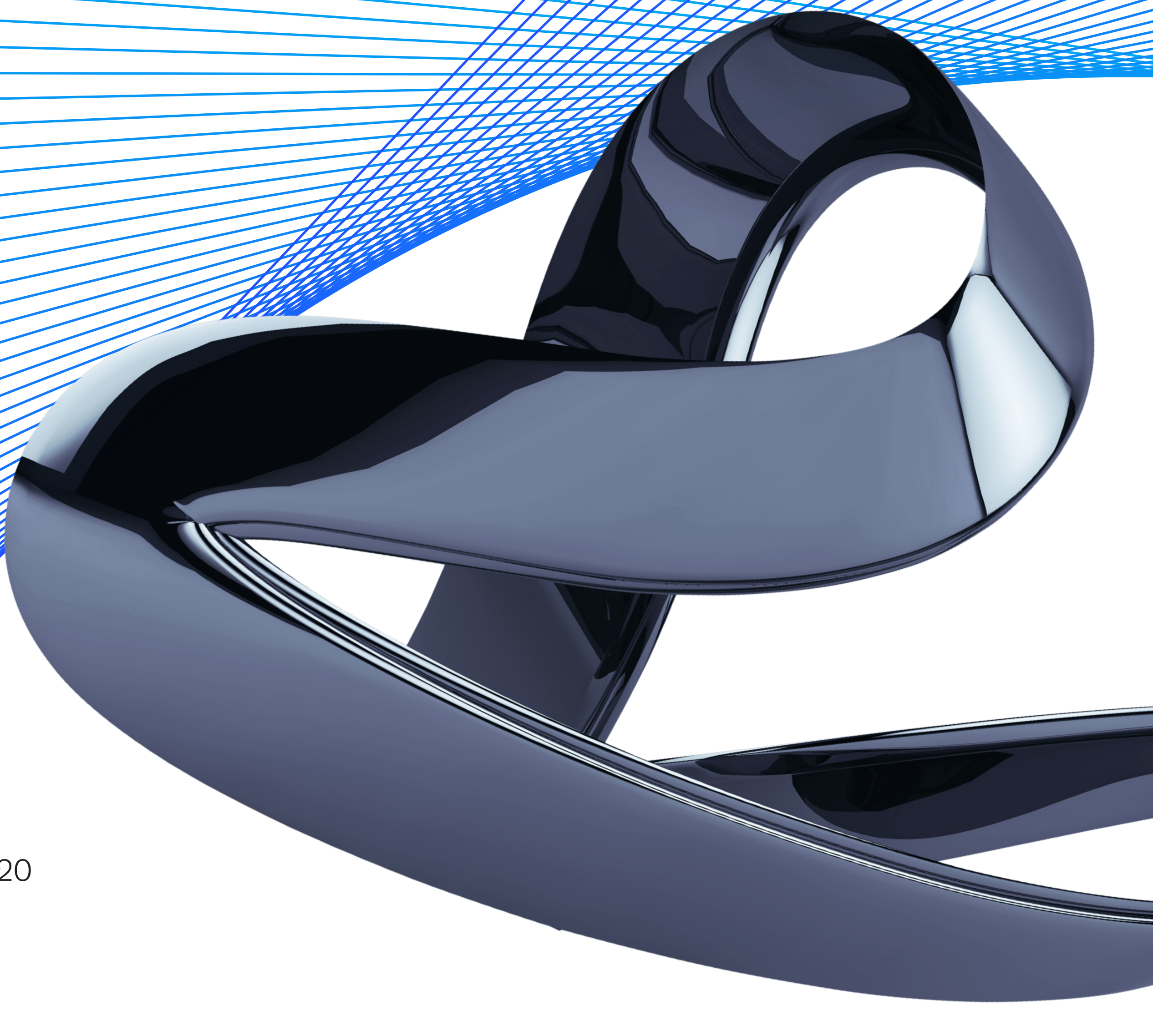
McKinsey & Company

Global Banking & Securities Practice

North American wealth management

Money in motion, but not always to the bottom line



December 2020

North American wealth management: Money in motion, but not always to the bottom line

Industry performance: Resilient, but with cracks in the foundation

The COVID-19 pandemic—beyond its vast humanitarian costs—has been an unprecedented challenge for businesses across the globe, causing abrupt dislocations to how people work, how customers and clients behave, and how supply chains function.

The wealth management industry in North America has been relatively fortunate, in terms of financial performance. While the pandemic has had an impact on traditional macroeconomic indicators (e.g., GDP growth, unemployment, consumer confidence), financial markets recovered quickly from initial lows to reach record highs over the past few months. And despite market volatility caused by subsequent waves of infection, valuations remain high as the low rate environment has left investors with little choice but to embrace riskier assets.

Therefore, it is not surprising that at first glance the industry performance in North America would appear as resilient as ever. As of end of the third quarter of this year, the industry was managing a record-high $34.7 trillion in client assets, with annualized year-to-date net flows at a healthy 2.6 percent (equal to the first nine months of 2019). However, the underlying economics of the industry tell a different story. Revenue pools, which have remained almost flat this year at an annualized $220 billion, have been significantly aided by equity markets—average client assets have been up by 10 percent—while return on assets has dropped by 11 percent (8 bps), the largest year-over-year decline in the last 15 years. The dramatic decrease in revenue yields has primarily resulted from narrowing spreads on deposits and the proliferation of zero commission trading for equities and ETFs. At the same time, costs continued to rise as they do perennially—with an increase of 4 percent year over year. As a result, industry profit pools and pre-tax margins declined by 15 percent (roughly $8 billion) and 4 percentage points, respectively.

Despite the boost from the capital markets, the performance of North American wealth management firms in terms of returns to shareholder has been weak: As of the end of the third quarter, year-to-date shareholder returns have been at negative 18 percent, a bottom-quartile performance when compared to all other industries.

Perhaps most concerning, beyond the profit and loss shifts, was an increase in money in motion of roughly 3.5 times pre-pandemic rates. The uncomfortable message is that clients may not be as loyal as the industry once thought.

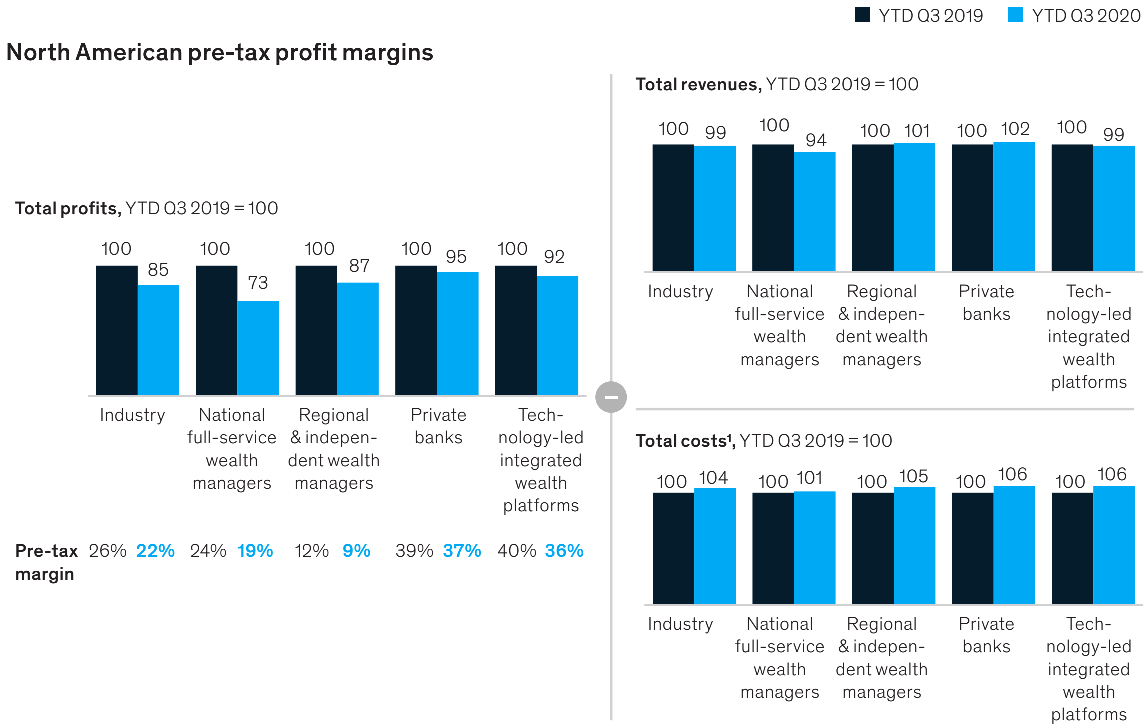
Client loyalty under pressure: Money in motion at 3.5 times the pre-crisis rate

The economic crisis stemming from the COVID-19 pandemic is by nature different from the financial crisis of 2008. This time, the financial sector as a whole is not suffering a decline of confidence, or facing the suggestion that they had a part to play in the troubles. Clients are not questioning the safety of their assets, as evidenced by the fact that, unlike 2008 and 2009, we have not observed large-scale withdrawals from financial institutions.

However, this does not mean that all wealth management industry fundamentals are solid and intact. Our consumer research suggests that clients are moving assets at an unprecedented rate—5.6 percent of investable assets, almost $2.0 trillion, were moved from one institution to another in the first six months of the COVID-19 pandemic. This is 3.5 times the rate observed over the last three years. Money in motion has been widespread—17 percent of respondents to a September 2020 McKinsey survey of more than 1,000 affluent and high-net-worth consumers indicate that they moved more than 20 percent of investable assets.

Exhibit 1

The North American wealth management industry saw a 15% decline in profit pools and 4 p.p. decline in profit margins over the past 12 months.



[1] Costs represent total expenses excluding extraordinary items

Source: Public filings, McKinsey North America Wealth Management Practice
Peer group averages based on a subset of firms with reported results
National full-service wealth managers – Merrill Lynch, Morgan Stanley WM, UBS WM
Private banks – JP Morgan Private Bank, Bank of America Private Bank, Northern Trust Wealth Management
Technology-led integrated wealth platforms – Schwab, TD Ameritrade, E*Trade, Interactive Brokers– Americas region, Wells Fargo WIM
Regional & independent wealth managers – LPL Financial, Ameriprise Advice & Wealth Management, Raymond James Private Client (RJF+RJA), Edward Jones, Oppenheimer Holdings, Stifel Financial

2X
increase in client churn observed in the months following the 2008-09 financial crisis

20%
of respondents say that are "likely or somewhat likely to switch financial advisors in the next 12 months"

45%
of those who do not have a financial advisor are considering meeting with one in the next year

17%
have a growing preference for combining their wealth relationships since the crisis began

75%
of those who moved money during the crisis moved it to an institution they already had a relationship with

Record levels of market volatility, combined with macroeconomic uncertainty, have increased stress and anxiety for wealth management clients. US households saw the value of their investments plunge and then recover in a short period of time. Those clients with an advisor who was proactive and could provide a broad range of products and services felt calmer about the path ahead (Exhibit 2).

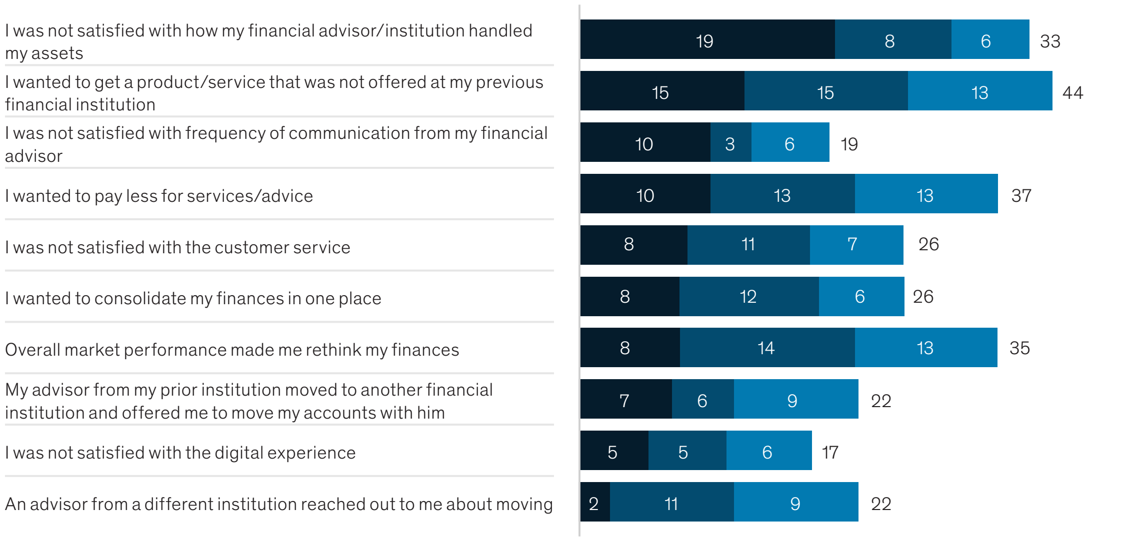
However, clients whose advisors were not proactive are less at ease: 40 percent say they are "likely or somewhat likely to switch financial advisors in the next 12 months." Meanwhile, 45 percent of consumers without a financial advisor and more than $100,000 in total investable assets are considering meeting with one in the next year.

Exhibit 2

Dissatisfaction with handing of assets, product availability, and communication are the primary reasons consumers gave for transferring assets away from an institution

Most important · 2nd most important · 3rd most important

Top reasons for transferring a significant[1] amount of money from an institution since the start of COVID-19, percent of respondents who transferred a significant amount of money



[1] Defined as 20% of total investable assets or more

Source: McKinsey Affluent and High-Net-Worth Consumer Survey, September 2020, n = 1,003 (10% with <$250K in investable assets, 56% with $250K-$1M, 19% with $1M-$5M, 15% with >$5M)

Clients who have already transferred a significant amount of money favored institutions with whom they already had a relationship. We expect this trend towards consolidation of relationships—which we have been observing over the last five years—to continue, putting a premium on primary relationships. The next three most cited reasons for selecting an institution to move money into were recommendation from a family or friend, lower fees, and proactive outreach (Exhibit 3).

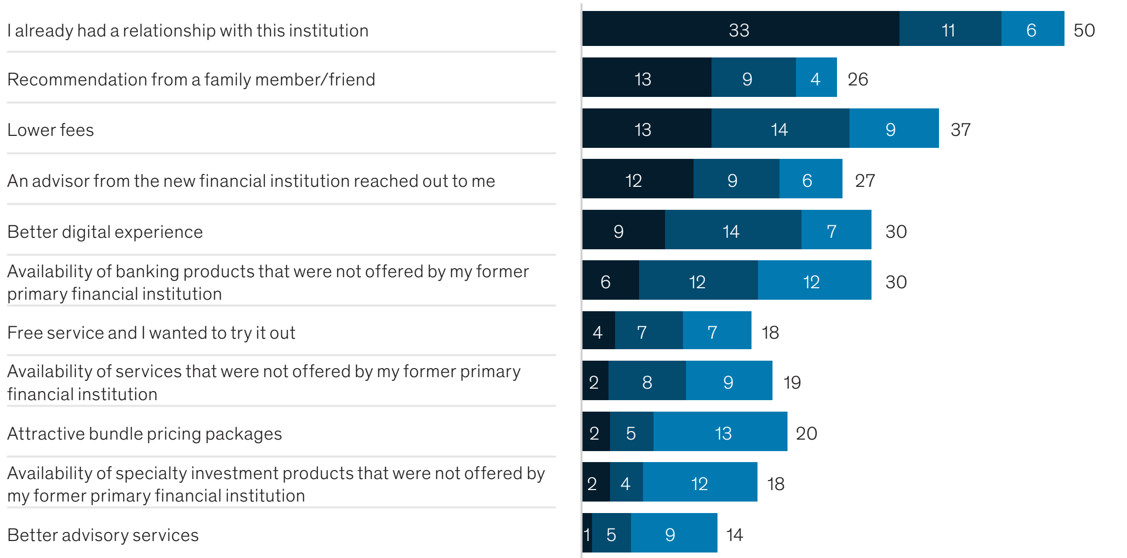
Importantly, the rate of money in motion varied significantly between segments. While the rate was largely the same across wealth bands (Exhibits 4), it varied to a striking degree between age groups.

Approximately one third of individuals aged 25 to 44 moved more than 20 percent of their investable assets since the start of the pandemic (representing 28 percent of assets held by the segment). The percent of individuals who moved significant amounts of money declines as we move up the age cohorts, all the way to 8 percent for clients aged above 65—or 1.6 percent of investable assets controlled by segment. This dispersion is largely reflective of the degree of financial concerns among segments—clients in the 25-44-year-old segment reported the sharpest increase in financial concerns across a broad swath of needs (Exhibit 5).

Exhibit 3

Existing relationship, recommendation from a family or friend, lower fees, and proactive outreach were the top reasons for transferring assets to an institution.

Top reasons for transferring a significant[1] amount of money to an institution since the start of COVID-19, percent of respondents who transferred a significant amount of money



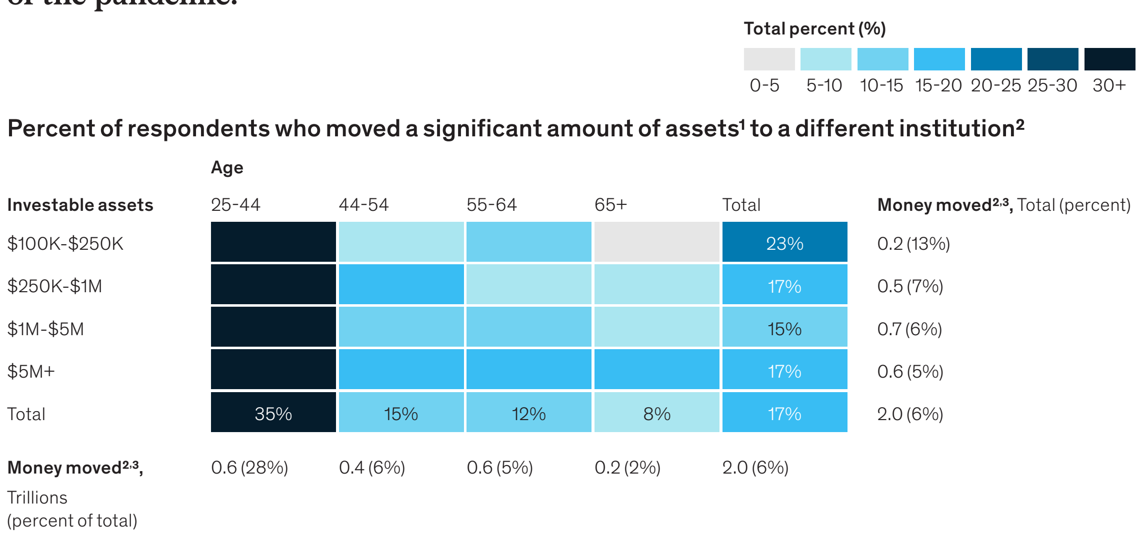
1 Defined as 20% of total investable assets or more

Source: McKinsey Affluent and High-Net-Worth Consumer Survey, September 2020, n = 1,003 (10% with <$250K in investable assets, 56% with $250K-$1M, 19% with $1M-$5M, 15% with >$5M)

Exhibit 4

Individuals aged 25-44 have been most likely to move money since the start of the pandemic.

Percent of respondents who moved a significant amount of assets[1] to a different institution[2]



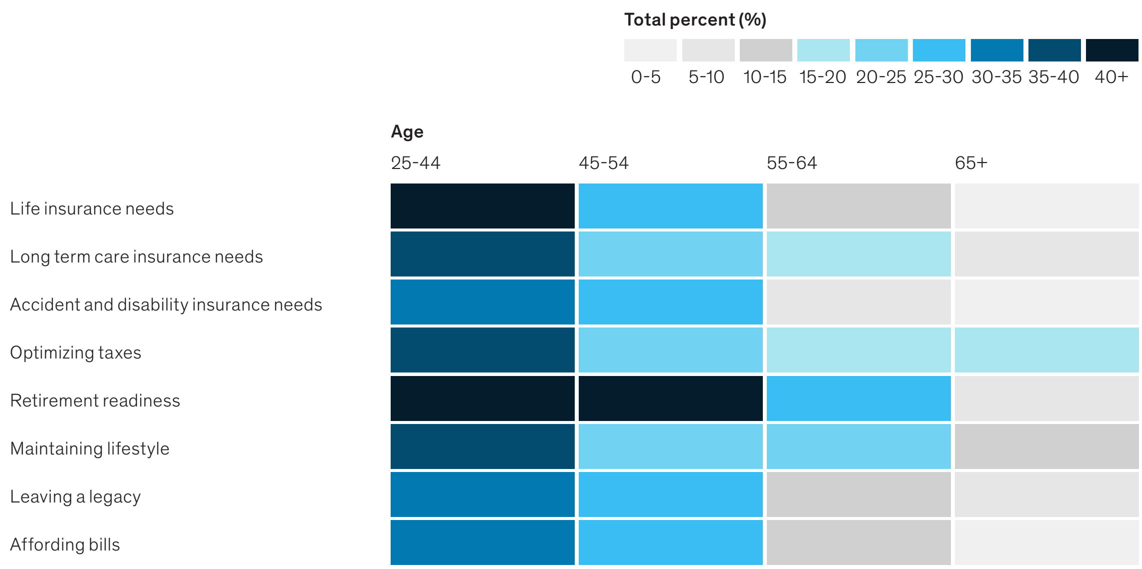
1 Defined as 20% of total investable assets or more
2 Between March and September 2020
3 Estimates

Source: McKinsey Affluent and High-Net-Worth Consumer Survey, September 2020, n = 1,003 (10% with <$250K in investable assets, 56% with $250K-$1M, 19% with $1M-$5M, 15% with >$5M); Federal Reserve Survey of Consumer Finance 2019

Exhibit 5

Individuals aged 25-44 have experienced the highest increase in their financial concerns during the COVID-19 crisis.

Percent of respondents who indicated an increase in financial concerns as a result of the COVID-19 crisis



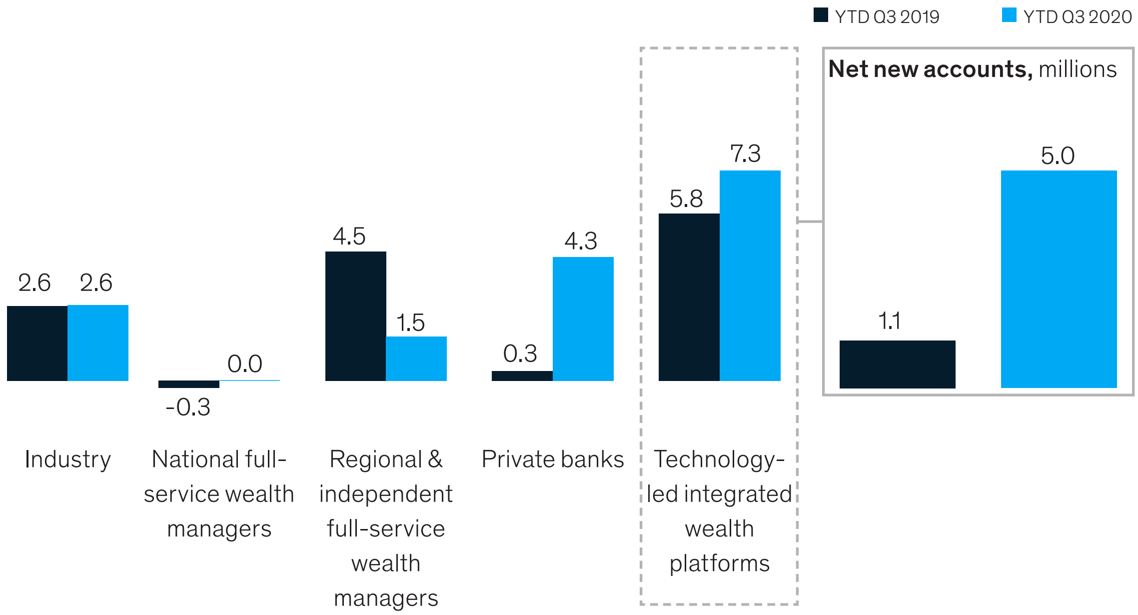
Source: McKinsey Affluent and High-Net-Worth Consumer Survey, September 2020, n = 1,003 (10% with <$250K in investable assets, 56% with $250K-$1M, 19% with $1M-$5M, 15% with >$5M)

Thus far in 2020, the two wealth management models that have benefited most from an acceleration of money in motion have been private banks and technology-led wealth management platforms (Exhibit 6). The dramatic increase of net flows for private banks has been likely driven by a "flight to quality" amid unprecedented uncertainty. Low-cost technology-led wealth management platforms attracted record amounts of new clients (in part due to zero commission trading) in addition to continued inflows from existing clients.

Exhibit 6

Private banks and technology-led integrated wealth platforms have been the early beneficiaries of accelerated money in motion.

Net inflows across asset classes, % of Beginning-Of-Year AUM



1 Peer group averages based on a subset of firms with reported results
2 National full-service wealth managers – Merrill, Morgan Stanley WM, UBS WM
3 Regional & independent wealth managers – LPL Financial, Ameriprise Advice & Wealth Management, Raymond James Private Client (RJF and RJA), Edward Jones, Oppenheimer Holdings, Stifel Financial
4 Private banks – JP Morgan Private Bank, Bank of America Private Bank, Northern Trust Wealth Management
5 Technology-led integrated wealth platforms – Schwab, TD Ameritrade, E*Trade, Interactive Brokers– Americas region

Source: Public filings, McKinsey North America Wealth Management Practice

Rewriting the industry narrative: Ideas for next 6-12 months

While the path to recovery is still uncertain, we expect the pace of change, evidenced by unprecedented amounts of money in motion, to remain unrelenting. For an industry that has seen a decade of steady revenue growth fueled by capital markets and rising interest rates, and enviable operating margins of 20 percent and higher, it is clear now that much will need to change. The industry needs to pivot away from the mindset of zero-sum competition for advisors and clients that made sense in a stagnant asset pool, and instead focus on innovation and superior client experience, which will enable them to respond to new sources of demand, whether it be consumers that have not been a focus for wealth managers in the past (e.g., minorities, millennials, women) or shifting client needs (e.g., retirement, protection, taxes, ESG). They will also need to look for adjacent revenue pools (e.g., asset management, retail banking). What's needed is a fundamentally new narrative of growth.

As they consider their strategy and competitive positioning in a time of uncertainty, wealth management executives should consider six broad categories of growth actions while maintaining focus on productivity both to fuel the growth and to maintain strong operating margins:

1. Grow through white-space opportunities

The last decade has been characterized by a zero-sum mindset, with North American wealth managers pouring resources into advisor wars and large bonus offers for clients. As a result, innovation and investments into new sources of growth have not been at the top of the executive agenda. At the same time, white-space opportunities abound. Wealth management executives should make deliberate decisions about which of these opportunities to pursue and lay out decisive plans to capture them. Two underserved segments in particular present large opportunities:

- **Adults aged 25 to 44 and below** tend to experience higher uncertainty and complexity as they go through a series of major life events during this period of life—paying back student debt, marriage, first child, and first house, among others. The current crisis has increased their financial concerns across a wide range of needs. Helping clients in this segment at this critical juncture will be highly rewarding for wealth managers—as this is the age when individuals tend to start their first advisory relationships, which can persist over decades. In fact, 60 percent of 25-44 year-olds who do not have a financial advisor indicate that they are looking to establish their first relationship with one.

- **Women** tend to approach wealth management differently than their male counterparts. As a group, they are more likely to seek professional advice and less likely to feel confident about their financial decision-making skill. Female decision makers tend to be less risk tolerant and more focused on life goals. In seeking an adviser, they tend to place more emphasis on a personal fit and are more likely than males to identify a life event as their motivation to seek guidance. Meeting these needs is crucial for any wealth management firm: North American women are expected to control much of the $30 trillion in financial assets that baby boomers will possess by 2030.[1] Importantly, the economics of serving women is more attractive, as they are more likely to seek professional advice and are willing to pay for it. As control of wealth begins to shift into the hands of women, firms will need a systematic approach to meeting their needs, transforming their business and client-service models to acquire, retain, and serve women as long-term investors.

2. Deepen relationships to both grow and retain assets or risk becoming irrelevant

Clients have been consolidating their wealth relationships in the past few years therefore being one of many advisors is become a less relevant calling card. Between 2014 to 2018, the proportion of consumers with only one wealth management relationship rose by 20% percent (from 43 percent to 52 percent), leading to a growing difference in share of wealth management wallet captured by the primary financial institution relative to non-primary firms (80 percent for primary and 15 percent for non-primary institutions). During the crisis, the trend has accelerated: 75 percent of those who moved money during the crisis moved it to an institution with whom they already had a relationship. Wealth managers thus need to deepen their current client relationships or risk losing them to competitors. The work should include:

- Proactively reaching out to clients—directly or through advisors—during periods when money transfer is likely
- Offering integrated advice and services across investments, cash management, lending, and protection as wealth-only relationships are easier to terminate
- Offering and championing the adoption of direct indexing
- Streamlining the money transfer experience to make it easier and faster for existing clients to transfer in cash and securities
- Offering interactive planning and reporting capabilities across clients' full balance sheets either for self-service or virtual collaboration with an advisor
- Offer relationship-based pricing across brokerage and advisory, investments and banking, personal and business

The challenge is not an easy one, particularly from a data and analytics standpoint. To adapt and build loyalty, wealth managers will need to stitch data from across business units and from third-party sources and overlay it with advanced analytics recommendation engines and pricing models. This will require achieving foundational data consistency and resolving governance issues many wealth managers are still facing.

Wealth managers will also need to retool and train advisors to engage clients on a broader set of needs—planning, investments, credit, cash management, tax optimization and protection, among others—all in a virtual setting. This will require expanding products and services and creating a smooth virtual experience leveraging both in-house development and partnerships.

[1] Pooneh Baghai, Olivia Howard, and Jill Zucker, "Women as the next wave of growth in US wealth management," McKinsey.com, July 2020.

Fortunately for wealth managers, a proliferation of robust fintech point solutions spanning the wealth management value chain is poised to accelerate development and launch of the capabilities essential for deepening relationships.

However, in addition to investments in vendor solutions, app development, data management, advanced analytics, and new products and services, firms will need to embark on a deep cultural transformation of advisor talent, both in terms of understanding the criticality of being the primary relationship for clients and the adoption of tools and technology. Wealth executives must ensure that for every dollar invested in new tools and technology, another has been invested in organizational readiness for at-scale adoption of new capabilities. Firms that get both technology and culture right will emerge as leaders.

3. Focus resources—including human capital—on areas of greatest growth

And the corollary is also important: cut back in areas where growth will be a struggle. While history may not repeat itself, if often rhymes: Active resource reallocation proved the difference between firms that succeeded after the 2008-2009 crisis, and those that did not. Wealth managers that made focused investments with conviction, as opposed to dabbling in multiple initiatives, were able to grow. We expect the aftermath of the current crisis—when it arrives—to be no different. Success will not come easy, however. Many wealth management firms face internal barriers ranging from business leaders protecting their turf to resources being embedded and hard to free up. Here are some steps wealth management executives can take to overcome internal resistance and fear of change:

— Clearly communicate to your team that dynamic reallocation is a priority and that decisions are final unless there is a material external change

— Create a common language for resource reallocation that integrates it into the culture of "how we do things" and stresses its importance to growth aspirations

— Establish clear accountability between corporate-center and business-unit levels, and determine which resource decisions need approval, who should approve them, what gets monitored and reported, and what escalation mechanism will be used in case of delays

— Regularly review the assumptions behind allocation decisions to ensure they still hold, both for new investment requests and previously allotted resources yet to be deployed

— Consider organizational changes to improve resource flexibility, such as creating shared resource pools or enabling talent to be more easily redeployed

— Embed dynamic resource reallocation into the planning process and management incentives

4. Consider inorganic growth and partnership accelerators, including in adjacent industries

Historically, downturns generally result in a handful of larger firms using their robust balance sheets to acquire less-well-positioned competitors, and emerging even more formidable. Wealth management M&A transactions increased 42 percent between 2009 and 2010.

While the economic pressure on the wealth management industry today is not as extreme as it was a decade ago, we expect M&A and partnership activity to continue to pick up after several slow years. We see four themes for M&A and partnerships going forward: First, transactions focused on platform synergies will continue apace, both among the largest wealth managers and in the RIA channel. Second, we expect to continue to see deals that give wealth managers access to new customer pools through firms focused on a different segment, geography, or financial services vertical (e.g., retail banking, P&C insurance, life insurance). Third, we expect to see more deals targeting specific capabilities that will be key for growth (e.g., thematic investing, tax solutions). Finally, we expect an increase in deals that help wealth mangers quickly access adjacent revenue pools (e.g., asset management, banking, retirement).

Well-capitalized wealth managers (or those that can access relatively inexpensive sources of capital) should identify the inorganic growth accelerators that are right for their business by taking a long-term view of value creation—pursuing programmatic M&A and partnerships to gain scale, enter new markets/customer segments, acquire new "turn-key" capabilities, and/or tap into new revenue pools. Smaller firms will require agility to ensure they have the capital to protect their business while looking at potential opportunities for collaboration that build on their niche presence and expertise.

5. Reassert "purpose" and ESG leadership while delivering on the promise to help clients navigate their financial lives
Societal issues were becoming more prominent as a theme in the financial services industry well before COVID-19 emerged. Now, the combination of a global pandemic and a resulting economic downturn has made addressing "purpose" and ESG a priority for many firms. The North American wealth management industry, which oversees $34.5 trillion across more than 53 million relationships, plays a central role in the economy and in people's lives. It is critical for firms to reassert their purpose and take the lead on ESG issues, while helping clients navigate the complexities of their financial lives and plan for the future. Specifically, wealth managers need to build on their existing efforts and address issues in three areas: financial security, diversity and inclusion, and ESG investing:

— **Re-emphasize retirement planning and offer innovative retirement income solutions.** Clients indicate growing concerns with their retirement readiness as a result of the pandemic. Importantly, these concerns are felt almost equally by clients with less than $250,000 in investable assets and those with between $1 million and $5 million in investable assets—roughly 36 percent and 30 percent of respondents, respectively, are now more concerned about their retirement readiness than they were before the pandemic

— **Champion diversity and inclusion through recruiting and training.** Improvements in diversity and inclusion can be boosted by reinvigorating interest in the industry among younger generations—partnerships with higher education institutions are one approach. Importantly, wealth managers must see diversity as a path to superior sustainable performance. McKinsey research shows that companies in the top quartile for racial and ethnic diversity are 33 percent more likely to have above-median profitability; companies in the top quartile for gender diversity were 21 percent more likely to have above-median profitability.[2]

— **Provide easy access to ESG products and solutions.** Wealth managers should increase the share of ESG products and solutions (including direct indexing) available to retail investors; educate advisors and consumers on the benefits of such strategies; hire and train ESG specialists to support clients and advisors; and embed ESG customization functionality and recommendations into buying journeys. Achieving this would also require close collaboration with other ecosystem participants—from fintech providers to asset managers.

6. Redesign operating models for scale and speed to maintain strong operating margins.
The current crisis has put economic pressures on wealth managers—who now need to invest in their business in a period of heightened financial anxiety among clients and a significant leap in money in motion. Marketing, digital, data and analytics, and advisor training and recruiting, are among areas that will require increased investment.

Executives will need to free up capital and talent through structural changes to the operating model of an intensity not seen since the 2008-2009 crisis. Actions can include:

— Optimizing the branch real estate portfolio by adopting new ways of working (e.g., full and partial work-from-home arrangements for some employees; use of shared WeWork-like spaces for client meetings) and moving branches to lower-cost properties.

— Drastically simplifying reporting by restructuring field management, while increasing accountability and transparency.

— Increased offshoring, nearshoring, and outsourcing in IT, operations, finance, compliance, and various home office functions to achieve both greater efficiency and greater access to the global talent pool.

— Prioritizing and reimagining the three to five journeys that create the most manual work in the middle and back office by leveraging technologies that firms in other financial services sectors have used to create operating leverage (e.g., robotic process automation, smart workflows, natural-language processing, machine learning).

— Simplifying products to reduce complexity (e.g., simple investment product shelf, standard wrap fee asset management programs).

[2] Vivian Hunt, Lareina Yee, Sara Prince, and Sundiatu Dixon-Fyle, "Delivering through diversity," McKinsey.com, January 2018.

To fund an ambitious growth and operating model redesign agenda in the near-term, wealth managers should take a hard look at their non-compensation expenses—travel and entertainment, printing, contractor spend, and market data, among others. Savings from these reductions can begin bearing fruit over the course of three to six months.

•••

In the aftermath of the COVID-19 pandemic—whenever that moment arrives—some wealth managers will find themselves in a position of strength, and others will face steep challenges. We learned from the last crisis that companies were not rewarded for standing still and waiting. Wealth managers will need to be fast, bold, and agile to succeed.

Authors

Pooneh Baghai is a senior partner in McKinsey's Toronto office. Vlad Golyk and Agostina Salvo are associate partners, and Jill Zucker is a senior partner, all in the New York office.