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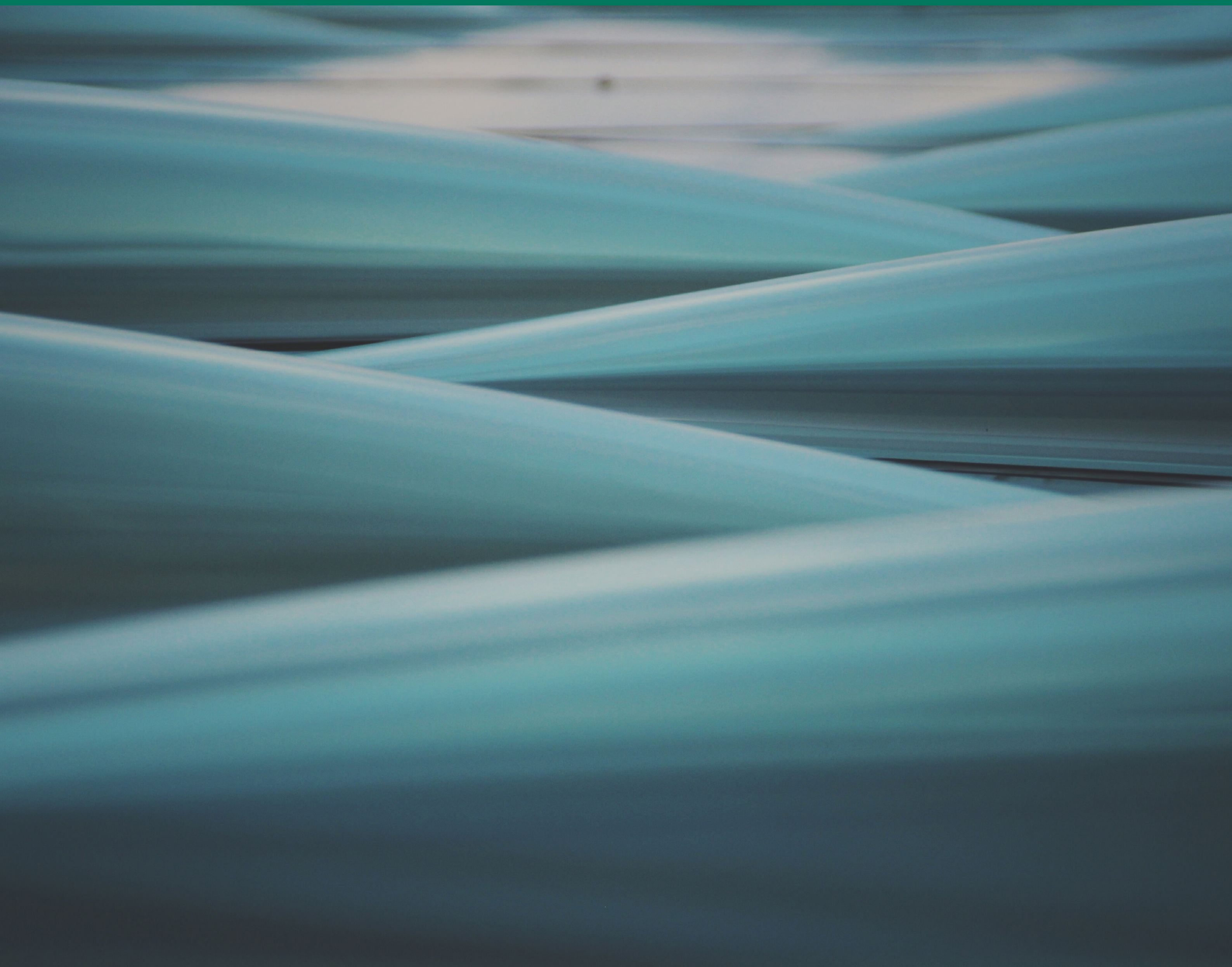
The Hidden Pressures on Asset Managers



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The Hidden Pressures on Asset Managers

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AT A GLANCE

Asset managers can celebrate the industry's best year since 2010. But they should not let it blind them to the underlying trends that are putting pressure on their margins. Top players will continue to capture a larger share of net inflows, and rapid advances in technology will increase the need for scale in asset management.

Strong, Market-Led Performance

Equities markets in the US and Asia enjoyed bull runs in 2017, and European markets performed solidly. Asset managers were among the beneficiaries. Globally, assets under management increased by 14%, net inflows were 4.3%, and profits were up by 9%.

Rising Costs and Falling Fees Pressure Profits

Fees continued their steady decline, falling on average 3% a year for the last four years. This is not the result of AuM migrating to low-fee product classes but of lower prices for the products themselves. Meanwhile, costs are being pushed up by new regulations, such as MiFID II, and by the need to invest in new technology. If current trends hold, average profit margins will fall from 38% to 36% over the next three years. If markets correct, we expect them to drop to 30%, though they could fall as low as 27%.

EVEN TIRING RUNNERS ACCELERATE when the road turns downhill, because gravity works in their favor. That was the story of asset management in 2017. Assets under management (AuM), net inflows, and revenues were all well up, but not because asset managers made equally impressive improvements in their business models. Market gravity was on their side. The bull market in equities increased the value of assets already under management and attracted much new money.

Asset managers should celebrate a banner year for the industry. But they should also use this moment of strength to position themselves for a business environment that may look very different in five years, transformed by new technologies and changing customer demands. If they don't, they face a future of persistently eroding margins.

The bull market was a boon for asset managers in 2017. Net new flows were 4.3%, the highest they've been in the ten years since the global financial crisis.

Net New Flows and Revenues Surge

The S&P 500 index appreciated by 19.5% in 2017, and other major equity markets did similarly well: Japan's Nikkei was up 19% and gains in major EU markets ranged from 6% to 17%.

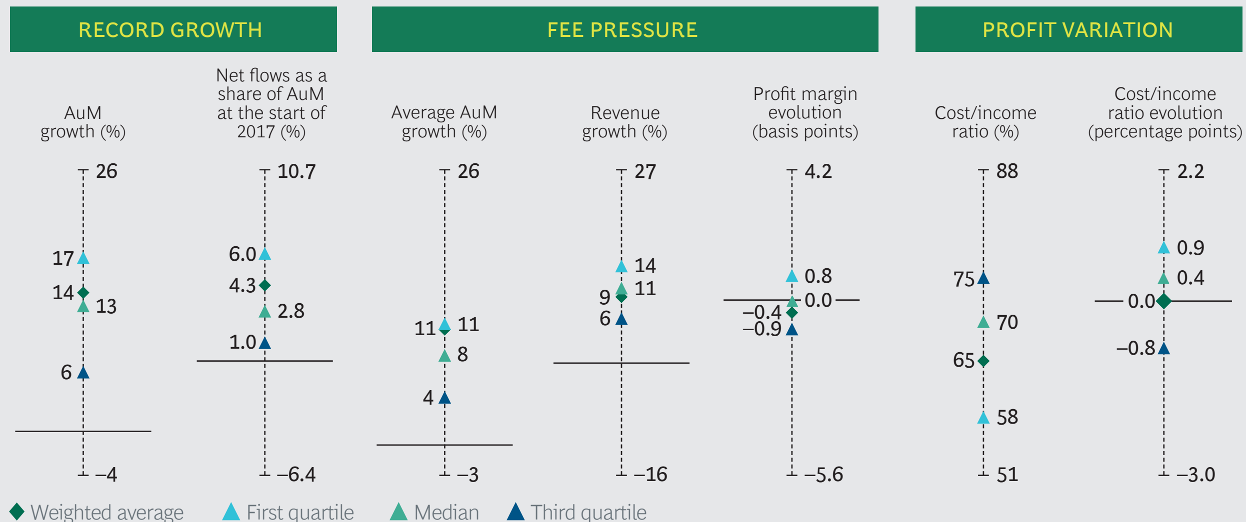
This made 2017 an exceptionally good year for asset managers. In a sample of 30 asset managers representing $34 trillion of AuM, or roughly half the industry, we found that AuM grew by 14% during 2017, which translated into an 11% increase from 2016 in the average AuM held over the course of the year. (See Exhibit 1.) Net new flows were an extraordinary 4.3%, the highest they've been in the ten years since the global financial crisis.[1] Net flows were negative in the years immediately after the crisis and then averaged 1.5% from 2013 on.

Asset managers' revenues increased by 9% in 2017. Given that average AuM grew 11%, this reveals continued pressure on fees, which appear to have declined by roughly 0.4 basis points (bps). However, costs also declined by 0.4 bps, meaning that profits as a percentage of AuM remained constant and increased by roughly 9% in absolute terms.

Active Investing Demonstrates Resilience

The product trends of recent years were still apparent in 2017. Money continues to move from traditional products to alternatives, solutions, and specialties—and, more generally, from active to passive.

Exhibit 1 | 2017 Was a Very Good Year for Asset Managers



Sources: Company information; Strategic Insight; BCG analysis.
Note: Analysis based on a sample of 30 asset managers representing $34 trillion of AuM at the end 2017. This sample includes large passive players such as BlackRock and Vanguard, so net flows may be somewhat higher than the average for the industry. However, even a 2% to 3% industry-wide average would be the highest in the last 10 years. These figures will be revisited in our Global Asset Management 2018 report. Cost/income ratio of 65% for 2017 for this subsample is higher than the average ratio for the total sample of the detailed BCG GAM benchmark including more than 150 players, which was at 62% in 2016. Upper and lower bands represent the maximum and minimum values found in our sample.

Yet active strategies showed resilience, accounting for 6 of the top 15 strategies in the US, measured by net flows, and 10 of the top 15 in Europe and in Asia. (See Exhibit 2.) In the US, some traditional active strategies, such as intermediate-term and multisector bonds, moved back up the rankings. In Europe, strong active products included many specialties and solutions along with traditional strategies.

Despite the long-running migration of AuM from active to passive, demand for products that can outperform the market remains strong and is unlikely to disappear. Our analysis of the drivers of inflows confirmed that in the US only active funds with five-star ratings or new products were capturing significant net inflows, while one- to four-star funds in aggregate suffered net outflows over the past few years. (See *Global Asset Management 2017: The Innovator's Advantage*, BCG report, July 2017.)

Some active managers have responded to the shift to passive by better aligning fees with performance. For example, a leading global asset manager has cut its base management fees for active funds by 10 bps but will increase them by 20 bps if they outperform benchmarks by 2 percentage points or more. The firm says that this new fee structure is a way of sharing risk and return.

Another interesting development is the ongoing advance of "smart beta" strategies. These passively track an index but include an active, rules-based component. Securities are selected and weighted by criteria other than market capitalization alone, which creates the possibility of outperforming the market.

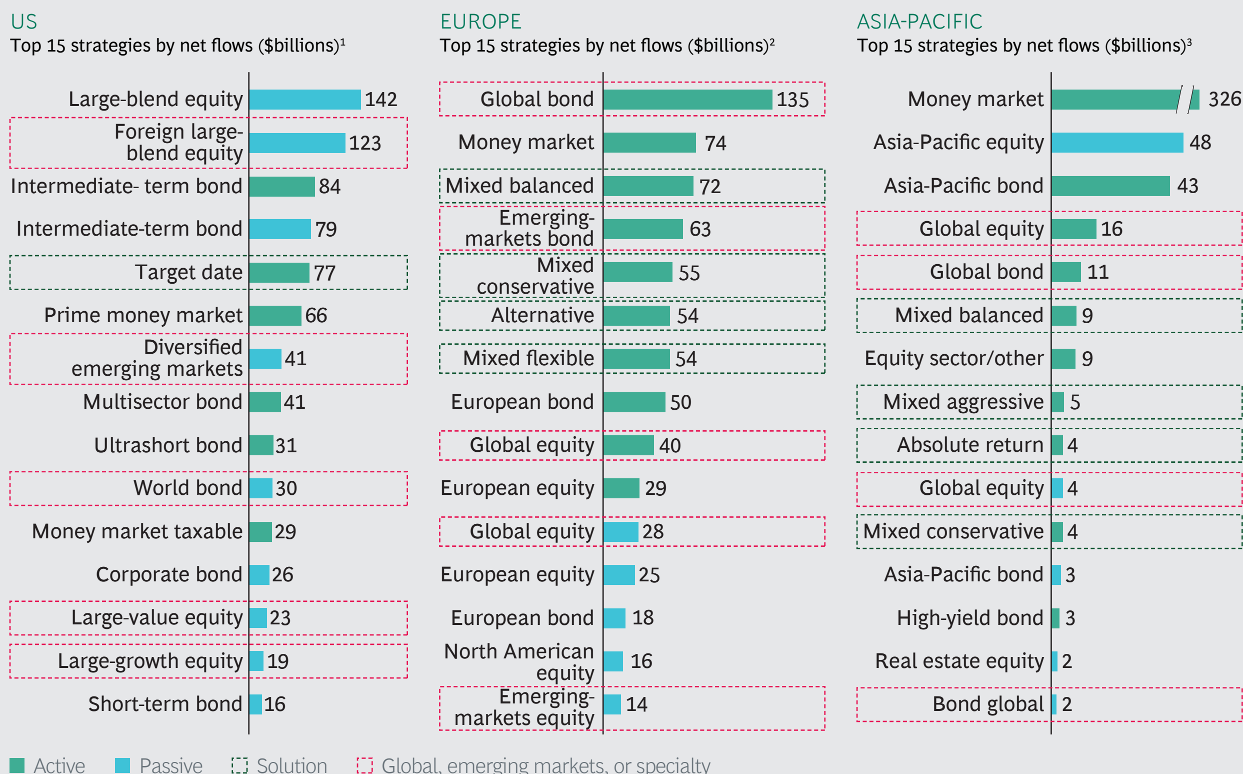
With only about $430 billion of AuM (0.5% of the global total), smart beta is a small

part of the industry. But it has been growing at a rate of 30% a year since 2012 compared with a 13% annual growth rate for standard passives. The US accounts for 88% of global AuM in smart beta. In Europe, only $50 billion is in smart beta, albeit with a CAGR of 33% since 2012. (Smart beta is effectively nonexistent in Asia-Pacific funds.)

Smart beta has been dominated by passive players seeking higher fees than they could earn for simple index-tracking products. BlackRock has about a quarter of the total smart beta market and is expanding rapidly in this area. (See Exhibit 3.) However, given that the strategy draws on ideas about stock picking and portfolio construction, it can be natural territory for active managers, some of which have successfully entered the business in recent years. Fidelity Investments and Goldman Sachs are both in the market's top ten after just three years in smart beta.

Ninety-four percent of smart beta funds are allocated to equities. However, the dominance of a single asset class belies the variety of approaches to specific asset selection. Dividend funds are the largest category, accounting for 30% of smart beta equity AuM. But single-factor funds, at 29% and doubling in size over the last two years, are about to surpass them.

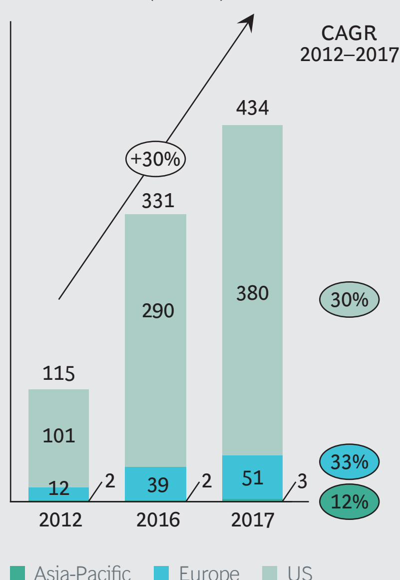
Exhibit 2 | Active Investment Strategies Showed Plenty of Resilience in 2017



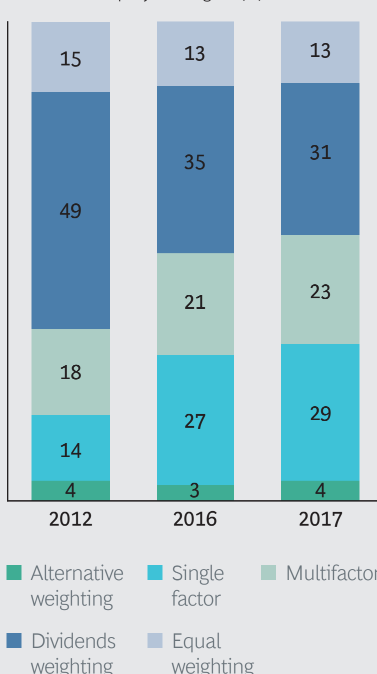
Sources: Strategic Insight; BCG analysis.
Note: Net flow figures are for mutual funds only.
[1]Out of 120 strategies defined by SimFund database.
[2]Out of 29 strategies defined by SimFund database.
[3]Out of 27 strategies defined by SimFund database.

EXHIBIT 3 | Investments in Smart Beta Strategies Have Grown Sharply Since 2012

Smart beta AuM ($billions)



Smart beta equity strategies (%)



AuM ($billions)

Top ten asset managers	2012	2014	2017
BlackRock	21	45	102
Invesco	30	45	63
State Street	20	33	48
WisdomTree	16	38	46
First Trust	7	28	37
Guggenheim	6	21	25
Charles Schwab	4	8	24
Fidelity	-	-	12
Northern Trust	0	3	9
Goldman Sachs	-	-	6
	104	220	372
Share of total AuM	90%	89%	86%

Sources: Strategic Insight; BCG analysis.
Note: Because of rounding, some percentages may not add up to 100.

The growth of smart beta makes it attractive to active players. But just as the smart beta investment strategy is somewhere between traditional active and passive, so are the fees, averaging around 35 bps. If these products cannibalize truly active funds with much higher fees, active managers will be forced to make up for falling revenue by cutting costs significantly—as much as about 27 bps on average for an active retail-oriented player and about 21 bps for a player focused on smart beta funds distributed through wholesale and retail channels.

Flows Continue to Concentrate

Strong market conditions meant that most asset managers enjoyed AuM growth and positive net new money in 2017—many more than did in 2016. But performance varied considerably. Top-quartile players increased their AuM by 17% or benefited from net flows above 6% of AuM, while bottom-quartile players increased their AuM by 6% or achieved only 1% net flows.

The US mutual fund market remained concentrated among the top ten players, which accounted for 116% of mutual fund inflows. When only asset managers with net inflows are considered, the top ten still accounted for 85% of inflows. (See Exhibit 4.) In Europe, despite greatly increased net inflows, the top ten asset managers accounted for 35% of flows (when only players with positive flows are considered), up from 23% in 2016. Europe lags the US in the winner-takes-all trend because the

market is fragmented across many countries and access to distribution remains a key driver of sales.

Unsurprisingly, the resilience of active strategies in the US and Europe is mirrored by the resilience of active players. In both markets, six of the top ten players received all or most of their inflows from active products.

A Positive Blip in a Negative Trend

As noted, the strong performance of asset managers in 2017 was market driven. It should not disguise the trends that are squeezing profits. Under the less spectacular but still positive market conditions of the previous five years, AuM grew at an average of only 6% annually. And margins were compressed by pressures that persist.

Contrary to conventional wisdom, the migration of AuM from active to passive products is not the main driver of reduced average fee income. This does indeed put downward pressure on average fees, but it is being offset within active products, where AuM are flowing to alternatives and solutions, the highest-fee products.

Exhibit 4 | The Winner-Take-All Trend Is Stronger in the US Than in Europe

US

Asset manager	2017 net flows ($billions)	Cumulative share of total net flows (%)	Cumulative share of net flows of players with positive net flows (%)	Share of total passive flows (%)
Vanguard	402	56	41	82
BlackRock	210	85	62	102
Capital Group	47	91	67	0
Pimco	44	97	72	–1
Dimensional Fund Advisors	31	101	75	0
State Street	30	106	78	91
Charles Schwab	28	109	81	109
TIAA	20	112	83	27
Edward Jones	14	114	84	0
Guggenheim	10	116	85	17
Total market flows	724			
2017 top-ten share		116	85	
2016 top-ten share		330	83	
2015 top-ten share		251	75	
2014 top-ten share		121	68	

EUROPE

Asset manager	2017 net flows ($billions)	Cumulative share of total net flows (%)	Cumulative share of net flows of players with positive net flows (%)	Share of total passive flows (%)
BlackRock	78	9	8	77
Pimco	64	17	15	1
Amundi	39	22	20	38
UBS	27	25	22	57
Eurizon Capital	23	28	25	0
Deutsche AWM	22	31	27	58
Vanguard	22	33	30	97
Allianz Global Investors	20	36	32	0
M&G Investments	18	38	34	0
Union Investment	16	40	35	0
Total market flows	822			
2017 top-ten share		40	35	
2016 top-ten share		75	23	
2015 top-ten share		47	35	
2014 top-ten share		42	31	

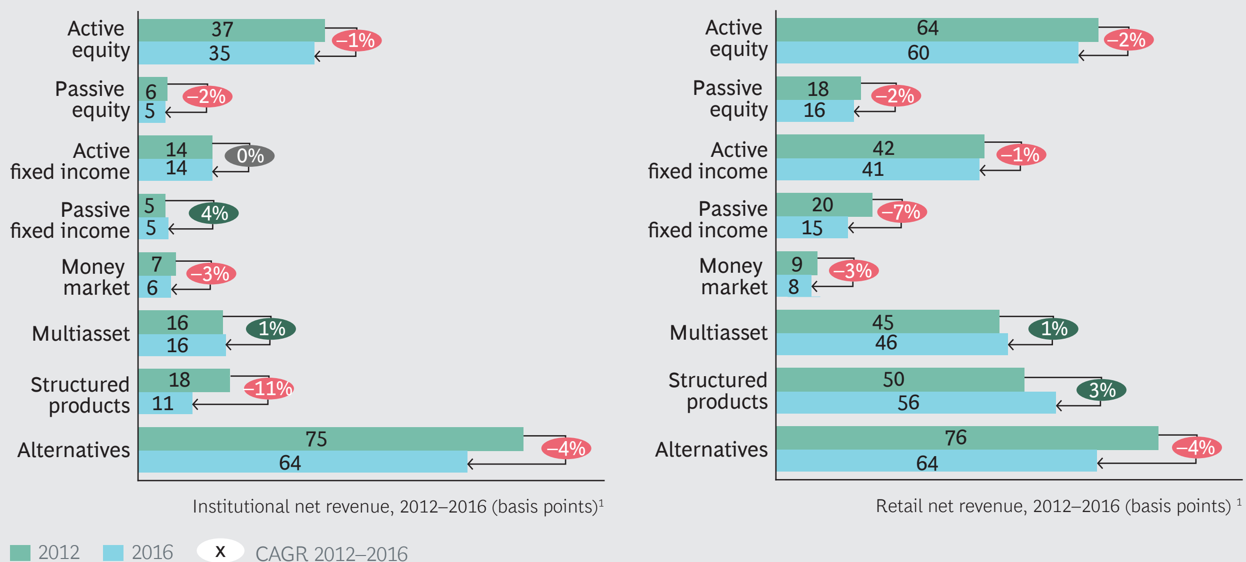
Sources: Strategic Insight; BCG analysis.
Note: This analysis excludes money market funds.

The real cause is pressure on the pricing of individual products. (See Exhibit 5.) Asset managers are competing for the business of large institutional investors and retail distributors with great bargaining power. In addition, regulators are demanding increased transparency and, in some jurisdictions, driving a shift to lower-fee funds by banning distribution fees. As a percentage of AuM, fees have declined by 3% a year for the last three years—though solutions are a notable exception.

Along with the pressure on revenue, asset managers face forces that are pushing up costs. To meet changing client needs, they must continually acquire or develop new capabilities, introduce new products and asset classes, and expand into new markets, such as China. New technology should cut costs over the long run, at least for large players with the scale required to deploy it; in the short term, however, it is driving up investment spending. And ongoing regulatory reform is driving up operating costs. For example, the introduction of the EU's MiFID II regulation this year will shift research costs previously paid by funds onto the P&Ls of most asset managers. This will apply to asset managers dealing in European funds, wherever they are based.

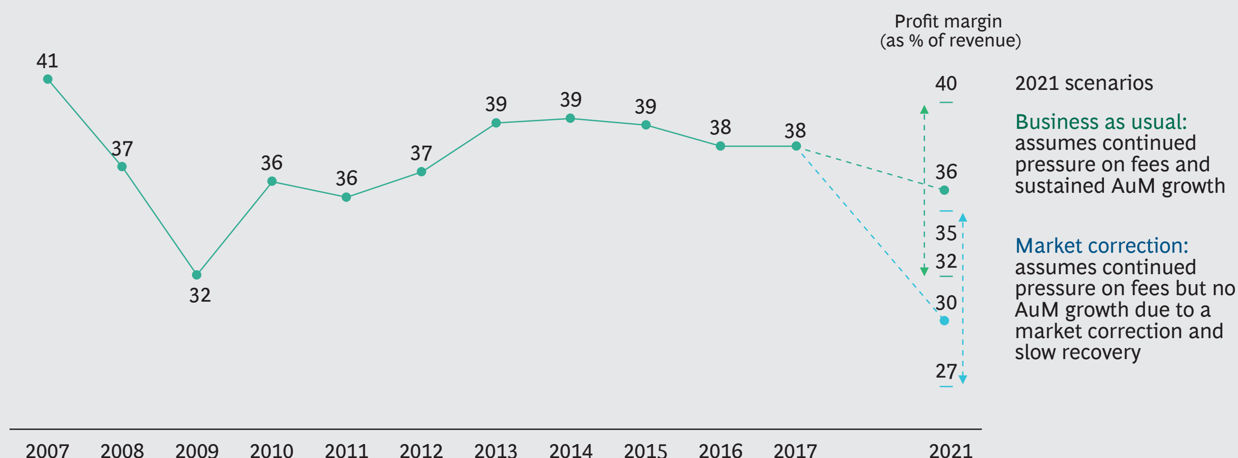
The effect of these trends on profit margins will depend on the rate at which they develop and on the growth of AuM, which is closely related to the performance of the underlying asset markets. Our business-as-usual scenario, under which recent trends will continue, sees profit margins falling from 38% at the end of 2017 to 36% in 2021. (See Exhibit 6.) However, AuM may fail to grow at all, perhaps as a result of a severe market correction followed by a slow recovery over several years. In this scenario, we expect margins would decrease to 30% but could fall as low as 27%.

EXHIBIT 5 | Revenue Falls as Competition for Investors Puts Pressure on Pricing



Source: BCG Global Asset Management Benchmarking Database 2017.
[1]Management fees net of distribution costs.

Exhibit 6 | Market Performance Will Shape the Fate of Profit Margins



Sources: BCG Global Asset Management Benchmarking Database 2017; BCG analysis.

Continued pressure on margins was not the only trend we observed beneath the exceptional performance of 2017. Three more are worth noting.

Digital and advanced analytics are starting to disrupt the industry. New data sources and analytical tools are improving the quality of research while reducing its cost, more powerful predictive tools are better targeting marketing and sales activities, and digital technology is automating many of the most mundane operational tasks. In short, digital has continued to go mainstream; most asset managers are experimenting with digital labs, hiring data scientists, and testing the use of alternative data. Few, if any, have developed these at scale, but we expect this to change soon.

China continues to grow rapidly. Our most recent market-sizing exercise revealed China to have already become the fourth-largest asset management market (after the US, the UK, and Japan), with $3.6 trillion in AuM at the end of 2016. It was in eighth position only five years earlier, with $1.1 trillion in AuM at the end of 2011. This strong growth is occurring in both the retail segment, thanks to a high household savings rate, and the institutional segment, where regulatory reform has increased the use of asset managers by pension funds and insurers. Government regulators' push for more transparency in the market has also led to an increase in the use of traditional asset management products.

The partial opening up of the Chinese the market is creating a "gold rush" for foreign firms. However, their role in the market, from much of which they are still excluded, remains nascent. Domestic players are already innovating, often in partnership with fintechs, and experiencing explosive growth.

M&A activity is increasing. As discussed in our 2017 Global Asset Management report, M&A activity in the industry increased in the six years up to 2016. It intensified further in 2017, with 208 deals, up from 149 in 2016 (according to data from

Sandler O'Neill). Changes in customer preferences and technology often make M&A the best option for creating a sustainable business model. Many of the deals over recent years have been small, aimed primarily at acquiring capabilities in real assets. But a few acquisitions have been much larger, reflecting a desire to build scale and reduce unit costs while significantly strengthening product offerings or distribution channels.

The performance of securities markets is the most important short-term driver of asset managers' profits. Markets, of course, are unpredictable. Few expected the 20% appreciation of global equities markets in 2017. Or the resulting 9% increase in asset managers' profits. At the same time, the long-term drivers of asset managers' profits are quite predictable. The shift to passive, the slow growth of mature markets, the erosion of fees, and the disruption of digital and analytics have been apparent for many years and are set to continue.

Asset managers may know what is coming, but they still have to take the actions necessary to get and stay in front of it. Some bold moves will be required—radically overhauling technology, entering new markets, and making acquisitions, among others. These are daunting challenges. But the extraordinary market-led performance of 2017 puts many in a strong position to take them on.

Note

1. These figures will be revisited in our Global Asset Management 2018 report, to be published in July, which will cover more than 150 players representing over 60% of global AuM.

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