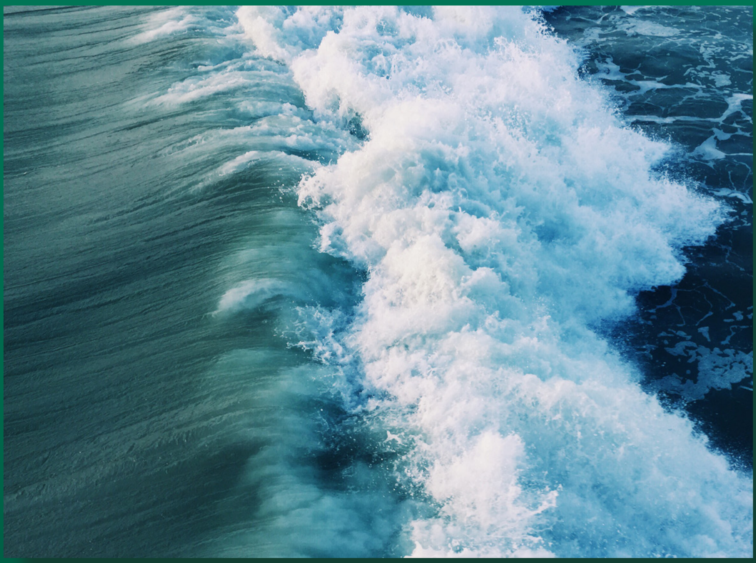
Global Asset Management 2018

The Digital Metamorphosis



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Global Asset Management 2018

THE DIGITAL METAMORPHOSIS

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INTRODUCTION

Asset management is in the midst of a metamorphosis, and so are its practitioners. Fresh evidence of flux and reinvention fill every corner of this report, The Boston Consulting Group's 16th annual study of the industry's current performance and huge potential.

Global asset management enjoyed strong growth in 2017. Fueled by bull markets, the industry broke its global records for net inflows and profitability. Assets under management (AuM) grew at their strongest rate in a decade. The robust 2017 results were especially remarkable in view of the previous year's plodding performance. In 2016, both global revenues and global profits fell for the first time since the 2008 financial crisis, and margins contracted. Still, most of the bounce-back growth of 2017 was market driven, not structural. Below the surface, pressure on margins (due to continued fee erosion and cost pressures) will persist, especially when the strong equity-market run eases or turns, as it eventually will.

The most successful firms will manage their business the way owners would. They will tightly manage costs and reinvest the savings—along with the temporary riches of 2017. Doing so will enable them to reinvent their platforms for the next wave of growth, while protecting their business against future adverse conditions.

Another sign of metamorphosis: asset managers continue to follow the shift in investors' product preferences from traditional active products to passives, solutions, and real assets. The expanding push into "smart beta"—passive products with an active component— by some firms could pose a bigger threat to active management than the broader passives trend. But to be competitive, firms joining the smart-beta bandwagon will need to achieve scale and an industrialized approach. Meanwhile, for firms charting their evolution amid shifting product trends, product diversification is a hotter topic than ever.

Geographic diversification also matters. The metamorphosis of regional markets in the global order is accelerating. The growth and potential of China stood out again in 2017 as that market advanced to become the world's fourth largest in AuM. The partial opening of the Chinese market, combined with its rapid growth, has created the conditions for a potential gold rush among foreign firms. Even so, such firms continue to have limited access to the market, and their role remains at an early stage of development. Meanwhile, domestic players are rapidly innovating—often in partnership with fintechs—and experiencing explosive growth. These achievements increase the challenges and opportunities for players that succeed in gaining entry.

The biggest act of reinvention, however, is still to come: embracing the full potential of the digital and analytics revolution. Despite its resources, the $79 trillion asset management industry hasn't rushed to join the first movers of that revolution. The digital assets of even the most advanced players fall far short of the operational and customer platforms of the world's leading digital-first businesses—from Amazon, Alibaba, and Apple to Baidu, Facebook, and Google.[1] But digital and analytics are finally going mainstream, as firms hire technologists and experiment with new analytics and alternative data. Every asset manager we engage with these days has a digital and analytics agenda.

We see 2018 as an inflection point in this transformation, with a lot more change ahead. Five years from now, asset managers will look very different from the way they look today, in part because of digital innovation and in part owing to structural shifts in the market.

To accomplish these profound changes across the board, we believe, most firms will have to adopt agile ways of working—methods that software developers devised to speed product development. Most asset managers are siloed organizations, but the collaborative teaming and problem-solving processes of agile can break the traditional siloes and accelerate the process of identifying, testing, and implementing change. This, in turn, could help unlock efficiencies for asset managers, which tend to be short on scale but long on talent.

Finally, digital and analytics advances are reshaping the market—creating opportunities for innovators to leapfrog forward and posing challenges for those who stay behind. Firms should act now to join the former and avoid getting caught among the latter.

When equity market growth slows, as it showed signs of doing in early 2018, flows will likely return to lower levels. Asset managers should take advantage of the past very strong year to leverage their capital and talent and reinvest in future growth. The ability to think longer term, as an owner does, will differentiate the winners from the industry also-rans.

The benchmarking survey that informed this year's report drew on 165 leading asset managers representing $48 trillion—or more than 65%—of global AuM and covered more than 3,000 data points per player. Our measurements assessed assets in 44 markets globally, including offshore. The aim of our annual research is to provide new insight into the current state of asset management and its underlying sources of profitability, to help managers build prosperous paths to the future. We hope you find it useful.

Note

1. In fact, the industry lags behind most others in data, analytics, and digitizing itself, even though investment data is a foundation of its business model and customer offerings. Asset management ranked 24th among 34 industries in digitization, according to a report by BCG and Morgan Stanley. (See "Data Analytics for Financial Institutions: The Journey from Insight to Value," BCG article, May 2017.)

A SNAPSHOT OF THE INDUSTRY

The asset management industry's growth accelerated in 2017, setting global records for net inflows and for profitability.[1] Over the past year, total assets under management (AuM) experienced their strongest growth in a decade.

The record profitability and improved margins of 2017 were largely the result of buoyant financial market investments and related net flows, evidence that many asset managers continue to depend on market swings. When the strong market expansion ends, as all bull markets eventually do, the firms that prevail will be those that operate with the mindset of owners—managing costs, protecting margins, and investing in future growth.

Global AuM Rises to $79.2 Trillion

The value of global AuM rose by 12% in 2017, to $79.2 trillion from $71.0 trillion in 2016. (See Exhibit 1.) It was the strongest annual growth since 2009, when assets rebounded from the depths of the global financial crisis the year before.[2]

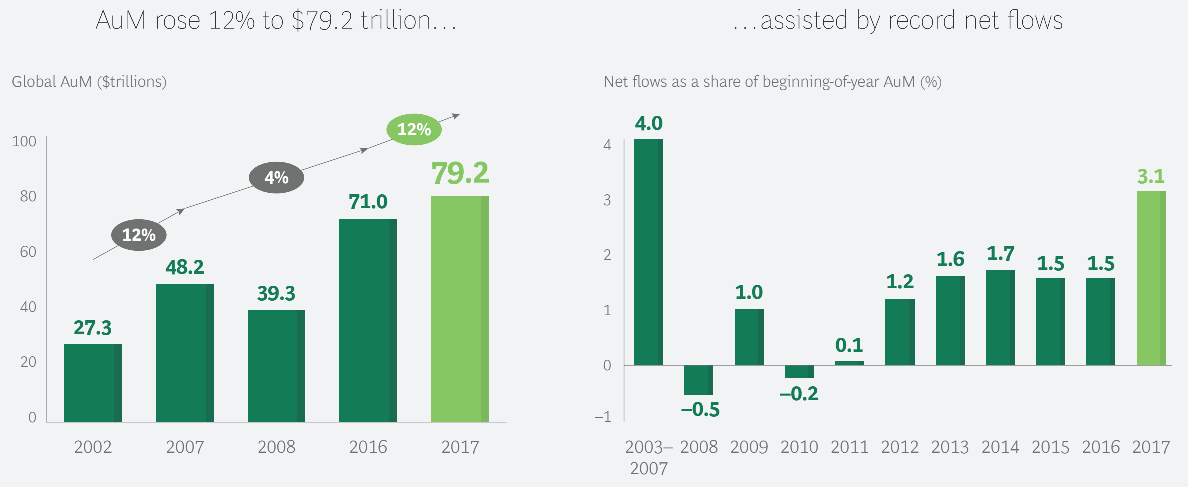
Some of the AuM growth in 2017 reflected rising investment values in booming financial markets. More noteworthy, however, was the related surge in net new asset flows. Flows equaled 3.1% of total AuM at the beginning of the year, compared with annual flows of about 1.5% during the previous five years. Net flows in 2017 were the strongest since the crisis, and nearly reached precrisis levels.

Total assets under management experienced their strongest growth in a decade.

Although AuM surged in retail and institutional segments, retail growth was especially strong. The segment's share of total AuM increased to 39% in 2017, from 37.5% in 2016. Retail net flows almost tripled to 5.3% in 2017, compared with 2% in 2016 and 3% in 2015. Institutional flows rose to 1.6%, compared with 1% in 2016 and 0.3% in 2015. Institutional growth was strongest in the defined-contribution (DC) pension plan segment, the only institutional segment whose share of global AuM increased during the past year, rising from 14.2% to 14.5%.

The weakest institutional performance was the insurance segment's AuM growth of just 5%, as its global AuM share shrank by 1 percentage point. That performance underscores the systemic challenges facing insurers and their asset managers, whether captive or external. (See the sidebar "Insurers and Asset Managers Collaborate on New Strategies for Mutual Growth.")

Exhibit 1 | Global AuM Rose to $79.2 Trillion in 2017, Propelled by Record Net Flows



Sources: BCG Global Asset Management Market-Sizing Database 2018; BCG Global Asset Management Benchmarking Database 2018.
Note: Market sizing includes assets professionally managed in exchange for management fees; AuM includes captive AuM of insurance groups and pension funds delegated to asset management entities with fees paid; 44 markets covered globally, including offshore AuM; For all countries where the currency is not the US dollar, we applied the end-of-year 2017 exchange rate to all years to synchronize current and historic data; values differ from those in prior studies due to fluctuations in exchange rates, revised methodology, and changes in source data.

Viewed globally, the record net flows of 2017 reflect increased penetration of asset management products supported by three trends: the bull market run encouraging retail investors to allocate more money to investment funds; the growth of wealth in emerging countries, especially China; and the continued flow into pension products to prepare for retirement.

When the equity market's growth slows, net asset flow will likely return to lower levels. Signs of slowing appeared in the first quarter of 2018. Institutional long-only asset managers recorded global net outflows in that quarter, after four positive quarters in 2017. Flows into mutual funds remained strong in most markets through the end of April 2018, representing 1.3% of AuM at the end of 2017. But in the US, a highly sophisticated global market, year-to-date net flows slowed to just 0.3% of AuM.

Mainland China and the US Lead Regional Growth

AuM grew vigorously in regional markets around the world in 2017, especially in China and North America, although less robustly in Europe. (See Exhibit 2.)

It was another very strong year for China, which registered 22% AuM growth in 2017 and is now the world's fourth-largest asset management market, (after the US, the UK, and Japan), with $4.2 trillion in AuM. Only five years earlier, China was in eighth position, with $1.5 trillion in AuM at the end of 2012. We expect the country's AuM to triple by 2025—and if that growth comes to pass, it will make China the second-largest market, after the US.

China's strong growth occurred in both its retail and its institutional segments, thanks to a high household savings rate and regulatory reforms that have encouraged pension funds and insurers to use asset managers. A recent regulatory push to increase transparency and reduce shadow banking, in particular, has spurred greater adoption of traditional asset management products and drawn investors away from return-guaranteed products invested in nonstandard credit assets.

The Chinese market is seeing rapid development of new products, digital distribution, and tech-driven innovation to improve customer experience. These advances will raise additional competitive hurdles—while at the same time creating new opportunities—for traditional players trying to build their business in China, as well as for those still trying to enter the market.

INSURERS AND ASSET MANAGERS COLLABORATE ON NEW STRATEGIES FOR MUTUAL GROWTH

The global insurance industry's plodding asset growth is just one of several challenges confronting insurers and the asset managers that serve them. Regulatory pressures, market volatility, and prolonged low yields also do their part to inhibit the returns that insurers' traditional investment models generate and the value that asset managers deliver.

In response to these challenges, some insurers and asset managers—both captive and external—are testing bold new ways to partner with each other for their mutual benefit. They are collaborating to invent and develop new products, services, and capabilities that can create growth and revenue streams for both parties.

Three Objectives in Collaborating

Life insurers are pursuing three objectives in these collaborations: gaining privileged access to new sources of yield, releasing capital from their legacy books, and orienting new business toward more capital-light activities—including retail savings and wealth, defined contribution pensions, and protection products.

Asset managers see these collaborations as a way to grow and diversify their sources of revenues beyond the historical, mostly fixed-income-based product range that they developed to serve insurers. The change requires them not only to develop new investment expertise in highly desirable asset classes, but also to ensure that these offerings quickly reach the critical size needed to attract the attention of third-party investors, which are asset managers' primary source of new money flows.

Developing a mutually beneficial collaboration is not simple, however, given the traditional captive relationship between the insurer and the asset manager it partners with, and given the need to carefully align these parties' sometimes divergent priorities. Insurers are keen to develop the lowest-priced solutions that suit their investment priorities and those of their end customers. They also expect their asset managers to dedicate a large share of resources to supporting them, as befits their status as the asset managers' largest client. Asset managers, on the other hand, need to diversify their sources of inflows beyond the insurer—and they expect the insurer's support in doing so.

Market forces, including distributors and regulators, may also contribute to putting insurers and asset managers on opposite sides with regard to a mutual customer. In the retail savings market, separately developed and distributed propositions sometimes place the two parties in direct competition for the customer's assets. In the world of workplace pensions, both the market and relevant regulations demand a well-curated selection of high-performing asset management solutions at the lowest possible cost. This can lead the insurer to turn increasingly to external products rather than to the captive asset manager's offerings.

Three Development Models

How can insurers and the asset managers they partner with work together more effectively to develop new growth opportunities? Here is a look at three types of development models—which can be combined or pursued independently—drawn from our client work.

In the first development model, asset managers and insurers join forces to design and develop new retail investments products that the insurers can wrap into their long-term savings solutions. Often, the shared objective is to create differentiating capital-light offerings that closely align with the needs of the life insurer's distributors and their end customers along a broad range of dimensions—from risk appetite to local regulations to, increasingly, the adoption of socially responsible investment criteria.

INSURERS AND ASSET MANAGERS COLLABORATE ON NEW STRATEGIES FOR MUTUAL GROWTH (continued)

Such building blocks cover not only investment funds but also asset allocation services such as discretionary portfolio management. Farther along the value chain, the asset manager also provides critical support to the insurer's go-to-market and after-sales effort, contributing investment and financial market expertise to the insurer's marketing and distributor training efforts, digital tools, and market updates.

The second development model involves the creation of third-party asset allocation solutions for smaller institutional clients. This entails fully industrializing and aggressively commercializing the capabilities that the asset manager developed to manage the insurer's assets—often with the insurer's support.

In today's complex regulatory environment, a skilled asset manager using the right tools can devise attractive offers to smaller institutional investors seeking a large, credible player to design and engineer regulatory-compliant, constraint-based investment allocation solutions.

The third development model involves asset managers' growing new, differentiated investment capabilities that make full use of the competitive advantage that a life insurer's balance sheet assets offers. This model is based on the proximity of the asset manager to the insurer, which enables them to share a long-term view of the insurer's investment strategy and needs. This joint understanding is critical for the asset manager to make the long-term investments required to develop new capabilities that will meet the insurer's needs. Such capabilities can cover new asset classes (such as real asset specialties), new geographies, or constraints-based portfolio engineering.

The asset manager can then commercialize the new offerings to third-party investors, while benefiting from the significant head start offered by the insurer's sizable seed investment and credibility.

Making Change Happen

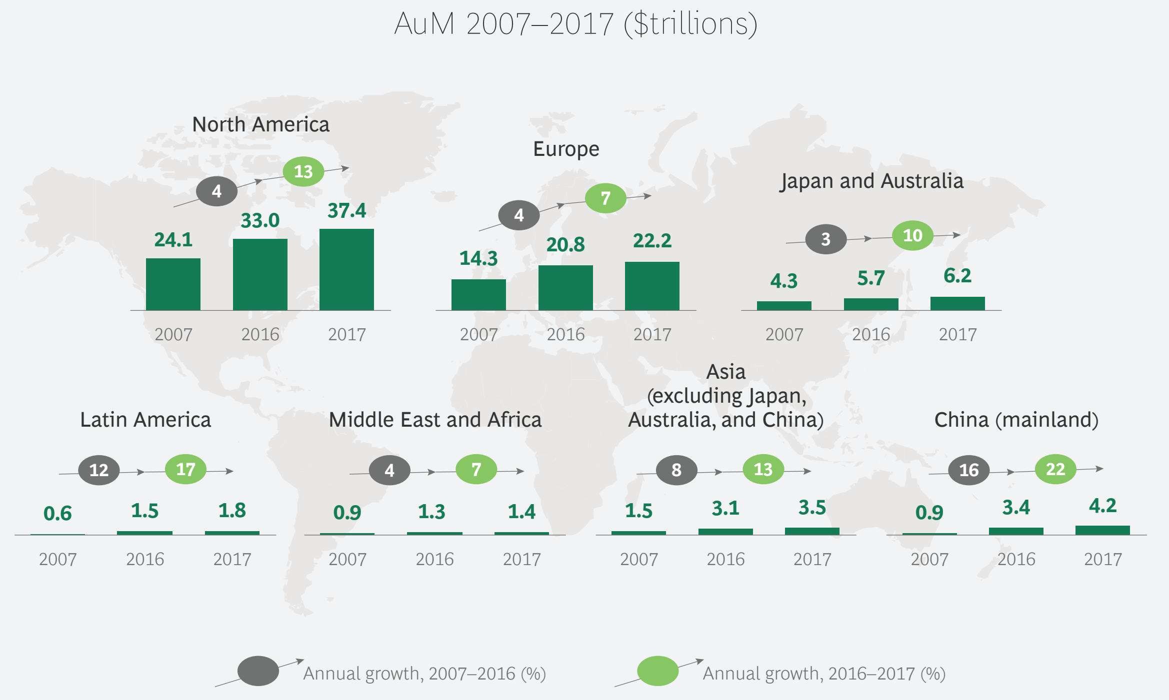
Creating winning new models from legacy components and established business practices and relationships is not easy. But our recent experience indicates that carefully designing and implementing the necessary transformational changes to firms' organization, infrastructure, governance, and capability sets is both possible and financially rewarding.

In our view, maintaining the traditional, compartmentalized relationship between insurer and asset manager is not a viable option for the future. Insurers playing in the capital-light savings and retirement space need to recognize that collaborative models are here to stay—and thrive.

As the Chinese market evolves, we believe that it will move toward a structure that resembles Europe's more closely than it does the US's market landscape: complex local distribution dominated by affiliated partnerships, with limited room for independent players, and with a customer preference for seeking absolute returns. That said, digitization is shaping the Chinese market to a degree unmatched elsewhere.

The North American market was the second standout global performer in 2017. Buoyed by AuM growth of 14% in the US, the region experienced a growth rate of 13% overall—the strongest among mature markets. This showing reflects the boost that financial markets gave existing AuM, along with robust asset flows of 3.8% in retail and 1.4% in institutional, contrasting with net outflows of both in 2016. Managed assets in the US increased

EXHIBIT 2 | AuM Increased in All Regions in 2017, Led Notably by Growth in China and the US



Source: BCG Global Asset Management Market-Sizing Database 2018.
Note: Market sizing corresponds to assets sourced from each region; AuM 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. Overall, 44 markets are covered globally, including offshore AuM (which is not assigned a region) and the ones named in the following regions: North America = Canada and the United States; Europe = Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Russia, Spain, Sweden, Switzerland, Turkey, and United Kingdom; Asia-Pacific = Australia, China, Hong Kong, India, Indonesia, Japan, Malaysia, Singapore, South Korea, Taiwan, and Thailand (note, however, that we have broken out the data for China and for Japan and Australia separately in this chart); 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 2017 exchange rate to all years to synchronize current and historic data. Some AuM numbers differ from those in prior studies owing to exchange rate fluctuations, revised methodology, and changes in source data.

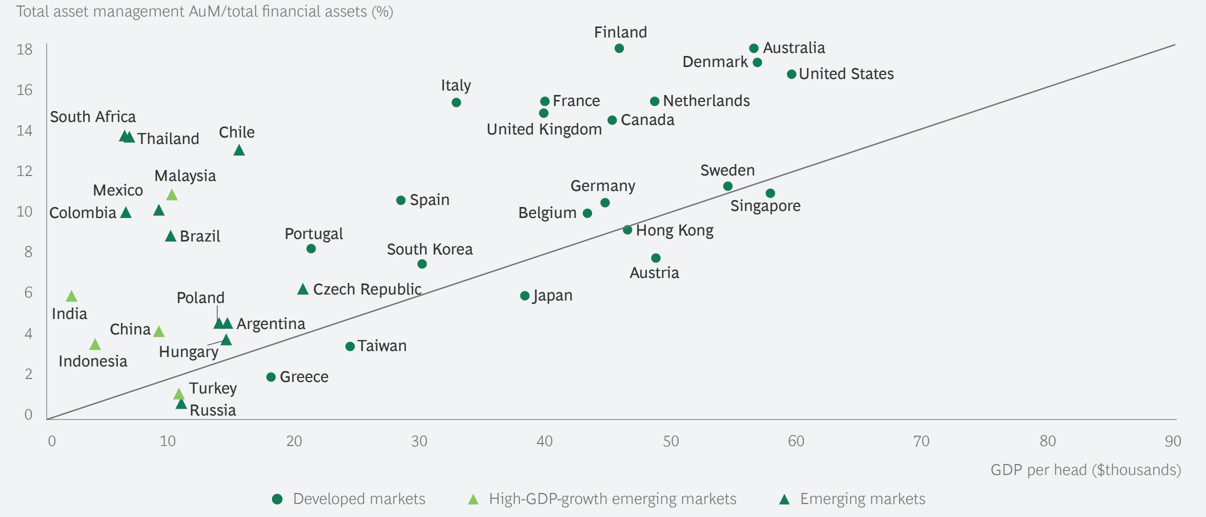
by 1.5 percentage points in proportion to total assets—the largest such gain among mature markets—at the expense of deposits, or savings accounts.

Europe's AuM experienced less robust growth at just 7%, despite strong net asset flows of nearly 3% of beginning-of-period AuM. This reflects, in part, the fact that the performance of European assets invested abroad shrank when translated into euros back home, due to the euro's significant appreciation over most currencies in 2017.

Growth in emerging markets other than China varied from 7% in the Middle East and Africa to 13% in Asia (excluding Japan and China) to 17% in Latin America. Only a few national markets stood out from the global pack in 2017, with growth rates above 20%. The most notable of these was India, with more than $500 billion AuM and a growth rate of 22%. Smaller high-growth markets, with less than $100 billion AuM each, included Indonesia, Turkey, and Argentina.

Overall, the growth across emerging markets—although weak in comparison with that in China or even North America—was consistent with the 13% annual growth rate for emerging countries (excluding China) over the period from 2012 to 2017. It indicates that the anticipated increase in penetration of asset management activities among developing countries—which typically correlates to higher wealth levels—has not yet occurred to the extent that some observers had expected. (See Exhibit 3.) As asset management activities advance in these markets, asset managers will require stronger support from local governments and regulators in order to achieve long-term savings for investors.

Exhibit 3 | Global Penetration of Asset Management Varies Widely by Region and Degree of Economic Development



Sources: Economist Intelligence Unit; BCG Global Asset Management Market-Sizing Database 2018; BCG analysis.
Note: Market sizing corresponds to assets sourced from each market; AuM 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; EIU data is based mainly on country statistic offices and International Monetary Fund data, but partly on estimates; high-GDP growth is defined as 2012–2017 annualized real GDP (US dollars at 2005 prices) of +5% growth. For all countries where the currency is not the US dollar, we applied the end-of-year 2017 exchange rate to all years to synchronize current and historic data. Values differ from those in prior studies due to exchange rate fluctuations, revised methodology, and changes in source data.

Growth opportunities for asset managers are not limited to emerging markets, however. Several developed countries—in particular, Japan and Germany—show low penetration relative to their wealth levels.

Record Growth for Passive Products

Among asset management products, passives were the fastest-growing category by far in 2017, with a record 25% increase in AuM. (See Exhibit 4.) Traditional active products continued to lose share against solutions and specialties. Active now represents just one-third of AuM, compared with 57% in 2003, even though strong flows in active fixed income more than compensated for outflows in active equity. Solutions, specialties, and alternatives now own 50% of the market, versus one-third in 2003.

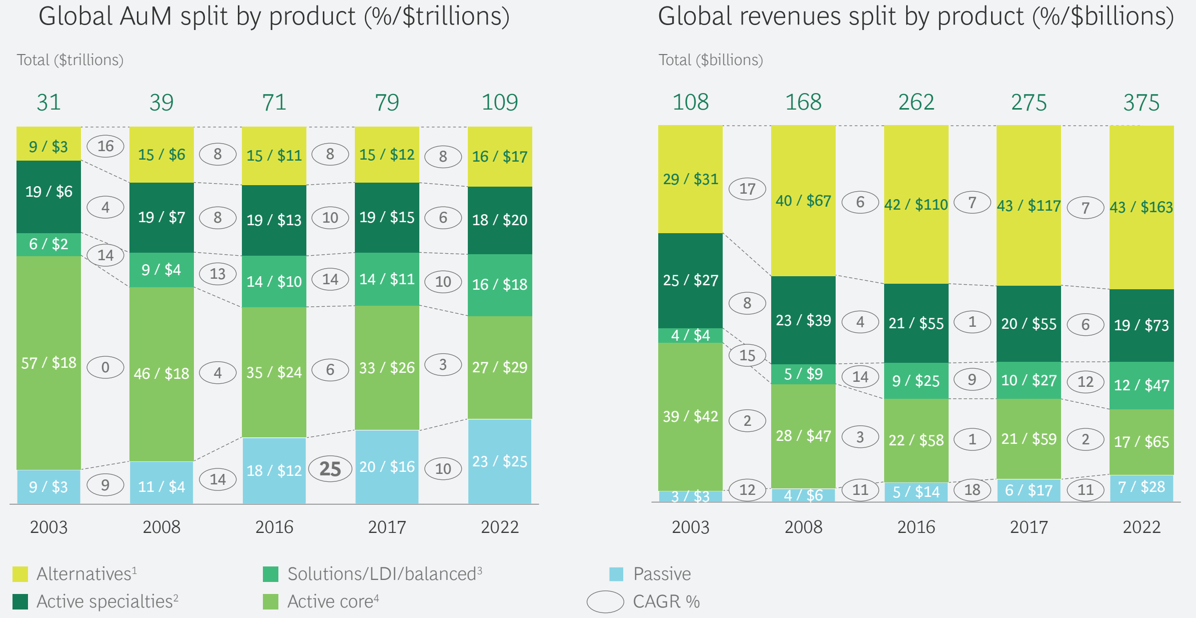
Much of the year's passive growth came by way of record net new flows into passive products, helped by the strong performance of equities markets, where most passive funds are invested. The results confirmed investors' continuing shift to passive strategies, both in the retail segment (thanks to transparency and, in particular, the distribution fee ban) and in the institutional segment.

Unfortunately, the growth of passive AuM provides limited revenue to asset managers. Passive assets, valued at $16 trillion and representing 20% of AuM in 2017, produced revenues of $17 billion—just 6% of the industry's total revenues. Although passives are increasingly popular, their margins are slender. Players should therefore focus on identifying higher-fee growth opportunities.

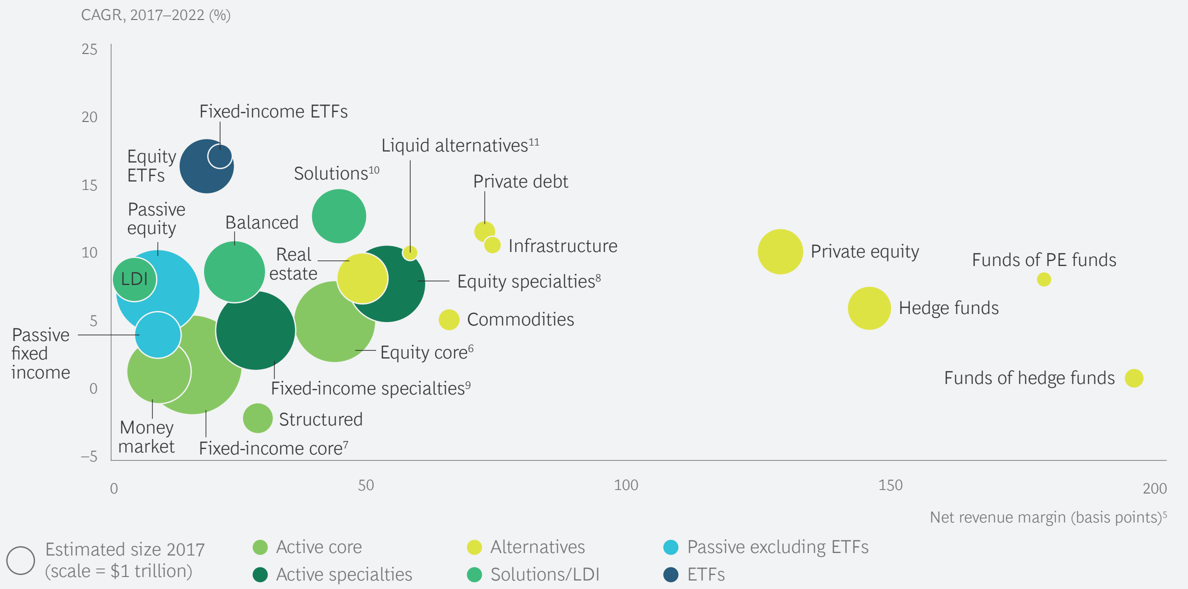
Banking on Smart Beta, the Hidden Threat

One option for passive players is smart-beta products, which passively track an index but include an active, rules-based component. Although smart beta is still a small category, with just $430 billion in AuM or 0.5% of the global total, it has grown by 30% a year since 2012. In the future, smart beta will pose a substantial threat to traditional active players—potentially even greater than that of the overall shift to passives. That is because smart beta seeks to replicate active management results

EXHIBIT 4 | Passive AuM Grows by a Record 25%, as Solutions, Specialties, and Alternatives Expand to 50% of the Market...



... While Traditional Actively Managed Assets Continue to Lose Share



Sources: BCG Global Asset Management Market-Sizing Database 2018; BCG Global Asset Management Benchmarking 2018; Strategic Insight; P&I; ICI; Preqin; HFR; BlackRock ETP report; IMA; BCG analysis.
Note: LDI = liability-driven investments; ETF = exchange-traded fund.
[1]Includes hedge funds, private equity, real estate, infrastructure and commodity funds, and liquid alternative mutual funds (absolute return, long and short, market-neutral, and volatility); private equity and hedge fund revenues do not include performance fees.
[2]Includes equity specialties (foreign, global, emerging markets, small and mid caps, and sectors) and fixed-income specialties (emerging markets, global, high-yield, and convertibles).
[3]Includes target-dated, global asset allocation, flexible, income, liability-driven, and traditional balanced investments.
[4]Includes actively managed domestic large-cap equity, domestic government and corporate debt, money market, and structured products.
[5]Management fees net of distribution costs.
[6] Includes actively managed domestic large-cap equity.
[7]Includes actively managed domestic government and corporate debt.
[8]Includes foreign, global, and emerging-market equities; small and mid caps; and sectors.
[9]Includes emerging-market and global debt, high-yield bonds, and convertibles.
[10]Includes target-date, global asset allocation, flexible, and income funds.
[11]Includes absolute return, long and short, market-neutral, and volatility mutual funds.

at lower cost to investors. Fee levels for smart beta equity funds average about 35 basis points, well below the average of about 50 basis points for active equity products.

We believe that smart-beta growth will become a driver of organic consolidation in the industry going forward. The winners in smart beta should be able to leverage their scale, along with any early investment they make in relevant data infrastructure, to maintain lower fees than those that follow.

> Smart-beta growth is likely to become a driver of organic consolidation in the industry going forward.

The industry's large passive players have dominated smart beta. But a few large active players, after failing to join the first-movers into passives, have joined the smart-beta fray, hoping to capture some of the new opportunity. Traditional active players tempted to capitalize on this growth will need to take advantage of scale and an industrialized approach to be profitable.

Solutions and Alternatives Continue to Gain Share

Solutions, in particular, continue to grow fast. This broad category encompasses institution-oriented solutions such as liability-driven investment or fiduciary services (known in the US as *outsourced CIO*) and target-dated or allocation funds focused on DC and wholesale channels.

As a category, solutions registered the second-fastest growth for AuM and revenues after passives, both in 2017 and over the longer period from 2008 to 2017. They remain a focus for asset managers, which are increasing their investments to develop relevant capabilities. Solutions are all the more attractive because they are among the few products that have not suffered from fee erosion in recent years. In fact, solutions fees have remained more stable than fees for other products.

As competition in solutions increases, asset managers typically invest in new teams or redeploy existing internal teams to establish a stronger, better-defined, and more differentiated market position. To achieve those goals, players should continue to invest in understanding clients' and intermediaries' evolving needs and pain points.

Alternatives grew by just 8% in 2017—half their precrisis CAGR rate. Nevertheless, their share of AuM and of revenues is increasing, and the category seems likely to remain relatively stable.

Real-asset categories continue to benefit from fast growth, led by infrastructure's 17% gain and followed by strong numbers for real estate and private debt. Private equity and hedge funds, on the other hand, were in low-growth territory, rising just 5% to 6% each.

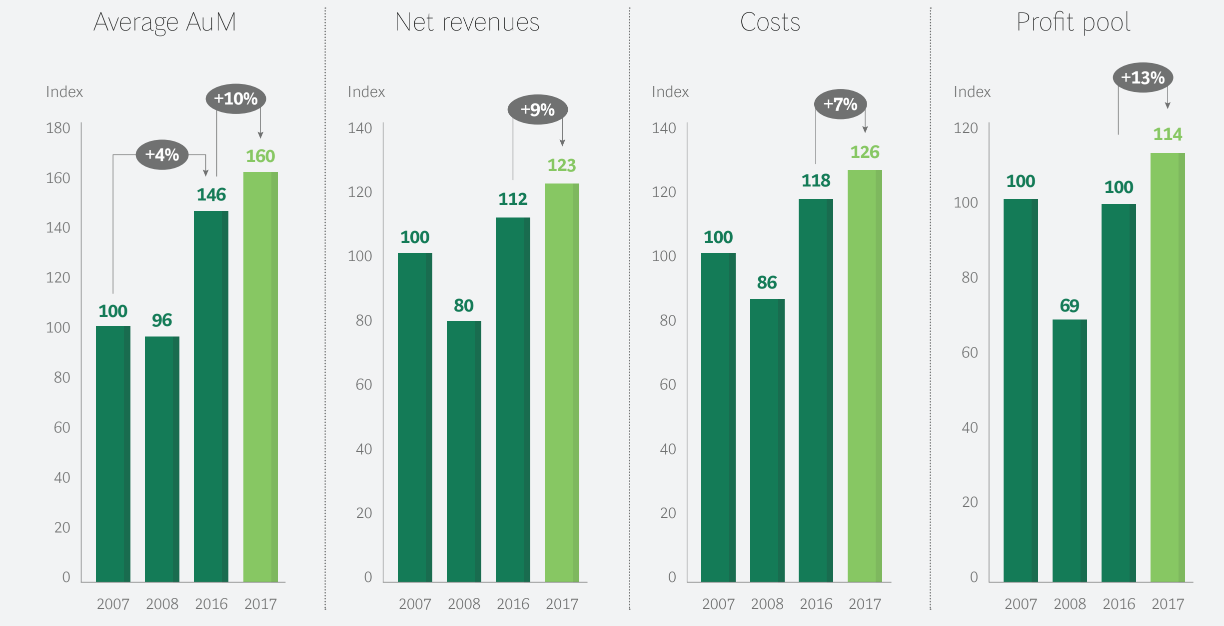
Record Profitability, Thanks to a Bull Market

Asset managers enjoyed record profitability in 2017. Their profit margin grew by 1.4 percentage points to 37% of net revenues and by 13% in absolute terms, thanks to market-driven asset growth. (See Exhibit 5.) This, in turn, permitted costs to drop in relative terms from 17.3 basis points to 16.8 basis points. (See Exhibit 6.) Revenues remained steadier, decreasing by just 0.2 basis point, from 26.7 basis points to 26.5 basis points.

The 0.2-basis-point shrinkage in relative revenues may not be good news, but it is fairly modest overall, in view of the continuing shift toward lower-fee passives and the continuing decrease across most product categories. Indeed, as in recent years, fees continued to decline across products. Fee shrinkage is having a particularly strong impact on active equity, active fixed income, passive equity, and alternatives such as hedge funds, private equity, and real estate. Just a few categories resist, including passive fixed income, money market, multiasset, and some real-asset categories.

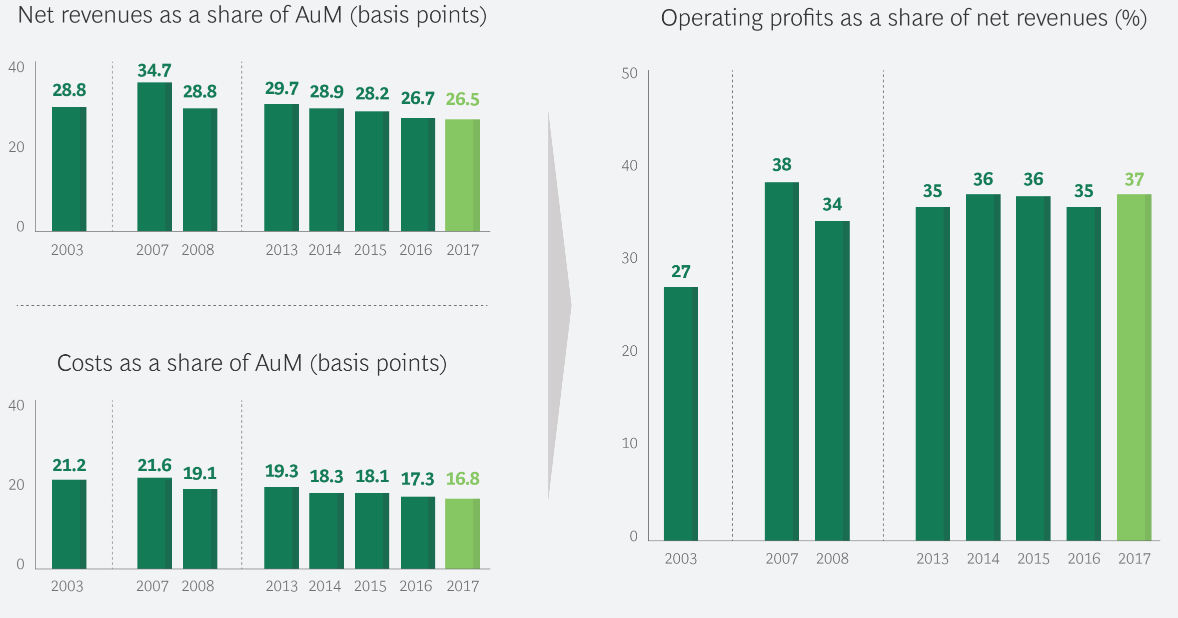
Despite continued fee pressure and the ongoing shift to lower-margin passives, asset managers' profitability improved, in part because of a shift in the business mix: the share

EXHIBIT 5 | Global Profits Rose to a Record High in 2017 as Revenue, Driven by AuM Growth, Increased More Than Costs



Sources: BCG Global Asset Management Market-Sizing Database 2018; BCG Global Asset Management Benchmarking Database 2018.
Note: Analysis based on our global benchmarking, which includes 165 leading asset managers, representing $48 trillion, or more than 65% 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 2017 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 6 | Profitability Increased Even Though Net Revenues Declined in Relation to AuM



Sources: BCG Global Asset Management Market-Sizing Database 2018; BCG Global Asset Management Benchmarking Database 2018.
Note: Analysis based on our global benchmarking, which includes 165 leading asset managers, representing $48 trillion, or more than 65% 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 asset management revenues based on our global product trend analysis. Values with fixed exchange rates: the year-end 2017 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.

of retail expanded from 37.5% of total AuM in 2016 to 39% in 2017.

Although costs decreased by 0.5 basis point, this statistic reflects cost containment, not cost management. Costs effectively increased by 69% of average AuM growth—a considerable rise, given the quantity of fixed costs involved. On the positive side, firms have a significant opportunity to boost efficiency. Many asset managers have not yet duly noted the importance of cost management. For example, of the players in the bottom quartile of profit performance five years ago, 80% have consistently continued to underperform ever since.

Stay Calm and Mind the Blip

In short, the high growth in profits and flow that asset managers experienced in 2017 was probably a blip, not a trend. We doubt that it will persist. Meanwhile, fee pressures remain and market performance will fluctuate. We believe that a market dip may be coming a few years down the road. If it happens, profit could decrease to as little as 27% to 32% of net revenues—which is 5 to 10 percentage points lower than current margins. (See *The Hidden Pressures on Asset Managers*, BCG Focus, May 2018.)

Asset managers should take advantage of the past very strong year to leverage the capital and talent they have and to reinvest in future growth. The ability to think longer term, the way an owner would, will differentiate the winners in the industry from everyone else.

NOTES

1. The economic and flow data in this report updates and expands a preliminary set of data and calculations published in *The Hidden Pressures on Asset Managers,* BCG Focus, May 2018. The basis of the earlier numbers was an initial high-level analysis of externally provided data drawn from 30 large asset managers. This report's data, by contrast, comes from proprietary bottom-up benchmarking measurements covering 165 leading asset managers that represent $48 trillion, or more than 65% of global AuM.

2. 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 research covers 44 markets globally. For all countries whose currency is not the US dollar, we applied the 2017 end-of-year exchange rate to all past years, in order to synchronize historical data. AuM differences in this year's report, compared with past years' reports, reflect changes in exchange rates, methodology changes for some markets, and data changes from primary sources.

TO DRIVE VALUE CREATION, THINK LIKE AN OWNER

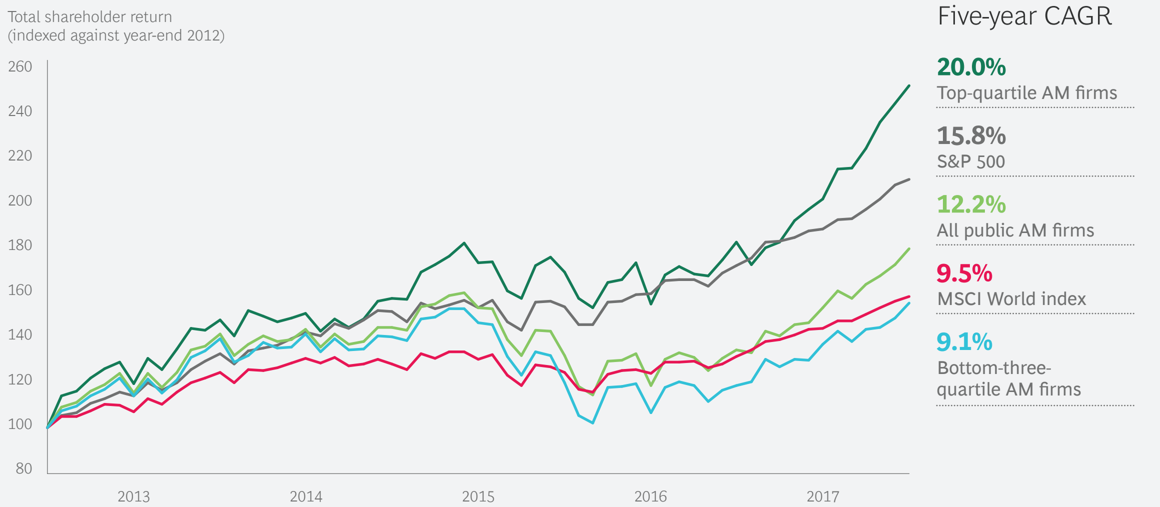
The improved performance of asset management in recent years extends beyond business fundamentals such as AuM, margins, and profitability. Managers have also rewarded their owners with excellent investment returns, as indicated by total shareholder returns (TSR), the standard measure of gains received by a company's owners.

Over the past five years, the TSR of publicly owned asset managers has averaged 12.2%, surpassing global stock markets' robust numbers, such as the MSCI World Index's 9.5% gain. That is a considerable feat, even if it owes something to the industry's rebound from the financial crisis and to the AuM boost from strong global equity markets. Even more impressive is the performance of the top quartile of asset managers, which have delivered annual TSRs of 20%, compared with 9.1% from the other three quartiles. (See Exhibit 7.)

What the Winners Did Differently

This difference in performance is informative. By disaggregating TSR data, we can identify

Exhibit 7 | TSR of the Top-Quartile Asset Managers Outperformed the Bull Market, as Well as Their Peers, over the Last 5 Years



Source: BCG ValueScience.

the firms that have produced long-term value and sustained growth, and we can assess what they did differently from the others. Of course, because TSR is the sum of the appreciation in the value of the shares and the dividends paid to owners, we can measure it only for publicly listed companies. But there is no reason to believe that the drivers of success are significantly different for privately owned asset managers or for subsidiaries of larger financial groups.

> Four key factors account for almost 90% of the variance in an asset manager's multiple.

An analysis of a sample of multinational asset managers revealed that the top-quartile performers were those that found a way to grow more profitably. The apparent key to top-quartile TSR performance was to maintain price points and expand margins, while continuing to grow in line with the market.

While the AuM growth of top-quartile firms was similar to that of their peers, their revenue per AuM contracted somewhat less. As a result, in terms of earnings, they expanded EBITDA margins while their peers experienced margin compression. As for product strategy, the top-quartile asset managers were either smaller, niche-market players capable of protecting and maintaining higher margins (in alternatives or specialties, for example) or very large firms, typically with strong growth in passives.

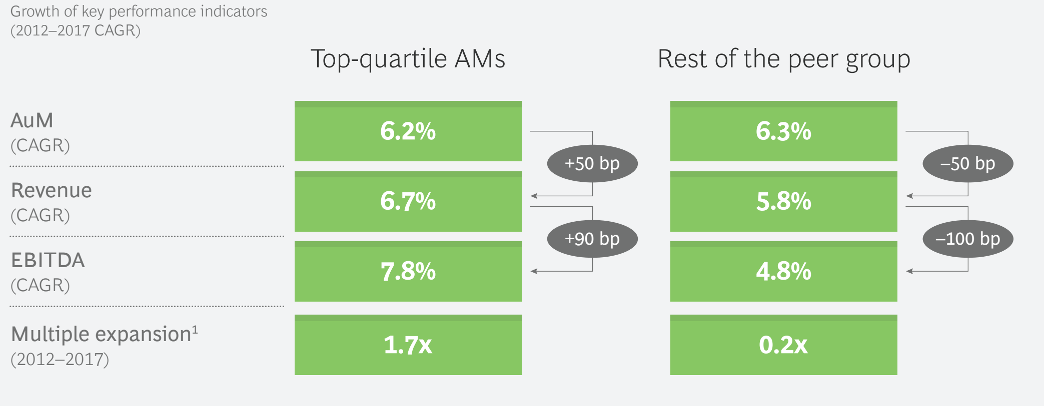
Lagging behind were midsize traditional core-asset managers, positioned between the niche specialist providers and very large operators. If they continue on this performance path, such managers are likely to suffer shrinking market share and greater fee compression, which in turn will increase the difficulty of investing to access the top talent and innovation needed for future growth.

Winners Get a Higher Multiple

In addition to their stronger underlying performance, top-quartile firms saw a faster run-up in their multiple—that is, in the ratio of earnings to TSR. They were thus double favored, achieving a higher multiple on their already higher EBITDA growth. (See Exhibit 8.)

Our regression analysis reveals that four key factors are responsible for almost 90% of the variance in an asset manager's multiple. EBITDA margin—or EBITDA as a percentage of total revenue—is the most important of these, followed by revenue growth, size, and dividend payout. A 1% increase in EBITDA adds 50% more to TSR when it derives from margin improvement than when it derives from revenue growth.

EXHIBIT 8 | The TSR Overachievers Beat Their Peers with Stronger Financial Performance and Expanded EBITDA Multiples



Source: BCG ValueScience.
[1]Enterprise value/EBITDA multiple.

At some point, a significant market reversal is likely, given the long period of gains that investors have enjoyed. Asset managers are unavoidably vulnerable to such downturns, as was evident in the first half of 2018, when their TSR dropped sharply. But they can minimize the damage by thinking the way owners do and taking action to improve margins while operating from a position of strength. That means evolving toward higher-margin business—through new products, geographies, or customer segments—and cutting costs. (See the sidebar "Growth Through Cost-Cutting: The Bottom Line Leverage That Lasts.")

GROWTH THROUGH COST-CUTTING
The Bottom-Line Leverage That Lasts

Following a year of record profits, focusing attention and effort on cost reductions may strike many asset managers as counterintuitive. But now is the time to act. Besides protecting their margins when the next downturn comes, this approach will free up cash to fund investments needed to deliver growth.

When and Where to Cut Costs

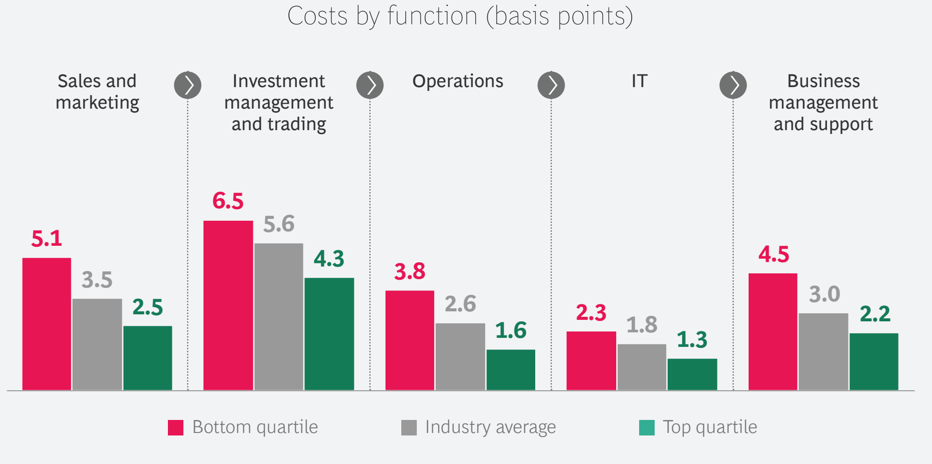
Exercising persistent discipline on margins and costs—in effect, managing with the mindset of an owner—is the foundation of long-term growth for both the business and the bottom line, as our analysis of TSR shows. The weaker returns of early 2018 were a reminder that market conditions will not always be as positive as they were in 2017, so asset managers should use their position of strength to do the work required to reduce costs structurally across all if their operations and functions.

Most firms have ample opportunity to cut costs and reap substantial rewards. Evidence for this proposition lies in the great disparity in operational efficiency among asset managers—and the wide gap between top-quartile players and typical asset managers. Closing half that gap would yield cost savings of about 15%, or $70 million, for a $300-billion AuM player.

How to Cut Costs Effectively

In our experience, asset managers that take a calibrated, structural approach to

Wide Disparities in Efficiency Indicate That Firms Can Gain Advantage Through Cost-Cutting



Source: BCG Global Asset Management Benchmarking Database 2018.
Note: Analysis based on a peer group of 28 players with similar business models and with overall characteristics similar to the total peer group (custom peer group: net revenues at 27 bp, with 70% institutional assets and 42% captive assets, versus industry-average revenues at 27 bp, with 62% institutional assets and 37% captive assets).

GROWTH THROUGH COST-CUTTING
(continued)

cost-cutting can reduce costs and improve margins—and make the changes stick. Rationalizing costs in this manner involves changing both the firm's operating model and its business model.

The required action unfolds in two stages:

- **Optimize the operating model.** This work typically delivers total cost savings of 10% to 20%. It addresses the asset manager's organization (for example, by reducing management layers and creating shared services), its processes (such as through automation and outsourcing), and its technology (for instance, by rationalizing IT applications or cloud migration).

- **Refocus the business model.** These efforts drive further cost reduction and margin uplift, often adding 10% or more to the bottom line. The work centers on the firm's core investment business, through such measures as consolidating investment desks and trading platforms, mutualizing research, and pruning underperforming products. It may also involve reducing distribution costs, by consolidating sales and servicing in regional hubs or adjusting client coverage models to suit business priorities.

If effectively customized, this dual approach can systematically identify needed cost-reduction measures for any asset manager. Even then, however, it does not guarantee success. Because asset management firms typically enjoy wide margins and because a large proportion of their spending is discretionary—with bonuses being cut in bad years—firms have rarely treated cost reduction as a priority. Indeed, senior managers often fear that such programs might jeopardize their company's growth.

To overcome this hesitancy and to ensure success, an efficiency program must satisfy three principles. First, the program must be purposeful. Cost reduction efforts should proceed with a clearly defined end in mind, such as fueling future growth or protecting the franchise. The firm's leadership must share this purpose across the organization so that all stakeholders understand it.

Second, the program should be both rapid and rigorous. Enthusiasm and commitment

Asset Managers Can Use Structured Cost-Cutting to Improve Their Operating and Business Models

Source: BCG project experience.

depend on fast, visible progress. The program's initial impact should be evident in 6 months, and the entire program should be realized in 12 to18 months.

Third, the program should be de-averaged; that is, it should be calibrated to create impact and benefit where the need is greatest, while minimizing cost cuts and risks to core and top-performing activities. This is especially important for overcoming the common fear that cost-cutting will undermine growth. A de-averaged approach usually entails the following elements, among others:

- **Push hardest outside the core.** Back-office and business management functions (such as HR and finance) and noncore technology (including infrastructure and noninvestment applications) can yield cost reductions of 50% or more, owing to advances in technology and the maturation of outsourcing providers. Underperforming or undifferentiated funds are a core-business drag; abandoning them will eliminate the front-office costs and supporting costs associated with those products.

- **Load up the mature businesses.** Asset managers should increase client loads, consolidate research, and reduce services and marketing overhead for most mature client businesses and geographies, as long as doing so does not jeopardize revenue growth.

- **Invest in the growth engine.** Asset managers should reallocate money saved through cost cuts to previously underfunded areas of new growth or to products with potential to scale. Besides encompassing the development of new products, geographies, and segments, reallocation may include investment in data and analytical tools, technologies, and talent that enhance investment outcomes and sales performance.

AN AGILE PATH ACROSS THE DIGITAL AND ANALYTICS DIVIDE

LIKE EVERY OTHER GLOBAL industry, asset management finds itself in a sea of rapidly evolving digital and analytics technologies. Unlike most sectors, however, it continues to cling by one hand to the rocky shore, resisting full digital submersion. Asset managers, so far, have escaped the major disruption of new digital tools, processes, and competitors.

But yesterday's digital disengagement is rapidly vanishing as firms come to recognize the power of digital and analytics to change the industry and to determine winners and losers. "If you don't understand how to treat data with respect, you will get eaten alive," says Luke Ellis, CEO of Man Group.

"If you don't understand how to treat data with respect, you will get eaten alive."

Digital is finally going mainstream in the asset management industry. Every asset manager we have spoken with this year is pursuing a digital and analytics agenda, experimenting with digital labs, hiring data scientists, and testing the use of alternative data.

But few of them have mastered digital and analytics at scale. Achieving that goal entails operationalizing lessons learned from experimentation and then scaling those lessons across the enterprise. Gaining the ability to do that requires significant, hard-fought, and sometimes complex organizational change.

Most firms that succeed in this effort, we believe, will do so by adopting new agile ways of working inherited from innovative software firms. Agile's test-and-learn approach is speedier and more efficient than traditional siloed work practices, generating stronger value and more engaged employees. We believe that agile will be the tool that enables asset managers to find a path across the digital and analytics divide.

The Asset Manager of the Future

Five years from now, asset managers will look, think, and behave very differently from the way they do today. They will need to identify a more distinctive value proposition—moving away from core active products into solutions, specialties, and alternatives. They will need to provide value-added services beyond investment performance for their clients and intermediaries. And to achieve the greatest degree of success, they will need to maximize the potential of digital and analytics in all aspects of the business—including strategy, operations, technology, investment management, product mix, and talent management. (See Exhibit 9.)

Exhibit 9 | Tomorrow's Asset Managers Will Look Quite Different from Today's

		Asset manager today	Asset manager of the future
Strategy and business model	Strategy	• Ad hoc strategy • Digital experimentation, largely incremental	• Clearly articulated strategy with areas of differentiation • Fully integrated digital strategy
	Product	• AuM focused on core active products • Reactive product innovation	• Rigorous portfolio approach: emphasis on investment in high-growth products, with pruning of undifferentiated products
	Investment management	• Siloed investment desks, duplication • Experiments with alternative data and tools	• Advanced data and analytics central to investment management • Increased integration across desks to deliver client solutions
	Marketing, distribution, and sales	• Retail focused on "sales push" • Institutional: low-tech, reactive sales and servicing	• Deployment of digital tools and predictive analytics to offer personalized products and services to distributors and clients • Institutional: technology leveraged to better serve and retain clients
Operating model	Operations and support	• Ops largely siloed, focused on efficiency • Support largely in-house with select outsourcing	• Bifurcated, agile operations and support: focus on driving back-end efficiency and enabling client-facing and investment value • Process automation at scale (in-house or via partner)
	Technology and data	• Legacy tech stack partially updated • Experimentation with new tools, tech, and data • Multiple, conflicting sources of data	• Modern technology stack fully integrated with next-generation digital tools • Data as strategic asset, Integrated across various data sources
	Organization and talent	• Investment-focused career paths/talent • Siloed organization	• Agile ways of working (cross-functional teams, and so on) • Influx of tech talent mixed with traditional investment talent

Source: BCG project experience.

The new technologies will reshape key roles and functions of asset management, in some cases rather dramatically.

Investment Management. Digital and analytics offer potentially high-impact innovation opportunities for portfolio managers. New data sources—including transactions, satellite feeds, and web aggregation tools, among others—paired with advanced analytics tools and techniques such as machine learning and advanced regression analysis will inform investment decisions.

Human portfolio managers will remain central to investment decision making. We don't believe that machines will replace human judgment and decision making anytime soon. Portfolio management is a complex activity; and at this stage in their development, most advanced technologies and analytics can solve only a narrow set of problems. But even today's highly successful asset managers will need to invest differently tomorrow.

Sales and Marketing. Advances in digital and analytics have the potential to transform distribution from largely push-based practices to a more marketing-led model enhanced by proactive and personalized outreach. This shift will be particularly strong in wholesaling, where greater personalization is possible for many aspects of adviser engagement. Firms will be able to deliver relevant information to the right people at the right time for them to consume the information. (See "The Digital Leap to Next-Generation Wholesaling" in *Global Asset Management 2017: The Innovator's Advantage*, BCG report, July 2017.)

Operations. Advances in digital and analytics will trigger a dramatic evolution of operations. Efficiency gains of more than 50% should be possible through the adoption and deployment of robotics process automation and artificial intelligence and through the leveraging of predictive techniques to anticipate errors and choke points in the back office. Operations will also become the curator and owner of high-quality data supporting the front office. And it will act as a driving force for improved client experience and satisfaction, by helping redesign processes front-to-back from a client's point of view.

The Importance of Being Agile

Getting the most out of rapidly evolving technologies while managing profound change will be taxing. Likewise, attracting the new talent needed to support these changes will be a difficult and competitive endeavor. Agile gives asset managers a platform to use in more rapidly assessing and deploying unfamiliar technologies. It can help create and spread the culture of autonomy and engagement needed to drive change, while fostering an environment that allows digital talent to thrive.

Agile methods rest on a straightforward set of premises: To confront a major challenge, bring together the people who can resolve it. Assign a large portion of the organization to multidisciplinary work teams, or squads. Take one challenge after another in iterative work sprints, continuously improving how the team does things and delivers products or other results to clients. Break down silos through face-to-face meetings, direct collaboration, and brainstorming to invent solutions from the ground up. Think big but start small, working quickly to produce short and steady gains. (See the sidebar, "Squads, Tribes, and Scrums: A Glossary of Agile Terms.")

Software developers pioneered agile as a way to speed product development. Agile processes focus on the work of multidisciplinary teams that operate in daily and weekly work cycles to produce minimum viable products that the team can quickly tweak and improve in response to customer feedback. (See "Taking Digital Way Beyond Software," BCG article, July 2017.) In adopting agile, most companies start by creating lighthouses—a set of

SQUADS, TRIBES, AND SCRUMS
A Glossary of Agile Terms

Here is a brief glossary of agile terms to help readers decode unfamiliar phrases, roles, and concepts.

Chapters. A collection of members from similar disciplines, such as marketing, drawn from different tribes. Chapters come together to ensure uniform practices across tribes.

Chapter leader. The person responsible for professional and career development of members of a chapter, and the link between individual squad members and the overall hierarchy of the organization.

Lighthouse. A set of high-profile pilot projects that become beacons of learning for subsequent efforts on the same topic.

Minimum viable product. The earliest version of a product to reach end customers. The agile squad responsible for this version subsequently improves it in response to user feedback.

Product owner. The person responsible for what a squad works on, although not officially the boss of any squad members.

Scrum. An agile approach or framework for project management, still used in software development. A scrum is light on process and embraces iterative and incremental practices.

Sprint. An incremental, iterative work project with a specific time limit, usually from one to four weeks. A sprint is the basic unit of a scrum.

Squad. A cross-functional team consisting of six to twelve members who have end-to-end responsibility for a particular mission. Most of the work in an agile workflow gets done at the squad level.

Tribe. A collection of interconnected squads, with 150 or fewer total members.

high-profile pilots that become beacons of learning for subsequent efforts. After building capabilities and confidence, firms assemble a roster of agile teams.

A number of asset managers have already adopted some form of agile practices for technology initiatives. A few leading firms have broadened their use of agile approaches beyond tech-focused projects. And a couple of asset managers have begun extending agile ways of working to activities and initiatives across substantial portions of the enterprise. (See Exhibit 10.)

Agile can touch 50% to 70% of an organization's employees, and in some instances even more. It works especially well in areas that involve business change, such as technology, product development, home office sales and marketing, and some portfolio management functions.

For highly systematic or routinized activities such as investing, trading, sales, and processing, full-scale agile deployment is probably unnecessary. Even so, many agile principles, processes, and tools—including the value of cross-disciplinary teams, team autonomy, and process-light workflows—will apply to these activities as well.

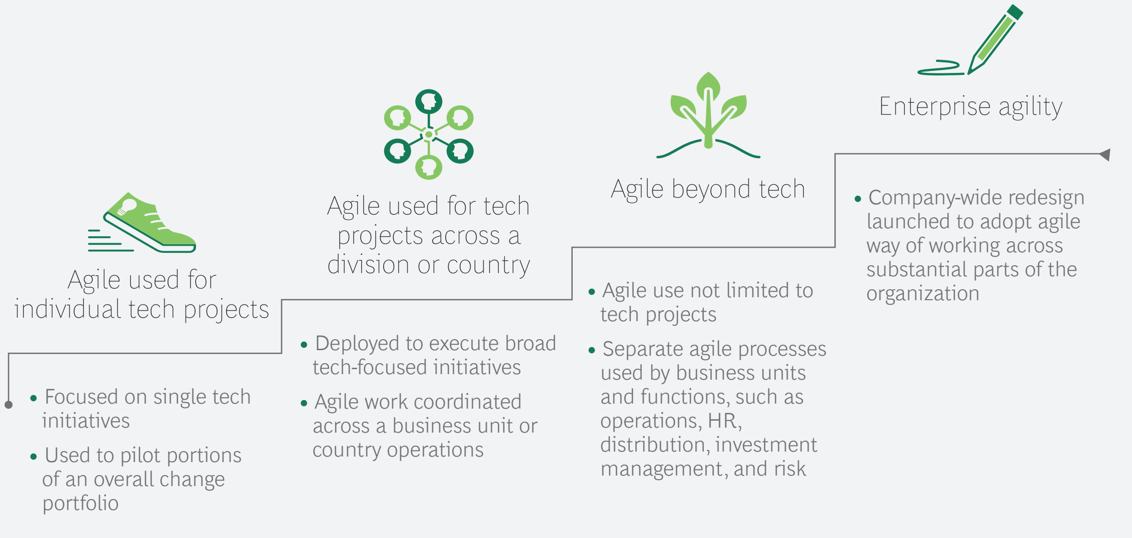
The Agile Asset Manager

Asset management firms tend to develop rigid functional silos, with leaders incentivized to focus on their own vertically organized domains. Work that aims to change the business typically cuts across multiple siloes and thus entails multiple hand-offs between different domains. End products reach the end user only after being thoroughly tested and vetted up and down the chain.

In response to the advance of digital, many large asset managers have overlaid digital labs and other centers of expertise on existing siloes. Rather than having individual units hire specialized resources, they reasoned, the company should create a center consisting of these specialists and share it across businesses. But shared resources are often unaccountable resources.

An agile organization, in contrast, works to break down organizational barriers, assembling multidisciplinary teams (or squads) of full-time resources to achieve a common goal and set of KPIs. The squads work iteratively, with full autonomy, to put early versions of products—commonly referred to as minimum viable products—in the hands of end customers. For internal products, the end customers are integral parts of the team. When

EXHIBIT 10 | Today Only a Few Leading Asset Managers Use Agile for Broad-Based Tech Initiatives



Source: BCG project experience.

external customers are involved, the process often relies on the use of internal proxies.

Agile is particularly applicable to an industry that is high on talent and low on scale.

Following are some examples of how agile asset managers can implement the advanced digital and analytics work that specific asset management functions require:

- **Investment Management.** Most asset managers divide their front-office organization by desk. But no single desk can support a team of data scientist or technologists, nor does it have broad access to the firm's research and data—and this makes developing and deploying next-generation investment management tools difficult. An agile approach uses multidisciplinary squads that bring together investment resources, data scientists, technologists, and researchers to support the investment managers. Squads aim to achieve common goals, such as developing new investment ideas or tools, and common KPIs. A CIO or head of an asset class typically leads tribes—groups of squads working together for a common purpose or theme—as well as running a traditional team of portfolio managers, research analysts, and traders.

- **Product Management.** Today, most new-product strategies and launches involve several working groups, multiple development stages, and a few weeks of work. The agile alternative relies on product squads that include a multidisciplinary team—a portfolio manager, a researcher, a risk manager, a compliance officer, and participants from trading, sales, marketing, and operations—with a common goal, such as building a client solution or new product capability, and a set of KPIs. Frequent testing occurs throughout the process—with clients, with the market, or against risk management and regulatory frameworks. The results are a more adaptive solution and a much faster time to market.

- **Distribution.** In the US, attempting to provide support and service to wholesalers typically involves allocating several functions, such as sales and marketing, to discreet projects. In an agile approach, common goals and KPIs unite a multidisciplinary squad whose members represent different functions. For example, a goal might be to increase penetration at a specific wirehouse or to build new predictive tools for wholesalers; and a KPI might involve setting the number of financial advisors who will test a product or use the tools. The head of distribution might lead the home-office distribution enablement squads, in addition to running a traditional field sales force.

- **Operations.** Although core processing today tends to be reduced to a routine that employees can perform within silos, many operations tasks—for example, redesigning and automating a specific process—involve work across silos. An agile operations squad can instead deploy a multidisciplinary team—which might include data scientists, automation experts, compliance officers, operators, and technology specialists—to accomplish the same tasks by working toward a common goal and common KPIs, such as speed of resolution. The COO might lead such an operations squad, while also owning day-to-day operations.

We are bullish on agile because we have seen it increase employee engagement (to greater than 90%), improve business and customer outcomes (doubling, tripling, or quadrupling customer satisfaction), accelerate delivery time (increasing output two- to fourfold), and strengthen financial performance (reducing costs in addressable spending by 15% to 25%).

Agile is particularly applicable to an industry that is high on talent and low on scale. Agile-inspired ways of working can help ensure that resource allocation and strategy remain in sync while at the same time providing the autonomy and flexibility that asset managers need in order to prosper in an industry that is on the verge of massive changes brought on by digital and analytics.

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 2018: Seizing the Analytics Advantage
A report by The Boston Consulting Group, June 2018

The Hidden Pressures on Asset Managers
A Focus report by The Boston Consulting Group, May 2018

Global Capital Markets 2018: Embracing the Digital Migration
A report by The Boston Consulting Group, May 2018

Global Corporate Banking 2018: Unlocking Success Through Digital
A report by The Boston Consulting Group, March 2018

Global Risk 2018: Future-Proofing the Bank Risk Agenda
A report by The Boston Consulting Group, February 2018

Global Asset Management 2017: The Innovator's Advantage
A report by The Boston Consulting Group, July 2017

How Asset Managers Can Succeed with Advanced Analytics
An article by The Boston Consulting Group, July 2016

NOTE TO THE READER

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