FINANCIAL SERVICES

zeb

European Asset Management Study

THE DISCOMFORT ZONE –
DEFINING A DISTINCTIVE STRATEGY FOR EUROPEAN ASSET MANAGERS

2019

DATA PROVIDED BY MORNINGSTAR

MANAGEMENT SUMMARY

Time to leave the comfort zone

The asset management industry has been growing rapidly for years with 2017 being an exceptional year in terms of net new money flows. However, its growth in terms of assets under management is on average three-quarters dependent on market performance. Also, the strong increase of bond and equity markets has so far hidden the fact that revenues are falling and costs are still too high for sustainable profitability. As 2018 was the first year with falling markets after a long bullish phase, the industry now finds itself in the discomfort zone. Weak growth and increasing pressure on revenues are causing especially the middle ground to collapse, and companies urgently need to carve out a distinctive position for themselves. One option is to tap into economies of scale and reshape the business model accordingly. The other is to specialise and focus on the quality of products and services as well as innovation.

To get a picture of the current state of the market and the outlook for the years ahead, we carried out a major survey of asset managers with a strong European footprint. The results prove revealing. Not only do they provide many unique insights, they also explode some common industry beliefs, such as the idea that simply having a large share in retail[1] business or non-traditional strategies in and of itself increases the chances of being profitable. To look ahead, we present three possible scenarios for future market developments and discuss the impact of each scenario on the profitability and growth of different types of players and business models.

Using the survey's findings, we formulate recommendations for asset managers in five key areas:

1. **Define a clear strategic position** since asset managers who cannot win through economies of scale must focus on areas where they can generate competitive advantages
2. **Professionalise distribution and sales management** and adapt distribution channels to digital customer needs not only in retail but also in institutional asset management
3. **Review pricing and revenue sources** as pricing should be more strongly correlated to the value generated for the client which does not only include the pure investment performance but also other services provided to the client
4. **Reduce cost levels and digitalise operations** in order to exploit the potential of new technologies – asset managers must either develop digital solutions themselves or build on existing solutions from other asset managers and technology providers
5. **Leverage digitalisation opportunities and take data management to the next level** because a clear data strategy from storage to analytics can boost asset managers' performance along the value chain from portfolio and risk management to distribution

These recommendations are not new. In fact the industry has been talking about them for several years. But now is the time to start acting.

Following these recommendations will be uncomfortable for many asset managers. But our message is clear: If asset managers hope to survive on the market, it is time for them to leave their comfort zone.

Dr. Carsten Wittrock
Partner

Norman J. Karrer
Partner

Maria Katharina Heiden
Manager

The authors would like to thank our colleagues Rasmus Mumme, Anna Katharina Tsitsirikos, Sarina Neumann, Kathrin Nadenau and Nicolas Seiler for their help in setting up the study and improving previous versions. Additionally, they would like to thank Axel Sarnitz, Wolfgang Schlaffer, Bertrand Lavayssière, Arnd Heßeler and Daniel Crow for their valuable comments and fruitful discussions on the topic.

1 Within this survey, retail business refers to the end client segment irrespective of the distribution channel which can target private clients (be it in the retail, private banking or wealth management segment) directly (e.g. via robo advisors) or indirectly (often referred to as wholesale business) via distribution partners, platforms or vehicles such as funds of funds.

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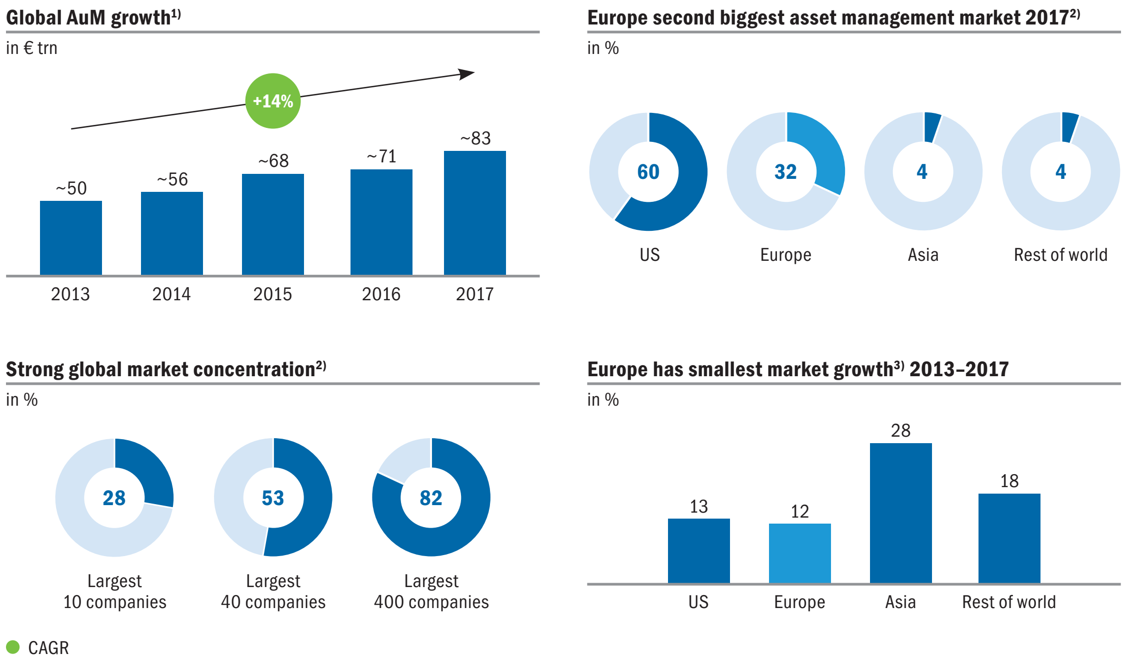
1 A VOLATILE BUSINESS

Despite a favourable environment, the industry faces pressure from all angles

Asset management is considered highly attractive as (regulatory) capital requirements are negligible. It is also currently one of the most profitable markets out there. It enjoys a high operating margin[2] of 37 percent compared to other industries: It is more profitable than banking with an operating margin of 34 percent and insurance with just 4 percent. The industry is also growing rapidly – by a stable 14 percent a year over the past half-decade until 2017. Global megatrends are driving this upward trajectory, such as the expanding middle class worldwide, the shift from deposits to financial assets, increasing life expectancy and growing urbanisation.

But the industry is facing increased pressure. There is downward pressure on fees due to weak performance, amplified by greater transparency – the result of increasing investor protection –, the low yield environment and the ongoing success of passive investments. There is upward pressure on costs due to the need to keep up with new regulations, the process of digital transformation and changing customer needs. And there is multidirectional pressure on companies' strategic positioning, with even greater industry concentration and the development of a "winner-takes-all" market, reflected by the observation that a significant, disproportionate share of new flows is directed to well-performing or highly rated products.

Industry concentration is a key characteristic of the asset management market. Globally, only ten companies account for nearly one-third of total assets under management, and just 40 companies hold over half of the total.[3] Europe is the second-biggest market globally, accounting for 32 percent of assets under management worldwide, including the UK as the second biggest country in terms of assets under management



1) EFAMA; estimate for 2017 based on historical growth of IPE Top 400
2) IPE Top 400 asset managers 2017; for comparison: around 4,200 asset management companies operate in Europe
3) IPE Top 400 asset managers 2013–2017 CGAR p.a.

AuM = Assets under management; CAGR = Compound Annual Growth Rate

Source: zeb.research

Figure 1: Overview of asset management market structure

2 FTSE all share; 10y operating margin (Operating margin is defined as operating profit divided by total revenue. Operating profit is defined as revenue less operating cost (staff plus non-staff cost) or earnings before interest and tax (EBIT))
3 IPE Top 400 asset managers; for comparison: around 4,200 asset managers operate in Europe

Arnd Heßeler, Executive Manager, Luxembourg

"To tackle the decreasing profit margins, two ways may be considered: either intensifying cost cutting efforts by systematically applying digitally empowered innovative processes and tools and streamlining operations, or offering real value for money that gives higher pricing power rather than poor performance. In both cases, dedicated investments and a focused business model are required."

after the United States. Its 12 percent compound annual growth rate (CAGR) over the last five years is around the same level as the United States, but a far cry from the level of growth seen in Asia (28 percent) or the rest of the world (18 percent).

Even though the assets under management have seen sound growth over the past years the asset management business can be highly volatile due to the strong correlation between revenues and market performance as well as the corresponding behaviour of clients. Historically, growth of both assets under management and net new money was stable as markets were in a long bullish phase. But 2018 put in a very poor show by comparison. Total assets under management, based on Morningstar's sample group of institutional and retail investment funds domiciled in Europe, fell by three percent in 2018 compared to the previous year, with net new money crashing by 90 percent.

To gain a clearer understanding of exactly what is going on in the market, zeb, with the support of Morningstar, carried out a major survey of asset managers. We canvassed nearly 50 asset management firms, differing in terms of size and business model but all of them with a strong European footprint. Together they manage assets of almost EUR 30 trillion, representing around one-third of the total global asset management market. Our objective? To find out which players are the most successful, what lies behind their success, which trends will impact different business models going forward, and what action asset managers should be taking as a result.

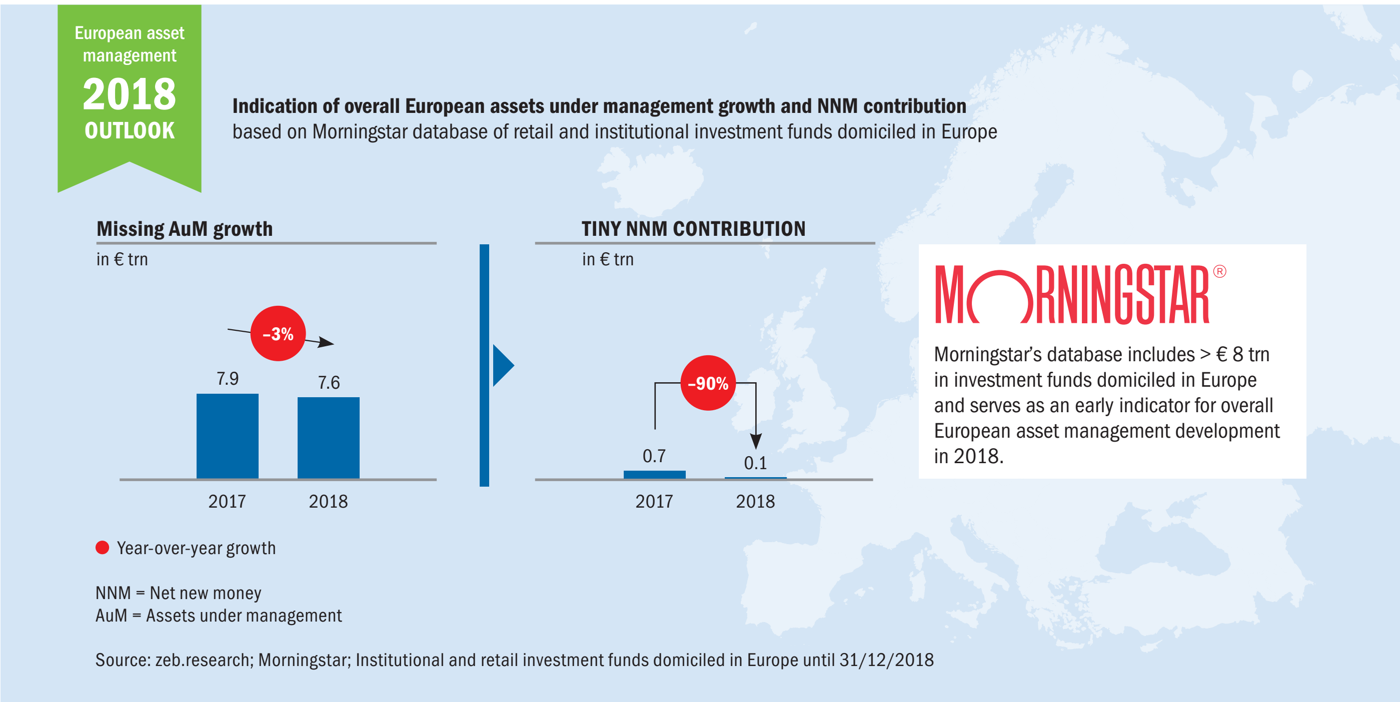


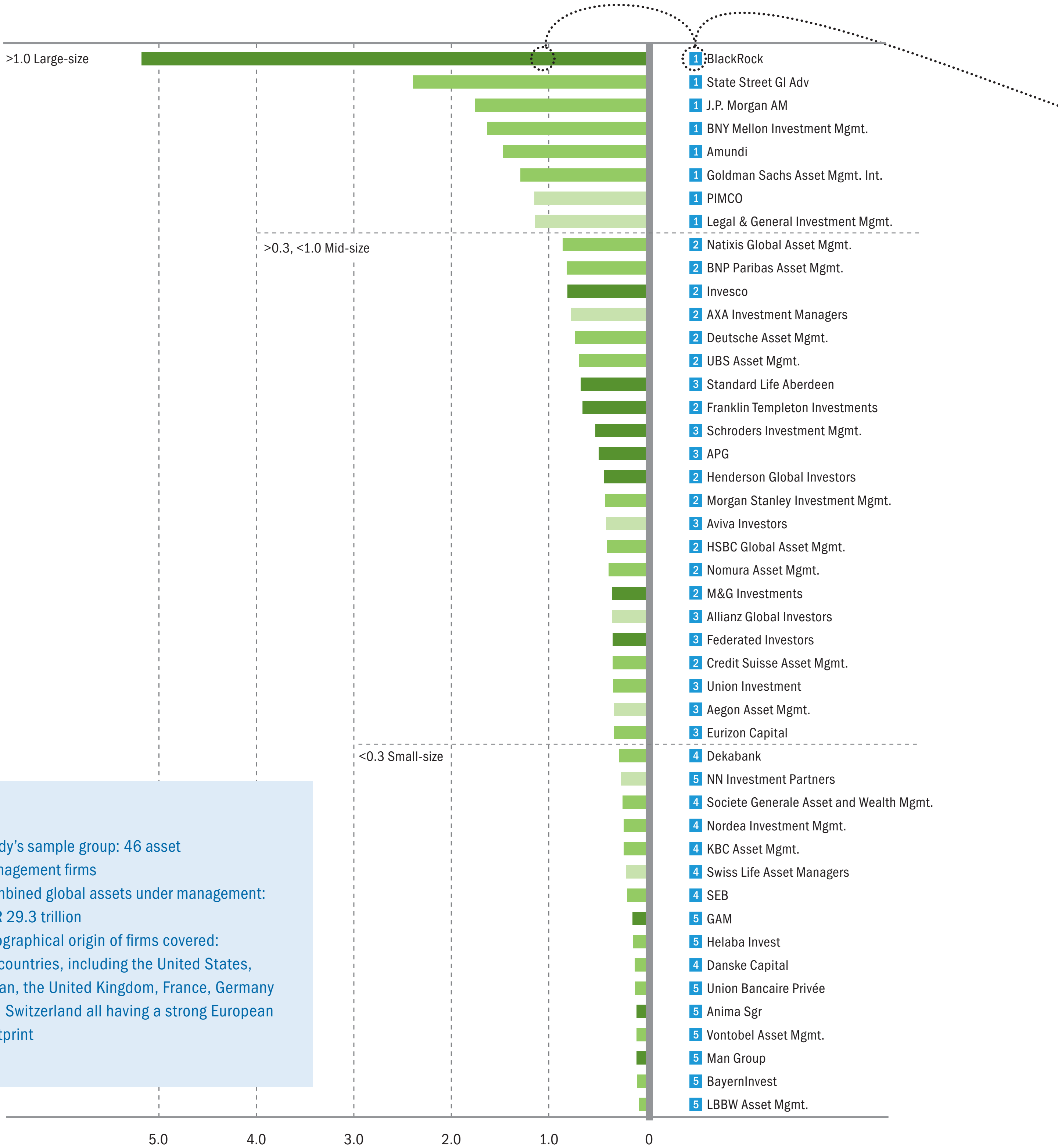
Figure 2: Indication of expected European asset management development in 2018

2 ABOUT THE SURVEY

Global analysis with a strong European footprint

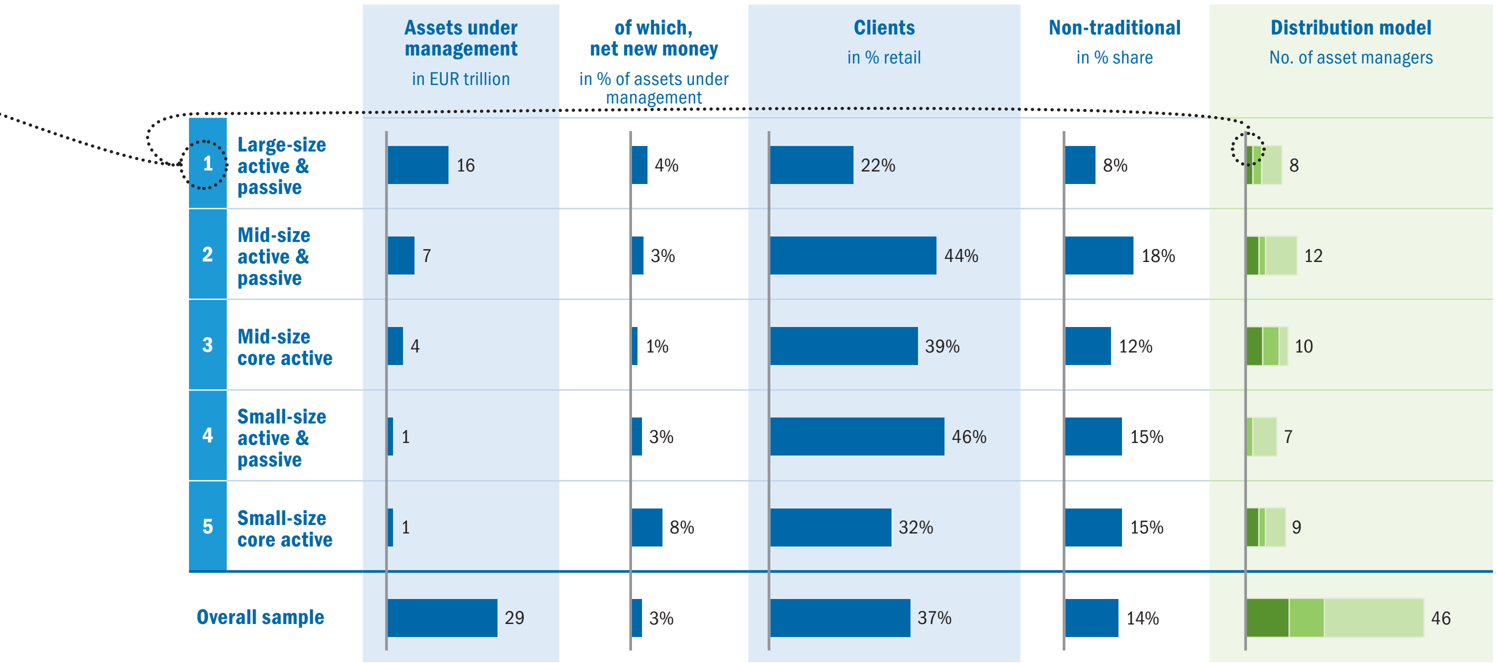
Global assets under management of study's asset managers range from > €100 billion to €5.2 trillion – Top 10 asset management firms by size dominated by global players with headquarters in the US

in € trn



- Study's sample group: 46 asset management firms
- Combined global assets under management: EUR 29.3 trillion
- Geographical origin of firms covered: 11 countries, including the United States, Japan, the United Kingdom, France, Germany and Switzerland all having a strong European footprint

Business models of asset management firms differ significantly – five categories defined with respect to size and investment philosophy (active/passive) focus for the purpose of the study



Explanation:
BlackRock belongs to 1 Large-size active & passive firms and is an Independent asset manager

1 Large-size active & passive firm 2 Mid-size active & passive firm 3 Mid-size core active firm 4 Small-size active & passive firm 5 Small-size core active firm
Independent asset manager Insurance captive Bank captive

Traditional = equities, bonds, multi-asset   Non-traditional = commodities, private equity, infrastructure, etc.

Source: zeb.research; IPE Top 400 asset managers, Morningstar, Institutional Money

Figure 3: Overview of study's asset manager sample and defined categories and their characteristics as of 2017

- Range: Firms in sample differ in terms of volume, distribution network, client focus, investment philosophy (active/passive) and asset/strategy focus
- Segmentation: Firms are grouped into five different categories on the basis of their size and investment philosophy

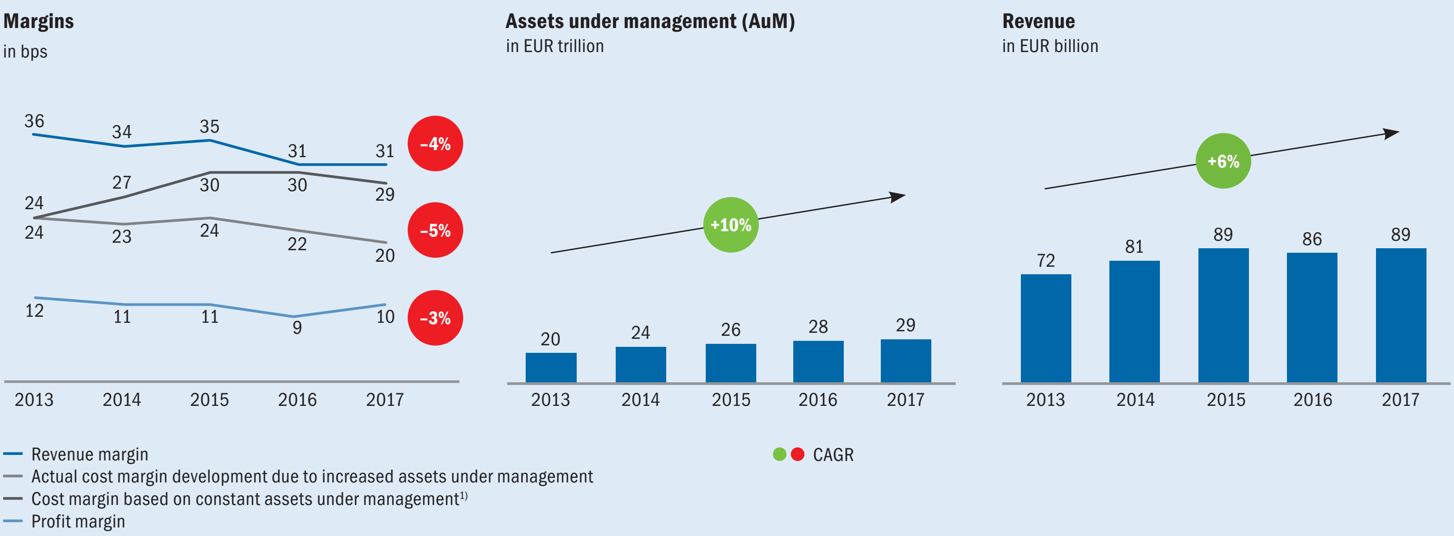
3 MARKET INSIGHTS

Portrait of an industry in which scale and specialisation matter

Part of our objective in conducting the survey was to identify which players were the most successful in the market and what lay behind their success. As to be expected, it turns out that market performance was the key driver of asset growth between 2013 and 2017. The assets under management of the firms in our sample grew by ten percent a year over the period. However, this was mainly fuelled by the performance of the market, which was responsible for three-quarters of this growth, rather than net new money inflows. Five large players were responsible for attracting around 70 percent of the net new money in our sample despite representing just 35 percent of the assets under management, showing that this is an industry in which scale matters.

Despite strong growth of assets under management during the period, profit margins slightly decreased for the companies in the survey, to around 10 basis points in 2017. Two factors combined to deliver this result. First, revenue margins fell over the period, reflecting a shift to lower cost strategies, driven, among other factors, by greater price transparency and increasing cost awareness among clients. Second, cost margins also

Despite strong assets under management growth of 10% p.a. since 2013, the profit margin slightly decreased to 10 bps driven by consolidating revenue margin



1) Cost margin adjusted = Cost margin calculated at constant 2013 assets under management basis

Revenue margin = net revenue / assets under management

Cost margin = operating costs / assets under management

Profit margin = operating profit / assets under management

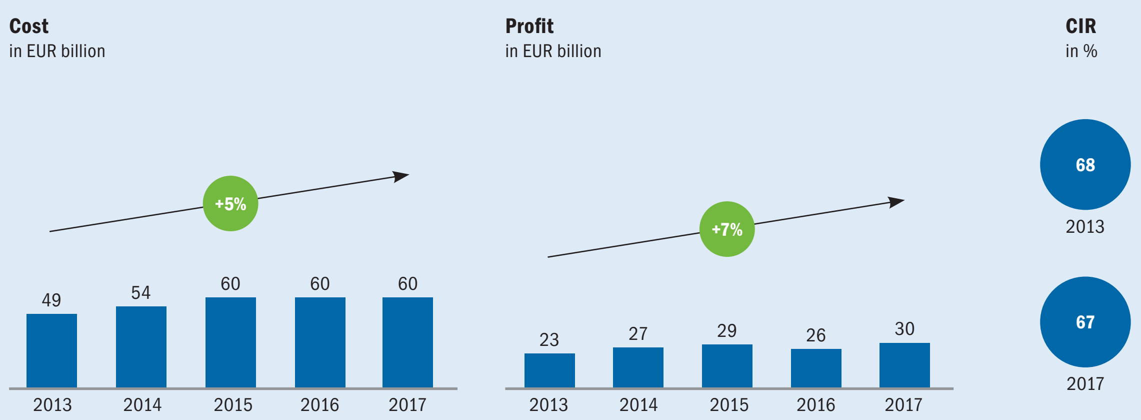
Source: zeb.research

Figure 4: Business performance of study's asset manager sample

fell – however not because of absolute cost reductions but rather due to the underlying AuM growth in the period. Increased cost discipline only resulted in slowing down relative cost growth by stabilizing absolute costs levels from 2015 onwards.

Which types of players were the most successful over the last five years in terms of profitable growth? According to our findings pointed out in figure 5, small asset management firms performed best. Particularly successful were specialised asset managers with unique strengths in specific topics or asset classes, and also smaller asset managers that were part of a strong captive distribution network. It has to be noted that in our sample "small asset managers" refers to firms managing assets of up to EUR 0.3 trillion – a size which, in some countries, cannot be found even among the biggest firms.

The weakest performers were found amongst mid-sized players, offering both active and passive strategies with above average cost-income ratios as high as 71 percent and growth in net new money at just 1.8 percent p.a., well below the average of 2.8 percent of assets

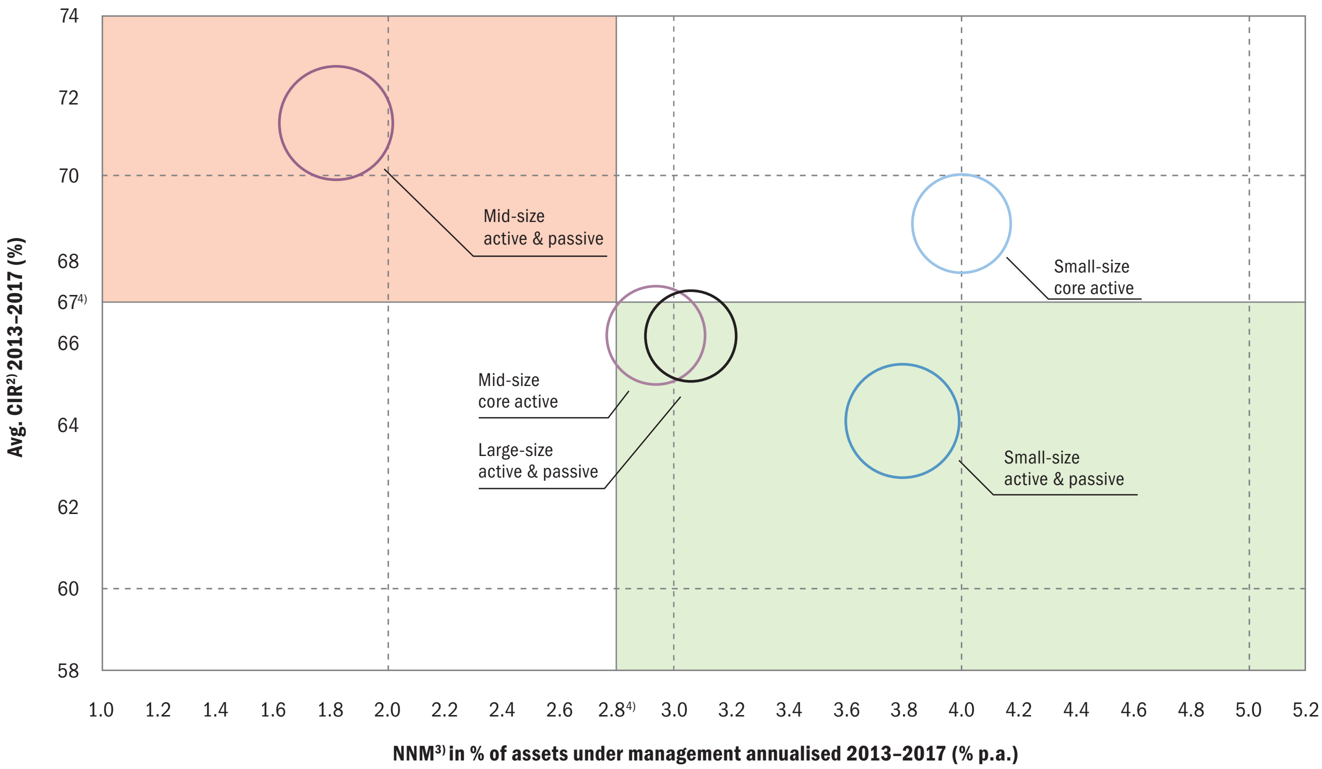


under management. Firms that attempted to cover almost every investment topic or asset class while not achieving significant scale effects in portfolio management production or distribution put in a particularly weak performance.

In fact, only a few individual asset management firms achieved profitable growth over the period. These companies are represented by green circles in figure 6. They enjoyed above-average growth, above-average profitability and decreasing cost-income ratios.

Mid-size active and passive providers had above-average profit margins but the lowest NNM growth and highest CIR over the last five years

in %



○ Bubble size = profit margin[1] 2017

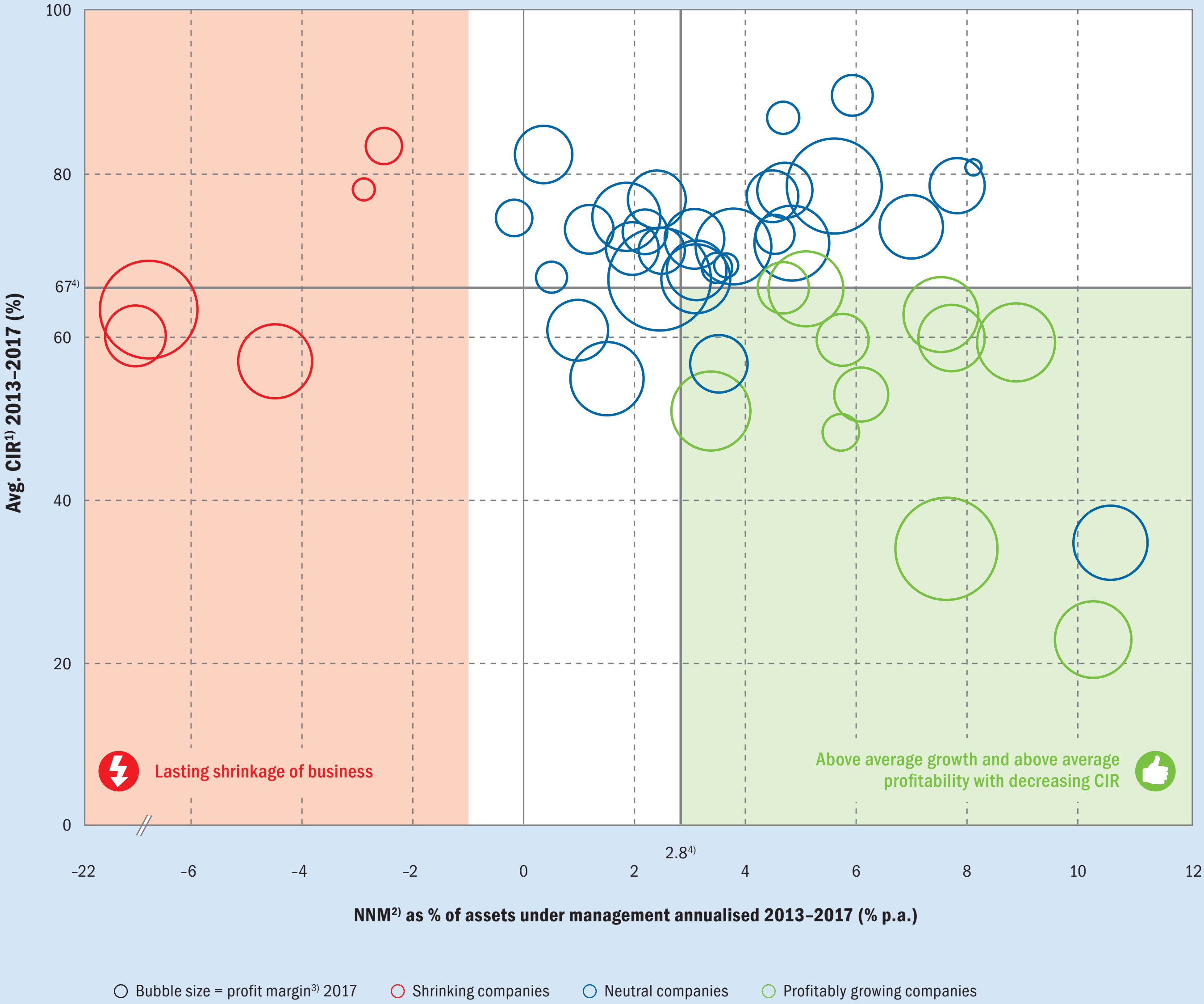
1) Operating profit / AuM
2) Operating costs / net revenue
3) Net new money 2013–17 as % of total assets under management 2012 EOY
4) Industry average

CIR = Cost-income ratio, AuM = Assets under management, NNM = Net new money

Source: zeb.research

Figure 5: Profitable growth analysis of study's asset manager groups

Profitability growth matrix – only a few asset managers successful in attracting new business and growing their profitability
in %



1) Operating costs / net revenue
2) Net new money 2013–17 as % of total assets under management 2012 EOY
3) Operating costs / net revenue
4) Industry average

CIR = Cost-income ratio, NNM = Net new money
Note: For profitable growth, CIR needs to decrease between 2013–2017

Source: zeb.research

Figure 6: Profitable growth analysis of single asset managers

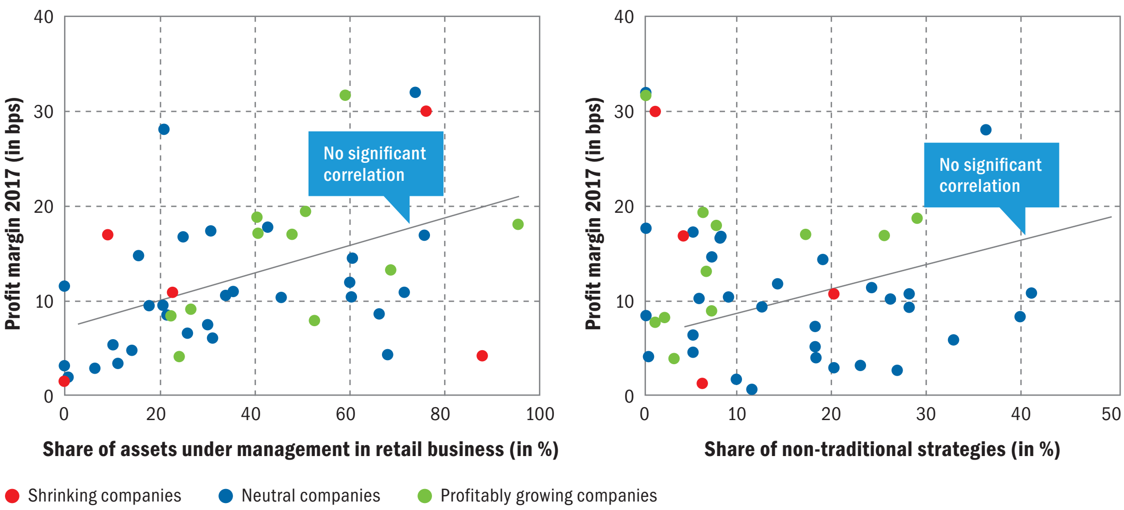
Myths versus reality

Our survey explodes some common industry myths or theses, respectively. For example, it is commonly believed that having a large share of retail business – individual investors as opposed to institutional investors – is associated with greater profitability, thanks to the higher fee levels that can be achieved in this client segment. In the survey we could not detect a significant correlation between the share of retail business in a firm's total assets under management and its profit margin in 2017.

We also found no significant correlation between a company's profit margin and its share of non-traditional strategies – alternative investments such as hedge-fund strategies, private equity, commodities, private debt and real investments (e.g. real estate, infrastructure), all with higher fee levels than those enforceable for traditional assets and plain vanilla strategies. A larger proportion of such investment strategies in a company's portfolio obviously has positive effects on the overall revenue margin but does in fact not necessarily boost its profit margins.

A third, equally prevalent myth is that asset management firms with products that perform below the benchmark inevitably suffer from weak profit margins. Over a period of five years, only 9 percent of the actively-managed multi-asset funds managed by firms in the survey outperformed a mixed global exchange-traded fund (ETF) benchmark and just 7 percent of the actively-managed global equity funds outperformed the global ETF benchmark (MSCI AC-World) whereas 43 percent of the actively-managed European equity funds outperformed the European ETF benchmark (Euro Stoxx 50). Yet, for none of these three strategies product performance is significantly correlated to firms' profit margins. Having said that, we cannot generalise our findings in this respect as they are based on a limited range of strategies even though these are considered as the basic disciplines in asset management. Nevertheless, as transparency increases, driven by regulation, we would indeed expect to see some correlation here in the future, supported by another trend that increasingly sees money directed to "winners" reflected by outperforming strategies, and/or (very) good product ratings and/or innovations.

Myth versus reality: high shares of retail business or non-traditional strategies are not significant indicators of a successful business model and individual company performance

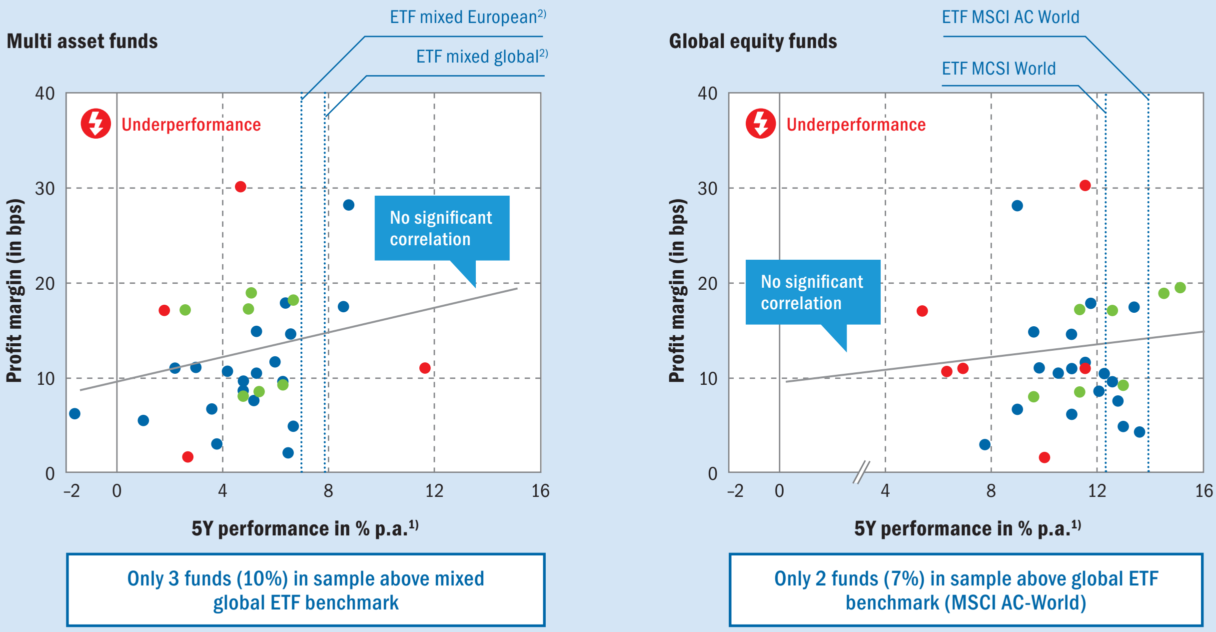


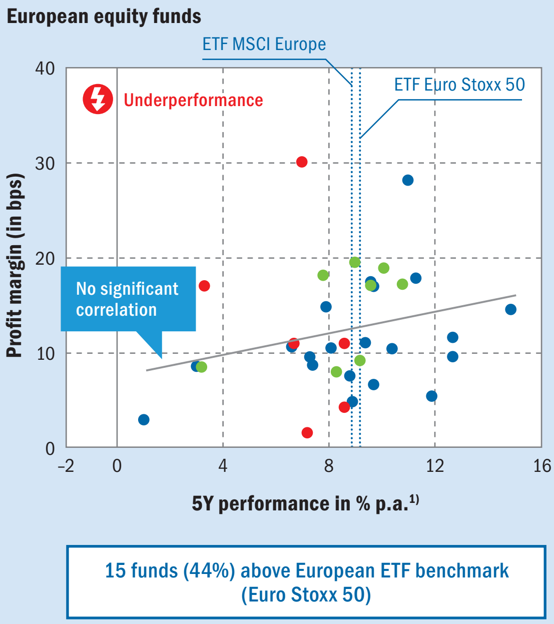
Source: zeb.research, based on sample; Morningstar

Figure 7: Key drivers of profit margins

Bertrand Lavayssière, Partner, London

"Our study shows that merely having a large share in a high revenue margin business like retail or alternative investments does not guarantee good profitability. More than ever a clear and focused business model with a visible USP shows the right way for a sound business to build a sustainable winning position"





● Shrinking companies ● Neutral companies ● Profitably growing companies

1) Net return p.a. over 5 years (01/01/2013–31/12/2017), for 8 funds since inception due to shorter life time; retail tranche; avg. TER 1.7% p.a.
2) ETF mixed European = 50% EuroStoxx 50 + 50% Euro Government Bonds, ETF mixed global = 50% MSCI World + Global Government Bonds; avg. ETF TER 0.15% p.a.; unhedged in €;

TER = Total expense ratio

Source: Reuters, zeb.research

Figure 8: Performance of funds actively managed by sample asset managers and respective profit margins

Maria Katharina Heiden, Manager, Hamburg

"Performance is key: it is not everything but without it everything else is nothing. As achieving sustainable outperformance by active management proves difficult, performance of asset managers needs to be re-defined. In addition to investment performance client access, convenience and specific services serve as factors that contribute to clients' satisfaction and allow for new pricing models that are less correlated to market movements."

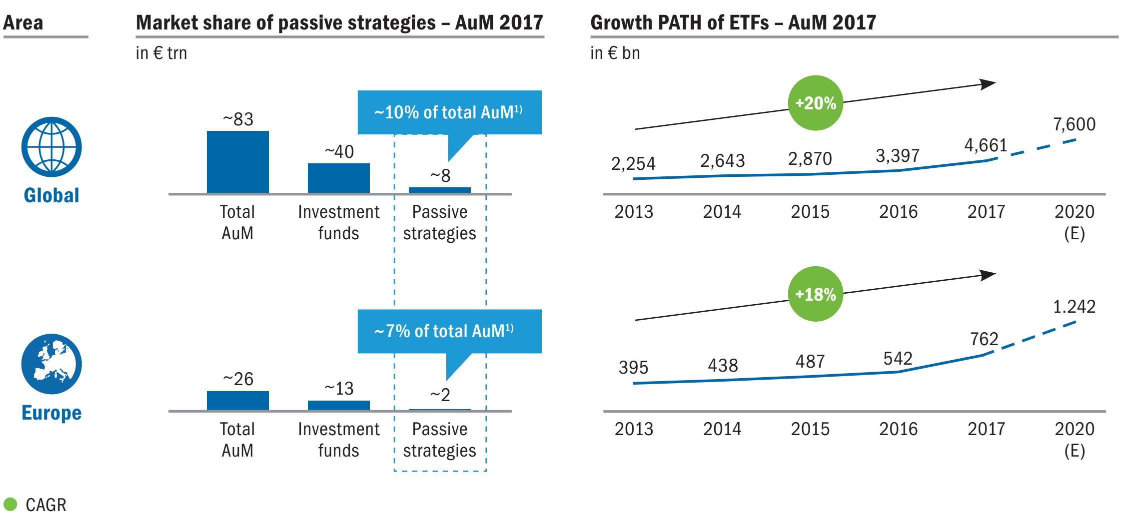
It pays to be passive

Which business model is the most promising for asset managers going forward? It is widely recognised that passive strategies show significant growth potential. Within our analysis period a significant shift from active to passive business has already been seen, reflected by ETFs expanding in terms of AuM by 18 percent a year in Europe and 20 percent a year globally. The strong growth of ETFs indicates how attractive passive investing has become.

Yet, the overall share of passive strategies is still small with an estimated share of total assets under management of just seven percent in Europe and ten percent worldwide – knowing, however, that the actual share is higher since publicly available data does not include all passively managed accounts (e.g. segregated accounts managed for institutional clients). In our survey, just over half of asset management firms offered ETFs as part of their portfolio, and these companies likely also offer passive management via other vehicles, such as index funds and segregated accounts. However, the share of ETF business compared to their overall assets is in most cases negligible.

Despite its small scale at present, passive business represents one of the biggest ongoing challenges for active asset management revenues. The reason for the popularity of passive products is clear: They offer almost unbeatable market performance for next to no

Passive strategies increasingly serve as an alternative to active strategies with significant growth potential in the next years even though absolute volumes are still relatively small



1) AuM in passive strategies (index funds + ETFs); without institutional mandates, e.g. special funds and segregated accounts) compared to total AuM; higher share of passive strategies in institutional mandates estimated

AuM = Assets under management

Source: BIS; Moody's; EFAMA; EY; Morningstar; zeb.research

Figure 9: Shift from active to passive business

fees. Active strategies, by contrast, have high product fees and often also underperform. This gives passive strategies a competitive advantage and puts enormous pressure on fees for active products.

Margins are under pressure

Revenue margins have already been under pressure for a while. Particularly noticeable is the fact that prices have declined across all asset classes. This development is largely due to the low yield environment, the underperformance of active management and competition from passive products, all of which has put pressure on margins. The same trend affects both institutional and retail segments: Institutional clients saw their average total expense ratio (TER) for investment funds (excluding ETFs) fall from 0.7 percent in 2013 to 0.6 percent in 2017, while retail clients saw a drop in TER from 1.6 percent to 1.4 percent.

Investment consultants play an important role in this trend towards lower prices. Their work leads to investors making better-informed choices – and often selecting a "cheaper" product over a more expensive one.

Ongoing pressure on prices is also increasingly driven by regulatory and financial conduct bodies. The introduction of the European Union's MiFID II in January 2018 has led to greater transparency about the fees charged by funds and commissions paid to financial advisors. It also introduced obligatory benchmarking, making it easier for clients to assess value for money. In addition, various official bodies are increasingly aware of the issue of the value for money offered by asset managers. For example, from September 2019 firms in the United Kingdom will be required to conduct annual assessments of value for money, preventing them from marketing funds as active that merely mirror their underlying indices.

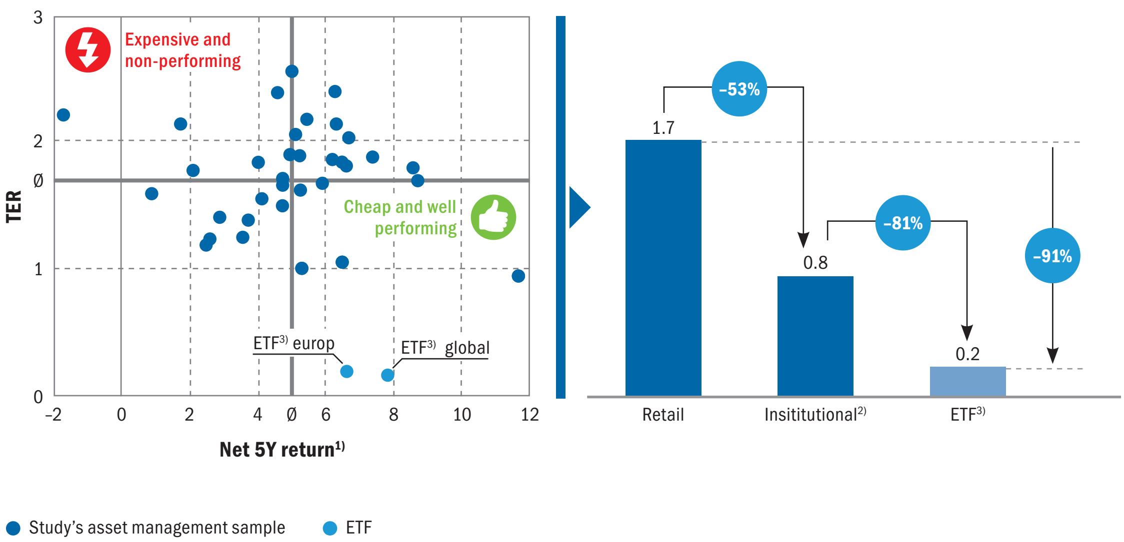
Passive business is the strongest ongoing challenge for active asset management revenues – almost unbeatable market performance for next to no fees

Multi-asset retail tranche – sample comparison

in % p.a.

Price comparison

Avg. TER in % p.a.



1) Net return p.a. over 5 years (01/01/2013–31/12/2017), for 8 funds since inception due to shorter life time, unhedged in €
2) Institutional share classes of retail funds
3) ETF mixed European = 50% EuroStoxx 50 + 50% Euro Government Bonds, ETF mixed global = 50% MSCI World + Global Government Bonds; Avg. EFT TER 0.15% p.a.; unhedged in €

TER = Total expense ratio

Source: Reuters, zeb.research

Figure 10: Price comparison

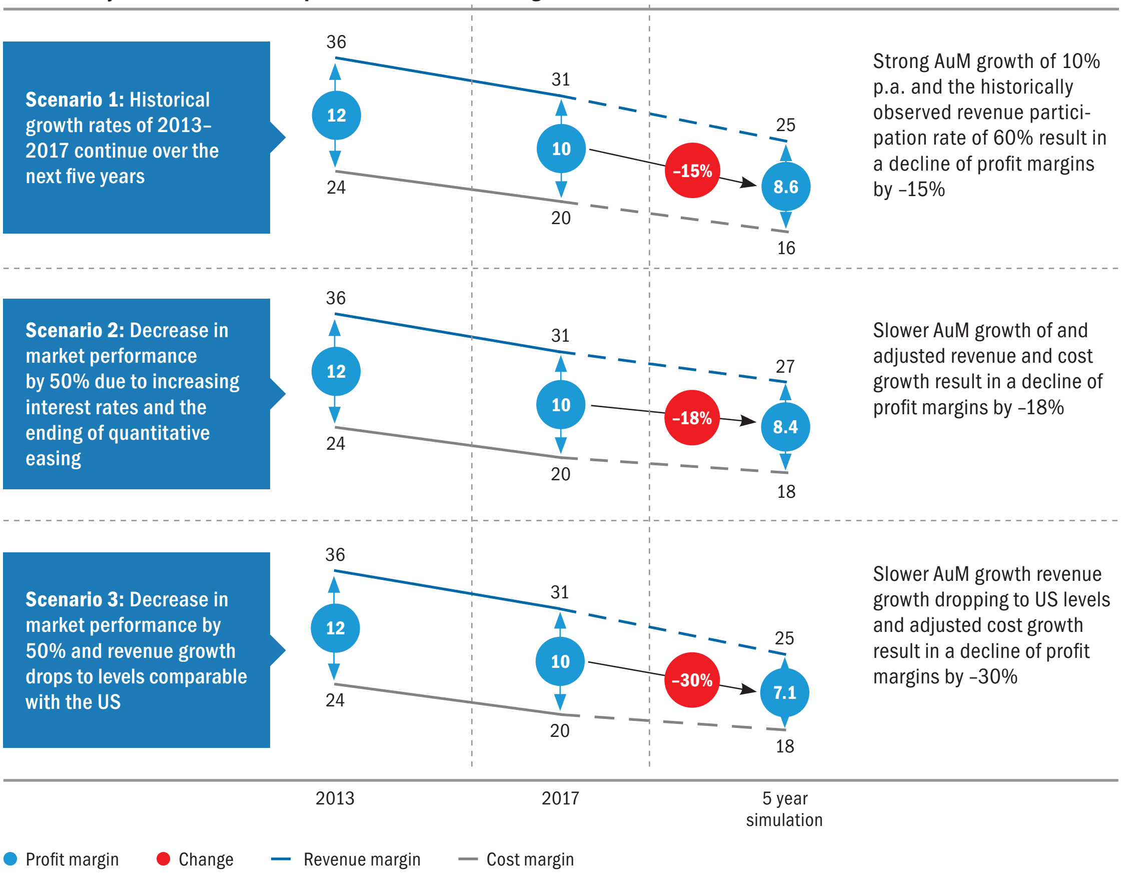
4 SIMULATING MARKET DEVELOPMENTS

Three scenarios for the future of the market show asset managers' vulnerabilities

A key part of our analysis is to simulate the market development over the coming five years. Below, we draw up three possible scenarios for the future of the market and discuss their impact on different types of players and business models. This process also identifies where asset managers' vulnerabilities lie.

Our simulation is based on a number of assumptions. The current situation, as described earlier, is that asset management is dominated by around 40 companies with more than 50 percent of European AuM. Further consolidation is expected, driven by the desire to realise economies of scale. Additionally, new players will aggressively enter the market in the future: As it can already be observed in Asia, Big Tech companies are expected to redirect asset flows, particularly if these new players start to launch more comprehensive offerings through their platforms which have strong retail client access. Alibaba spinoff Yu'e Bao has created the largest money market fund accruing 370 million account holders and USD 211 billion in assets in just 4 years, leveraging its strong platform and retail client access. At the same time, global megatrends will boost wealth creation and demand for asset management. Increasingly, traditional investment strategies will give way to passive models. Today's satellite investments in alternatives and solutions will become more common, and the main differentiating factor for cost savings and distribution channels will be digitalisation.

Even though assets under management are expected to grow, profit margins will decrease substantially as a result of further price erosion – cost cutting levers and focus unavoidable



AuM = Assets under management

Figure 11: Simulation results – overall sample margin development

In terms of how the different categories of asset managers will develop, we assume that the shift from active to passive strategies will continue, as will the shift away from "plain vanilla" investment types to non-traditional types. Consequently, providers offering both non-traditional investment and passive strategies can realise an increase in net new money of up to 20 percent a year in the future. By contrast, core active players will experience a drop in net new money unless they are able to offer real value-for-money with high-performing product and service solutions.

We posit three scenarios for a 5 year simulation, differing in their assumptions about future growth rates and revenues:

- In Scenario 1 everything will stay as it was, i.e. the historical growth rates for assets under management, revenues and costs from 2013 to 2017 continue
- In Scenario 2 market performance – the major driver of asset growth, as mentioned above – declines by 50 percent due to increasing interest rates and the ending of quantitative easing. The individual growth rates observed for net new money continue as before. However, the growth rate for revenues decreases proportionally due to the slower growth of assets under management for the different asset manager categories. Furthermore, 50 percent of the growth rate for costs is adjusted down to cater for a certain amount of flexibility with regard to variable costs and assumed cost cutting efforts.
- Scenario 3 assumes a decrease in market performance by 50 percent and a drop in revenue growth to levels comparable with the big US asset managers: down 30 percent for firms offering both active and passive products, and down 15 percent for core active providers.[4] Developments for assets under management and the resulting adjustments for revenue and cost growth are as in Scenario 2. With the shift from active to passive products, we assume a 20 percent growth in net new money for firms offering both active and passive products, at the expense of core active providers.

The assumption of a continuous AuM growth, regardless of its size, seems unrealistic amid the volatile markets experienced in the past. It does, however, reflect the generally positive environment for asset managers as the underlying factors of an increasing demand for asset management are intact and will persist for the future.

Applying the three scenarios to our sample of 46 asset management firms shows the challenges ahead. Overall, we see a decline in profit margins over the 5 year simulation period. In Scenario 1, ten percent annual growth for assets under management and a revenue participation rate of 55 percent result in a 15 percent decline in profit margins (assuming no further cost cutting beyond that seen in the past takes place). In Scenario 2, 6.5 percent annual growth for assets under management and adjusted revenue and cost growth rates lead to an 18 percent decline in profit margins. And in Scenario 3, 6.5 percent annual growth of assets under management, the drop in revenue growth to US levels and adjusted cost growth rates result in a 30 percent decline in profit margins in the 5 year simulation period. So, even though assets under management are expected to grow further, profit margins will decrease substantially as a result of ongoing price erosion.

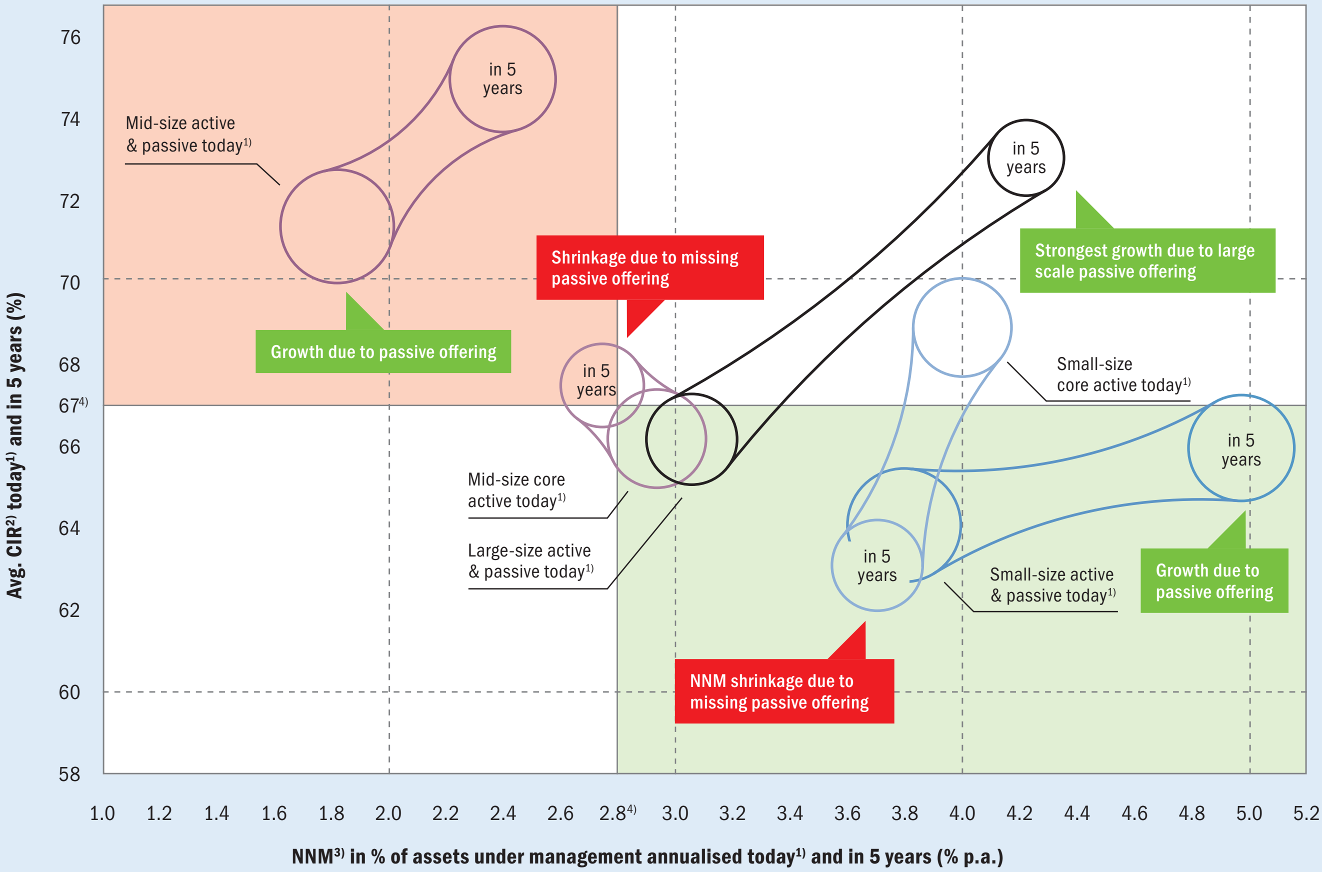
Scenario 3 appears as a worst-case but is, we believe, the most realistic scenario. Looking at this scenario, how will profit margins develop for the five different categories of asset managers when it comes to profitable growth?

As seen in figure 12, the group of large active and passive players will experience a strong increase in net new money for two reasons: They can price their products low thanks to scale effects, and they benefit from their passive offering. On the other hand, their profitability will further decrease because their cost-income ratio is unlikely to improve as their revenue and costs margins are already extremely low.

In our scenarios, the group of small active and passive players will continue to outperform the industry aver-

4 Benchmark of top 6 American players with average revenue CAGR 2013–2017 of 4% p.a.; CAGR 2013–2017 of overall sample 5.6%, American levels 4%/5.6% => –30%; core active players less affected by drop in revenue growth (–15%) because their revenue margins are not diluted by passively managed assets.

Simulation of future asset management business development shows intensification of "collapse of the middle" phenomenon as the respective players are already in an uncomfortable situation



○ Bubble size = profit margin today[1)] and in 5 years

1) For CIR and NNM average 2013–2017, for profit margin as of year-end 2017
2) Operating costs / Net revenue
3) NNM 2013 in % of total AuM 2012 EOY or 2017 EOY
4) Industry average today

CIR = Cost-income ratio, AuM = Assets under management, NNM = Net new money

Source: zeb.research; based on sample

Figure 12: Simulation results – profitable growth analysis, scenario 3

Dr. Carsten Wittrock, Partner, Frankfurt

"Our study reveals some common industry myths, e.g. that poor product performance leads to low profitability levels of the provider. This may be an indication that distribution power and brand perception can offset fundamentally negative factors. This highlights all the more that securing effective access to targeted client groups may be the most important success factor for asset managers."

age. They will enjoy high levels of net new money as they offer a strong unique selling proposition (USP) and include selected passive products in their portfolio. They will maintain their profitability at better than industry average levels, as their quality focus allows them to command higher prices and they can streamline their operations due to their limited product range. This result may be surprising at first – less so, however, bearing in mind that small asset managers in our sample are still managing assets under management of up to EUR 300 billion.

The most significant impact of scenario 3 can be observed for mid-sized players of both types which will find themselves in the top-left quadrant indicating that they will experience the slowest and least profitable growth. Mid-sized core active providers will move from the middle (average growth and average profitability) to the uncomfortable top-left quadrant as they will find it increasingly difficult to attract net new money from investors with their lack of passive offerings and they will face the strong pressure on fees for their active products. The group of mid-sized active and passive players will shift slightly to the right thanks to the increase in net new money, as they benefit from the shift from active to passive products, but they will further lose on profitability with an increase in cost-income ratio to 75% due to fee pressure. At first glance it seems that the medium size of the asset managers in this category is the driving factor for the comparatively strongest negative impact. However, a closer look into the companies in the category of mid-sized active and passive managers reveals that a high proportion of the companies runs mixed business models with a wide range of products and services lacking a clear product focus or the necessary scaling. Therefore these companies operate on a relatively high cost level. In addition, most of asset managers in this category are bank captives, which, compared to independent asset managers or insurance captives, still operate with relatively high revenue margins. Therefore they will be particularly affected by the expected fall in prices. Due to the currently still comfortable revenue situation, these providers have also so far saved the least on the cost side so that their future profitability is even more affected.

5 RECOMMENDATIONS FOR ASSET MANAGERS

Move out of the comfort zone

Based on the analysis above we have formulated five key recommendations that will take many asset managers into their discomfort zone – and, in so doing, ensure a successful, sustainable business in a highly competitive environment.

Our recommendations are not entirely new to the industry, in fact many players have already been discussing various aspects already for several years. But our profitability analysis and outlook simulation clearly show that it is now time to leave the comfort zone and to systematically implement measures along these key dimensions.

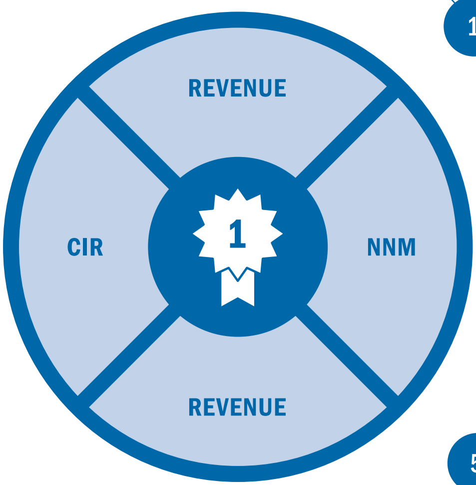
#1 Define a clear strategic position

As our analysis shows, the collapse of the middle ground is the preeminent challenge for asset managers going forward. Especially mid-sized companies with no clear business strategy and a lack of economies of scale and scope risk ending up piggy in the middle. For these companies, the key management lever is to set their strategy focus on their future positioning.

The middle ground has become a low or no-growth zone, and firms must move away from the centre as quickly as possible. They have two principal options, as figure 13 illustrates. Either they focus on achieving economies of scale and scope and reshape their business model accordingly – moving to the left and further upwards in the figure. This also includes generating and leveraging distribution power, either through captive networks, strong distribution network management or by leveraging already existing ecosystems – here BigTech company Alibaba is pointing the way in Greater China with the already mentioned Yu'e Bao money market fund. Or asset managers focus more on offering superior quality and benefits, which, in most cases, requires a focus on specific capabilities, innovation and specialisation, moving to the right and further upwards. In both cases they will need to develop a competitive business model and high-quality products and services.

Within this context, asset managers need to be clear on their product mix strategy. Does their market positioning and client focus require them to be a one-stop shop which has to have products across

Analysis and simulation of key performance indicators serve as a basis to derive five management levers for individual future business success



1. **Define a clear strategic position** since asset managers who cannot win through economies of scale must focus on areas where they can generate competitive advantage
2. **Professionalise distribution and sales management** and adapt distribution channels to digital customer needs not only in retail but also in institutional asset management
3. **Review pricing and revenue sources** as pricing should be more strongly correlated to the value generated for the client which does not only include the pure investment performance but also other services provided to the client
4. **Reduce cost levels and digitalise operations** in order to exploit the potential of new technologies—asset managers must either develop digital solutions themselves or build on existing solutions from other asset managers and technology providers
5. **Leverage digitalisation opportunities and take data management to the next level** because a clear data strategy from storage to analytics can boost asset managers' performance along the value chain from portfolio and risk management to distribution

NNM = Net new money; CIR = Cost-income ratio

Figure 13: Main areas for management levers

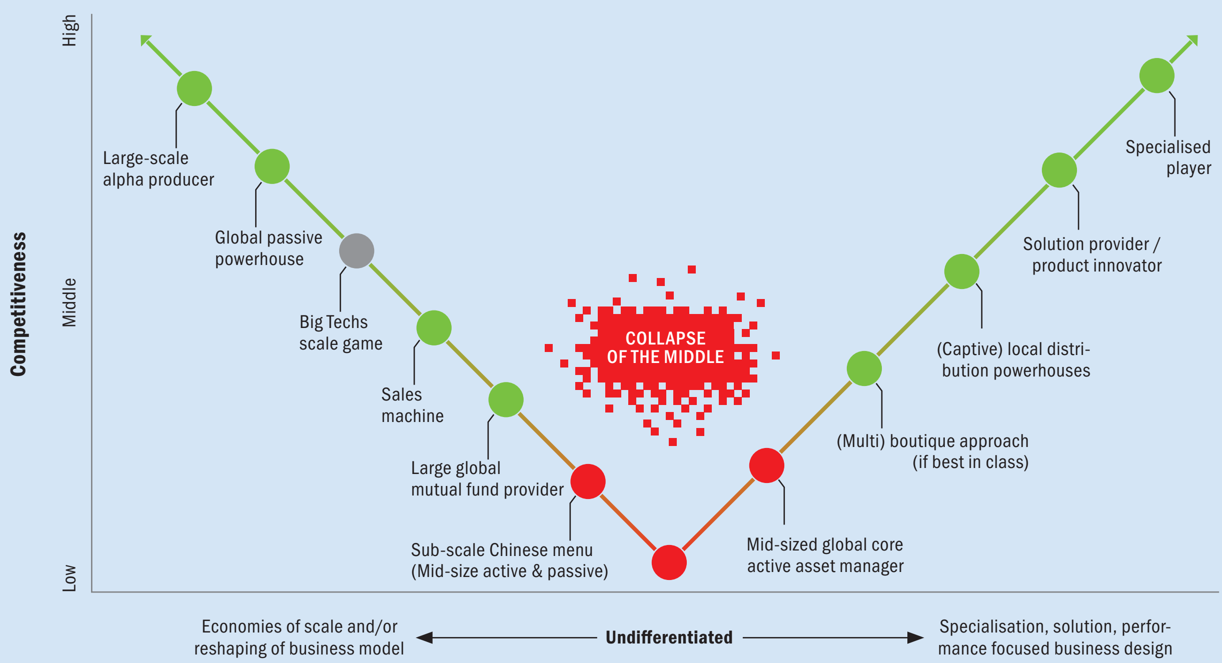
all asset classes, investment philosophies, strategies and vehicles? It needs to be clear within their overall strategy what this diversity means in terms of revenue profile and production efficiency. Equally, those asset managers who specialise need to recognise the risks in terms of revenue and market conditions that this approach entails. Even a pure focus on scale and passive products has risks of its own – revenue margins are extremely tight and the lack of diversity puts these asset managers disproportionately at risk from market headwinds.

For asset managers the major element of product quality is investment performance. In a market where the majority of strategies are replaceable, performance will always be the key success factor for active asset managers: It is not everything, but without it, everything else is nothing. Net new money increasingly flows into funds that have performed well in the past, have a high rating or are relatively new and innovative. So, asset managers that already have strong products in their portfolio are in an enviable position. Increasingly, Europe is developing into a winner-takes-all market.

The problem is, of course, how to generate superior performance. Many studies have been published showing just how difficult this is in practice. We suggest a number of possible strategies for asset managers to deal with this:

zeb's analysis indicates collapse of business models without a clear business strategy – key management lever to put strategy focus on future positioning

Illustrative example



Source: zeb analysis

Figure 14: Future strategic options for asset managers

Norman J. Karrer, Partner, Zurich

"As the high profitability level of the industry is coming under pressure and the middle ground is collapsing, asset managers need to assess their business against five principal key levers, assessing their strategic competitive position and value proposition, reviewing distribution approaches and how to improve pricing in a smart way as well as systematically addressing costs and how to leverage data strategies."

I. Become "smart passive": This means offering passive or semi-passive strategies, creating low-cost basic products to meet basic investment requirements and offering smart beta and smart alpha strategies for providing factor performance
II. Compete with passive players: This entails focusing on specific asset classes or a specific investment strategy, potentially developing innovative products within a specific segment and taking a truly active approach to management, also using new analysis techniques based on Big Data and AI.
III. Avoid competition with passive players: Focus instead on niches that are not suitable for passive management in the first place, such as illiquid segments, provide strategic and tactical allocation rather than security selection, and address specific client needs directly by offering outcome-oriented investment strategies
IV. Re-define performance: Operate as a solution provider where performance is defined more broadly as the delivery of a high-quality overall service package, the investment performance being only one factor

Each of these strategies has its own merits. But they all require a clearly focused business model to be successful long term and to create a strong USP and brand. Less successful firms, especially those stuck in the middle ground, often offer a whole range of different investment strategies, from passive across plain vanilla active to alternatives, and often spread across too many different countries, regulatory regimes and client segments – inevitably ending up average at best in each of their business areas, lacking a focused approach to generate economies of scale or scope in their relevant fields.

#2 Professionalise distribution and sales management

The effective organisation and management of distribution and sales activities are key success factors for attracting new client inflows and keeping existing clients. In order to choose the optimal mix of distribution channels, asset managers need a clear understanding of their target client groups and, in retail business, focus especially on the needs of their distribution partners.

An integrated sales management approach consists of three dimensions:

I. A client segment oriented omni-channel approach specifically adjusted for the different needs of institutional, retail/distribution partners and captive client segments. This includes a clearly defined organisational team setup with the required relationship manager skills/competences and KPIs.
II. A systematic funnel management with efficient sales processes and supporting tools to identify, generate and manage leads (online marketing, campaigns, calendar management, CRM, opportunity reviews, etc.). This also includes systematic sales controlling.
III. A change of behaviour in the sales force. Therefore an implementation and coaching concept is needed that focuses on the individual competences of the client managers/front office and helps them to work effectively in the overall sales management approach.

As asset management clients have already or are quickly moving into the digital age, both in the institutional and especially in the retail segment (including wholesale distribution partners), defining a respective client segment specific omni-channel management approach is critical. Especially the digital marketing and distribution channels are still heavily underdeveloped by many asset managers.

Since institutional investors are typically more advice-focused they mostly still very much value human interaction. Therefore the principal approach is to digitally enable the client managers to effectively manage their institutional prospects and clients in an omni-channel world. Nevertheless, new digital channels starting with online marketing and offering state of the art institutional client portals and mobile information/interaction apps are becoming more important also in this client segment. After all, institutional assets are managed by individuals whose expectations and needs become more digital. Obviously, this will eventually also affect the needs of institutional investors.

A common mistake made by more traditional firms is to underestimate the speed of change of people's mindsets and attitudes, especially when it comes to technological affinity and digital channels. A professional digital footprint and easy-to-access products are a must to stay competitive – especially in the retail business where distribution partners are already expecting to be supported accordingly, be it through app-based real-time advice, websites featuring customised content or the use of chatbots, etc. Digital platforms with a strong focus on services, e.g. MiFID II compliant reporting or robo-advisors to enable distribution partners are key. Leading retail platforms already offer fund comparisons, ratings and functions such as "check and invest" on the fly and "rate and evaluate" your advisors or investments.

Various asset managers have introduced digital platforms to serve either distribution partners or in certain markets the end clients directly. We expect that this platform trend will accelerate quickly and first movers who generate scale will have a clear advantage, as the winner-takes-all effect will also apply to the asset management platforms.

Benefits of new sales channels and opportunities offered by new technology are mostly discussed in a retail context. However, there is no reason why at least some features of these solutions should not be adapted to institutional business. When it comes to digital offers and distribution, there is certainly more room for being a first mover here.

#3 Review pricing and revenue sources

Given the rather weak overall mid and long-term performance of most active investment managers, there is often little reason for these players to increase fee levels to boost revenues – especially in light of increased transparency and competition from passive asset managers. In addition to the trend of falling revenues due to the increasing fee pressure, revenues strongly correlate with market performance due to the pricing models currently in place. Therefore, price models should be, from the asset manager's perspective, less closely correlated with market movements and, from the customer's perspective, more closely correlated with the value-for-money generated.

Performance-based fee models strive to achieve a better balance between managers' and clients' interests. Whichever way the models are constructed, the "savings" by clients in the event of poor performance should be transparent, otherwise clients may not even notice their advantages over mutually beneficial pricing models. Another way to maintain asset levels and with it the basis for fees may be to offer discounts on fees depending on how long a fund or mandate is held. Such models have already existed for a long time but are not found in many countries.

To ensure stable revenues in the relevant investment categories a modern asset management pricing framework is required which revolves around the following key elements:

I. Pricing principles – These typically five or six principles are based on the defined pricing strategy and help to make key decisions, e.g. in client negotiations.
II. Pricing models and approach – Various pricing models can be considered, such as performance based pricing for relevant product categories; however, asset managers should strive for a client oriented pricing approach, taking into consideration the cost of production (portfolio management, administration, custody, reporting, etc.), competitor benchmarks and especially the clients' willingness to pay. While the first two aspects are commonly applied, the latter is not systematically exploited by most asset managers, even though appropriate methodologies are at hand.
III. Pricing governance – Clearly defined roles & responsibilities across the organisation, including establishing a pricing committee for decision making.
IV. Pricing tools – Front end tools to support Client/Relationship Managers in the systematic fee calculation, incl. assessing clients' willingness to pay and to support methodological discount management.
V. Channel specific elements – e.g. ensure consistency in retrocession/kickback usage across all channels, segments and countries/regulations.
VI. Sales and pricing implementation training and systematic price enforcement by implementing appropriate controlling.

Reviewing and improving pricing does not just mean establishing a systematic pricing framework or introducing performance-based or flat-fee models. It also means coming up with services for clients that add true value – services that can be charged for separately and, more importantly, irrespective of market developments. Specific services that may stimulate the interest of otherwise passive investors could include innovative apps or other innovative formats to provide investors with new investment ideas and other relevant information. They should consider tailoring such services for specific client segments, catering for their different needs and investment affinities. A good example can be found in the direct banking area, where companies frequently differentiate customers depending on their behaviour into long-term investors, heavy traders and so on.

Some players have found additional revenue sources by offering services or their own capabilities to other financial institutions or even competitors. An example is Blackrock earning a significant share of their revenues by offering Aladdin, its risk management platform, to institutional investors. By leveraging internal capabilities especially in the area of IT and data management significant efficiency gains can be realised.

Sustainable cost reduction by digitalising operations with a customer-centric approach through holistic E2E is a key success factor for future profitability			INDICATIVE POTENTIAL
	STRUCTURAL ADJUSTMENT OF PRODUCT OFFERING & CAPABILITIES	• Review existing investment capabilities and fund offering regarding profitability, critical size, trend relevance and future growth potential • Close or merge subcritical / not competitive funds/mandates and the relevant capabilities (resources), move relevant assets / clients into relevant/similar funds/strategies where possible	10–20%
10101 01010 10101	DEFINITION OF CLEAR DATA STRATEGY & DATA MANAGEMENT	• Enforce high data quality & golden source principal: Allows for massive complexity & cost reduction (often to be combined with system landscape rationalization) • Creates additional potential in data analytics and use of machine learning and AI	10–15%
	PLATFORM OPTIMIZATION & COMPLEXITY REDUCTION	• Simplify entire platform / modernize system landscape along strategy/business logic, also by using SaaS, cloud based solutions, third party offerings, etc. where relevant • Centralize Middle Office activities, use selective outsourcing, optimize highly manual support activities, (e.g. in order management) – in collaboration with process automation	5–15%
	E2E DIGITAL PROCESS OPTIMIZATION	• Digitalize & automate processes end2end, simplify and standardize processes - eg work-flow solutions in client onboarding increase speed, reduce costs & reduces operational risks) • Repetitive, rule based activities with a high volume can by automated with robotics (RPA) - eg collateral reporting, pre-trade compliance checks or security data reconciliation	5–10%
	RESTRUCTURING OF SUPPORT UNITS	• Optimization / centralization of support unites like e.g. marketing or HR • Outsource or offshore commodity functions in the Back Office (eg fund reporting) • Rationalize ManCo setup(or outsource where not of strategic relevance)	2–5%
	ADJUSTMENT OF STRATEGY / BUSINESS MODEL	• Sell of low margin or sub scale business (e.g. fund servicing or ETF business if too small) • Exit strategy for non profitable markets (sale, cut back of distribution, reduction of marketing)	N/A

Source: zeb.research

Figure 15: Cost reduction by digitalising operations: Disruptive technologies and agility

#4 Systematically reduce cost levels and digitalise operations

As we have shown in chapter four in our simulation, in any scenario the profitability of asset managers is coming under pressure without taking concrete management actions. The current cost levels are not sustainable for most asset managers even under the growth assumptions underlying all three scenarios, let alone a situation in which growth may be negative. Therefore all cost elements need to be addressed systematically.

To ensure a sustainable and not growth-hindering cost reduction, asset managers need to systematically improve front2back efficiency. Asset management is characterised by a high degree of repetitive operations, many of which have great potential for efficiency gains. This is hardly news. But today's technologies and tool sets (e.g. RPA, Blockchain or cloud solutions), as well as 3rd party offerings for realising cost savings can, if properly managed, take effect much faster and more accurately than those available in the past. Speed and cost efficiency have become major competitive factors along the entire value chain.

In order to address their own legacy IT which often drives many inefficiencies and hinders straight through processing, asset managers must decide whether they want to develop the necessary technical infrastructure to take advantage of today's technology and, if so, make it available also to other asset managers for a fee (see also #3 Review pricing and revenue sources), or whether they want to build on existing platform solutions from other asset managers or third-party providers. Digitalisation helps to design a variety of operating models aiming for an ultra-lean approach to all non-core elements of the asset management value chain.

#5 Leverage digitalisation opportunities and take data management to the next level

Today's digital trends and their impact on asset managers are evolutionary rather than revolutionary, yet the future potential to improve the strategic positioning, distribution, analytics or efficiency for asset managers is enormous. The current digital opportunities lie particularly in improving transaction speed or in enabling better client services. For example:

- To improve efficiency and speed, asset managers should consider approaches for e.g. digital client onboarding, automated end2end processing through RPA or workflow solutions, cloud services or machine learning.
- To improve customer service and added value, topics like digital platforms (also for 3rd party wholesale players), mobile apps (myAM in a pocket), robo advisors for distribution partners or big data & investment analytics/client analytics need to be considered.

However, a large international survey among 458 asset managers conducted by Create Research & Dassault Systems in 2017 reveals that most players are still only in the "digitalisation awareness raising phase" for many digitalisation aspects. The urgency is clearly missing. Few asset managers have so far adopted or implemented digitalisation on a large scale – i.e. holistic programs with a clear digital vision are often still missing. Nevertheless, the rise of passive funds and increase in cost pressures as described earlier in this study are strong accelerators to look at technology now.

But the biggest digital lever, or at least the foundation to take advantage of digitalisation, is data management. Only with seamless front2back data flows and maximum data quality are straight through processing, lower costs through automation or improved client services, investment and risk analytics as well as investment performance possible. Data is the most vital asset of an asset manager. Therefore, asset managers need to strive for fast, flexible and efficient data management. To achieve this some key areas must be tackled which include:

I. Definition of a clear data strategy and roadmap,
II. Setting up of a compelling data governance,
III. Systematic addressing of data quality issues and
IV. Improvement of the typically historically grown, scattered legacy IT architecture, which often hinders automated E2E data flows.

Taking the comprehensive management of data to the next level can give asset managers a competitive advantage across their entire business. One example is to use data for detailed insights into the needs of clients to improve product development or to identify the most promising clients and distribution channels.

Currently, the use of Big Data is still in its infancy. It can, combined with artificial intelligence technology, help active managers generate better results by means of more forward-looking assessments of investment opportunities and improved risk management capabilities. State-of-the-art data management is therefore essential in order to fully benefit from digitalisation.

In summary, besides state-of-the-art data management, we recommend that asset managers focus their digital initiatives on improving the client experience, enhancing alpha generation and optimising underlying/enabling technical platforms.

6 CONCLUSION
It's all about execution

Asset management firms with a strong European footprint need to move out of their comfort zone. As the market develops over the coming years, providers that try to offer a vast variety of products and services but do not have the size to realise economies of scale are likely to be hit the hardest. They are the ones that will end up stuck in the middle. These companies are in need of something that makes them stand out from the crowd, be that providing lower costs or offering superior benefits, requiring a minimum degree of specialisation.

At the same time, asset management firms of all types need a new focus on performance – the key success factor in a winner-takes-all market. To attract inflows, they must define a clear, distinctive strategic position, professionalise their distribution and sales management and, for the sake of ensuring efficiency, digitalise their operations. They must also review their pricing and revenue sources and take their data management and data collection to the next level with the help of the latest technology.

Sounds challenging? That's because it is. But entering the discomfort zone is the precondition for profitable growth.

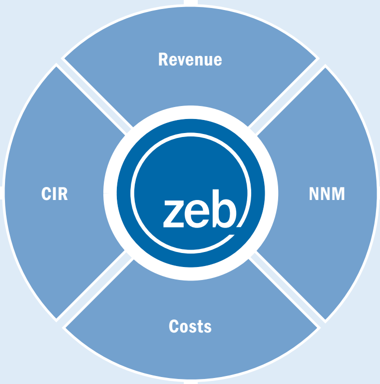
zeb is a leading European consultancy focusing exclusively on the financial industry – extensive market experience to help asset managers master their future challenges

Business Model

- Thought leader for strategic options and business model optimisation
- Comprehensive market knowledge to help understand and strengthen individual market positions
- Organisational excellence to help with restructurings and innovative organisational concepts

Products & Services

- Broad product understanding to help optimise product range
- Deep mathematical insights to help quantify strategies and find new sources of alpha generation
- Excellent portfolio management knowledge to help set up processes



Operations & Outsourcing

- Leader in operational excellence
- Digital thought leader to help asset managers move into the digital era
- Deep business knowledge with respect to optimising work flows / process design
- Extensive track record of projects in IT transformation, data management and outsourcing

Marketing & Distribution

- Analysing pricing and performance of current product range and service offering
- Communicational excellence to help improve client specific communication and sales process
- Deep market insights to help identify new and enhance existing distribution channels

NNM = Net new money;
CIR = Cost income ratio

Figure 16: Strategy implications and how you can utilise zeb

ABOUT ZEB

zeb is a leading European strategy and management consultancy specialising in the financial service sector with over 1,000 employees and 18 offices spread across Europe.

zeb's dedicated asset management and capital market practices support clients in defining and optimising their business and operating modes, from strategy and concept definition to implementation.

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