Global Asset Management 2020

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INTRODUCTION

The global asset management industry ended 2019 on a high note—only to face a new chapter of economic turmoil when the coronavirus pandemic broke out in early 2020. In 2019, total assets under management (AuM) grew by 15%, to $89 trillion. Retail clients were the fastest-growing segment, with assets rising by 19%, while institutional client assets grew by 13%. North America, the world's largest asset management region, showed the strongest growth at 19%, or $7 trillion in value, due to a combination of strong consumer spending, historically low unemployment, and quantitative easing. In China, the second-largest single market after the US, AuM expanded by an estimated 10% in 2019, driven largely by a strong retail investor segment. Yet even when the markets were soaring and asset flows were the highest they had been in a decade, the asset management industry faced a set of structural challenges brought on by fee compression and mounting cost pressures—and the result was a marginal decrease in profitability.

In the year ahead, it will be essential for asset managers to address their asset flows and profitability through continued structural changes in such areas as product innovation, cost structure, and growth strategies.

In this 18th annual BCG report on the global asset management industry, we look at the industry's challenges and opportunities through the lens of one of the strongest asset classes: alternatives. This category comprises nearly half of all global asset management revenues, despite representing only 16% of AuM, and we expect to see alternatives approach 50% of global revenues by 2024. One of the tailwinds driving this growth is a rise in nontraditional return profiles for some product subcategories.

Still, we found that not all alternatives are created equal. Private markets—including private equity, real estate, infrastructure, and private debt—have grown assets at a breakneck compound annual growth rate of 9% since 2008, and they currently represent 60% of revenues in alternatives. Hedge funds, by contrast, have seen their asset growth decline as overall returns over the past decade have trailed the S&P, although capital still flows disproportionately into the larger funds, with AuM of more than $5 billion. At a time of fierce competition for limited investor capital, asset managers in the alternatives space will need to identify opportunities to rebuild and grow, establishing an edge through technology, expertise, and scale.

Moreover, in the next big wave of competition, successful industry players will need to create world-class client experiences that extend beyond performance at a given cost and become something closer to an all-encompassing value proposition for the client. To that end, the firms that lead in distribution are beginning to put a number of best practices into effect. They are creating data-driven business intelligence to help the entire organization develop a deeper understanding of client needs. To enable that intelligence, they are building strong data science capabilities that operate in partnership with sales and marketing. The roles of these two functions are evolving as marketing teams become key players rather than just serving a support role. Top firms are also bringing the personalized needs of clients into the product development process, increasingly tailoring their products to such areas as environmental, social, and governance (ESG) investing. And they are revamping their internal cultures to ensure that the compensation structure pays attention to increasing customer satisfaction as well as to such traditional business metrics as meeting sales goals.

In working with investors from the insurance industry, which holds nearly 15% of total AuM globally but is likely to face challenges in the present economy, asset managers have an unprecedented opportunity to add value by acting more as partners and advisors to investors. To do so, however, they must alter their service model, focusing on such needs as risk management support and flexibility in products and pricing.

The year 2020 will not be an easy one for the industry, but it could mark the start of a pivotal era in which investors become more judicious about who they trust with their assets, and in which the asset managers that flourish are those that innovate and evolve to fit the new realities ahead.

A SNAPSHOT OF THE INDUSTRY

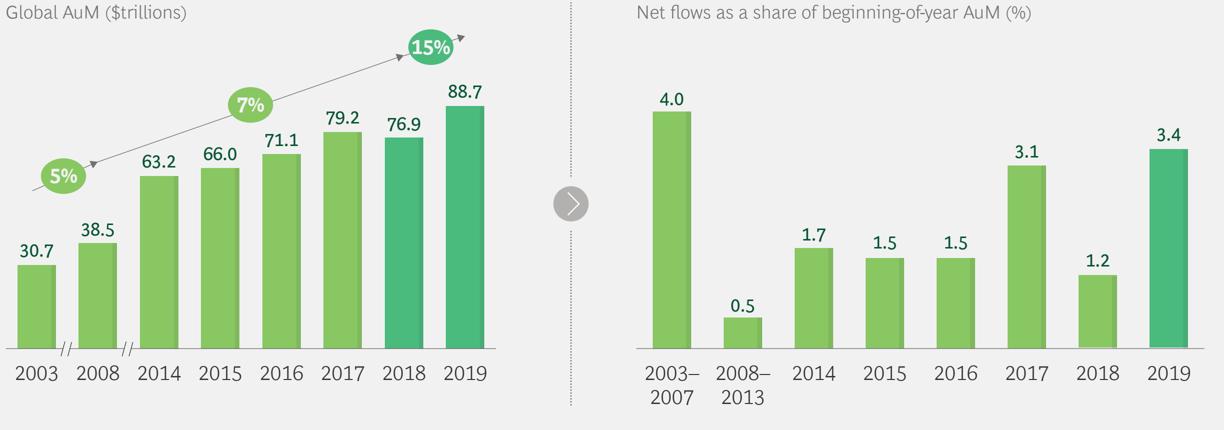
Following an AuM decline of $2 trillion in 2018, asset managers made a significant comeback in 2019. Total AuM in nearly every region grew by a double-digit percentage, thanks to strong market performance and net flow figures. Yet despite this impressive rate of growth, structural challenges caused by fee compression and mounting cost pressures persisted, to the point that industry profitability decreased marginally.

The market storm of early 2020 has only intensified these challenges, as asset managers find themselves in uncharted territory. After the crash of 2008, the asset management industry benefited from a market rebound that produced the longest bull market in history. In 2020, however, firms must recover flows and profitability through more fundamental changes to their business models. Here is a look at the industry in 2019 and our perspective on the year ahead.

AuM Grew by $12 Trillion

The total value of global AuM grew by 15% in 2019 to about $89 trillion, up from about $77 trillion in 2018. (See Exhibit 1.) Retail clients,

Exhibit 1 | 2019 Asset Levels and Money Flows



Sources: BCG Global Asset Management Market-Sizing Database 2020; BCG Global Asset Management Benchmarking Database 2020.
Note: Market sizing includes assets professionally managed in exchange for management fees; AuM includes captive AuM of insurance groups or pension funds where AuM is delegated to asset management entities with fees paid; 44 markets are covered globally, including offshore AuM. For all countries where the currency is not the US dollar, we applied the end-of-year 2019 exchange rate to all years in order to synchronize current and historic data; values differ from those in prior studies because of fluctuations in exchange rates, revised methodology, and changes in source data.

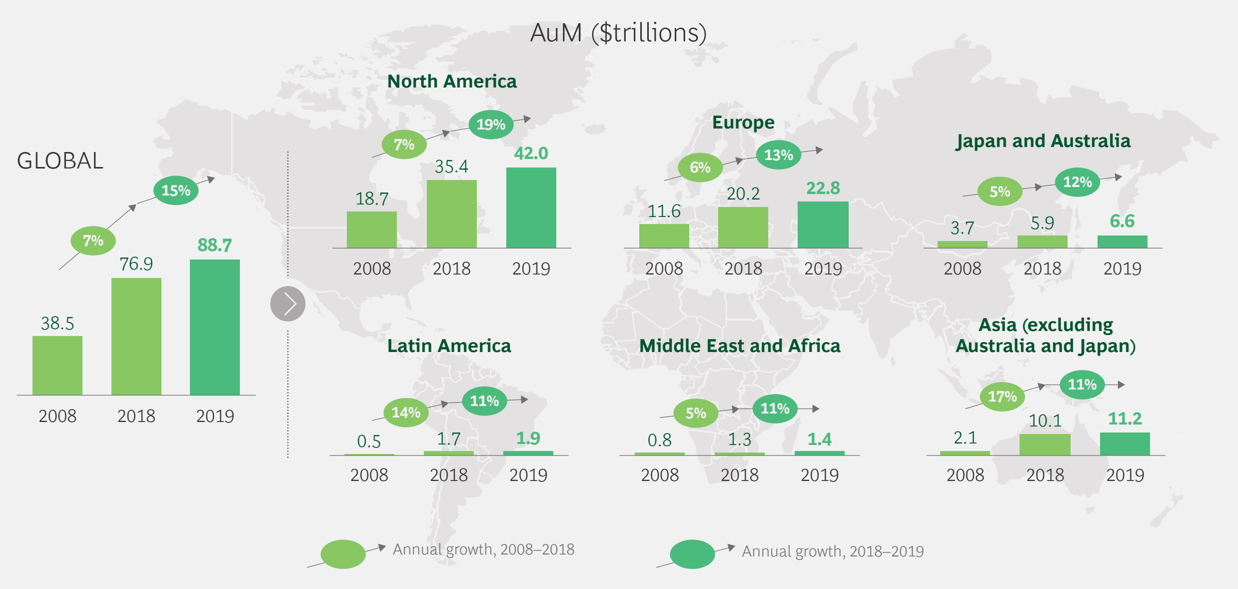
representing 42% of the global assets at $37 trillion, grew even faster, at 19% in 2019, while institutional clients, representing 58% of the market grew by 13% to $52 trillion. Market performance was the primary driver of this growth, contributing roughly three-quarters of the AuM growth in 2019 as markets across regions posted record highs for the period since the 2008–2009 financial crisis. The MSCI World Index realized a 27% return for the year—its strongest showing since 2009, when it achieved a return of 35%.

Record net new asset flows painted an encouraging picture of robust investor demand. Net flows totaled $2.6 trillion globally, accounting for 3.4% of global AuM at the start of the year—a significantly higher proportion than the historical average of 1% to 2%. The main cause of these higher-than-ever net flows was heavy demand from retail investors, who contributed net flows of 4.7% in 2019, compared with 1.8% for institutional investors. Retail's standout year was driven by a strong confluence of wealth accumulation, bullish market conditions, and improved access to investment platforms and vehicles.

North America Led the Pack; Europe Followed

North America, the world's largest asset management region, experienced the strongest growth in 2019. (See Exhibit 2.) AuM in the region increased by 19%, adding $6.7 trillion in value. Asset managers in North America recovered from a bearish 5% decline in 2018 by an impressive 24-percentage-point spread. Much of the AuM expansion in the region is attributable to quantitative easing, strong consumer spending, and a historically low unemployment rate. These tailwinds helped investors overcome performance threats arising from a potential trade war and early-stage recession scares, resulting in one of the region's most robust growth periods in recent years.

Exhibit 2 | 2019 Saw Double-Digit Growth, with Developed Regions as Top Performers



Sources: BCG Global Asset Management Market Sizing 2020; The Economist Intelligence Unit; Strategic Insight; Willis Towers Watson; local organizations, including regulators; press; BCG analysis.
Note: Market sizing corresponds to assets sourced from each region and professionally managed in exchange for management fees; it includes captive AuM of insurance groups or pension funds where AuM is delegated to asset management entities with fees paid. Overall, 44 markets are covered globally, including offshore AuM (which is not included in any region); 2019 values were extrapolated on the basis of retail and institutional segment 2018 AuM in local currency and, mostly, pension growth rates for institutional business and mutual fund growth rates for retail business. Where data for year-end 2019 was not yet available, it was extrapolated using capital market performance and asset allocation of the respective product (retail mutual funds or pension/insurance investors). North America = Canada and the United States; Europe = Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Norway, Poland, Portugal, Russia, Spain, Sweden, Switzerland, Turkey, and United Kingdom; Asia (excluding Australia and Japan) = China, Hong Kong, India, Indonesia, Malaysia, Singapore, South Korea, Taiwan, and Thailand; Middle East and Africa = selected sovereign wealth funds of the region and mutual funds, Morocco, and South Africa; Latin America = Argentina, Brazil, Chile, Colombia, and Mexico. For all countries where the currency is not the US dollar, end-of-year 2019 exchange rate is applied 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.

Europe, the second largest region by assets, realized strong AuM growth, too, rising by 13% to $22.8 trillion. Europe's biggest market, the UK, held 27% of market share, or $6.1 trillion. That represented an expansion of 13% for the year, and it occurred despite looming Brexit concerns. The institutional segment, which represents 79% of the UK's AuM and is a major driver of the nation's wealth, grew by 13% during the year. France, another leading European market, with $3.5 trillion in AuM, also has a strong institutional orientation; institutional assets there accounted for close to 81% of AuM, expanding by 9% during 2019, while retail AuM growth was muted at 4%. The institutional segment dominates Germany, too, where it represents more than 70% of total AuM; it experienced strong growth in both client segments, leading to 15% overall growth in the market. Germany closed the year with $3.1 trillion in AuM.

Growth was slower in the Asia-Pacific region. The most developed markets there—Japan and Australia, representing a combined $6.6 trillion—grew collectively by 12%. Both markets benefited materially from the year's strong market performance. Assets in other Asia-Pacific countries grew at a slightly slower clip of 11% to $11.2 trillion. This growth rate was heavily influenced by China, the second-largest asset management market in the world, where nonchannel AuM (excluding bank wealth management products and trust companies) is estimated to have expanded by 10% during 2019, reaching $7.3 trillion. The Chinese asset management industry tilts toward retail investors, which account for 60% of the country's total AuM and showed strong growth of 14% during 2019. A recent BCG Focus found that rapid changes are taking place as a result of regulatory amendments, increased openness toward foreign players, and rising wealth and innovation.

South Korea was another strong regional performer, as its AuM rose to $1.1 trillion, a 12% increase for the year. Institutional investors, which dominate the South Korean market at 84% of total AuM, grew by 13%, more than twice the rate of the country's retail investor asset growth (5%). In contrast, Hong Kong's asset management industry grew by 14% to $1.0 trillion, driven primarily by the retail segment, which grew by 17% and represents nearly half of the market's AuM. Institutional assets in Hong Kong posted relatively modest gains of 11%.

AuM growth in Europe, the number two region by assets, rose by 13% to $22.8 trillion.

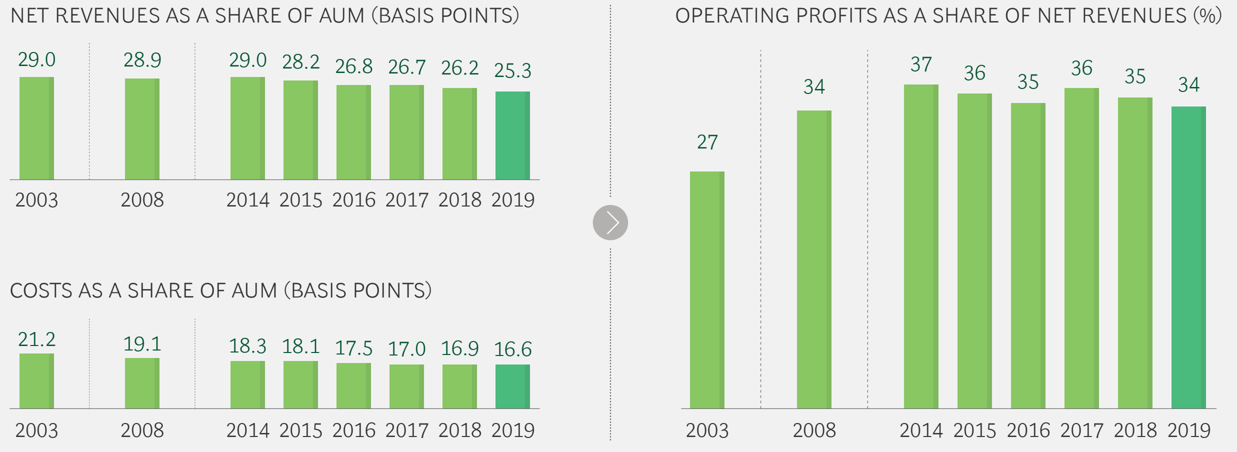
Both Latin America and the Middle East and Africa (MEA) grew at 11%. Within Latin America, AuM increased to $1.9 trillion. Brazil, the largest Latin American market, holds 61% of the region's total AuM. Heavy investment in fixed income and strong market results in this asset class helped fuel the nation's AuM growth, which rose by 8%. Most of the increase came from retail portfolios, which account for 56% of Brazil's AuM and grew at 10%, while the institutional sector showed an increase of 6%. A bright spot for the Latin America region—and a development for asset managers to watch closely—is the growth of pension funds, as more employers provide retirement plans and as employee contributions to these plans gradually rise. In MEA, the Middle East is the region's largest market at $1.2 trillion AuM. Driven by strong market performance and higher oil prices during 2019, the Middle East's AuM is expected to grow by 11%.

Profitability Evolution, Cost Controls, and Fee Pressure

Despite the strong AuM growth during 2019, the global asset management industry experienced a negligible decrease in profitability, with an average operating profit of 34% of net revenues, versus 35% in 2018. (See Exhibit 3.) Although these consistently high margins far exceed those in most other industries, asset managers cannot afford to rest on their laurels.

The prominence of fee pressure persisted throughout 2019. Revenues as a share of average AuM decreased from 26.2 basis points (bps) in 2018 to 25.3 bps. Furthermore, positive year-over-year growth in revenues of 2%,

Exhibit 3 | Cost Measures Were Not Sufficient to Offset Fee Pressure



Sources: BCG Global Asset Management Market-Sizing Database 2020; BCG Global Asset Management Benchmarking Database 2020.
Note: Analysis based on our global benchmarking, which includes 100 leading asset managers, representing $52 trillion AuM, or more than 60% 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. For values with fixed exchange rates, the year-end 2019 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.

which included record levels of flows for the past decade, was insufficient to offset fee compression across the industry. (See Exhibit 4.)

In terms of basis points, costs were essentially flat in 2019 at 16.6 bps versus 16.9 bps in 2018. Furthermore, asset managers took prudent steps to address costs throughout 2019. Numerous firms across the industry aimed to cut expenses by such means as organizational restructuring, staff reductions, and rationalization of office locations. So far, however, these efforts have yielded limited benefits. Costs in absolute terms grew by 4% in 2019, twice the rate of absolute revenue growth, indicating that cost control measures are not fully counterbalancing the effects of top-line pressures.

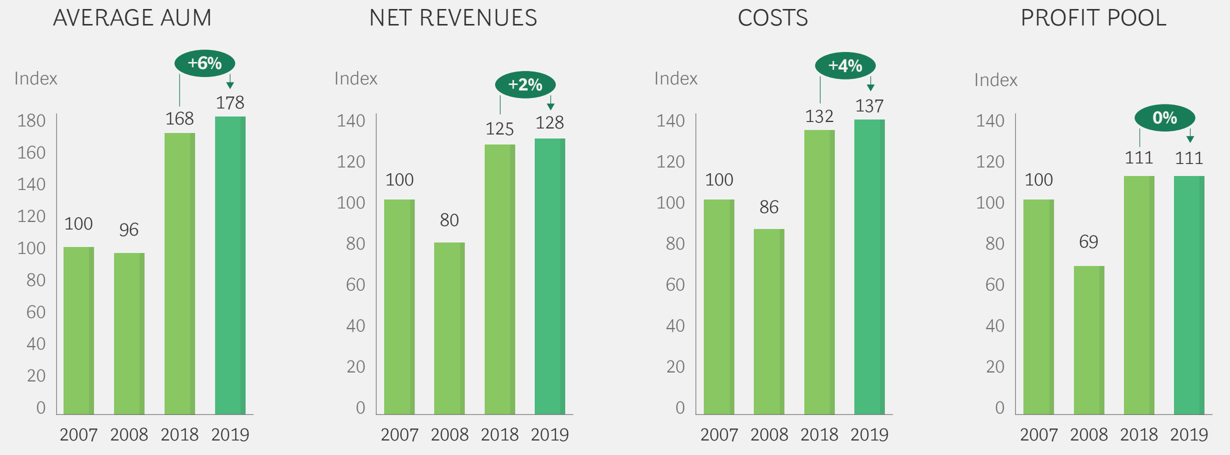
The costs issue will remain at the forefront, and it points to a larger phenomenon threatening the industry. Fixed expenses—in particular, people costs—are high, and that reality limits short-term cost-control options. As a result, companies that need to control their costs often start by cutting discretionary investments, including those in innovation and technology. Unfortunately, the short-term savings that such moves achieve may lead to the loss of exactly the initiatives needed for longer-term strategic advantage and for a step-change transformation of the cost structure. Successful players must take a balanced approach toward playing offense versus playing defense. In practice, that means refocusing the company's product portfolio, making difficult decisions to transform the cost structure where possible, and continuing to invest in innovative technologies that will propel the business forward in the medium to long term.

Passive Products, Select Alternatives, and Sustainable Investing Were Winners

All traditional asset classes generated double-digit growth in 2019. Moreover, alternative products captured AuM growth of 13% for the year. (See Exhibit 5.) This asset class has grown from less than 10% of the total market AuM in 2003 to 16% in 2019. It has become the largest revenue pool across products and is likely to capture a 49% share of global revenues by 2024. We examine this space in greater detail in the "The Alternatives Revolution" deep dive on page 13.

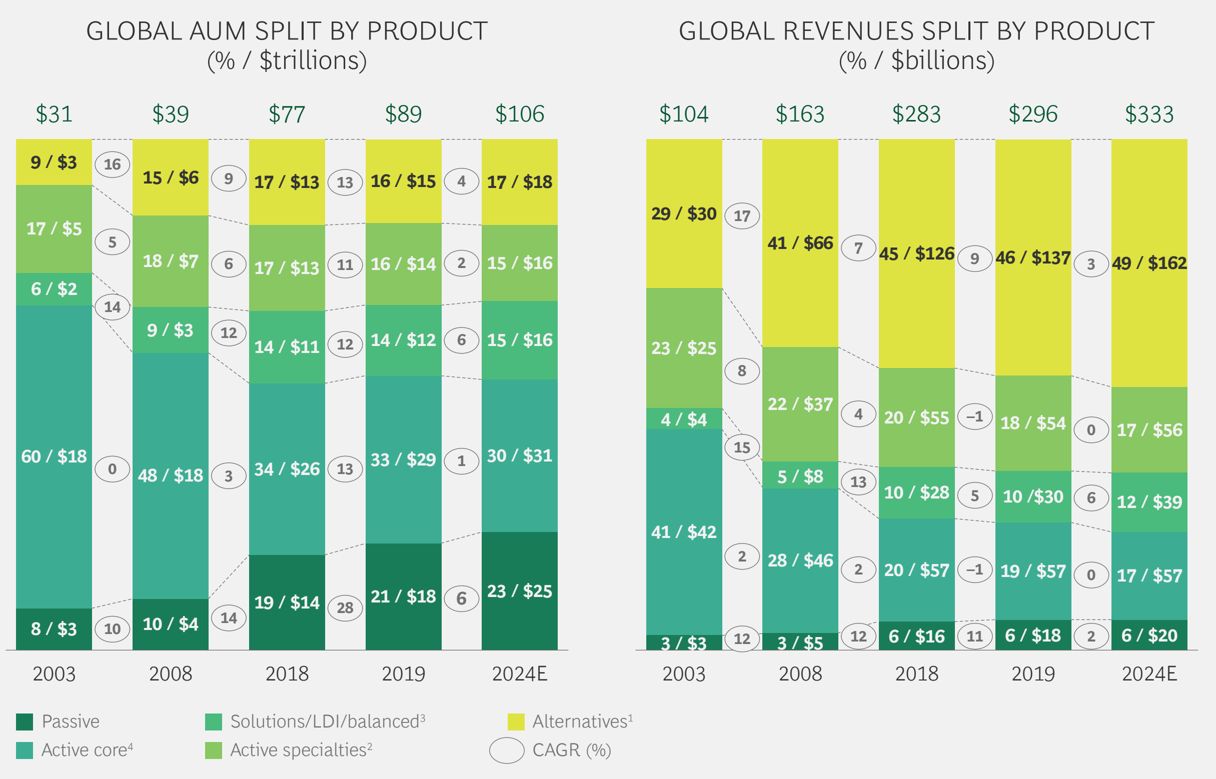
As they did in previous years, active core products continued to lose out to other categories in 2019. Their market share of global assets has fallen by nearly half since 2003, from 60% to 33%, while their share of global revenues has dropped dramatically, from 41% in 2003 to less than 20% by 2019.

EXHIBIT 4 | Profits Remained Flat Amid High Cost Pressure



Source: BCG Global Asset Management Benchmarking Database 2020.
Note: Analysis based on our global benchmarking, which includes 100 leading asset managers, representing $52 trillion AuM, or more than 60% 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. For values with fixed exchange rates, the year-end 2019 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 5 | AuM Growth Did Not Translate into Revenue Increase for Active Assets



Sources: BCG Global Asset Management Market-Sizing Database 2020; BCG Global Asset Management Benchmarking 2020; Strategic Insight; P&I; ICI; Preqin; HFR; BlackRock ETP report; INREV; BCG analysis.
Note: Bar chart values may not add up to 100% or to the specified sum because of rounding. LDI = liability-driven investment.
[1]Includes hedge funds, private equity, real estate, infrastructure, commodities, private debt, and liquid alternative mutual funds (such as absolute return, long and short, market-neutral, and trading-oriented); 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-date, 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.

We expect the AuM and revenue share of active core products to decline further as investors increasingly scrutinize the true value that active managers add relative to their cost.

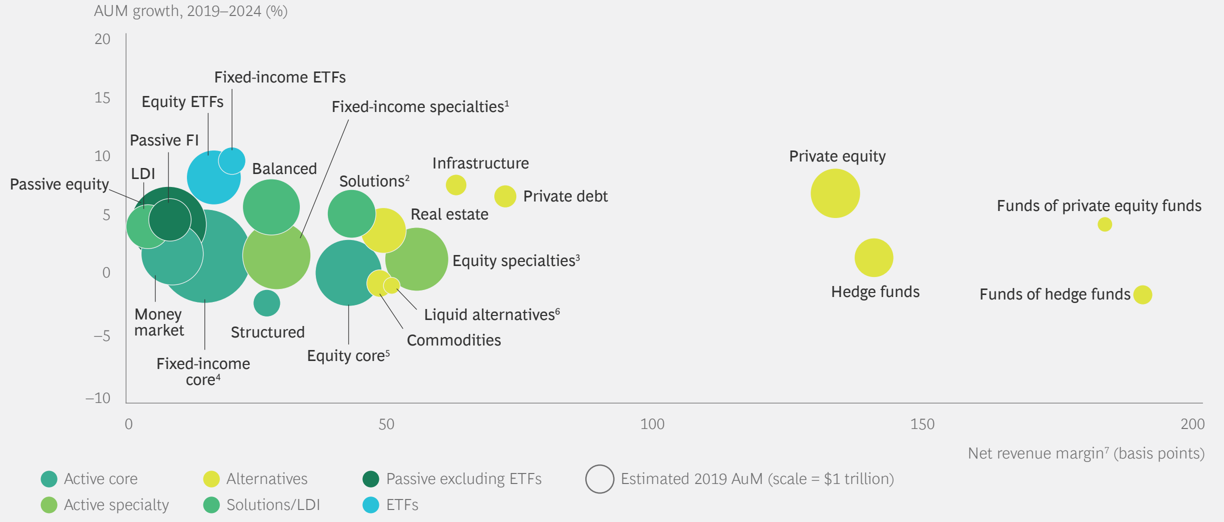
Meanwhile, active specialty offerings are experiencing pricing pressure. The decline in specialty offerings as a percentage of global AuM has been slight, from 17% of global assets in 2003 to 16% in 2019, but revenue share over that same period has fallen from 23% of global revenues to 18%. This change reflects, in part, the rise of lower-cost options such as smart beta funds, which purport to closely track some active strategies at a fraction of the cost.

Passive investments overall grew faster than any other product category, with total AuM rising by 28% in 2019. Equity and fixed-income exchange-traded funds (ETFs) produced the highest AuM growth rate in passive products, at 32% and 35%, respectively. Although the success of passive products is likely to last, with AuM growing at about 6% annually over the next five years, revenue will remain at around 2% CAGR due to the already depressed pricing. (See Exhibit 6.)

Solutions products seem to have plateaued following the period from 2003 to 2009 when their market share of global AuM nearly doubled. Still, growth in these products should increase in the years ahead, given heightened interest in products such as outsourced chief investment officer (OCIO) and liability-driven investment (LDI) as institutional investors demand more customized services.

In addition, as noted in a recent BCG/World Economic Forum report, sustainable investing has experienced a dramatic rise in prominence in asset management, driven by the increasing financial relevance of ESG factors, better ESG data, growing investor demand, and—in some markets—growing regulatory pressure. Since 2012, global assets managed by one or more sustainable investing methodologies have grown by 15%. European institutional investors have led the demand, but interest among US and Asian institutions and global retail investors is starting to accelerate. ESG capabilities are already table stakes for

EXHIBIT 6 | ETFs and Select Alternative and Solution Products Are Likely to Lead Growth Through 2024



Sources: BCG Global Asset Management Market-Sizing Database 2020; BCG Global Asset Management Benchmarking 2020; Strategic Insight; P&I; ICI; Preqin; HFR; BlackRock ETP report; INREV; BCG analysis.
Note: ETF = exchange-traded fund; LDI = liability-driven investment.
[1]Includes emerging-market and global debt, high-yield bonds, and convertibles.
[2]Includes target date funds, global asset allocation, flexible and income funds.
[3]Includes foreign, global, and emerging-market equities; small and mid caps; and sectors.
[4]Includes actively managed domestic government and corporate debt.
[5]Includes actively managed domestic large-cap equity.
[6]Includes absolute return, long/short, market neutral, and trading-oriented mutual funds.
[7]Management fees net of distribution costs.

asset managers looking to compete in Europe or for large institutional mandates, and they will likely play an expanding role across geographies and investor types. Investor demand for ESG products was strong in the first four weeks of the 2020 market turbulence, with persistently positive net inflows even as the broader universe of ETFs struggled with outflows.

Sustainable investing offers asset managers—particularly managers that focus on active strategies—a way to differentiate their brand. They do this through continuous product innovation while also developing more rigorous proof points of ESG integration across asset classes, incorporating ESG factors into engagement and proxy voting efforts, creating proprietary data and analytical models, and measuring and reporting ESG factors alongside financial performance. In 2019, many asset managers boosted their data, research, and analytics capabilities on ESG topics, and increased the rigor with which they applied these insights to investment decision making. Asset managers have many options in devising an approach to ESG integration, but all such efforts should align with a clear narrative and house stance, and should deploy the capabilities needed to support that stance.

A Glimpse at 2020 and Beyond

The year 2019 was an upbeat one for asset managers and investors, but in Q1 of 2020 the coronavirus pandemic shook markets across the world and drove economies into crisis mode. During the second half of March, the MSCI World Index had fallen by more than 30% since peaking in February. Unemployment figures have risen around the world, and governments, central banks, and other decision makers have introduced policies, exercised economic tools, and offered stimulus packages to mitigate the long-term effects on the global economy.

The crisis will undoubtedly ripple through the asset management industry. The financial crisis of 2008–2009 prompted the rise of passive assets and catalyzed a winner-take-all phenomenon—especially in the US, where the top ten firms capture about 80% of net mutual fund flows. We expect this phenomenon to continue in response to the early 2020 crisis. We also expect this period to see accelerated digitization, increased M&A activity, and product innovation.

Although the asset management industry still has lofty margins compared with other financial service providers and has proven to be

Exhibit 7 | Anatomy of a Pandemic Response Game Plan for Asset Managers

PRELIMINARY PHASE
Protect the house

Within 30 days

Safeguard your people
- Enable remote working; create clarity and security; adjust benefits

Assure and advise clients
- Reinforce stability; provide perspective; double down on client service

Minimize trading disruption
- Ensure access to trading and liquidity; monitor counterparties; clarify governance

Prepare for extended BCP
- Mobilize “war room”; ensure that back office and middle office are equipped; check cybersecurity

NEAR TERM
Adapt the core business to the new reality

Within 90 days

Preserve the top line
- Use analytics to deploy advanced retention
- Adapt product portfolio
- Accelerate advice offering

Accelerate cost efficiency
- Act on no-regrets moves ASAP
- Kick off holistic operating model assessment, including partner ecosystem

Refactor strategic plans
- Triage existing plans into keep/stop/start
- Invest in stability, cost reduction, and revenue growth

Augment business resilience
- Optimize business continuity planning on the basis of lessons learned; rethink global footprint

Strengthen digital distribution
- Train front office on best practices for virtual selling and relationship management

Adapt people management
- Drive performance, culture, productivity, and connection virtually

Continue strategic M&A and partnerships
- Selectively expand product shelf; look for targeted scale opportunities

MEDIUM TERM
Innovate and evolve

Within 180 days

Pivot to strength
- Differentially invest in competitive advantage
- Scale across products, channels, and geographies, and/or streamline to win through deep focus

Reshape operating model with tech
- Standardize and digitize end-to-end ecosystem across internal and external partners

Differentiate on client experience
- Leverage digital, data, and analytics to unlock personalized client experiences across products, services, and engagement models

Reframe total societal impact
- Refresh the firm's purpose, and fully integrate ESG

Source: BCG analysis.

resilient in previous market drawdowns, asset managers need to consider how they will adapt to the new reality. Responses range from revising strategic plans to prioritizing efforts to protect top and bottom lines. We urge firms to adapt their core business for the near term—for example, by accelerating cost efficiency initiatives, doubling down on digital distribution, and pursuing opportunities for M&A—while also focusing on innovation and evolution over the medium term. Examples of such focus include reimagining the operating model with a partner ecosystem and identifying new ways to differentiate on client experience. (See Exhibit 7).

THE ALTERNATIVES REVOLUTION

HOW TO COMPETE IN ASSET MANAGEMENT'S LARGEST REMAINING REVENUE POOL

Alternatives continued to be among the strongest asset classes in 2019. AuM growth of alternatives accelerated to 13%, and the category now comprises nearly half of all global asset management revenues, despite representing only 16% of AuM. We expect alternatives to continue to grow at an annual rate of 4% through 2024, at which point they will represent 17% of global AuM and will capture 49% of global revenues.

The key driver of this growth is investor demand for heightened performance, uncorrelated returns, illiquidity premiums, and other nontraditional return profiles, particularly as institutions across the globe face the challenge of a widening gap between assets and liabilities.

Even so, several challenges lie ahead. The demand will come with an increased level of investor scrutiny, as the global economic uncertainties of early 2020 reach into virtually every corner of the markets. At the same time, liquid investable capital is likely to decline sharply in the wake of this year's global economic downturn, and a short-term flight to safe-haven assets is possible. The degree to which this becomes a longer-term headwind will depend to a large extent on the shape and timing of economic recovery—currently an open question that has drawn divergent views and carries a high degree of uncertainty. Funds and strategies that have failed to deliver on precrisis promises of uncorrelated performance are most likely to face investor questions and potential outflows in the near term.

Putting further pressure on asset managers, investors will probably continue to insource their alternatives capabilities. This is especially the case among institutions that have sufficient scale and are culturally reluctant to pay high fees to an external manager.

In 2024, alternatives will hold 49% of global revenues and represent 17% of global AuM.

The winner-take-all phenomenon that emerged 12 years ago during the 2008–2009 financial crisis will be in evidence as investors become ever more judicious about whom they trust with their assets in a volatile, complex environment. Leading asset managers will continue to amass scale, add breadth and depth to their investment expertise, and reinvent their business and operating models—not only to survive, but also to strengthen their competitive edge.

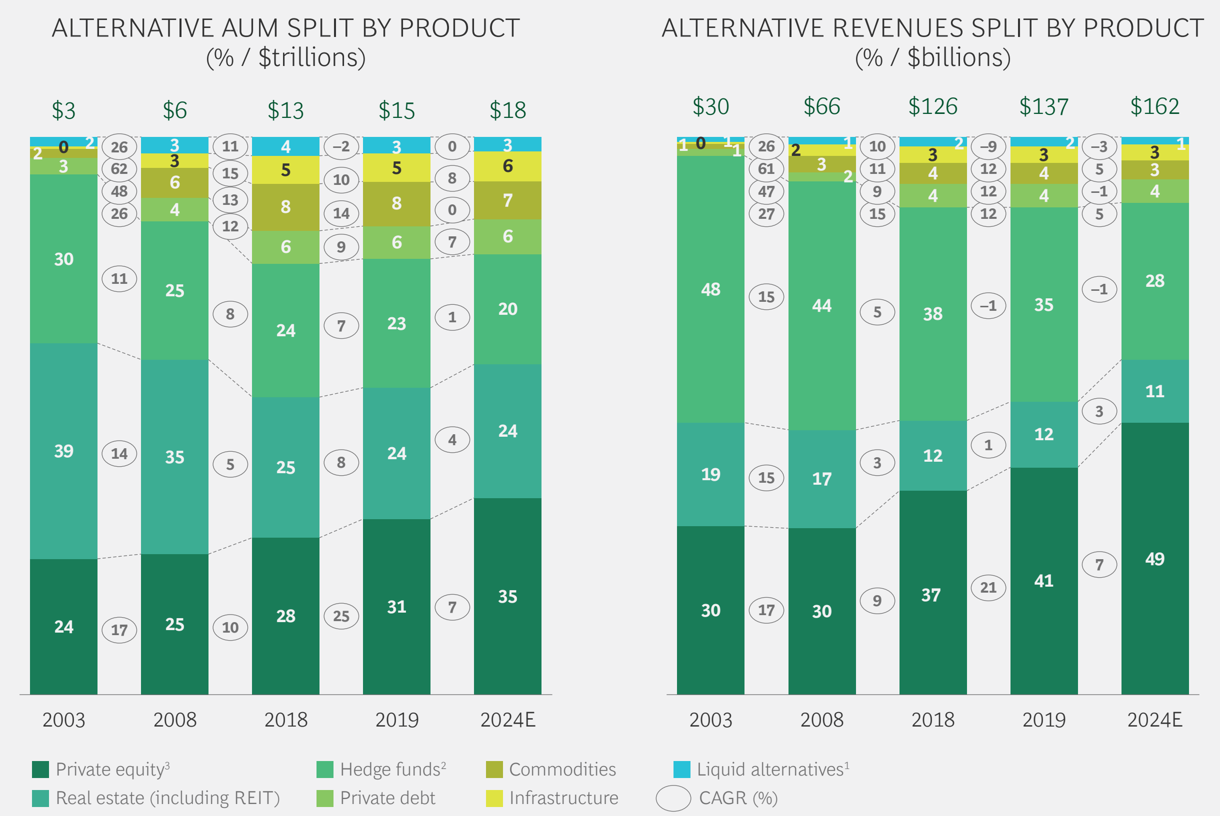
For many asset managers, participating in alternatives may be an imperative as new economic realities materialize. But such participation may require large investments in capabilities. Without a clear and deliberate strategy rooted in a defensible edge and a fit-for-purpose operating model, asset managers risk being caught in no man's land as the economics disproportionately accrue to firms that have a clear value proposition, expertise, brand recognition, distribution capabilities, and scale.

State of the Market

The alternatives market keeps growing overall, but not all alternatives are created equal. (See Exhibit 8.) Private markets, including private equity, real estate, infrastructure, and private debt, have grown at an annual pace of 9% since 2008, and today they represent 66% of AuM and 60% of revenues in alternatives. Within private markets, private equity AuM has grown at 11%, real estate AuM at 5%, infrastructure AuM at 15%, and private debt AuM at 12%.

Despite high fees and illiquidity, investors have flocked to private market funds in search of better-than-market-average performance and access to illiquidity premiums. By and large, fund managers have delivered: private asset classes have outperformed public markets across the globe over the past two decades, and managers have built track records, legitimacy, and expertise. Going forward, we expect sustained demand despite increased investor caution. As a result, these asset classes are likely to capture a disproportionate share of growth in the space, growing at a CAGR of 6% and representing 71% and 68% of alternative AuM and alternative revenues, respectively, by 2024. We expect much of this growth to continue accruing to the largest

Exhibit 8 | Allocations to Alternatives Continue to Rise, with Private Equity Winning over Hedge Funds



Sources: BCG Global Asset Management Market Sizing Database 2020; BCG Global Asset Management Benchmarking 2020; Strategic Insight; P&I; ICI; Preqin; HFR; BlackRock ETP report; IMA; BCG analysis.
Note: Bar chart values may not add up to 100% because of rounding. REIT = real estate investment trust.
[1]Includes absolute return, long/short, market-neutral, volatility, and trading mutual funds.
[2]Includes hedge fund of funds; revenues exclude performance-based fees.
[3]Includes private equity fund of funds; revenues exclude performance-based fees.

players: funds with AuM in excess of $5 billion increased their share of capital raised from 8% in 2010 to more than 43% in 2018.

Hedge funds, on the other hand, have seen their global AuM growth taper to 3% CAGR in the past five years, continuing to underperform against expectations. Overall returns in the past decade have trailed the S&P every year. We expect hedge fund AuM to grow by 1% annually through 2024, and we expect revenue growth to compress further, shrinking by 1% annually as investors respond warily to the current economic outlook. As a result, underperforming firms are likely to face redemptions and outflows.

Although the picture looks rather bleak in aggregate, some hedge funds remain well positioned to win in the space. Capital is flowing disproportionately into the larger funds as investors prioritize reputation and track record. Most of the net asset flows in the past ten years have gone to funds with AuM over $5 billion, accounting for $142 billion of the capital flow, while funds of less than $100 million place a distant second with $33 billion in net asset flows. The smaller funds retain some niche market appeal, but midsize funds with assets in the range of $500 million to $5 billion are having difficulty achieving scale and have lost $98 billion in asset flows over the past decade.

Liquid alternatives represent a very small portion of the alternatives category and are likely to shrink by less than 1% annually over the next five years. Despite a spike in growth during most of the past decade, liquid alternatives have delivered significantly poor aggregate performance over the past two years, calling into question whether this will continue to be a profitable niche product for managers, especially considering the capabilities required to compete in the space.

The Outlook for Alternatives

Overall, we see a series of trends reflecting growth in opportunities through expanded markets and expanded data capabilities, but also the reality of intense competition for a pool of investment capital that will be smaller in 2020 than it was last year.

Private Markets. In private markets, origination, sourcing, and diligence are likely to continue serving as critical means of differentiation. While many opportunities will arise, especially in the distressed space, competition for the best deals will intensify and become more complex. Firms would be well advised to invest in capabilities that provide a unique, sustainable edge, such as by focusing on deep specialization in an industry or geographic niche, evaluating a broader set of potential deals more efficiently through advanced analytics and digital tools, or partnering with other firms that offer complementary capabilities. The current environment could foster cooperation between distressed shops and industry-specialized shops, for example.

> During the 2010s, most net asset flows went to funds with AuM over $5 billion.

Managers will need to be attuned to establishing an edge through operational excellence, including both revenue growth and margin expansion. We estimate that close to 70% of value creation in private equity over the past decade was attributable to increases in operating profit. We expect a similar dynamic in asset classes with a strong operational component, such as real estate and infrastructure equity stakes, especially in the current economic environment. Managers can invest in operational excellence through either an in-house operations arm or strategic partnerships with transformation partners, ensuring that adequate attention is paid to the top line—for example, by tapping new revenue pools—as well as to the bottom line by such means as adopting traditional operational efficiency measures.

All private markets will find increasingly innovative uses for data and analytics, and not just in the origination and sourcing process. One opportunity that players in the space are exploring involves mining proprietary operating company data to look for synergies across the portfolio and to inform future investment decisions. New data providers are enabling firms to track and leverage data at a granular, actionable level; one such provider tracks clickstream data that can help asset managers anticipate sales and online customer behavior and can provide information on the strategies that portfolio companies are deploying. In the private credit space, one player improved the accuracy of its charge-off and prepayment predictions fivefold by tapping into a deep neural network trained on historical and third-party loan-level data.

> Strong risk management and contingency planning are key at the fund and asset levels.

Another notable trend in private markets is an increase in product democratization. The high yields have attracted the interest of mass affluent investors who are willing to pay full fees to invest in this space but currently have allocated very little capital to alternatives. We estimate that only about 5% of retail capital in the US is allocated to alternatives. Investor demand is evident, but it is less clear whether asset managers will view the opportunity as being worth the considerable effort, cost, and complexity needed to comply with the regulatory framework.

In these uncertain times, we expect to see two archetypal approaches. Some asset managers will play defense, consciously eschewing the opportunity in private markets in favor of focusing on their core business and reducing costs. Others will play offense, prioritizing this new market as a potential growth engine even in the face of economic uncertainty. One way to start tapping into this market might be to offer select vehicles through retirement plans; here, participants have long investment horizons and would be thrilled at the prospect of collecting an illiquidity premium. Firms that choose to pursue any retail segment must deal with significant issue related to product development, such as how to structure products to ensure enough liquidity for some redemptions, or how to build a retail secondary market in case of an urgent need for cash. The winners in this space will quickly establish, scale, and industrialize these new capabilities.

ESG considerations are gaining ground as investment criteria in private markets. Real estate and infrastructure investments, in particular, lend themselves well to environmental and social considerations; and private equity investments, especially majority stakes, are naturally suited to influence governance decisions. We advise private asset managers, at a minimum, to have a clearly articulated point of view to facilitate investor discussions on the topic, as the standard for transparency is quickly rising. Some firms are using ESG as a way to differentiate themselves in an increasingly competitive market, by embedding ESG in their investment and ownership process and by providing comprehensive portfolio-company-level ESG reporting to all limited partners.

The current economic environment should remind managers of the value of strong risk management and contingency planning capabilities at both the fund level and the asset level. Firms should ensure that they have developed these capabilities to a degree of maturity and usefulness that will help them avoid getting caught off-guard by another exogenous shock.

Finally, we expect M&A activity and inorganic partnerships to accelerate, especially as distressed pricing may present attractive opportunities for firms equipped with resilient economics and strong balance sheets.

Hedge Funds. As every financial downturn reminds us, hedge funds can be a highly volatile space. With the industry in an overall slump, firms must clearly articulate and justify their value to investors or risk continued outflows and redemptions.

Some are finding that they must innovate their business models, leveraging their own distinct capabilities to go beyond their traditional sources of revenue. Many managers are mixing organic and inorganic growth, partnering and integrating with fintechs and diversifying into entirely new lines of business such as insurance or back-office operations.

Other firms have invested in new technologies as a way to build differentiation and edge, such by as mining data for tradable signals or by leveraging technology to efficiently implement market-based views. Performance has varied widely across strategies and funds; but across all fronts, technology is likely to increase as a force in shaping industry dynamics. For example, funds are now in fierce competition with technology firms for talent. Beyond talent, investment firms may seek to incubate, partner with, or acquire technology ventures focused on niche use cases.

Liquid Alternatives. We expect this space to be a battleground as players strive to redefine the frontiers of what is possible and regulators struggle to keep pace with the most innovative vehicles. Asset managers looking to participate in this space should ensure that they have adequate product development expertise, as product wrappers carry varying degrees of complexity, cost, and constraints.

Four Future Growth Strategies

In a landscape of relentless competition for limited investor capital, asset managers that want to participate in the alternatives space need to face the future with a clear roadmap. A plan to overcome the new challenges, identify opportunities for rebuilding, and grow by establishing an edge through technology, expertise, and scale will be critical.

Alternative managers will need a deliberate growth archetype. Three particular approaches are appropriate in the current climate. The one-stop-shop approach favored by many of the largest private market managers provides investment opportunities across market segments and leverages the synergies and scale that a very large firm can provide. The focused-scale approach offers investors a few key core segments but also some adjacent, complementary products. The double-down approach prioritizes alpha in one specific segment and sector.

Inorganic growth by such means as M&As and partnerships offers a quick way to enter new segments in the alternatives space at a time when gaining scale may be the best defense against market uncertainties. Firms should proactively analyze the market to identify potential players to acquire, and they should ensure that they have sufficient financial flexibility to move rapidly when an opportunity arises.

Firms should also ensure that their operating model reinforces their growth ambitions. If managers plan to expand into technology deals, for example, they may need to have a physical or virtual foothold in Silicon Valley. Transformation partners may be required to enhance the firm's operational capabilities for optimizing their top and bottom lines. Firms must invest in finding, attracting, and retaining the right talent across both the front office and the back office, and they must align their internal organizational structure, compensation, and performance management appropriately.

Top players in the alternatives space are making significant investments in data and analytics across the value chain. Asset managers that want to position themselves as best-in-class firms should do the same, while ensuring that they can tangibly measure the value of these new capabilities. Data capabilities can be an important source of differentiation. Some private equity firms, for example, use proprietary operating company data to inform their future investment decisions or to hedge against risks.

Finally, two potentially disruptive strategies can challenge the status quo in the alternatives space. A traditional asset manager entering the space might seek to build a low-cost, at-scale alternatives business that challenges the cost structure of current incumbents—in much the same way that passively managed vehicles transformed the mutual funds industry. We can also envision a select set of appropriate private-market products expanding into other investment vehicles such as defined contribution retirement plans. This approach would require product innovation and potential lobbying for regulatory approval, a domain in which the recent passage of the SECURE Act in the US offers an encouraging precedent. In any case, the economic upside is likely to ensure that the alternatives landscape will remain a dynamic, innovative competitive space in the years to come.

THE NEXT WAVE IN DISTRIBUTION

DIFFERENTIATING ON CLIENT EXPERIENCE

An asset manager can win and retain client business in any of three primary ways:

- By offering a competitive edge through performance, delivering better results
- By offering a competitive edge through cost, delivering the same results for less
- By offering a competitive edge through client experience, delivering more total value

Historically, performance-based and cost-based business models have dominated the industry—and both will continue to be relevant. However, they have natural limitations. In particular, relatively few managers have managed to deliver sustained outperformance, and costs can go down only as far as zero.

We believe that the next wave of competition will be based on creating world-class client experiences that extend beyond performance at a given cost and into a more comprehensive value proposition for the client. Personalized portfolio solutions and tailored client engagement models are typical ways to add such value. (See the sidebar, "A New Role as Advisors to Global Insurance Clients.") So are value-added services that the firm can unlock by going digital at scale and by borrowing customer-centric practices from other industries—for example, the deep customer insight data that consumer product companies and digital giants leverage.

This next phase of competition will create a multitude of opportunities for asset managers to differentiate, but it will also require a new approach to the business.

Five Best Practices

Firms that are leading the way in client experience view it as a transformative strategy and are betting big on it. In particular, they consistently apply five best practices that result in a greater share of wallet, higher retention, and preferred economics.

Leading with Data-Driven Business Intelligence. Many asset managers continue to struggle to gain a basic understanding of who their clients are and what motivates them to buy or redeem. In the institutional segment, consistent customer relationship management (CRM) adoption and quality control are common challenges. Lack of consistency can lead to low-fidelity reads of client situations and flawed strategies that over-rely on a single relationship manager's decision. In retail, where more data on financial advisors is available, the challenge lies in breaking through the noise to create effective sales and marketing campaigns that are both personalized and scalable.

A NEW ROLE AS ADVISORS TO GLOBAL INSURANCE CLIENTS

For nearly two decades, insurers and pensions have represented, on average, 80% of global institutional asset management business every year. Currently they hold more than $40 trillion in AuM overall. The fiduciary mandate in serving this key market segment was already evolving before 2020, with insurers facing competitive pressure to provide attractive returns to their clients amid regulations that have increased their capital charges. Now the industry must deal with a slowdown in new business, pressures on capital ratios and cash flow, and potential losses from the volatile market and low interest rates.

The resulting discontinuity reinforces the need for closer partnerships between asset managers and their global insurer clients, with the asset manager acting more like a full-fledged advisor. In this enhanced role, asset managers must gauge insurers' short-term and medium-term needs and adapt their services accordingly.

In the short term, they must develop risk management capabilities to support "what-if" scenarios in the post-pandemic world. That includes factoring in worst-case scenarios that might entail activating emergency plans to increase cash buffers and lower capital charges linked to investments. In some cases, asset managers will also have to develop adjustable fee structures that can help alleviate capital stress as needed. Furthermore, asset managers must devise flexible investment strategies and categorize portfolios by liability buckets to offer policyholders an attractive return, while at the same time optimizing the risk-reward profile for insurers. This will be especially important in countries where market volatility makes individual investors reluctant to return to risky assets.

Over the longer time horizon, asset managers must create innovative business models that are suitable for a very different world. They should consider products designed for a low-interest-rate environment, with attractive returns but lower capital charges. A reshaped operating model may include technology that provides a standardized, fully digitized ecosystem to support insurance partners and their distribution networks to enhance client experience. Another key will be a tailored approach to embedding ESG factors in the asset manager's investment processes.

Successful firms have taken action by creating a centralized business intelligence function that is responsible for developing a clear, all-encompassing understanding of the client profile, which they can share across the sales and marketing organization and with senior stakeholders.

In retail, asset managers can leverage the power of data and analytics to create predictive algorithms that anticipate client needs, suggest communications, and flag early redemption risks. In our work with a top asset manager, we co-created a financial advisor prediction engine that anticipated redemptions over a three-month period with 90% accuracy, by harnessing the power of unstructured data. We are using the same methodologies to target new customer acquisition strategies to deploy wholesalers at scale more effectively.

In the institutional segment, best-in-class firms have a clear commercial strategy planning process that explicitly describes the target client universe, incorporating details ranging from AuM attractiveness to philosophical alignment to propensity to buy or redeem, and can attribute flows back to the sales team. The most sophisticated firms have integrated multiple data sources, including CRM and third-party data, into rich visual dashboards that operate in real time. Such systems paint a picture of opportunities and risks across the book of business, so the firm can establish more timely and relevant client touch points.

Building Robust Data and Technology Organizations. To improve business intelligence, leading firms are building data science capabilities that enable them to gather, clean, synthesize, and visualize vast amounts of client information. They invest heavily in people and competencies that are governed centrally but are tightly linked to the business, often working hand-in-hand with sales and marketing. This close partnership helps avoid the perception of data capabilities as being just a science project—a view that can stifle momentum.

> Leading players are bringing the customer voice into the product development cycle.

In parallel, these firms are building appropriate technology stacks. Many asset managers get lost while trying to build the ultimate technology platform, leading to frustrated developers and business sponsors. More-experienced players take a customer-centric use-case approach that ties into a deep understanding of customer needs and business goals. Like data teams, technology teams are tethered to a center of excellence but spend most of their time on the ground building practical and useful technology.

In delivering these new capabilities, it helps to incorporate agile practices that permit rapid experimentation and proof of concept for new products, services, and client communications. By keeping the feedback loop tight, firms can spot winning and losing ideas quickly, and this helps business sponsors gain confidence that their investments are paying off.

Realigning Sales and Marketing. As the importance of digital marketing increases, asset managers should ensure that marketing and sales have equal seats at the table. Marketing is no longer just a support function for sales teams, but a key player in the commercial conversation, with a role that includes driving client segmentation, creating the content agenda, and developing tools. When managed appropriately, both sales and marketing can raise their game in support of the common goal of serving clients, leading to more fulfilling jobs and better client outcomes.

At the same time, sales coverage models must align with client needs, as opposed to following a one-size-fits-all approach. A financial advisor who is near retirement and has an older client base, for example, has different needs and expectations from a younger advisor who is building her practice with a millennial client roster. Establishing client archetypes can inform sales strategies and ongoing service models that are better customized to client needs.

Upgrading the Product Development Cycle. Taking a page from consumer-packaged goods companies, leading players are bringing the customer voice into the development cycle, actively co-creating strategies with clients—in the retail channel through model portfolios, and in the institutional channel through customized separately managed accounts (SMAs). This practice makes it possible to design products that address client values in areas such as ESG investing, as well as offering the ability to select and deselect industries, companies, and geographies across asset classes.

Firms can also establish a winning edge by strategically culling their existing product shelf to ensure quality and focus. Most large asset managers have a long tail of products that are subscale but nevertheless require sales attention and ongoing servicing. It can be difficult to scale back a portfolio, so most companies are setting a higher bar for the future and are being judicious in their choice of new products to launch.

Strengthening Culture and Incentives. Finally, firms should measure and reward client-centric behavior—as indicated by improvements in customer satisfaction—along with using hard business metrics such as sales goals. None of the preceding transformations will work in the absence of a client-centric culture and supporting system of incentives.

Putting Best Practices to Work

Many firms are already putting these best practices to work through personalized portfolio construction, better client engagement models, and value-added services.

Portfolio construction alpha is an excellent way to serve client needs more effectively while also creating stickier relationships through personalization. In the institutional segment, best-of-breed SMAs are a classic way to deepen client relationships. These accounts often come with specialized, noncommoditized fee schedules. In retail, several players are creating personalized portfolios that reflect client values—for example, through ESG preferences. We expect the trend toward portfolio personalization to accelerate, driven by client demand and enabled by more flexible technology and data platforms.

Client engagement models enable firms to operate on client terms in a more nuanced way. For example, a leading retail manager created separate "home" and "away" teams. The home team engages with clients via video and phone, while the away team functions as a traveling sales team. This structure enabled the firm to serve diverse client needs, increase client engagement, and grow its AuM.

The broader trend toward meeting clients on their terms—whether in person, by video, or by phone—is also gaining momentum. To do this effectively, asset managers must rethink digital tools and training for their relationship managers.

Value-added services have enabled firms to increase client loyalty. Examples of such services include hedge funds that provide daily best-in-class macroeconomic research to clients, and a tech-savvy fund manager that offers cutting-edge portfolio evaluation tools to help clients identify risk factors. Firms that do this well stay close to home and make their value-added services a natural extension of their business. As a result, the offering is distinctive and delivery is sustainable.

This type of competition is unconstrained. The number of low-cost leaders is necessarily limited, and only a few managers have truly delivered sustained outperformance; but the only limits to innovating on customer value are creativity and the ability to execute. Still, delivering on this value proposition entails reframing the traditional goal of asset management. The firms that win will be those that deliver not just a great product, but also a world-class client experience.

FOR FURTHER READING

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