

GLOBAL ASSET MANAGEMENT 2017

# THE INNOVATOR'S ADVANTAGE



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# INTRODUCTION

**T**HE GROWING CHALLENGES CONFRONTING asset management were confirmed by the industry's global performance in 2016. For the first time since the 2008 financial crisis, the revenue pool of traditional managers fell worldwide, along with their profits. Margins contracted as fee pressures continued to increase.

Assets under management (AuM) returned to growth, largely thanks to rising asset values on financial markets. Net new flows, the industry's wellspring of growth, remains tepid and little changed from recent years.

In 2017, the environment remains challenging, with the specter of continued outflows from active products and even esoteric long-only asset classes. Meanwhile, the acceleration of new, disruptive technologies will create opportunities for some asset managers while posing threats to others.

With that in mind, we argue in this report that tomorrow's industry leaders will appear quite different from today's. To be among them, asset managers will need to seize opportunities to act boldly and transform the very way they work, through innovation that fully embraces advanced technologies such as artificial intelligence, machine learning, big data, and analytics. This will be especially true in investment management and distribution.

Understanding and pursuing opportunities embedded in big market moves will also define success—whether through M&A, partnerships, or gaining entry to promising new markets, such as China. Finally, acting to address costs structurally will differentiate winning managers, whether they take advantage of automation technology or leverage third-party resources.

Those that succeed in making these changes will consolidate their position. Others will increasingly struggle with disruption and turbulence.

These conclusions are among the central themes of this report, The Boston Consulting Group's 15th annual study of the global asset management industry. They are the result of market-sizing research, an extensive worldwide benchmarking survey, and insights from our client work and other industry activities.

Like its predecessors, this report opens with a detailed and data-based profile of the industry's overall state of health. It reviews asset management performance, globally and by region, as well as emerging

product and competitive trends. The opening chapter concludes with a discussion of the five sources of the most significant gain for players in the years to come: growth in China, product portfolio management and innovation, business models and mergers and acquisitions (M&A), technology, and cost management.

The second and third chapters of this report assess two topics critical to every asset manager's future growth. The second chapter explores the benefits of optimizing investment management for the digital age. Investment management stands at the crossroads of success and failure as firms race to enhance investment performance while achieving customer-driven innovation, technological prowess, and heightened operational efficiencies.

The third chapter explores the strategic value—and dangers—of M&A for asset managers. As the industry's economics become more difficult, M&A activity will likely accelerate. Deals will become bigger and more international, raising the stakes and the challenge of postmerger integration.

As a result, M&A opportunities will abound for firms to acquire the scale, products, expertise, and distribution channels needed to leapfrog to higher levels of prosperity—but so will the dangers of forming a catastrophic “marriage.” We look at how firms can avoid the pitfalls of bad partnering and use M&A to close the gap by adapting one of four business models that offer the potential for sustainable success.

Failure to act decisively—whether in revamping investment management or optimizing M&A opportunities—will especially dim the prospects of asset managers that cling to traditional active assets. The decade-long migration from their legacy products will continue, as it did in 2016.

Traditional active core assets will be squeezed, losing share of revenue and AuM. Alternatives, solutions, and specialties will continue to generate strong fees, while passives will persist in dominating the growth of AuM, if not revenues.

In an environment of uncertain market growth, weak net inflows, and diminishing fees, it will be impossible for all asset managers to thrive. In our view, success will be limited to organizations that earn advantage through innovation and excellence in managing their entire portfolio of businesses. Winning players will include those that fully embrace advances in data and analytics to achieve superior investment performance. They will excel at structuring solutions and invent compelling client service while keeping costs under control.

The benchmarking survey that informed this year's report involved 153 leading asset managers—representing \$43 trillion, or more than 62%, of global AuM—and covered more than 3,000 data points per player. Our measurements covered assets in 43 markets globally, including offshore.

The assessment of investment management included a review of organizational structures for investment, research and trade execution

functions, benchmarking of costs and staffing, and deep dives on innovation, customization, and best-practice use of technology and tools.

The aim of our annual research is to provide new insight into the state of asset management and its underlying sources of profitability in order to help managers build prosperous paths to the future. We hope you find it useful.

# A SNAPSHOT OF THE INDUSTRY

**2**016 WAS THE FIRST year since the 2008 financial crisis that the revenue pool of traditional asset managers fell worldwide, along with profits. AuM grew, but margins contracted as pressure on managers' fees continued to increase in both the institutional and retail segments.

## Global AuM Rises to \$69.1 Trillion

The value of global AuM grew by 7% in 2016, to \$69.1 trillion from \$64.6 trillion. This was a marked improvement over 2015, when it rose only 1%, and it exceeded the average annualized rate of 5% from 2008 through 2014.<sup>1</sup>

But growth figures can be deceptive. The global increase in AuM was produced largely by the rising value of investments in buoyant financial markets.

Net new flows—the industry's lifeblood—were a tepid 1.5% of beginning-of-year AuM, little changed from recent years. Annual inflows seem unlikely to return to the pre-2008 levels of 4% to 6% except in China and a few other high-growth markets. (See Exhibit 1.)

## A Regional View: China's Growth Stands Out

Looking at growth by region, China was the notable exception to the tepid global growth of AuM in 2016, sharing the spotlight with

Brazil. Each market accounted for most of the growth in its region: Asia (excluding Japan) and Latin America, respectively.

The North American market, dominated by the US, remains the world's largest, with 48% of global AuM, but it is growing slowly. (See Exhibit 2.) Despite solid gains in domestic equity prices in 2016, US AuM increased just 5% as the market suffered from net outflows of -0.3%. The institutional segment performed slightly better than retail, with 6% and 5% AuM growth respectively. Yet net outflows were higher: -0.4% for institutional versus -0.1% for retail. Retail benefited from continued positive flows from IRAs, partly compensating for outflows in other retail segments.

The next-largest developed markets, Japan and the UK, both had weak net flows of 1%. In Japan, which suffered from low equity returns and the predominance of fixed income in investment portfolios, AuM grew by only 3%.

In the UK, by contrast, currency devaluation following the Brexit vote, along with buoyant financial markets, compensated for weak net outflows: AuM grew by 11%.

European markets generally saw solid gains from net flows in 2016—in particular, more than 3% in Germany, Italy, and Spain. In Germany, the increase was the result of rising

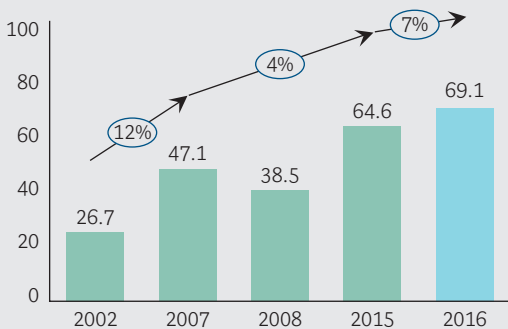


## EXHIBIT 1 | Global AuM Grew 7%, to \$69.1 Trillion, Mostly Because of Rising Market Values

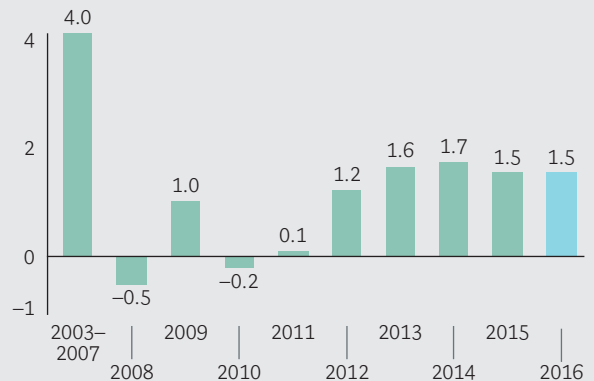
GLOBAL AuM ROSE 7%...

...WHILE NET NEW FLOWS WERE FLAT, AT 1.5%

Global AuM (\$trillions)



Net flows as a share of beginning-of-year AuM (%)

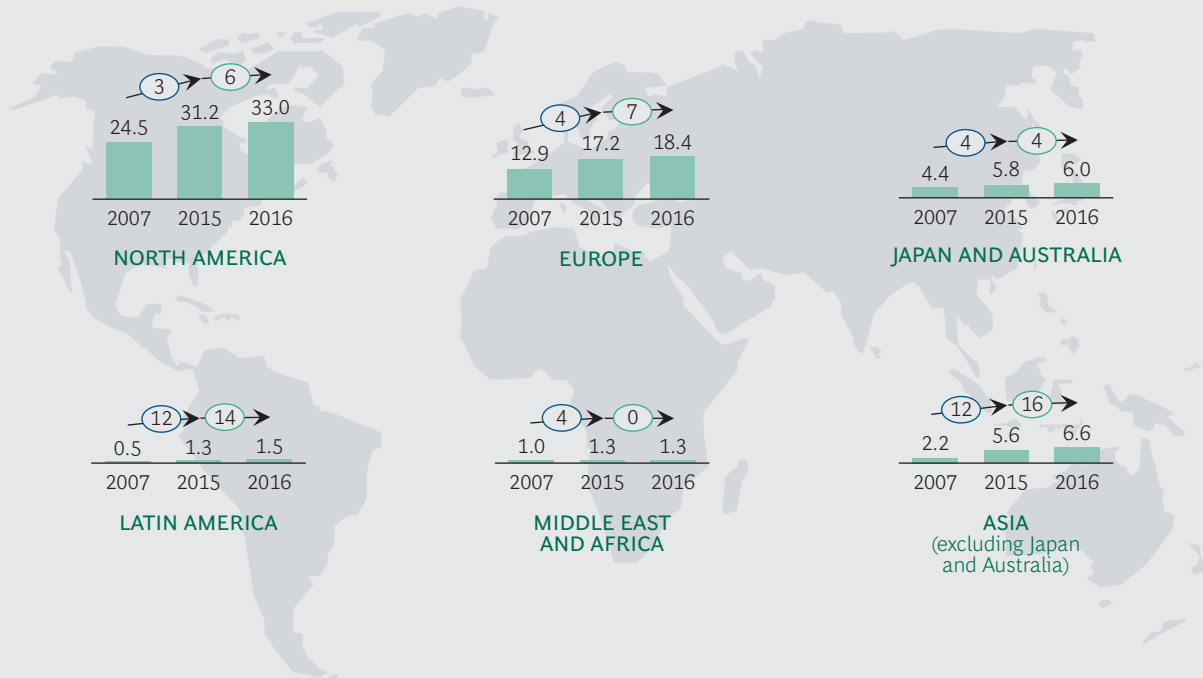


Sources: BCG Global Asset Management Market-Sizing Database 2017; BCG Global Asset Management Benchmarking Database 2017.

Note: Market sizing includes assets professionally managed in exchange for management fees; includes captive AuM of insurance groups and pension funds delegated to asset management entities with fees paid; 43 markets covered globally, including offshore AuM. For all countries where the currency is not the US dollar, we applied the end-of-year 2016 exchange rate to all years to synchronize current and historic data. AuM decreases shown for past years reflect changes in exchange rates, methodology changes for some markets, and data changes from primary source.

## EXHIBIT 2 | AuM Increased in 2016 in All Regions Except the Middle East and Africa

AuM, 2007-2016  
(\$TRILLIONS)



Annual growth, 2007-2015 (%)

Annual growth, 2015-2016 (%)

Source: BCG Global Asset Management Market-Sizing Database 2017.

Note: Market sizing includes assets professionally managed in exchange for management fees; includes captive AuM of insurance groups or pension funds delegated to asset management entities with fees paid; 43 markets covered globally, including offshore AuM. North America = Canada and the United States; Europe = Austria, Belgium, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Russia, Spain, Sweden, Switzerland, Turkey, and the United Kingdom; Asia = China, Hong Kong, India, Indonesia, Malaysia, Singapore, South Korea, Taiwan, and Thailand; Middle East and Africa = selected sovereign wealth funds of the region, Morocco, and South Africa; Latin America = Argentina, Brazil, Chile, Colombia, and Mexico. For all countries where the currency is not the US dollar, we applied the end-of-year 2016 exchange rate to all years to synchronize current and historic data. Some AuM numbers differ from those in prior reports owing to exchange rate differences, revised methodology, and changes in source data.

wealth. In Italy and Spain, savers shifted money from traditional deposit accounts, currently paying ultra-low rates of interest, into products managed by asset managers, such as life insurance. However, these impressive net flows were insufficient to compensate for the weak or negative performance of several European equity markets, and non-UK European AuM growth averaged only 6%.

In the Middle East, net flows continued to decline. Persistently low oil prices caused outflows from sovereign wealth funds, and some large investors continued to move fund management in-house.

AuM in China grew 21%, driven by net inflows of 17%. This growth occurred in both the retail segment, as a result of high household savings rates, and in the institutional segment, where insurance companies and pension funds are becoming increasingly significant players. New regulations aimed at reducing leverage in financial services, which will affect interinstitutional business in particular, may temporarily slow growth. But this is welcome in a market prone to overheating.

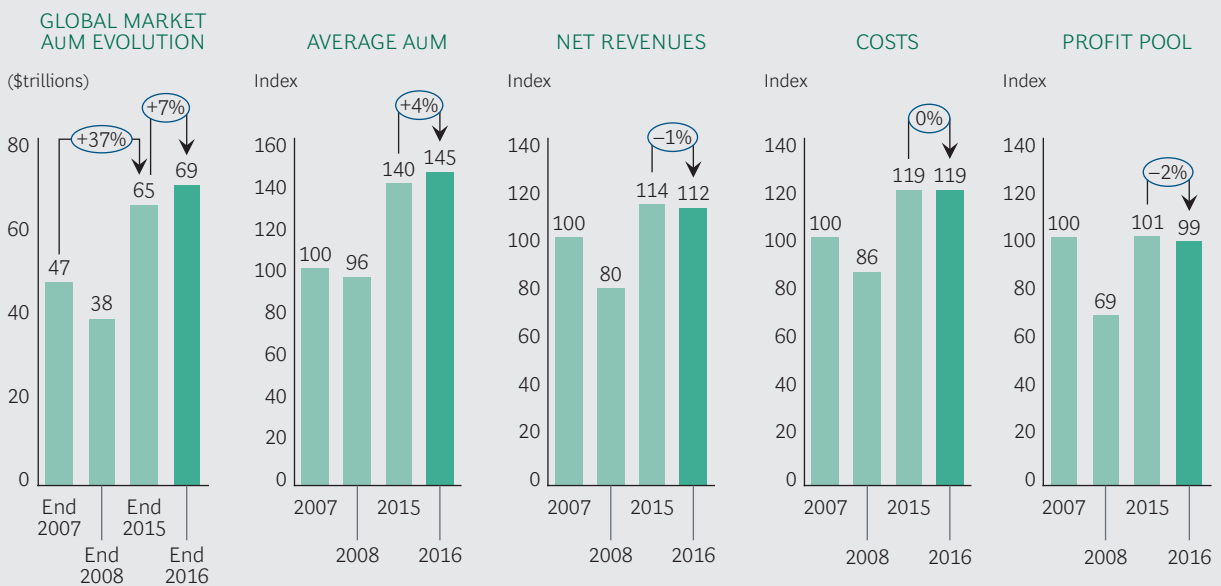
AuM in Brazil increased an impressive 17% in 2016. Unlike in China, however, the growth was driven by asset appreciation in financial markets rather than inflows.

### The Revenue Squeeze Continues

The AuM of traditional asset managers (those not purely invested in alternatives) returned to growth in 2016, following weak growth in 2015. But the AuM gain was largely due to asset appreciation on financial markets. Asset managers' revenues and profits did not follow suit: both contracted as costs remained unchanged. (See Exhibit 3.)

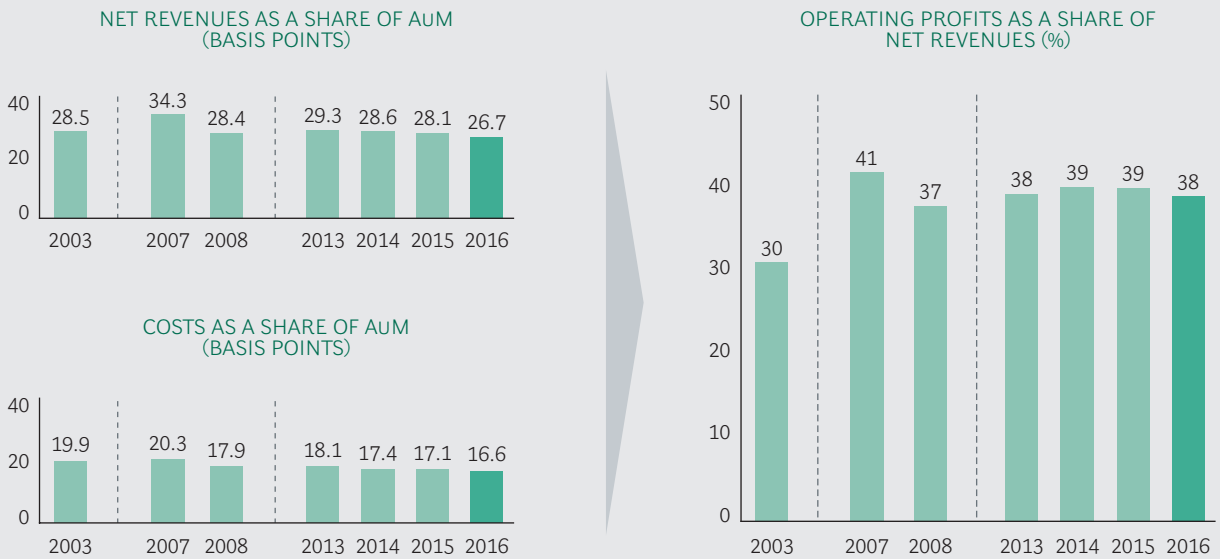
Although average AuM during 2016 was 4% higher than the 2015 average, revenues declined 1%. From 2013 to 2016, net revenues fell from 29.3 basis points to 26.7 basis points. (See Exhibit 4.) Some of this revenue decline resulted from the evolving mix of high-fee and low-fee products—in particular the ongoing shift from active to passive management and, in 2016, flows in to active core fixed-income products and out of active equity. But margins would be declining even

### EXHIBIT 3 | Global Profits Decreased 2% as Net Revenues Fell 1% and Costs Remained Unchanged



**Sources:** BCG Global Asset Management Market-Sizing Database 2017; BCG Global Asset Management Benchmarking Database 2017.  
**Note:** Analysis conducted on the basis of our global benchmarking, which includes 153 leading asset managers in 43 markets, representing \$43 trillion, or more than 62%, of global AuM. This sample is weighted toward more traditional players and does not include pure alternative players, so those economics are not comparable with total revenues based on our global product trend analysis. Values with fixed exchange rates: the year-end 2016 US dollar exchange rate has been applied to all past years to synchronize current and historic data. Historic data has been restated to maintain consistency of samples over time. Net revenues are management fees minus distribution costs.

## EXHIBIT 4 | Operating Profits Dipped, While Net Revenues as a Share of AuM Continued to Decline



Source: BCG Global Asset Management Benchmarking Database 2017.

Note: This trend analysis is based on our global benchmarking, which covers 153 players in 43 markets, representing \$43 trillion, or 62% of global AuM. This sample is weighted toward more traditional players and does not include pure alternative players, whose economics, therefore, fall outside our global trend analysis. Historic data has been restated to maintain consistency of samples over time. Net revenues are management fees minus distribution costs.

without a shift in product mixes, because fees are declining for most products in both the institutional and retail client segments.<sup>2</sup> In institutional, the decline is driven by competition among suppliers. In retail, it is a consequence of regulatory pressure for fee transparency and, in some markets, a ban on distribution fees.

High-margin products have been hit hard. The net management fees of hedge funds (in basis points) have decreased by 1% per year since 2010. Over the same period, private equity fees have fallen at an annual rate of 1.5%, infrastructure at 3%, and commodities at 7%.

Fees (in basis points) for equity specialties—the highest-margin active product following alternatives—have decreased by 3.5% per year since 2010. Fees for some low-margin products also declined. Money market fund fees fell 3% per year, exchange-traded funds (ETFs) 3%, and liability-driven investments 7%.

A few innovative products in demand by investors have bucked this trend, commanding higher fees. Since 2010, fees for multiasset products have increased at a rate of 2% per

year, fixed-income specialties at 3% per year (partly driven by the mix among those specialties), and private debt at 2%. This trend showed signs of slowing in 2016, which is to be expected as products mature.

### The Decoupling of AuM and Revenue

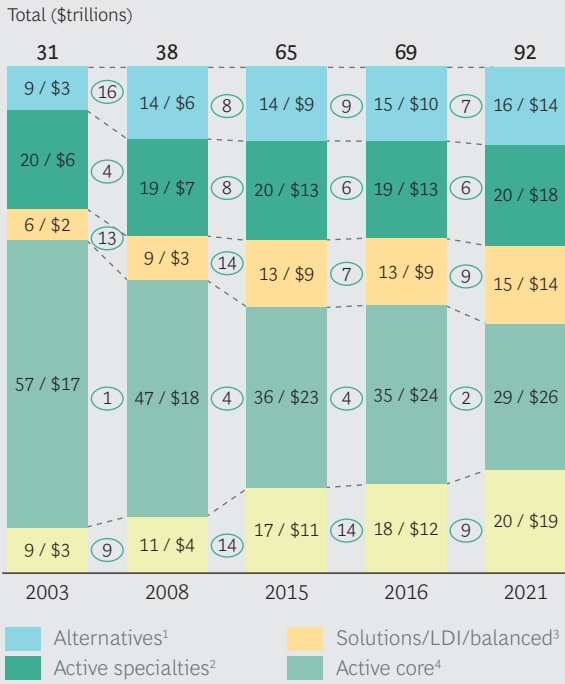
The decade-long migration of investments from traditional active core products to passives, alternatives, specialties, and solutions continued in 2016.

We expect that traditional active assets will continue to be squeezed, losing share of revenue and AuM. Alternatives, solutions, and specialties will persist in generating strong fees and—along with passives—will dominate the growth of AuM. (See Exhibit 5.)

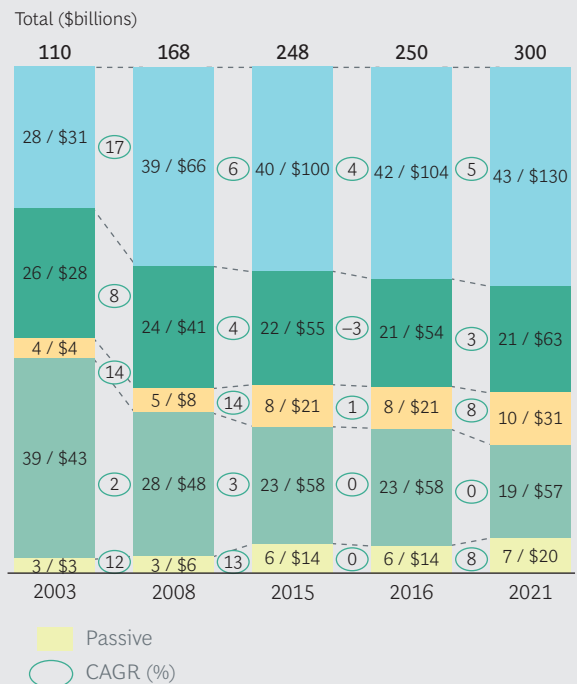
But a fresh assessment of AuM and revenue trends reveals a decoupling of the two: products' shifting share of AuM doesn't produce an equivalent shift in share of revenue. Despite the faster growth of AuM in passive products, passives' contribution to managers' revenue pool remains small. Revenues from passive mandates, passive funds, and ETFs

## EXHIBIT 5 | Alternatives, Solutions, and Specialties Will Drive Revenue and, with Passives, Dominate AuM Growth...

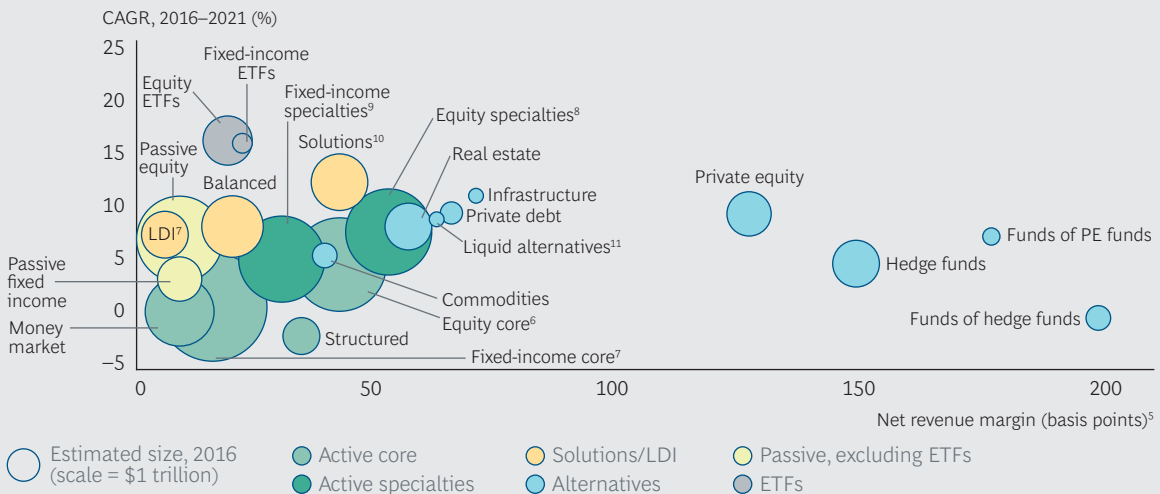
GLOBAL AUM SPLIT BY PRODUCT (% / \$TRILLIONS)



GLOBAL REVENUES SPLIT BY PRODUCT (% / \$BILLIONS)



### ... While Traditional Active Assets Will Continue to Be Squeezed, Losing Share



**Sources:** BCG Global Asset Management Market-Sizing Database 2017; BCG Global Asset Management Benchmarking 2017; Strategic Insight; P&I; ICI; Prequin; HFR; BlackRock ETP report; IMA; BCG analysis.

**Note:** LDI = liability-driven investment; ETF = exchange-traded fund.

<sup>1</sup>Includes hedge funds, private equity, real estate, infrastructure and commodity funds, and liquid alternative mutual funds (absolute return, long and short, market neutral, volatility); private equity and hedge fund revenues do not include performance fees.

<sup>2</sup>Includes equity specialties (foreign, global, emerging markets, small and mid caps, sectors) and fixed-income specialties (emerging markets, global, high yield, convertibles).

<sup>3</sup>Includes target-date, global asset allocation, flexible, income, liability-driven, and traditional balanced investments.

<sup>4</sup>Includes actively managed domestic large-cap equity, domestic government and corporate debt, money market, and structured products.

<sup>5</sup>Management fees net of distribution costs.

<sup>6</sup>Includes actively managed domestic large-cap equity.

<sup>7</sup>Includes actively managed domestic government and corporate debt.

<sup>8</sup>Includes foreign, global, emerging-market equities; small and mid caps; and sectors.

<sup>9</sup>Includes emerging-market and global debt, high-yield bonds, and convertibles.

<sup>10</sup>Includes target-date, global asset allocation, flexible, and income funds.

<sup>11</sup>Includes absolute return, long and short, market-neutral, and volatility mutual funds.

grew from roughly \$6 billion in 2008 to \$14 billion in 2016. But this still represents only 6% of the industry's global revenues. Even with strong growth forecasts for net flows, passives may reach only 7% of revenues by 2021.

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## Net flows demonstrated the continuing rise of passives, especially in the US.

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In contrast, alternatives account for only 15% of AuM but contribute 42% of total revenues, even after excluding performance fees. Alternatives revenues grew from \$66 billion in 2008 to \$104 billion in 2016. The next two strongest contributors to asset manager revenue growth in 2016 were active specialties as well as solutions and multiassets, which increased by \$13 billion each, to reach \$54 billion and \$21 billion respectively.

Although active core products accounted for 35% of AuM globally in 2016, maintaining their position as the largest product category, they contributed only 23% of revenues, continuing the downward trend from 39% of revenues in 2003 and 28% in 2008. Despite this decline, some active core categories still record strong growth, such as active fixed-income products in 2016, confirming that traditional active products will not disappear.

The 2016 ranking of strategies by net flows demonstrated the continuing rise of passives, especially in the US. Passives represented 10 of the 15 top US strategies in 2016, up from 8 in 2015. They claimed six top spots in Europe (up from five) and six in Asia-Pacific (up from three). In all three regions, passives extended their grip across asset classes, including equity, fixed income, and specialties. (See Exhibit 6.)

Solutions and specialties claimed many of the top 15 strategies in Europe and Asia-Pacific, but they were slightly less popular in the US. Target-dated funds, which are default options in most US defined-contribution plans, should keep seeing sustained growth.

Traditional players, meanwhile, continued to suffer significant outflows from their legacy products. Of the 15 worst-performing product categories in the US, 11 were in active equity and fixed income. These included three key active-equity categories—large-cap growth, large-cap value, and large-cap blend—which saw combined net outflows of \$183 billion in 2016.

The trend was similar in Europe, where the worst-performing product categories were active equity Europe, active equity Asia-Pacific, and active equity North America, with combined net outflows of \$111 billion. In Asia-Pacific, traditional products (except for money market funds) fared better, with net outflows of \$37 billion.

## Paths to Success in a Difficult Market

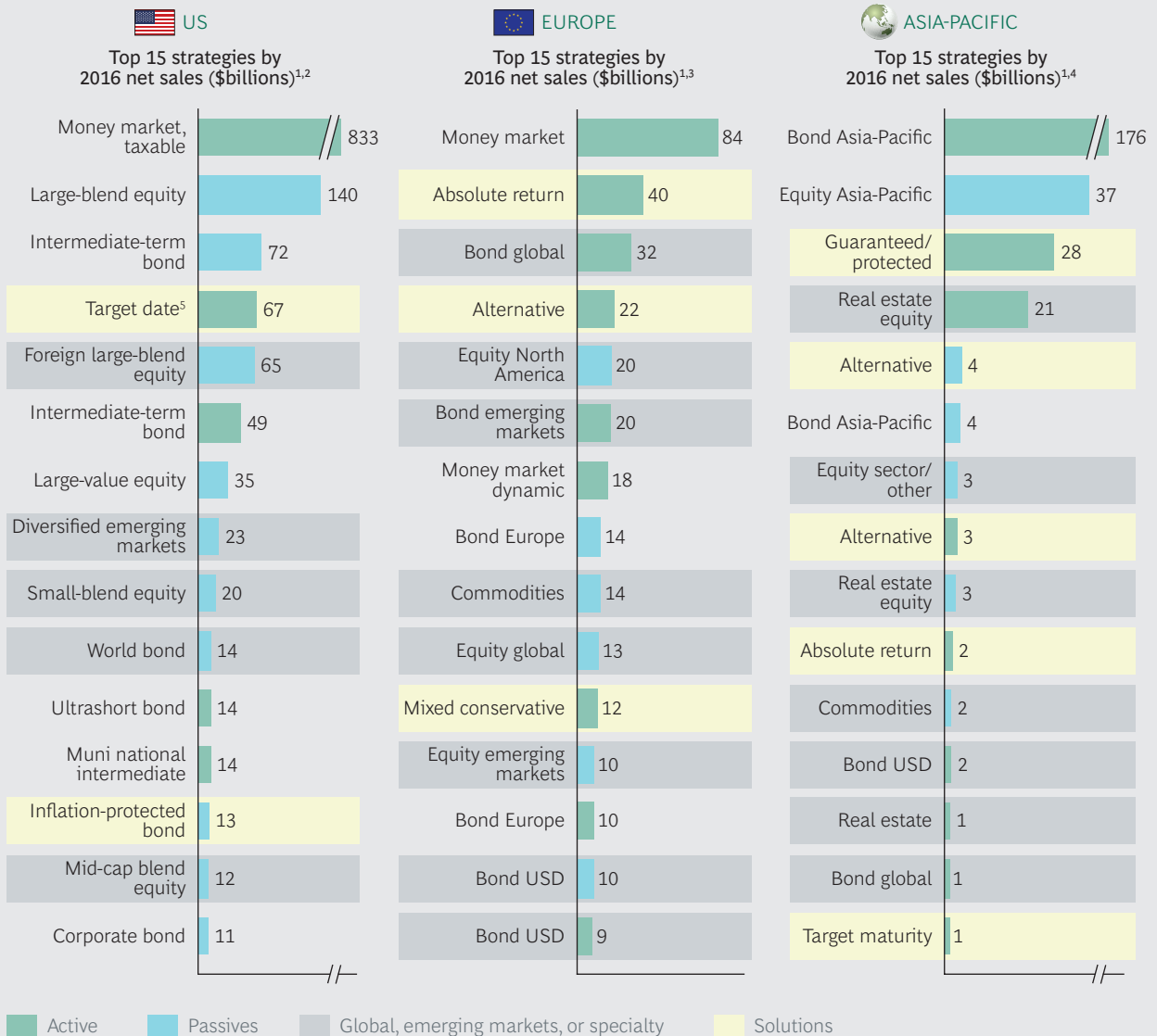
In an environment of uncertain market growth, weak net inflows, and diminishing fees, it is impossible for all asset managers to increase their AuM and revenues. Success will be restricted to firms that beat the market average through superior investment performance, solution structuring, product packaging, or other elements of client service.

Firms at the top of the US and European rankings have at least one of the following three characteristics: a strong passive offering, differentiated and well-performing products (especially in solutions and active specialties), and strong relationships with institutional investors and distributors focused on meeting their specific needs, often across multiple markets.

Passive is the main driver of mutual fund net flows both in the US, where it accounts for the success of five of the top ten, and in Europe, accounting for four of the top ten. (See Exhibit 7.) The importance of scale in passive means that AuM is concentrated in the largest few managers. In the US, Vanguard's 2016 net inflows of \$276 billion were almost double the \$140 billion of the entire market. In other words, excluding Vanguard, net flows were -\$136 billion. Among asset managers with positive net inflows, the top ten captured 83% of the total, confirming the winner-

## EXHIBIT 6 | Money Market, Passives, Specialties, and Solutions Gathered High Flows

PASSIVES REPRESENTED 10 OF THE TOP 15 STRATEGIES IN THE US AND 6 OF THE TOP 15 IN EUROPE AND ASIA-PACIFIC



Sources: Strategic Insight; BCG analysis.

<sup>1</sup>Mostly retail assets of mutual funds and exchange-traded funds, excluding, for instance, assets of mandates.

<sup>2</sup>Out of 120 strategies defined by the Simfund database.

<sup>3</sup>Out of 29 strategies defined by the Simfund database.

<sup>4</sup>Out of 27 strategies defined by the Simfund database.

<sup>5</sup>Refers to a summation of 12 target-date funds categories defined by the Simfund database.

take-all trend we have noted previously. (See *Global Asset Management 2016: Doubling Down on Data*, BCG report, July 2016.)

The winner-take-all trend was less pronounced in active products in 2016, with the top ten firms capturing 58% of the net inflows. The top player attracted net inflows of \$20 billion, compared with \$4 billion for the tenth-ranked firm. These are small sums com-

pared with passive inflows, yet they are significant given that the overall US active market suffered net outflows of \$300 billion.

The European market remains less concentrated. That is partly because passive products are less advanced there and partly because the market is fragmented across many countries and access to distribution remains a key driver of sales volumes. In some markets,

## EXHIBIT 7 | The Winner-Take-All Trend Accelerated Among Mutual Funds in the US but Not in Europe

### PASSIVE-FOCUSED PLAYERS DOMINATED NET FLOWS IN THE US AND EUROPE

#### THE TOP TEN ASSET MANAGERS IN THE US, BY MUTUAL FUNDS NET FLOWS

ASSET MANAGER	2016 NET FLOWS (\$BILLIONS)	CUMULATIVE SHARE OF TOTAL MARKET NET FLOWS (%)	CUMULATIVE SHARE OF NET FLOWS OF PLAYERS WITH POSITIVE NET FLOWS (%)	PASSIVE SHARE OF TOTAL FLOWS PER FIRM (%)
Vanguard	276	197	50	93
BlackRock	95	265	67	118
Dimensional Fund Advisors	18	277	70	2
SSGA	16	289	73	99
Charles Schwab	13	298	75	114
TIAA-CREF	11	306	77	59
Invesco	10	313	79	100
Edward Jones	8	319	80	0
Robert W. Baird	8	325	82	0
DoubleLine	8	330	<b>83</b>	0
<b>TOTAL MARKET</b>	<b>140</b>			
	<b>2015 ratios (%)</b>	<b>251</b>	<b>75</b>	
	<b>2014 ratios (%)</b>	<b>121</b>	<b>68</b>	

#### THE TOP TEN ASSET MANAGERS IN EUROPE, BY MUTUAL FUNDS NET FLOWS

ASSET MANAGER	2016 NET FLOWS (\$BILLIONS)	CUMULATIVE SHARE OF TOTAL MARKET NET FLOWS (%)	CUMULATIVE SHARE OF NET FLOWS OF PLAYERS WITH POSITIVE NET FLOWS (%)	PASSIVE SHARE OF TOTAL FLOWS PER FIRM (%)
BlackRock	23	12	4	136
Nordea	22	23	7	2
Vanguard	17	31	10	95
Union Investment	15	39	12	0
KBC	14	46	14	9
Aviva Investors	12	52	16	3
Eurizon Capital	12	59	18	0
Amundi	12	64	20	42
SSGA	11	70	22	94
Pictet	10	75	<b>23</b>	-7
<b>TOTAL MARKET</b>	<b>197</b>			
	<b>2015 ratios (%)</b>	<b>47</b>	<b>35</b>	
	<b>2014 ratios (%)</b>	<b>42</b>	<b>31</b>	

xx = new player in the 2016 top ten rankings compared with the 2015 rankings

Sources: Strategic Insight; BCG analysis.

Note: Analysis excludes money market funds.



such access is even more important than investment performance.

## Strategic Imperatives for Future Gains

As noted earlier, traditional asset managers' revenues declined by 1% in 2016, but costs were not reduced. As a result, their average cost-to-income ratio increased from 61% to 62%, and aggregate profits fell 2%.

We expect that, despite slow AuM growth and pressure on fees, traditional players' revenues will resume growing—but by a meagre 3% CAGR from 2016 to 2021 compared with 5% CAGR from 2008 to 2016. Costs, however, are likely to increase faster. Product life cycles are shortening, requiring asset managers to spend more on innovation and product launches to maintain growth. Moreover, technological advances require relentless investment; and the growing demands of clients and regulators also militate for higher costs.

This dismal outlook requires a strategic response. We believe that most of the significant gains will come from five sources: growth in China; product portfolio management and innovation; business models and M&A; technology; and cost management.

**Growth in China.** While China's robust growth is a global exception, many asset managers that invested there have yet to see positive returns. But prospects may be improving. The Chinese market and its investors are becoming more sophisticated. An aging population and the growth of wealth are expanding demand for dedicated products, including target-dated funds and ETFs. Meanwhile, foreign players are now able to get onshore licenses, and new regulations allow insurers and pension funds to enter the market. Foreign players that want to participate directly in the market have a growing number of potential entry paths. (See the sidebar "Entry Paths for Foreign Players Multiply as China's Market Evolves.")

**Product Portfolio Management and Innovation.** Despite the generally gloomy environment, there are pockets of growth in high-fee products, such as solutions, alternatives, and

traditional active. To take advantage of future growth, traditional players must move beyond their current product focus and find fresh opportunities in growth areas. Product development initiatives have served as the foundation for several success stories over the past few years.

**Business Models and M&A.** The market continues to polarize between very large players with passive or diversified offerings and small, specialist niche players—while the middle is getting squeezed. Firms that currently lack a source of sustainable competitive advantage will need to find one. Through M&A or organic transformation, they will need to more closely align with one or more of four business models, introduced in last year's report, that can drive sustainable success in the future. Players will need to become alpha shops, beta factories, solution providers, or distribution powerhouses, as we detail in this report's third chapter.

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To win, asset managers must become more adept in data and digital.

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**Technology.** New data analysis and decision-making technologies, including artificial intelligence (AI), are revolutionizing the investment management function. Distribution is also increasingly crucial to asset managers' success, and wholesale distribution is evolving especially fast. To win, managers must become more adept in data and digital. (See the sidebar "The Digital Leap to Next-Generation Wholesaling" on page 18.) If players do not act now, they will fall even further behind the front runners.

**Cost Management.** Continued margin pressure means that asset managers must seek any cost savings consistent with the company's growth strategies. Asset managers tend to believe that they know how to reduce costs because they can trim fat and make use of the bonus pool. But most are inexperienced in the more comprehensive overhauls that provide lasting impact. Our experience



## ENTRY PATHS FOR FOREIGN PLAYERS MULTIPLY AS CHINA'S MARKET EVOLVES

Foreign asset managers hoping to enter China's rapidly evolving market must do their homework. As with other markets, they should study local trends, understand the needs and expectations of investors, and calibrate what they themselves bring to the table as potential business partners.

They would also be wise to focus on the two most promising paths to entry: establishing a joint-venture partnership with a local player or obtaining a private fund-management license as a wholly foreign-owned enterprise (WFOE).

Joint ventures were once the most common path for foreign asset managers that were initially entering the market. Partnerships can help outside players secure a mutual fund license, thus opening the door to provide onshore services to a broad range of investors. Of the 109 mutual fund companies operating in China, 44 are Chinese-foreign joint ventures. They account for roughly 40% of the market's mutual fund AuM.

Under current rules, however, foreign ownership in joint ventures is capped at 49%, a minority share that can sometimes limit influence in the business. There is discussion of loosening the cap, which could make joint ventures more equal partnerships.

In the meantime, foreign interest is turning to the WFOE program, a recent initiative that allows foreign-owned companies to obtain Chinese fund-management licenses on their own. However, few foreign fund managers have obtained a license to date.

WFOE licensees have substantial limitations. They can offer onshore private funds only to institutional investors and individuals with high net worth. Retail investors, which account for a significant portion of China's AuM, may not participate.

Apart from these two direct channels, foreign asset managers can also tap growth opportunities indirectly.

One path for doing so is to receive a license to enter a so-called qualified domestic limited partnership (QDLP). The program allows foreign asset managers to sell offshore investment products directly to high-net-worth investors in China.

Joining a QDLP allows foreign players to raise Chinese-currency investment capital domestically and invest it in overseas assets. Significant constraints exist on QDLP funds, including a proscription on investing in onshore assets.

QDLP licenses are issued by the State Administration of Foreign Exchange (SAFE). The agency issues a quota that limits the size of a foreign asset manager's fund before it can open for business. Quotas usually start at \$100 million for each manager. However, they have sometimes been suspended or revised by SAFE if the agency believes that China's capital outflows are rising too quickly or that its currency faces pressure.

Becoming a registered fund through Mutual Fund Connect allows foreign players with registered funds and product manufacturing capabilities in Hong Kong to offer funds to Chinese retail investors. Investments sourced in China, however, are limited to 50% of a fund's capital base.

Another potential avenue for entry by foreign asset managers is the qualified domestic institutional investors (QDII) program, which permits Chinese companies to invest abroad.

Foreign players can leverage their overseas investment experience—in cooperation with a local institution holding a QDII license—to manage a QDII fund and to launch and sell competitive QDII products

## ENTRY PATHS FOR FOREIGN PLAYERS MULTIPLY AS CHINA'S MARKET EVOLVES

(continued)

to domestic investors. At the end of May 2017, SAFE had granted QDII quotas totaling roughly \$90 billion.

The main disadvantage of QDII funds is that, to date, foreign players can access only a relatively small portion of the market. As a result, domestic fund houses manage many QDIIs by themselves.

Still, joining a QDLP and the Mutual Fund Connect and managing QDII funds provide ways for foreign players to leverage their global product manufacturing capabilities.

To succeed in China, whatever the channel, foreign players must be keen students of the market's unique characteristics, trends, and tastes. To stand out among competitors offering thousands of local funds, they need to have a distinct brand and differentiated products, generate real value for investors, and associate with strong distribution partners.

Foreign asset managers should also understand the importance of offering products in China that compete on the basis of yield rather than an emphasis on stability. In a market where asset prices have soared rapidly, China's investors often

focus on products that maximize short-term absolute returns—unlike investors in developed markets, which often search for long-term stable returns.

In addition, foreign players should seek to provide diversified assets that help Chinese institutional clients improve their return on risk and global allocation and offer solutions that help fulfill the increasing regulatory requirements for asset liability management and the transparency of underlying assets.

As China's retail market rapidly goes digital, outside asset managers should focus on learning how to collaborate through digital channels while keeping pace with the country's digital customer experience. Data and analytics capabilities also will be critical to accelerate business growth in China, broaden access to partnerships, and provide the insights about investors' needs that are required to design winning products.

suggests that there are many opportunities to reduce costs in all functions, especially with regard to adopting the new digital tools that are now available. Four levers, in particular, stand out:

- **Organization Delaying.** Asset managers can delay the organization by increasing managers' span of control. This makes the organization more agile while reducing middle-management head count. In one recent project, a global asset manager increased the average span of control from five direct reports to six, resulting in two fewer layers and a savings of 15% to 20% in managers' positions.
- **Centralization and Automation.** Some functions can be centralized or automated or both. The obvious opportunities are usually in operations, IT, and support functions. It is not rare to cut original costs by 20% to 30%, and reductions can reach up to 35% in fragmented organizations. New robotics and automation tools allow digitization and automate key processes, dramatically reducing costs by 30% to 40% across targeted areas. For example, operations processes, such as data reconciliation, are good candidates for rule-based approaches, including robotics. Others, such as development of client material and reporting or informa-

tion processing by research and portfolio management, can adopt judgment-based approaches. These include AI, machine learning, chatbots, and natural language processing. Progressive asset managers are already launching automation and digital accelerators to build internal capabilities.

- **Efficiency Review.** More traditional approaches to systematically review efficiency should also be considered. Where asset managers are subscale, outsourcing can reduce costs. This is already common for back- and middle-office functions and increasingly used for support functions.
- **Business Transformation.** Large cost reductions can come from strategic moves—most obviously, from exiting underperforming lines of business. At a more tactical level, costs can be shed by rationalizing the product, pruning unprofitable clients, exiting poor locations, closing subscale sales offices, and reviewing service levels.

These are tough times for the asset management industry. The business is changing rapidly, and firms that lack a sustainable source of advantage will struggle to survive. Intense competition means that asset managers must strive for operational efficiency. But that

alone will not suffice. As we explain in the next chapter, success will require asset managers to offer investors a portfolio of products that satisfy demand where it is growing.

#### NOTES

1. Our research defines AuM as assets professionally managed in exchange for management fees, including captive assets of insurance groups and pension funds delegated to asset management entities with fees paid. Our measurements covered 153 leading asset managers in 43 markets, representing \$43 trillion, or more than 62% of AuM. For all countries whose currency is not the US dollar, we applied the 2016 end-of-year exchange rate to all past years to synchronize historic data. AuM differences with past years' reports reflect changes in exchange rates, methodology changes for some markets, and data changes from primary sources.
2. Revenue and product analysis is based on our global benchmarking sample weighted toward traditional asset managers and therefore not applicable to managers such as pure alternative players.

## THE DIGITAL LEAP TO NEXT-GENERATION WHOLESALING

As disruptive challenges reshape asset management, distribution success is increasingly crucial for generating sustainable growth of assets and profit. In the US, the largest potential channel is wholesaling—that is, distribution to retail channels through direct relationships with financial advisors and other intermediaries. Advisor-led assets now account for one-third of total AuM in the US and more than 75% of retail AuM.

Yet boosting revenue and net flows through advisors, or even retaining existing business, is increasingly elusive for asset managers. Their traditional wholesaling models and relationships have been undermined by accelerating changes in the advisory business—including the arrival of a new generation of advisors, the transition from commission-based models to those that are fee-based, and the slowing growth of the largest firms.

Consider a typical wholesaler who calls on retail financial advisors. Many of his or her most loyal clients are advisors preparing for retirement, thus ending long-cultivated relationships and setting money in motion. In the US, 40% of advisors will retire in the next decade, and fewer than half of them have succession plans. The younger advisors replacing them, advancing through a different system, often have different expectations for their wholesaler relationships. This is especially true for registered investment advisors (RIAs)—the individuals and firms constituting the fastest-growing market segment. RIAs tend to prize market insights as a basis for relationships with asset managers, given their client-focused, portfolio-management approach.

With their investment flows in play, some asset managers are making incremental changes to their traditional wholesaling model in an attempt to address the challenge. Leading firms, however, understand that success will require developing a next-generation operating model. While

retaining a focus on the advisor relationship, they are adopting highly sophisticated data and digital tools and capabilities in a comprehensive fashion to transform wholesaling into a growth engine for the future.

Successful next-generation wholesaling models, we have found, comprise four elements:

- Microsegmentation on the basis of big-data-driven profiling of financial advisors to create so-called curricula—that is, sets of specific messages and actions to influence an advisor's future investment choices
- A digitally enabled demand-response system and capabilities in marketing and sales to identify and prioritize the most promising opportunities and focus resources accordingly
- Timely, relevant, and coordinated messaging for each microsegment, with content synchronized in real time across channels
- Efficient and accessible digitized services that address an advisor's generic product questions and service needs

In our experience, firms that invest in transforming their distribution models on the basis of these four elements can increase wholesaling net flows from both existing and new clients by 10% to 50%. In addition, outflows can be reduced 10% to 30% by identifying and preventing potential losses.

### Microsegmentation

The first element in this transformation starts with assembling a highly detailed, data-driven profile of each advisor. An array of data sources, proprietary and public, are integrated into an analytic engine to create the profile, which includes the advisor's business model, transaction activities, and demographic characteristics. The individual profiles are then sorted into client micro-

segments for which individual curricula are designed.

Once the curricula have been mapped against the individual profiles, they are continuously updated and optimized by machine-learning algorithms that use performance data and qualitative feedback from the field. This ensures that the right actions are taken at the right time for each advisor.

### A Demand-Response System and Capabilities

This element identifies high-priority sales targets on the basis of digital and other data, such as inbound communications, product queries, responses to digital marketing initiatives, and web search engine data. The model allows an asset manager to respond effectively to demand signals, customize pitches and offers, and engage customers on their own terms and with regard to their own subjects of interest.

For example, imagine an advisor who has rarely recommended an asset manager in the past but suddenly logs a flurry of research activity on the firm's portal. Time spent meeting with this advisor, a potential new client, is probably a better bet than a courtesy call with an existing customer.

Demand-response models have driven significant success in other B2B industries, including health care and enterprise technology, but they are nascent in asset management.

### Messaging

Providing advisors with timely, relevant messaging and content across web, mobile, print, and other channels is critical for winning and maintaining a seat at the table. Advisors now enjoy quickly expanding access to digital information and tools to guide investment decisions, resources provided by their own organizations, rival asset managers, and other sources. That has raised the bar for wholesalers to earn a role in the decision-making process.

### Digitized Services

The final element of a next-generation model is the deployment of effective digitized service capabilities, focusing on self-service and the use of chatbots and other virtual assistants. These can address an advisor's generic product questions and service needs better and more quickly than manual processes, thus providing an improved experience while freeing the wholesaler for interactions with a higher priority.

### Integrating the Elements

To achieve a successful next-generation wholesaling model, all four elements must be integrated and operationalized together rather than as isolated solutions. Doing so will impose four broad requirements on an asset manager:

- A strategy that clearly defines desired business results and key use cases
- Advanced data and analytics capabilities, including the use of diverse data sets, deep learning, and AI analytics
- A scalable technology platform and effective coordination across systems and teams to deploy campaigns
- New ways of working, including agile development of digital tools and an evolving talent model for the wholesaling team

Integrating these elements requires a fundamentally new approach. Success is typically achieved not via large-scale project planning and one-time technology implementation but rather through iteratively building, testing, learning, and refining with wholesalers and advisors in the field.

A successful transition to a new model will therefore require a clear vision as well as commitment and investment. But the payoff will be significant for firms that succeed.

# A MATRIX MAKEOVER FOR INVESTMENT MANAGEMENT

**T**HE ACCELERATING PACE OF disruptive change in asset management has turned a spotlight on investment management. That function now sits at the crossroads of success and failure as firms race to enhance investment performance and achieve customer-driven product innovation, technological prowess, and heightened operational efficiencies.

Difficult times merit rethinking the basics of business strategy. To help asset managers clarify their strategic response, we have rebooted BCG's classic growth share matrix and applied it to the challenges facing investment management in the digital age.<sup>1</sup> The matrix remains relevant, with some important enhancements. (See "BCG Classics Revisited: The Growth Share Matrix," BCG Perspective, June 2014.)

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We have rebooted BCG's classic growth share matrix for the digital age.

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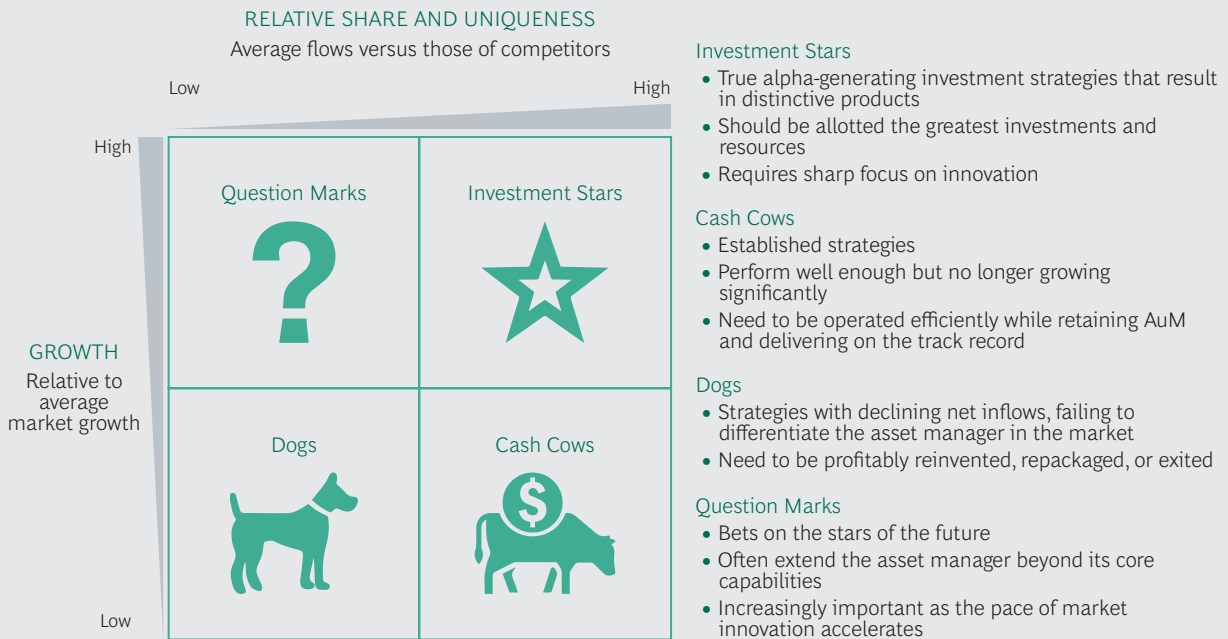
The growth share matrix enables companies to assess a portfolio of products, services, or businesses by assigning each to one of four quadrants on the basis of its market share and rate of growth: investment stars, cash cows, dogs, and question marks. Each quad-

rant defines a specific strategic imperative. (See Exhibit 8.)

Managing a portfolio of products is as critical to the success of asset managers as it is to other businesses. Recognizing which investment management products are in which categories is the first step toward effectively managing a product portfolio.

- **Investment Stars.** These are typically true alpha-generating investment strategies that result in distinctive products. Stars create the most value, we believe, and thus should be allotted the most investment and resources. Success will require a sharp focus on product innovation and continuous improvement in the use of data and digital technologies.
- **Cash Cows.** These established strategies—typically the core products and sometimes flagship funds—perform well enough but are no longer growing significantly. They provide the necessary cash flow to finance stars. It's important to find ways to operate cash cows efficiently while retaining AuM and delivering on the track record.
- **Dogs.** These strategies have declining net inflows, fail to differentiate the asset manager in the market, and are likely to

## EXHIBIT 8 | The Growth Share Matrix, Rebooted for Investment Managers



Source: BCG analysis.

generate losses over time. Unless they can be profitably reinvented or repackaged, dogs should be abandoned. Given that, in asset management, it can take years of outflows before economics are affected, some players have lagged in this effort. However, these difficulties are beginning to become more visible, and action is required for more and more players.

- **Question Marks.** These products and strategies are bets on the stars of the future. They often extend the asset manager beyond its core capabilities—such as when core active funds enter the infrastructure or alternatives space. Question marks are increasingly important as the pace of market innovation accelerates and the need to replace winning products becomes more urgent. The key to success is to deal with these products quickly, either by moving them into the star category or dumping them as dogs.

The refreshed matrix is a simple but powerful tool that can help maximize the competitiveness, value, and sustainability of investment management. It can balance the exploitation of mature strategies with the exploration of new strategies to secure future growth.

### Innovate to Build Your Stars

Generally speaking, we would expect to find three kinds of star strategies: top-performing active-core products, high-performing strategies in hot products (such as solutions and passives), and new strategies, especially in hot products.

The picture will vary by market and asset manager, of course. But in general, the correlation between fund performance and inflows is true for all regions. In the US, Europe, and Asia-Pacific, five-star, four-star, and unrated funds dominate recent inflows. (See Exhibit 9.)

The correlation between fund performance and inflows also holds true across most product categories in the US, as in other regions. (See Exhibit 10.)

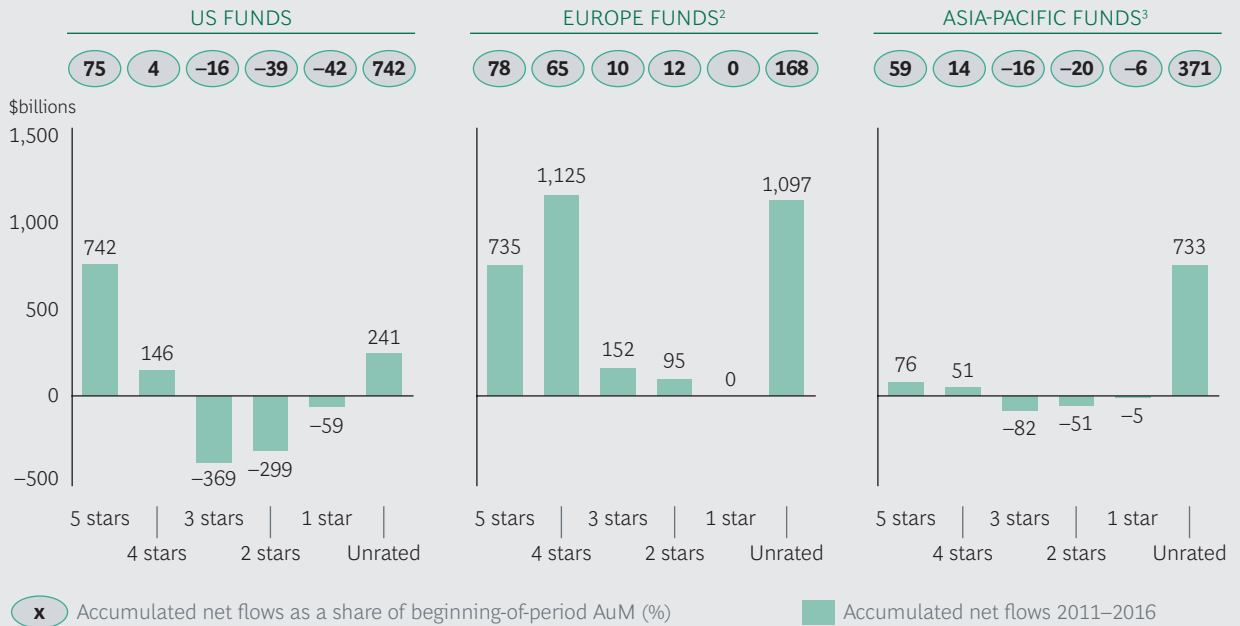
And the performance bar for winning those new flows is rising. In the US, for example, only five-star and unrated funds still benefit from positive net flows. (Exhibit 11.)

These trends represent the sources and trajectory of the industry's growth and highlight where asset managers should invest when bringing new products to market.



## EXHIBIT 9 | Top-Performing Funds Dominate the Capture of New Flows in All Three Regions

2011–2016 ACCUMULATED NET FLOWS BY FUND RATING FOR ALL ACTIVE PRODUCTS<sup>1</sup>



Sources: Strategic Insight; BCG analysis.

Note: Based on Morningstar ratings for mutual funds; unrated active funds mostly relate to funds that are less than three years old (91% in the US, 56% in continental Europe, 69% in the UK, 74% in Asia) or to specific product categories.

<sup>1</sup>Excludes money market.

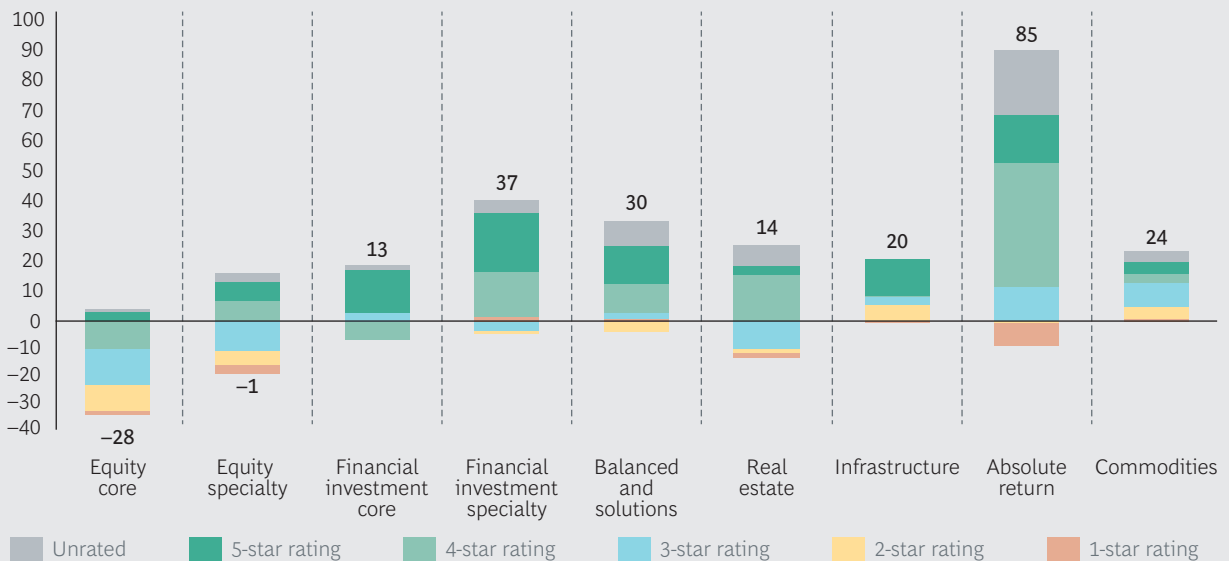
<sup>2</sup>Includes the UK and offshore.

<sup>3</sup>Includes Australia.

## EXHIBIT 10 | US Inflows Reflect the Dominance of 5-Star, 4-Star, and Unrated Funds by Product

2011–2016 US MUTUAL FUNDS BY RATING AND PRODUCT CATEGORY<sup>2</sup>

Accumulated net flows as a share of AuM (%)<sup>1</sup>



Sources: Strategic Insight; BCG analysis.

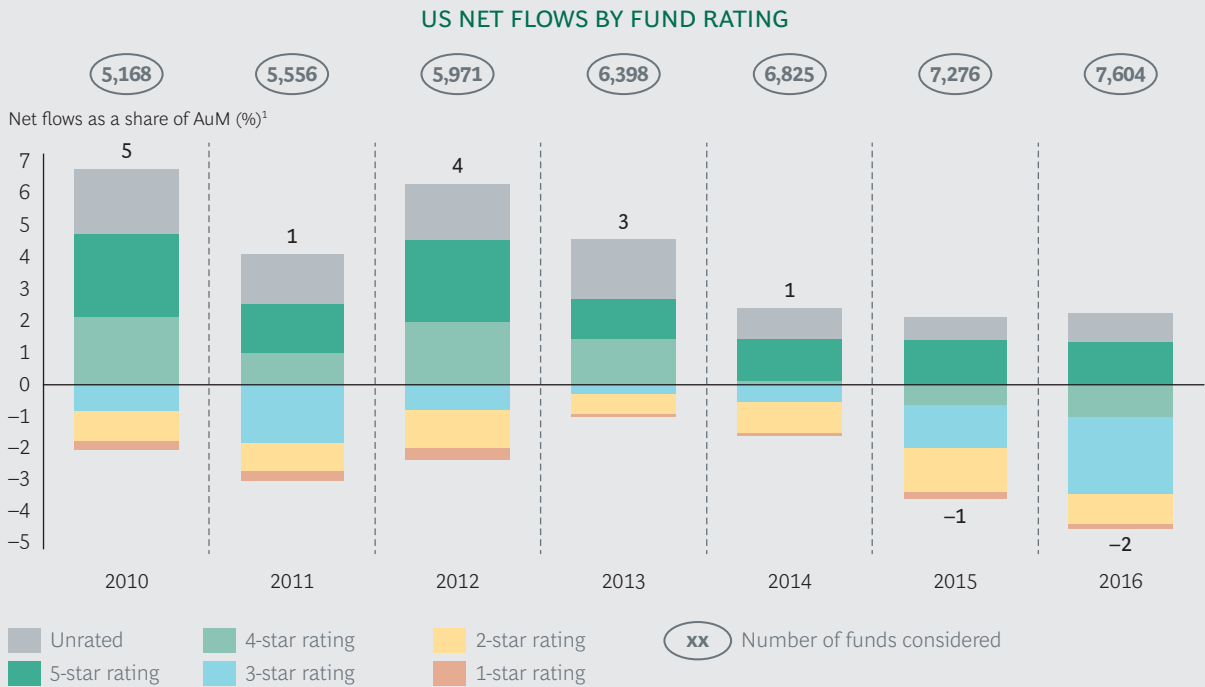
Note: Mutual fund ratings are from Morningstar; unrated active funds are those less than three years old (91%) or in specific product categories (equity, 3%; fixed Income, 3%).

<sup>1</sup>Based on beginning-of-period AuM.

<sup>2</sup>Not including exchange-traded funds or money market funds.



**EXHIBIT 11 | As the Performance Bar Rises, Only 5-Star and Unrated Funds Now Benefit from New Flows in the US**



Sources: Strategic Insight; BCG analysis.

Note: US mutual fund ratings are from Morningstar; unrated active funds are those less than three years old (91%) or in specific product categories (equity, 3%; fixed Income, 3%).

<sup>1</sup>Based on beginning-of-period AuM.

High-performance investment management is difficult to sustain over the long run. To maintain an edge, it is critical to invest and innovate—whether by adopting the latest data and analytics technology to support existing products or through innovating with those technologies.

- Data and Analytics Innovation.** The findings of our 2016 survey revealed that a small set of best-in-class asset managers already use AI, data visualization tools, machine learning, and natural language processing. Most players lag behind in those capabilities. Less than 50% of asset managers reported using big data and advanced analytics, beyond aggregation and integration techniques. We expect this gap in capabilities to grow, widening the divide in performance between leaders and laggards.
- Product Innovation.** Because newer funds attract greater inflows, product innovation is increasingly important. Even in a slow-moving market, we expect to see a

sustained pace of innovation. That will heighten a fundamental challenge of innovation: getting the timing right. Many good ideas take time to mature and become relevant to investors. Such is the case with socially and environmentally responsible investing. For years a niche market, it is now going mainstream as an important area of innovation for leading asset managers. (See the sidebar “Responsible Investing Grows from Niche to Mainstream.”) Some asset managers have mastered it, but most are still learning.

Innovation requires a more agile way of working, with dedicated cross-functional teams (involving staff from marketing, sales, operations, technology, and investment) and iterative processes that allow a new product to be designed and launched rapidly.

Asset managers needn’t be trail blazers—in fact, they can do better as fast followers. But they will be more successful if they are able to launch strategies within three months of an idea surfacing in the market. That

## RESPONSIBLE INVESTING GROWS FROM NICHE TO MAINSTREAM

Who cares whether corporations do good, as long as they do well? A growing number of socially and environmentally conscious investors, that's who. And there is increasing evidence that their bets on companies with above-par practices on those issues are paying off.

What began as a niche market is now an area of increasing interest and innovation among mainstream asset managers, including private equity firms. Their clients, both institutional and retail, are demanding access to responsible investments because they truly care about those issues—and because they believe they get extra alpha.

Meanwhile, companies are doing more to establish, measure, and report on efforts to improve environmental, social, and governance (ESG) practices. This trend is partly the result of growing interest among investors. But it also reflects that many CEOs genuinely care to make a positive impact and believe that the business benefits of doing so are significant.

A number of studies have also concluded that socially responsible behavior by companies on issues material to their business can have a significant, positive impact on their financial performance.

Gender diversity at companies leads to markedly better performance, for example, yet most executives don't have a clear plan for achieving it. (See *Getting the Most from Your Diversity Dollars*, BCG report, June 2017). The study identifies the measures that work—and those that don't.

In a recent report, Harvard Business School authors Mozaffar Khan, George Serafeim, and Aaron Yoon found that stock market returns were significantly greater for firms with good performance on social and environmental issues that are materially relevant to their business strategy and operations than for firms with poor

performance. They found that the alpha for the portfolios of top-rated companies ranged from 3% to 7% higher than the portfolios of bottom-ranked companies, depending on weighting. Similarly, they found that strong performers had better return on sales than poor performers.

Another study—by Robert Eccles, Ioannis Ioannou, and George Serafeim—found that companies adopting a broad set of social and environmental policies enjoyed higher stock market performance, return on assets, and return on equity than other companies.

BCG's research on companies that use their core business to create positive social and environmental impact goes a level deeper. The research, the subject of a forthcoming study, focuses on identifying specific topics, by industry, that have positive correlations with valuations and fundamentals.

While initial findings are promising, and investor interest is clearly rising, responsible investing faces challenges with regard to definitions, data availability, and measurement. Groups including the Sustainability Accounting Standards Board have identified industry-specific ESG issues that companies should manage and report. These include proposed KPIs providing apples-to-apples comparisons similar to financial reporting.

While the approach has potential, no consensus has been reached in actual practice by either companies or investors. As a result, comparing the performance of companies is difficult even when they report ESG information—and many do not.

This is changing as company reporting gets better, vendor data becomes sharper, and investors refine their models. These are all positive signs for the future viability of responsible investing.

means faster cycle times for the sales team to find initial investment, testing the strategy, and market launching. Investment managers need to learn to fail fast and fold a strategy quickly, even when it means returning money to investors.

## Milk Your Cash Cows

The cash cows of the asset management business are the core active strategies. This is where the asset manager will have an established brand that allows it to maintain AuM. Margins on these mature products are compressing, but scale and the absence of development costs means that they continue to generate good cash flows. Net flows do not always run toward these products, so their contribution to the asset manager's profit will diminish over time. Asset managers can respond in one of two ways.

The first is to try to turn these products into stars. This would require investment, perhaps in star portfolio managers (PMs) with expertise in these products or in reinventing the product's delivery or packaging to be more attuned to client needs. Most cash cows, however, will not transform into stars.

Asset managers can maintain the profitability of their cash cows by cutting the cost of supplying them. This can be achieved in at least five ways:

- **Increase PM loads.** The obvious objection to this method of cutting costs is that it threatens performance. However, we have seen the move succeed when it is achieved by better aligning the time that PMs spend on activities with the value that those activities create. Activities that add no value should be eliminated. For example, we found that one client's PMs spent a significant time on operational and reporting activities that could have been handled by middle-office staff. In addition, the relationship between time spent and value contributed by specific strategies and clients was weak. Reviewing and centralizing trade execution and middle-office activities fixed these problems, allowing significant gains in efficiency without damage to client service.
- **Streamline research.** Many asset managers are using new tools to promote knowledge and data sharing. This not only cuts research costs but also improves performance as front-office staff learn from the successful practices of managers in different asset classes.
- **Reduce customization.** Product customization can be important to success; in fact, more than 70% of our survey respondents provide customization. But it can be expensive. Asset managers should offer it only when it is needed to generate value and can be done efficiently. In addition, just 8% to 41% of our survey respondents price in the cost of customization either systematically or in the majority of cases. And only 8% to 26% of companies price the cost of customization using risk-return target adjustments. In the new market environment, asset managers need to understand the costs and benefits of customization and, hence, how to offer it at scale and make the value transparent to the clients.

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Maintain the profitability of cash cows by cutting the cost of supplying them.

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- **Centralize trading.** There was once value in keeping trading desks close to the PMs. However, the electronification and commoditization of trading has made this less important. Many asset managers are combining trading desks and rationalizing trading platforms across locations and asset classes. This can dramatically reduce technology and transaction costs—for example, by netting trade blocks together.
- **Reduce technology costs.** The front offices of most asset managers have accumulated systems that are poorly integrated, rely on multiple data sources, require manual data reconciliation, and run on antiquated technology. Our survey found that only 50% of asset managers have invested in a new front-office system in the past five years, despite the advance

of technology. Legacy systems are costly to maintain and upgrade, and they undermine performance. Many asset managers struggle to get new funds to market because processes rely on multiple systems or complex batches that impede data flowing back to the front office. Many firms would benefit by migrating from largely proprietary platforms to a mix of customized commercial platforms—at least for standard functions, such as portfolio, order, and execution management systems. Proprietary tools should be used only for critical “secret sauce” apps. This would reduce maintenance costs, ease the launch of new products, and focus scarce in-house technology resources where it matters most.

## Dump the Dogs

Asset management dogs are usually me-too products in the core active space; they are undifferentiated and low performing. Companies need to take a hard look at each product. Is the fully loaded margin positive? If not, is the product needed for other reasons—for example, as a building block for a client solution? If so, can it be sourced in another way or replaced?

Measuring a product’s actual contribution can be difficult because a portion of its costs are indirect and could persist even if the product were eliminated. Even harder is making the decision to axe an investment strategy, because closing a strategy means letting go of AuM, and capturing the savings in the indirect costs is difficult. But these problems are not insurmountable.

We recently helped an asset manager identify and eliminate a substantial number of weak investment strategies. An analysis of true margins, based on both direct and indirect costs, found that about 30% of the firm’s strategies were negative current contributors or had poor future prospects. The solution was to wind down strategies by reallocating them to an adjacent PM desk and ceasing their marketing. Given the critical mass of strategies eliminated, the company not only closed desks—cutting direct costs—but also eliminated indirect capacity, such as in trad-

ing and operations. Significant savings were redirected to newly prioritized products.

## Bet on the Question Marks

Question marks stretch an asset manager beyond its core competency, such as when a traditional asset manager expands into alternatives or private assets. The key to success here is to make decisions quickly, doubling down on question marks when they look like stars in the making and abandoning them quickly when it’s clear they’re going to the dogs, so to speak.

Products identified as potential stars can be scaled up in three ways: organically, by hiring needed investment professionals, or through acquisitions or partnering.

When the product is in a space sufficiently close to the firm’s established business, scale can be created organically. For example, an asset manager focused on fixed income can use its existing client relationships and processes to move into infrastructure.

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Potential stars can be scaled up organically, by hiring, or by acquisitions or partnering.

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But this won’t be possible when a firm is moving well beyond its core business. In this case, hiring the needed investment and sales staff can be an attractive option. One firm we know built an adjacent infrastructure business this way. Having identified demand in the client base of its existing core products, the firm poached a team of investment managers experienced in the product and launched a pilot. The pilot was extraordinarily successful, and the client quickly scaled up, growing from \$2 billion AuM in alternatives to more than \$30 billion in just three years.

The third option is to acquire or partner with another firm. This firm could be a niche player with capabilities in the right areas or a larger player with a complementary footprint. But M&A is far from a sure thing. Forming partnerships with players that have man-

ufacturing know-how but lack distribution can be a more prudent path. This can allow the distributor to test market viability before developing full capabilities.

Partnering with third-party asset managers is a top priority on the agenda of many insurers. Leading players are developing bold,

high-impact ways to manage general account assets in the face of low interest rates, market volatility, and secular shifts in risk and return. The value at stake can be immense—more than \$100 million in annual earnings for a \$100 billion general account. (See the sidebar “Insurers Wring Extra Earnings by Refocusing Investment Management.”)

## INSURERS WRING EXTRA EARNINGS BY REFOCUSING INVESTMENT MANAGEMENT

Investment management is higher than ever on insurance companies’ agendas. The value at stake is immense: some insurers have increased the annual earnings of a \$100 billion fund by more than \$100 million. In-house investment teams and third-party asset managers can help companies succeed in investment management.

Insurers’ core businesses have been under pressure on a number of fronts, while their general account funds (the assets that support insurance liabilities) face low interest rates, market volatility, and secular shifts in risk and return. Many insurers have not kept up with the changes, and, in the past, some have treated the investment function as a back-office process. But leading insurance players are developing bold, high-impact ways to better manage their general account assets. They are learning from top asset managers, pushing the boundaries further, and creating more partnerships than ever to access expertise.

Overall, we see players achieving significant incremental risk-adjusted annual returns in select asset classes. Measurable gains can exceed 10 basis points averaged across a general account—or \$100 million for a \$100 billion fund. The actions some insurers are considering include:

- Optimizing asset class allocations and expanding into new diversifying, higher-value asset classes, such as private debt
- Accessing skill where it is best available, building specialist internal teams in

some areas while outsourcing elsewhere—though always with close oversight and careful risk management

- Improving investment execution, such as mandating frameworks that are closely aligned with insurers’ liability profiles and required returns on capital, using more advanced research and market insight and implementing more robust investment decision processes
- Enhancing organizational structures—for example, a multijurisdictional insurer adopting a matrix approach and creating global centers of excellence for specialized asset classes, asset structuring, or asset-liability management
- Boosting operational efficiency, such as by automating key processes with new digital tools and creating shared-services platforms

The amount of value at stake is enormous, yet the challenges of achieving it are significant. Consider, for example, access to data and the use of performance analytics. Even seasoned experts are surprised by how widely the approaches to measuring returns can vary. Low-hanging fruit seems to be available.

Yet creating effective partnerships that offer real value to insurance clients is not completely straightforward. Asset managers need to develop a full understanding of the financial, regulatory, and fiduciary impact of different investment choices for insurers. Only then can a manager help

## INSURERS WRING EXTRA EARNINGS BY REFOCUSING INVESTMENT MANAGEMENT (continued)

improve a partner's strategic asset allocation and asset liability management, both of which have substantial impact on insurers' profits.

This enriched understanding is also necessary for the asset manager itself to benefit. Knowing which investment processes and mandate structures are needed allows the manager to create scalable products that provide liability-specific solutions for multiple clients.

Asset managers have extensive data and analytics capabilities. Repackaging them for use by cost-conscious clients will support their investment and asset liability management frameworks and cement partnerships. Ultimately, the true test will be in the delivery of what every insurer

wants: consistent, liability-beating returns that map well to available capital and risk appetites.

For asset managers, the real reward of closer proximity to their insurance clients' balance sheets is the ability to move up the value chain from providing commoditized products to offering higher value (and diversifying) asset classes, as well as more comprehensive solutions.

As the economic and market cycles mature, sharing knowledge, expertise, and infrastructure—whether to add value or manage risk—becomes more valuable than ever. Suddenly, asset managers and insurers need to understand each other much more clearly.

Of course, some question marks will turn out to be dogs. The sooner an asset manager recognizes and acts on this, the better. The recent exit of private equity players from the hedge fund business shows how bets that seem attractive on paper can prove to be too far removed from the investor's core business.

Asset managers and their products must evolve if they are to prosper in the new market environment. This will require investment managers to become true innovators—knowledgeable about the latest digital and data technologies, skilled in adopting new tools and partners, and ruthless in managing costs.

In disrupted, quickly shifting markets, a sharp view of where value is generated—combined with the ability and agility to make tough, quick decisions—can position players for growth.

### NOTE

1. The growth share matrix was introduced by BCG's founder, Bruce Henderson, in 1970. By the late 1970s and early 1980s, the matrix, or approaches based on it, were used by about half of all *Fortune* 500 companies.



**T**HESE ARE TRYING TIMES for asset managers. Changes in technology, asset performance, and customer preferences leave many with unsustainable business models. Some may be able to make the required changes organically. But M&A will often be the more attractive option. Bold firms can rapidly acquire the scale, products, expertise, or distribution channels they need for sustained success.

M&A is not a silver bullet, however. Less than half of M&A deals in asset management create shareholder value. Indeed, when ill conceived or badly managed, they can be calamitous. Firms undertaking a deal must understand the strategic imperative it serves, and they must have the right team, whether internal or external, to get the job done. Postmerger integration must be executed swiftly, with strict discipline.

### A Future Shopping Spree?

Conditions that promote consolidation have been present in asset management for several years. Flows have concentrated, distributors have consolidated their suppliers, and fixed costs have risen as a result of technological and regulatory change. However, M&A activity has only slowly picked up in recent years. The number of asset management deals globally rose from 49 in 2011 to 65 in 2016. (See Exhibit 12.)

Now, with the industry's economics continuing to deteriorate, M&A activity will likely accelerate both in quantity and magnitude. Most deals in the past were small tuck-in acquisitions driven by private equity or multiaffiliate firms. But we expect deals to become larger and often cross-border, giving rise to more challenging postmerger integration. Indeed, such deals are already occurring: three very large cross-border mergers have taken place in recent months.

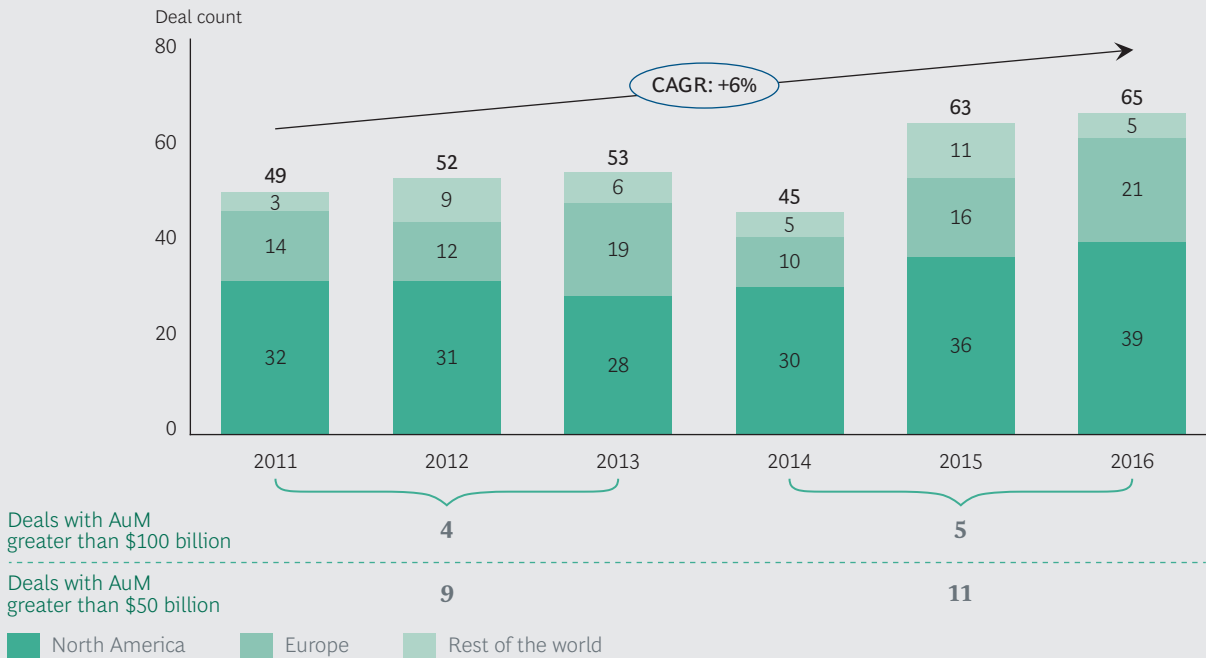
But this trend does not, in itself, support the viability of any given deal. M&A must serve some strategic purpose, putting the combined entity in a stronger market position than either of its component firms before the integration.

### Strategic Goals for Asset Management M&A

In last year's report, *Global Asset Management 2016*, we identified four winning business models that can deliver sustainable success for future asset management. (See Exhibit 13.) Each is grounded in clear, compelling, and sustainable sources of competitive advantage:

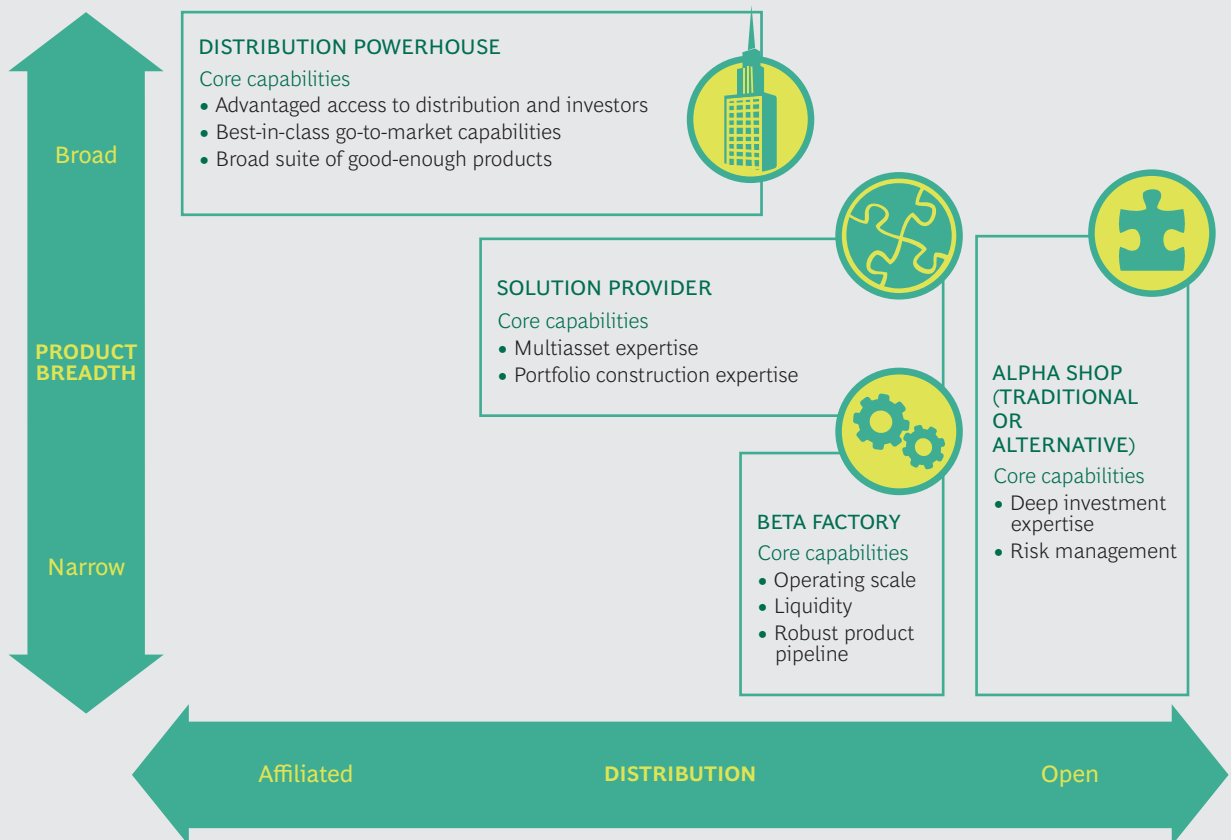
- **Alpha shops** have deep investment expertise in specific asset classes and investment strategies.
- **Beta factories** have scale and operational efficiency.

### EXHIBIT 12 | Asset Management M&A Has Accelerated Slowly Over the Past Six Years



Sources: P&I; BCG analysis.  
 Note: Two deals with AuM greater than \$100 billion are scheduled to close in 2017.

### EXHIBIT 13 | Four Winning Asset Management Business Models of the Future



Source: BCG analysis.



- **Solution providers** are skilled in multiasset class portfolio construction, asset allocation, manager selection, and monitoring.
- **Distribution powerhouses** have superior access to investors and distributors and offer best-in-class support to intermediaries.

Many asset managers have adopted some aspects of one or another of the models but do not fully embrace any one in particular. M&A can help to close the gap in three ways:

- **Product expansion: access to new products and investment capabilities.** One notable recent merger was driven by product complementarities, allowing the merged entity to offer a comprehensive set of strategies to a global distribution network by combining one firm's alternatives-heavy portfolio with the other firm's specialty and multiasset product lines.
- **Distribution expansion: access to new distribution channels or end clients.** This was the primary rationale for a recent merger in which the acquirer, which served primarily institutional investors, gained a broad proprietary and third-party retail network through which it could sell its products.
- **Volume expansion (scale): reduced unit costs from adding volumes to an existing platform.** Scale typically works in technology and operations-heavy businesses, where the advantages of scale can dramatically improve competitive positioning; it is therefore more suited for passive players. And while scale has resulted from some recent mergers—with cost benefits ranging from 10% to 20%—this was not the primary rationale for merging. Since many firms now outsource operations and IT, scale benefits may be captured by asset servicers rather than asset managers.

The merits of any deal, of course, depend on an asset manager's starting position, its target business model, and the availability of better ways of achieving it, such as organic growth or partnerships.

Firms that are now regional asset managers—players with balanced product offerings and strong regional distribution networks—can leap to the solution provider model. We believe that multiasset class portfolio construction, manager selection, and other solutions will continue to grow faster than the market and generate higher margins. M&A can supplement the product range or packaging capabilities of regional players, which they can then sell through their current distribution networks.

Alternatively, M&A can turn regional asset managers into distribution powerhouses. The distribution of asset management is changing as intermediaries consolidate and firms move toward direct distribution. Regional players can use M&A to realign their distribution networks with these trends. And M&A can help them distribute their products to new markets outside their home regions.

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## M&A can turn regional asset managers into distribution powerhouses.

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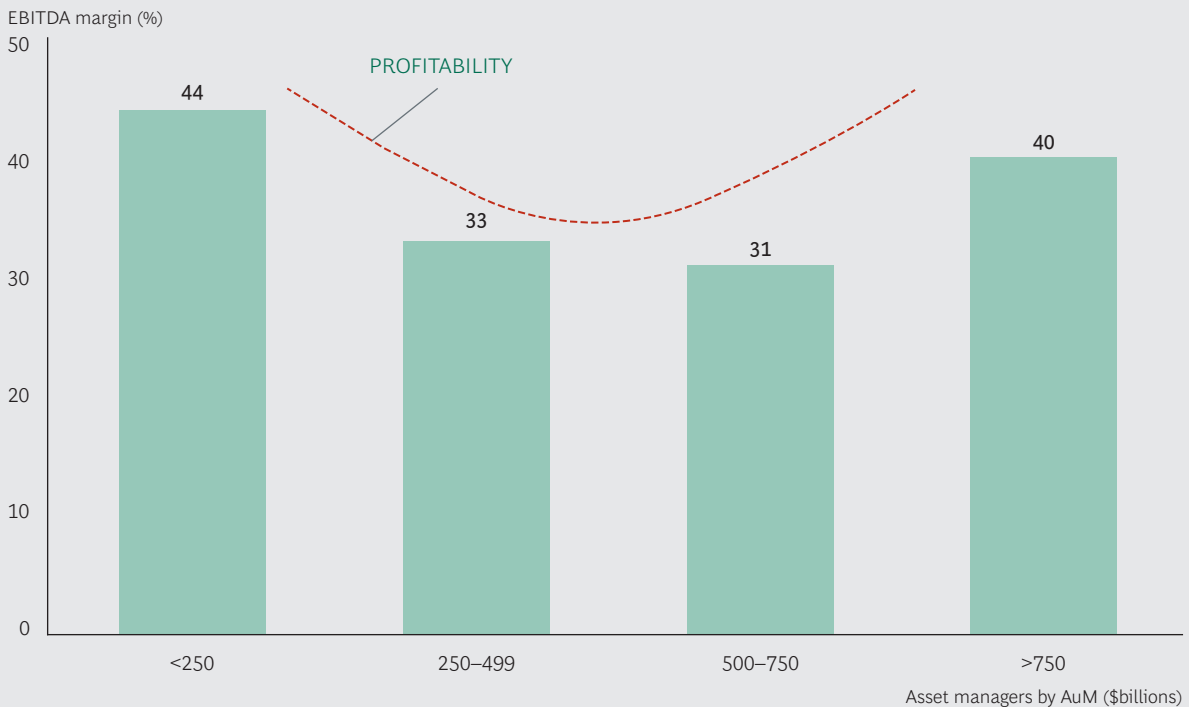
The situation may be more complicated for small and midsize asset managers, which typically have an incomplete product offering, a partial distribution network, or both. Their profits are being squeezed, which makes them attractive targets. (See Exhibit 14.)

For these players, being acquired may be a tempting option. However, assuming that a midsize asset manager can find some source of differentiation, merging with or acquiring another company may allow the asset manager to gain the extra product or distribution capacity it needs to have a viable business model.

Passive players, with lower margins, will continue to depend on scale, a strong product pipeline, continuous innovation, and access to distribution. Sensible M&A plays will depend on a firm's strength in these three dimensions. If not among the top players in the space, a passive manager can become a beta factory

## EXHIBIT 14 | Midsize Players Are Stuck in the Middle with Squeezed Profits

### ASSET MANAGER PROFIT MARGIN RELATIVE TO SIZE OF AUM



Source: BCG Global Asset Management Benchmarking Database 2016.

Note: EBITDA = earnings before interest, taxes, depreciation, and amortization.

by simply acquiring new volumes to add to an existing platform, thereby lowering unit operational and IT costs and allowing the asset manager to compete on price. Or, if distribution is misaligned with the typical passive channels (such as institutional, wirehouses, registered investment advisors, and index fund advisors), it might acquire additional distribution. M&A can also deliver new product capabilities to a player with a strong passive platform but a lackluster product offering.

Of course, some firms already exemplify one of the four winning models. For these global leaders, M&A can be useful for consolidation rather than transformation. Any deal should strengthen the characteristics that made the firm a global leader, whether through its product offering, distribution, or operational scale.

### Success Depends on Postmerger Execution

The success of an M&A deal is far from guaranteed. The ten largest deals of publicly traded asset management companies over the past six

years show a wide spread in total shareholder return (TSR). Only four achieved a TSR that clearly outperformed the asset management industry. The other deals either delivered no gain to shareholders or destroyed value.

BCG research across industries suggests that serial acquirers with a proven integration playbook produce twice the TSR of one-time acquirers (10.5% versus 5.3%). (See *2016 M&S Report: Masters of the Corporate Portfolio*, BCG report, August 2016.) Executing a successful integration is a skill that only a few firms have mastered, especially in the asset management industry.

On the basis of our global experience in supporting postmerger integrations, including several recent integrations in asset management, we suggest 12 imperatives. (See Exhibit 15.) These principles apply broadly to postmerger integration across industries, but five are especially important in asset management:

- **Define first principles: merger in support of a better business model.**

## EXHIBIT 15 | There Are 12 Imperatives for Success in Postmerger Integration



Source: BCG client experience.

While scale is important in asset management, growth through acquisition is a winning formula only if it achieves or consolidates a winning business model. If done for the wrong reasons, a merger can dilute the brand, erode margins, and drive away the firm's top talent. A strategic North Star must guide the journey, informing all decisions in the integration.

- **Cost synergies matter, but revenue synergies matter more.** Cost synergies are important for generating short-term value, sending a signal to shareholders, and funding subsequent transformation. They also have the virtue of being predictable, typically reducing unit costs by 10% to 15% when overlap is limited and by 20% to 30% when overlap is considerable. But cost reduction is not the main show. Asset management remains a high-margin business, and the top priority should be growing AuM—for example, by cross-selling current products into new regions or through new channels, or by providing new or stronger products in current

markets. When the merger is well conceived, additional net new flows of 5% to 10% should be achievable, contributing more to the bottom line than cost synergies do. Delivering these synergies needs careful planning before the close, and rigorous program management after it.

- **Decide on a workable organization—and do it fast.** M&A provides valuable opportunities to review and redesign the operating model, starting with the front office and moving to the rest of the organization. At BCG, when we work with a company's leadership, we ensure that organizational decisions are made quickly, starting from the top within a month of announcement of the merger and continuing across the organization before close. Slow and indecisive action in the target organization can lead to extended paralysis and the loss of top talent. The best portfolio managers, analysts, and sales staff will not wait around to see where the chips fall. Decisive action is easier in an acquisition than in a merger—especially a

merger of equals. In that case, the difficulties can be considerable, and serious thought should be given to the ultimate organization before the deal is done.

- **Communicate, communicate, communicate.** The time between announcing a merger and closing the deal typically involves considerable uncertainty among leadership teams, investment professionals, staff, regulators, distributors, and clients. Failure to communicate can have profound consequences. Without information, people will assume the worst. In the first few months of the integration, we typically work with the leadership team to articulate the mission and vision of the new business and the value it will generate for clients, shareholders, and employees. Many firms focus on the first two categories but forget about the employees, who are especially nervous. Competitors will use the opportunity to poach talent and clients.
- **Embrace cultural differences.** The culture of asset management firms typically runs deep. These companies are people businesses, often with strong brands and

iconic leaders. Integration can lead to cultural clashes that can be exacerbated when the new leadership team acts inconsistently and does not quickly come to speak with one voice. The target culture must be defined rapidly with a clear and honest acknowledgment of differences. In postmerger integration work, we often conduct a culture survey across the organization to pinpoint any cultural conflicts that should be addressed. This requires buy-in from senior managers, who not only enforce behavioral rules but also promote and exemplify the target culture.

Many asset managers will be able to find acquisition targets that can help them become true alpha shops, beta factories, solution providers, or distribution powerhouses. And in current market conditions, those targets may be available at a price that makes the deal viable. But this is where the real work begins. Great strategy often fails from poor execution. Acquirers must make sure not only that the deal makes sense but that they have the right team to make it work. Too much is at stake to risk it through uncertainty.

# FOR FURTHER READING

The Boston Consulting Group has published other reports and articles that may be of interest to senior financial executives. Recent examples include those listed here.

**Global Wealth 2017:  
Transforming the Client  
Experience**

A report by The Boston Consulting Group, June 2017

**Global Capital Markets 2017:  
Mastering the Value Migration**

A report by The Boston Consulting Group, May 2017

**Global Risk 2017: Staying the  
Course in Banking**

A report by The Boston Consulting Group, March 2017

**Global Asset Management 2016:  
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A report by The Boston Consulting Group, July 2016

**How Asset Managers Can  
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**Global Retail Banking 2016:  
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A report by The Boston Consulting Group, May 2016

**Why Life Insurers and Asset  
Managers Must Join Forces  
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An article by The Boston Consulting Group, December 2016

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