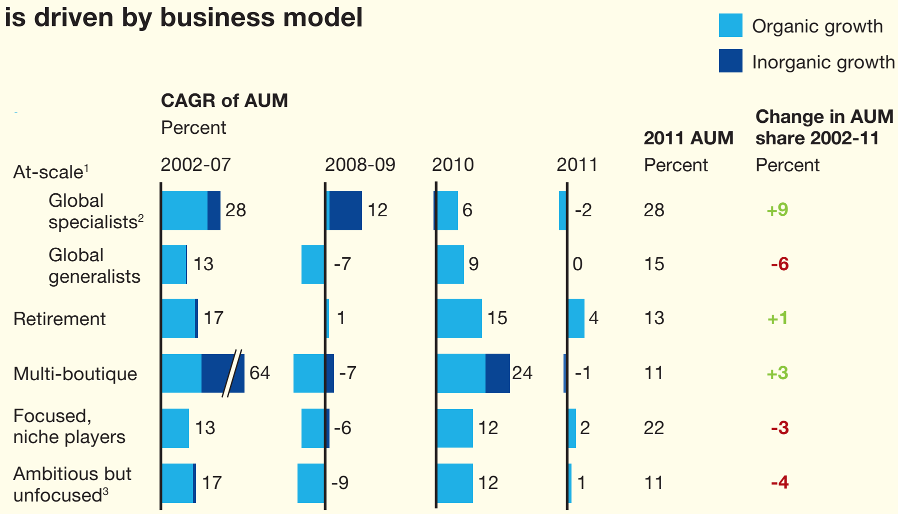
Source: Strategic Insight Simfund

Several of these winning players are among the industry's largest, but they are leveraging more than their size. They are also pursuing business models that greatly enhance their growth prospects, as McKinsey benchmarking research has proven consistently over the years. Indeed, the firms winning across two or more growth categories tend to be large-scale specialists, with a predominant subset consisting of retirement specialists. Most of the firms winning in two or more growth categories are focused on solutions and alternatives.

Across the industry in general, McKinsey research has shown that investment performance, while obviously important, has explained a relatively small portion (just over one-third) of net new flows over the past decade. In fact, none of the industry's growth leaders had the best investment performance. Instead, firms with superior net flows delivered solid and consistent returns for their investors, while simultaneously pur-

Exhibit 10

The ability to capture growth opportunities is driven by business model



[1] At-scale asset managers had more than $300 billion in AUM in 2002.
[2] Global specialists and focused, niche players had more than 65% of AUM in a single asset class (equities, fixed income or alternatives) in 2002
[3] Ambitious but unfocused firms are companies that are not specialists, at-scale or multi-boutiques
Source: Institutional Investor Top 300 asset managers; McKinsey analysis

suing specific business models that produce a growth advantage unrelated to size (Exhibit 10).

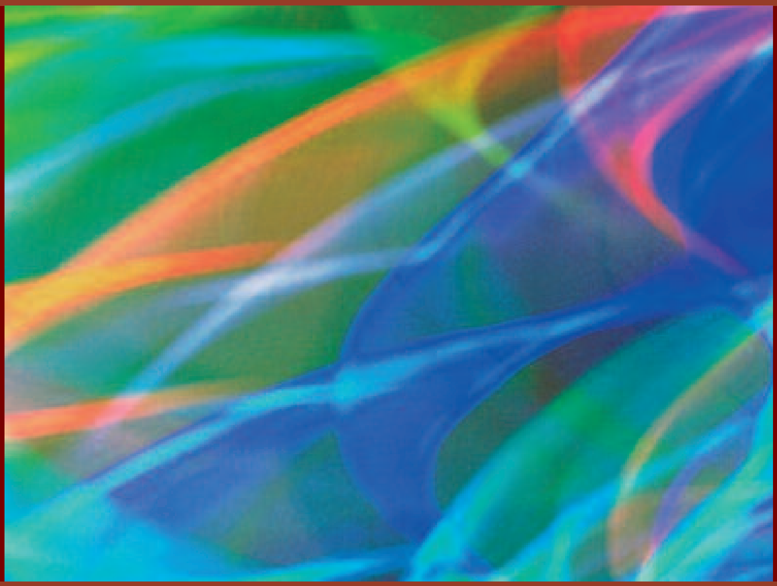
As detailed in McKinsey's 2011 report, *Growth in a Time of Uncertainty: The Asset Management Industry in 2015*, these winning firms possess the following characteristics:

- At-scale global specialists (firms with AUM greater than $300 billion and more than 65 percent of AUM in one asset class such as equities, fixed income or alternatives) were able to grow before, during and after the financial crisis, and, as a result, have captured significant AUM share. These firms tend to have the most global focus and have been more profitable than other models.

- Retirement specialists (firms focused on retirement, including recordkeeping platforms), such as at-scale specialists, grew during all three periods of the last decade. These firms have clearly benefited from consistency and scale of flows into the DC and IRA market, default target-date options (which drove proprietary flow) and a steady focus on a particular client need.

- Multi-boutiques (firms owned as a multi-boutique holding structure) significantly increased their share of AUM over the past decade, fueled in large part by M&A and their ability to grow in emerging products and regions ahead of competition. These firms also continued to deliver superior profitability.
- Focused, niche players (firms with AUM less than $300 billion – typically $50 billion or less – and more than 65 percent of AUM in a single asset class) have shown less impressive growth overall than their larger peers, but this is highly variable depending on an individual firm and its products. Of all the business models, focused, niche specialists are most dependent on superior investment performance to drive flows.

Almost none of the winning firms are "generalists" — and particularly not ambitious but unfocused firms with AUM less than $300 billion and no particular asset class focus. Roughly one quarter of all firms in the industry belong to this latter group, which has relied almost entirely on organic rather than inorganic growth. As noted in past McKinsey papers, firms that attempt to do too much with too little, rather than make focused, realistic strategic choices, inevitably falter. In an environment where solutions-based investments continue to take on more importance, generalists will have some of the biggest strategic questions to address about their models and focus.



Outcomes Are the New Alpha

A defining characteristic of the asset management business is the dominance of the "relative performance" game. Industry players are constantly striving to squeeze out every extra basis point of alpha, like Formula One drivers pushing their vehicles to the limit. Increasingly, though, their clients would prefer to ride in sturdy SUVs instead of race cars. Retail and institutional clients alike are starting to shift away from high-octane performance in favor of more assured outcomes — like not outliving their money or containing their pension costs. In short, these investors just want to get from Point A to Point B, and are looking for a vehicle that will get them there safely and efficiently.

Winning asset managers are already breaking away from the pack and offering investment solutions, generally defined as a range of products and strategies aimed at helping clients achieve specific goals. In the process, they are tapping into an enormous source of future growth.

Structural and cyclical forces are driving the growth of investment solutions

Powerful forces are driving the rapid growth of investment solutions. Topping the list is the market's dismal performance throughout the financial crisis. Avoiding a repeat of 2008's devastating losses is a top priority for retail and institutional investors across the board. And legions of investors simply cannot afford to bear the brunt of another "lost decade" of equity returns, as many did from 2000 to 2010 when the S&P 500 produced a total return of -1 percent. With Treasury yields now hovering near historic lows, these clients are actively seeking ways to preserve capital while still generating income.

Adding to investor angst is persistently high volatility amid ongoing global financial turmoil. One-quarter of all trading days in 2011 saw the S&P 500 rise or fall at least 2 percent within a single session, compared to only four such days in 2006. Meanwhile, unprecedented monetary easing by central banks around the world has led to even more market and economic uncertainty and caused investors to search for inflation protection solutions, including real assets like commodities and real estate.

Unlike the generation that came before them, baby boomers are heading en masse to their "target dates" without significant DB pensions.

On the retail front, some 70 percent of all investable assets within the next five years will be controlled by retirees and near-retirees who are reaching their "target dates." As a result, they are seeking out solutions like income generation and principal protection.

Importantly, these forces are converging in the context of a major demographic shift towards retirement, driving the need for new solutions to help individuals meet their capital preservation and income requirements. Unlike the generation that came before them, baby boomers are heading en masse to their "target dates" without significant DB pensions. As a result, they alone own the risk of outliving their retirement savings. Worse still, these investors must shoulder that risk in an environment of rock-bottom yields and income-generating options that are not sufficient for their needs. And they are understandably cautious, given the drubbing they've taken from equity markets in recent years.

Because retirees and near-retirees will control such a large share of retail assets, their needs will define the market. On the institutional side, meanwhile, the continued underfunding of DB pension plans is driving the need for solutions to reduce volatility and produce greater consistency of returns. More and more, both retail and institutional clients are turning to absolute return products in the hopes of fulfilling their objectives.

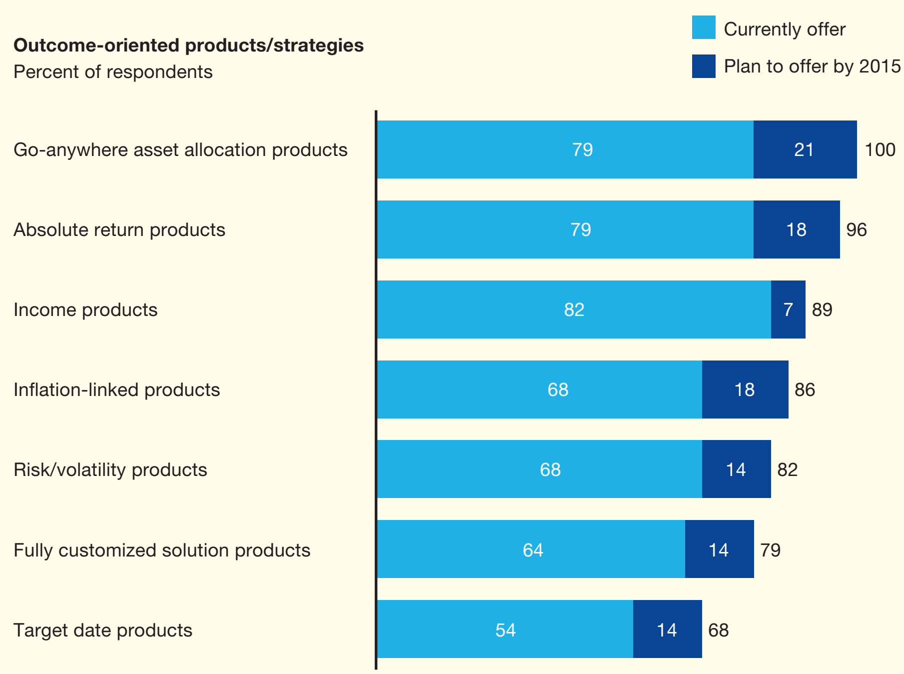
The asset management industry has already begun a fundamental shift to offering outcome-oriented solutions. Most firms have an offering of some kind — including inflation-linked strategies, target volatility products that offer downside protection, "go-anywhere" funds that can invest in virtually any asset class, and fully customized investment solutions (Exhibit 11). But, while virtually every asset manager has a solutions offering, most face serious challenges when it comes to delivering solutions effectively.

The new challenge: Solve for what happens after the "target date"

Over the next five years, as millions of boomers transition out of the workforce, the largest opportunity in asset management, by far, will be the $400 billion of net flows from DC to IRA rollovers. As a result, the demands of mil-

Exhibit 11

Most asset managers are gearing up to offer absolute return, multi-asset/"go-anywhere" and income products and strategies



Source: 2012 McKinsey North American Asset Management Benchmarking Survey

lions of investors are shifting dramatically, from an almost exclusive focus on savings and accumulation to a much heavier emphasis on income generation and principal protection — after all, retirees can't spend a benchmark.

Retirement-oriented solutions are, of course, already a major business for many asset managers. Target-date funds, for instance, have exploded over the past decade, and at $371 billion represent one of the largest single asset classes in the industry. But target-date funds have not always lived up to their promise. Some underperformed during the financial crisis and exposed investors, especially those on the verge of retirement, to a far higher degree of risk than they had anticipated. As a result, the basic outcome —accumulating sufficient savings on which to retire — was not achieved.

Moreover, for retirees, another crucial challenge looms: namely, what happens once they reach the target date? The solution to that problem is even more pressing given today's low-rate environment. In a world where 10-year Treasury yields are below 2 percent and the average investment-grade corporate bond is yielding less than 4 percent, traditional fixed-income portfolios simply do not work for today's retirees. A 65-year-old retired couple with a combined $1 million in savings (far above the norm) and a portfolio fully invested in fixed income would, optimistically, be living on $25,000 a year — hardly enough to maintain their living standard in retirement, absent a significant DB benefit.

To address these and other consumer needs, asset managers are increasingly offering solutions that cut across current style and asset class categories, marketing specific outcomes that not only address target retirement dates, but also individuals' exposure to risks including volatility, longevity and inflation. Retail investors have already exhibited a robust willingness to purchase them: the annual growth rate among outcome-oriented solutions has averaged 25 percent over the past five years (Exhibit 12). Advisors have also indicated an increasing preference for solutions-based products and are using them as an important component in portfolio construction.

This trend will continue unabated, and McKinsey estimates that assets for retail outcome-oriented solutions will more than double over the next five years, to $2 trillion.

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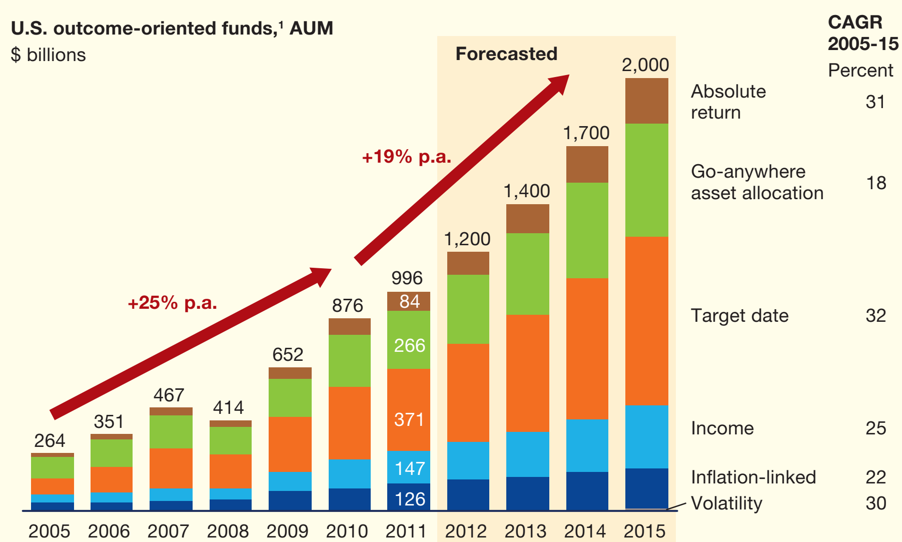
Pension reform is spurring the institutional need for solutions

The de-emphasis of relative performance and focus on outcome is not restricted to the retail market. Even before the financial crisis roiled markets, institutional investors had begun to employ fundamentally different approaches to asset allocation and performance measurement. In particular, many sponsors of DB pensions are actively seeking outcome-oriented solutions, as they attempt to cope with worsening plan deficits amid a persistently low-return environment and volatile equity returns.

Only five years ago, the corporations controlling some $2 trillion in DB assets pursued astonishingly similar asset allocations, with long-only equities comprising almost two-thirds of the typical portfolio. But changes to accounting and funding rules since then have forced corporate DB sponsors to radically adjust their thinking on portfolio construction, with an emphasis on de-risking. Among other things, DB pension plans must now be 100 percent funded, with most sponsors getting only seven years to make up any existing shortfall. And the ability to average the value of pension assets and liabilities over long time horizons has been sharply curtailed. The upshot: far more volatility for corporate cash flow and earnings.

Exhibit 12

In retail, outcome-oriented mutual funds have been growing strongly



[1] Includes passive and active solutions products

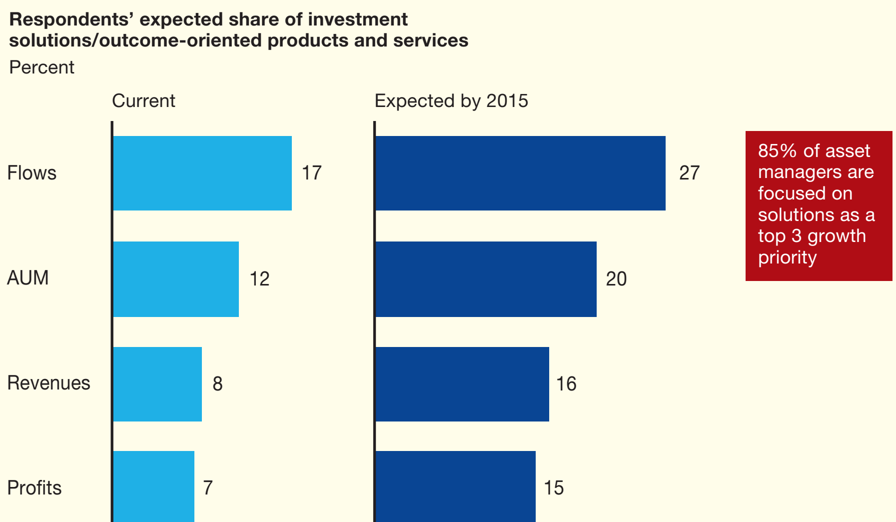
Source: Strategic Insight; SimFund; eVestment Alliance; McKinsey Wealth Management, Asset Management and Retirement Practice

Companies have been moving quickly to mitigate these risks. In 2011, almost one-quarter of all Fortune 1000 corporations sponsored a frozen pension plan, up from only 7 percent in 2005. Once a symbol of troubled businesses, pension freezes are being initiated today mostly by healthy corporations. Meanwhile, the average equities allocation of large plans had dropped below 40 percent by the end of 2011. The need to reduce risk is leading many institutional investors to increase their use of investment solutions. For example, plans' use of liability-driven investing — which describes a range of strategies, from extending the duration of bonds in a plan's portfolio to matching the size and timing of each liability to payment — has tripled over the past five years, to more than 60 percent.

Beyond liability-driven investing, plan sponsors are adopting entirely different approaches to portfolio construction. Risk management solutions, using derivatives and balance sheet capabilities, are starting to become just as important as long-established asset management products. For asset managers, one message is clear: in a market where asset growth is almost nonexistent, the gains accruing to players who can provide those solutions will come at

Exhibit 13

Asset managers expect investment solutions will represent one-quarter of flows and 15% of profits by 2015



Source: 2012 McKinsey North American Asset Management Benchmarking Survey

the direct – and probably permanent – expense of those who fail to do so over the next three to five years.

Asset managers have lofty ambitions for solutions, but challenges persist

Most industry players have lofty ambitions when it comes to the solutions space. Three-quarters of asset managers recently surveyed by McKinsey anticipate that outcome-oriented investment solutions and products will grow faster than traditional products. Survey respondents further expect solutions to account for more than one-quarter of flows and 15 percent of profits by 2015 (Exhibit 13). In line with these expectations, 85 percent of asset managers consider investment solutions a top-three strategic priority and are investing heavily to build these capabilities.

But while virtually every asset manager has a solutions offering of some kind, most face capability and credibility challenges in their efforts to deliver investment solutions effectively (Exhibit 14). For instance, the business models of many asset managers operating in the DC space are still firmly rooted in ac-

Exhibit 14

Asset managers face capability and credibility challenges in their efforts to deliver investment solutions

Challenges faced in offering investment solutions and outcome-oriented products
Percent of respondents

Source: 2012 McKinsey North American Asset Management Benchmarking Survey

cumulation mode, rather than on developing a suite of solutions geared to retirees who have already passed their target date. Some have developed complex retirement investment solutions but have underinvested in marketing them to financial advisors and retail investors, where 70 to 80 percent of the rollover money is flowing. A key issue is the capability of the sales force to sell solutions products.

At the individual advisor level, many firms must move to a more consultative sales model that involves less focus on pure relationship management and more time spent in specific discussions around particular solutions that could help advisors adapt their book to changing consumer needs. Making matters more difficult, we are already seeing a strong tendency among individual financial advisors to concentrate their purchases. McKinsey research indicates that the average advisor currently allocates almost two-thirds of his or her assets to only three fund families.

For the financial firms serving DB sponsors, winning players will need to develop and continuously refine segmentation tools to identify those plan sponsors interested in their particular solutions. These firms will know which DB sponsors warrant the most attention and will manage those relationships more thoughtfully and profitably. The sale itself must also shift from a product-centric approach to a more CFO-level, consultative dialogue around the pension plan's risk-return tradeoff within the context of the overall balance sheet.

As consumers become much more interested in products that contain risk-mitigation features, insurance companies – with their large balance sheets and risk management expertise – could become formidable competitors or potential partners.

Asset managers looking to gain a significant foothold in the solutions space also face challenges when it comes to investment and risk management capabilities. As consumers become much more interested in products that contain risk-mitigation features, insurance companies – with their large balance sheets and risk management expertise – could become formidable competitors or potential partners. Indeed, several have already begun to market products to address these risks. Some insurers are now offering so-called "longevity insurance," for example, a product which guarantees a stream of income starting at a specified future age, in return for a relatively modest lump-sum payment today. Insurers are likely to accelerate the pace of new product development along these lines over the next few years.

Beyond the issues of capability and credibility, the majority of asset managers are also not yet sure about how the economics of providing solutions will play out for their individual businesses. This analysis will clearly be a management imperative for firms moving forward.

Three approaches for success in the solutions space

As already noted, institutional investors like DB sponsors have begun to dramatically adjust their thinking around portfolio construction. McKinsey has identified three distinct approaches that have emerged for asset managers seeking to engage with those investors and compete in the solutions space.

Holistic solutions providers cater to the needs of sponsors and others who are looking for more wide-ranging strategic advice, customization and support that spans the spectrum of asset classes. These asset managers typically offer large suites of investment solutions, including CIO fiduciary solutions, across all asset classes. They will work to form strategic partnerships with institutional investors, bundling advisory services and investment management.

Product-driven solution providers, on the other hand, offer minimal advisory or solution design. Instead, they will generally offer multi-asset class, prepackaged solution products designed for a large customer base. Target-date funds are one high-profile example.

Finally, *asset class specialists* focus on delivering alpha, to be used as sleeves within specific solution strategies. For example, these asset managers might provide some of the components embedded into target-date funds.

Winning in the Era of Outcomes: Imperatives for Management

Beyond their growth potential, solutions will change the way money is managed, products are developed and marketed, and firms are organized. Accordingly, more than 80 percent of asset managers place solutions among their top three growth priorities. However, few have internalized the changes necessary to succeed. To win in the solutions arena, management teams must begin by asking five questions:

1. What is the magnitude of our growth ambition in solutions?

The average firm expects its solutions business to deliver more than a quarter of their flows and one-sixth of revenues by 2015. What portion of our overall growth will come from solutions in the next three to five years and where will that put us relative to both market growth potential and our competitors? Do we seek to be a holistic solutions provider or a niche player in certain products?

2. Do our investments of time, money and talent match our growth ambitions?

While most firms have lofty ambitions in solutions, many are stuck in legacy resource allocation decisions, with the result that their investments are not supporting their ambitions.

3. What specific client problems are we seeking to solve and in what innovative way are we addressing and marketing to client needs?

The underlying driver of solutions growth is a shift in client demand, but firms often under-invest in understanding client needs (especially in retail) and packaging them in a way that resonates with consumers and their advisors. As a result, there are hundreds of failed “me-too” products, myriad “solutions” in search of an ill-defined problem, and many great products that fail to be understood (and bought) by consumers. What is our firm doing to avoid this risk?

4. Should our investment function shift more significantly from alpha to outcomes?

While most firms have some form of multi-asset solutions group, investment functions are still largely organized and incented on beating relative-return benchmarks. But client needs are moving on, with profound implications for how money is managed. Should portfolio managers be organized and compensated by client outcome (e.g., income generation, inflation protection) rather than outperforming an asset class? How can portfolio manager behavior more closely track the shift in client need?

5. Is our firm willing to become an asset *and* risk manager in pursuit of our solutions strategy?

Developing holistic solutions will often require firms to manage not just assets but also the risk from guaranteeing income, preserving capital, and managing volatility and longevity. Often, the ideal client solution is neither a pure asset management product nor a classic insurance product but a hybrid. Pursuing this hybrid will require firms to decide whether and how they want to manage certain risks (e.g., internally, with partners) and how they will be compensated for them.

* * *

Despite volatile and uncertain markets, the asset management industry – including average firms – has proven again to be a dependable generator of high profit margins. Growth, however, continues to elude all but a few firms, for whom growth has been less about size or beating a benchmark, and more about investing, innovating and executing behind one or two major growth themes. Similarly, more than 80 percent of firms are pursuing solutions as a top priority, but few have meaningfully reallocated their investment spend and fewer still have begun to retool their business models to meet the shift in client needs.

The shift in models will not be immediate, especially for an industry cushioned by strong profitability and decades of focus on alpha rather than outcomes. But the shift in demand toward solutions will be lasting and significant. Those that embrace outcomes as the new alpha may well find that they are laying the foundations of a more modern asset management firm.

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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 80 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 40 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:

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September 2010

2012 McKinsey North American Asset Management Benchmarking Survey

This report is based in part on McKinsey's 11th annual economic benchmarking survey of North American asset managers, the largest and most comprehensive survey of its kind, encompassing more than 2,000 business performance metrics. In 2012, more than 100 firms took part in the survey, representing $15 trillion, or 65 percent, of North American AUM. In addition, the leaders of 30 firms participated in a survey and interviews on the growth of solutions. The North American survey is part of a global McKinsey effort that included a record 300 firms worldwide with over $25 trillion in AUM.

The McKinsey Asset Management Growth Cube

Asset growth and profitability vary greatly across the major regions of the world, reflecting fundamental differences in market maturity, industry structure and regulatory frameworks. To provide insights at the geographic/regional, client segment and asset class/product level, McKinsey has developed a global growth model that analyzes asset growth, flows, revenues and profitability along each of these dimensions.

Overall

Approximately 1,000 datapoints

Metrics

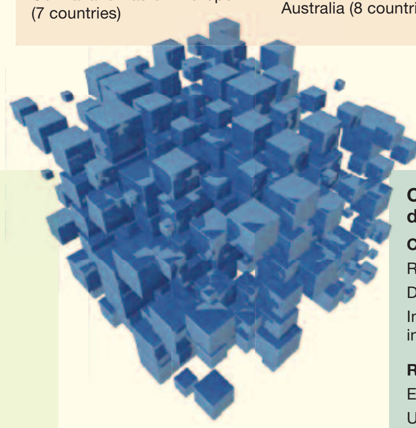
AUM, flows, profitability, revenues, costs

Timeframe

2007-11 with projections beyond 2015

Regions/countries

North America (2 countries)
Latin America (4 countries)
Western Europe (17 countries)
Central and Eastern Europe (7 countries)
Africa and Middle-East (3 countries)
Japan and Australia
Asia ex. Japan and Australia (8 countries)



Asset classes/ products/vehicles

Asset classes

Equity
Fixed income
Money market
Balanced
Alternatives

Vehicles

Mutual funds
Unit-linked life/variable annuity
ETFs
SMAs, UMAs and wrappers (U.S. only)

Client segments/ distribution channels

Client segment

Retail
Defined contribution (by segment)
Institutional (by segment, e.g., insurance, defined benefit)

Retail distribution channel

Europe (3rd party versus captive)
U.S. by retail channel (e.g., wirehouses, broker dealers, IFAs)

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