Asset management opportunities in new realities
Times are tough for European asset managers. Close scrutiny from regulators and clients alike is resulting in higher uncertainty and is putting pressure on profitability. Yet at the same time, new realities in financial markets and the asset management industry are also opening up opportunities for innovative products, services and business models. Drawing on a study featuring extensive expert interviews from around the globe, Roland Berger and Ernst & Young have jointly identified ten opportunities that promise sustainable growth and greater competitiveness for asset managers.
01 Asian growth markets

Asia is not just China and India. When expanding toward the Far East, European asset managers should also focus on feeder markets such as Indonesia, South Korea and Taiwan.

The prospects for Asian asset markets are excellent. Driven by the emerging middle class and high savings rates, asset distribution is shifting eastward. Forecast year-on-year growth rates of up to 10% in the coming years have attracted the attention of European asset managers who are struggling with tight margins and fierce competition in their home markets. Having said that, not every Asian market offers ideal conditions for foreign providers.

Generally speaking, four distinct types of market can be observed in Asia:

> Established and highly developed markets (Japan and Australia) that exhibit similar characteristics to those in Europe and North America – including high saturation and low profitability

> Regional hubs (Hong Kong and Singapore) that serve as a gateway to Asia

> Large growth markets (China and India) that promise the most attractive opportunities

> Feeder markets (Indonesia, South Korea and Taiwan) that serve the larger markets and are experiencing similar growth

When companies think about going east, the billion plus economies of China and India tend to be the focus of attention. Relentless growth and vast long-term market potential hold out the promise of high and sustainable profits. However, accessing these markets involves overcoming cultural, regulatory and legal barriers. Both countries still have extensive capital controls in place that prevent foreign investors from buying local assets. It is therefore imperative for foreign asset managers to work with a local partner if they want to set up an investment company within either country and tap into these fast growing retail markets. China in particular is moving only slowly toward greater liberalization. In the meantime, it is keeping a tight grip on its currency and protecting local business with limitations to sustainable business.

For Asset managers unwilling or unable to accept the restrictions of the major Asian markets, Hong Kong and Singapore traditionally offer easier access via the region’s "back door". Even so, a local presence in certain markets cannot be fully replaced by branches in regional hubs. Furthermore, smaller banks and asset managers may well experience difficulties gaining a foothold in hubs that are dominated by large international bank groups. In addition, cost management has become a major concern for all players.
Feeder markets to the large economies are thus a more attractive alternative for asset managers. Indonesia, South Korea and Taiwan all offer similar growth opportunities, but with lower barriers to entry and with the benefit of little competition. Boasting the world’s fourth largest population and an abundance of natural resources, Indonesia in particular has grown healthily at above 6% in recent years, attracting vast amounts of foreign investment in the process. Compared to other developed Asian countries, the ratio of Indonesian assets under management to the country’s GDP is still relatively low at 3%, but is growing rapidly. Home to the world’s largest Muslim population, this market offers excellent prospects for Sharia-compliant investment products.

In large feeder markets such as Indonesia, organic growth can be achieved in addition to growth fueled by partnerships, mergers and acquisitions. The biggest challenge is the distribution of mutual funds, which still requires a local partner. Other success factors include a long-term commitment, sufficient scale and a clear value proposition adjusted to local market conditions.

**02 New regulations**

Asset managers should capitalize on new regulations. Some of the proposed changes impose fresh burdens – but also present new opportunities.

The financial markets are being hit by a seemingly constant barrage of new regulations. As a result, many players have suffered in recent years from higher costs and lower profits. There is, however, another side to this coin: If they are implemented in line with recent drafts, some of the impending changes – such as the Alternative Investment Fund Managers Directive (AIFMD) – will also open up new opportunities for asset managers.

Since 2001, the second revision of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directives has allowed traditional managers to make extensive use of financial derivatives and complex financial instruments in the context of UCITS funds. It has also enabled hedge funds to enter the fray with what are known as “Newcits” products. This convergence of the traditional and alternative worlds, facilitated in part by the possibilities opened up under the UCITS regime, is now a present reality – and is expected to continue to gain momentum under AIFMD. According to a recent study by Greenwich Associates, 52% of US hedge funds and 46% of traditional funds are now poaching on each other’s turf, provoking a convergence of business models, too.

The mainstreaming of alternative investment models gives traditional asset managers an opportunity to harness the benefits of moving into higher-margin products. To do so successfully, they must embark on a major shift in their operating focus, breaking free from the relative return investment framework and embracing the management of investments based on absolute return targets and holistic solutions for dedicated client needs.
At the same time, they will need to address various shortcomings in risk management, reporting and sales capabilities, as well as resolving the organizational conflicts that will likely arise from the integration of traditional and alternative work cultures.

Conversely, alternative asset managers clearly stand to benefit from brisker demand for "their" asset class as a function of improved access to distribution networks in the wake of regulatory initiatives.

At the end of 2011, global alternative assets under management reached the record level of USD 6.5 trillion. The recent surge in assets under management is expected to be only the beginning of a new wave of growth in demand. By 2013, institutional investors expect to increase their allocations in all alternative forms. Retail investors around the globe are likewise demanding asset diversification and risk mitigation. By 2015, revenues from alternative products are therefore expected to account for 25% of total retail revenues.

On the distribution side, AIFMD aims to open up the EU market for non-UCITS funds. Authorized AIFMs will effectively be granted pan-European passports in 2013, which will allow them to market their funds to EU-based professional investors in their home states or on a cross-border basis. The same holds true for Swiss asset managers who have already been operating on EU markets via their European subsidiaries. Subject to minor local adjustments, individual EU countries could also adopt AIFMD for retail distribution purposes.

Asset managers who see regulatory developments as an opportunity rather than merely an exercise in compliance can thus gain market share by being the first-movers, driving the distribution of non-UCITS products across European markets.

03 Focus on core competencies

Size matters in asset management – but small can be beautiful. By developing and presenting a clear value proposition, small and medium-sized asset managers can stand out from larger full-line players.

The majority of mid-sized asset managers are still trying to cover many asset classes and target groups. Especially for these firms, however, that is a risky strategy. Faced with competition from bigger asset managers, they may find themselves unable to demonstrably add value for potential investors. For them, being the "best of breed" in all asset classes is an unrealistic goal. For smaller and medium-sized asset managers, differentiation is therefore the key to success. Focusing on proven core competencies and the resulting product offering in both depth and breadth allows asset managers to communicate clear value propositions and reduce costs at the same time.
Most "pure" asset managers are currently positioned either as "alpha hunters" or "beta grazers". Alpha investments exploit inefficiencies and behavioral biases in the financial markets and therefore deliver above-market returns. On the other hand, beta investments perform identically to the chosen market. Asset managers who choose the alpha strategy need superior, specialized investment and risk management skills and in-depth expertise in specific markets. Accordingly, their offerings will tend to consist of small, clearly defined portfolios of products. Beta grazers such as i-Shares and Lyxor ETF essentially compete on the basis of distribution power, breadth of product coverage and – most importantly – scale and thus cost. Because they offer commodity products, only the ability to maintain low-cost, efficient operations translates into bottom-line success. The implication is that sheer size and, by consequence, the ability to exploit economies of scale are crucial success factors. In both cases, a strong, well-communicated brand is also required to clearly communicate the value proposition.

While alpha hunters and beta grazers are essentially product-focused, some asset managers have moved on to more demand-oriented business models. "Trusted advisors" – many of them smaller asset management boutiques – sell independent investment advice and services alongside a relatively restricted range of products. In particular, a proven ability to manage risks and guarantee a maximum loss or volatility level is integral to the process of trust-building.

This approach is also viable for big players who prefer not to customize products for individual clients, but to focus on general trends in client needs. These "demand experts" tend to be the asset management units of large banks or insurance companies. In this capacity, they are able to develop a good understanding of their clients by using internal channels. They also benefit from research capacity and established product development capabilities within the company. Demand experts are thus able to quickly develop products that cater to local client needs, and to make these products commercially viable by pushing them through proprietary distribution channels.

As they strive to build brand strength, asset management firms are increasingly focusing on investors' online user experience. Across the industry, firms have been revamping their websites to improve content and simplify navigation. In addition, social media such as Facebook and Twitter provide various ways for them to enter into direct contact with investors, including news coverage, up-to-date research and product information. Unlike websites, social media create opportunities to interact with investors and receive valuable feedback that can help drive the shift from a product-centric to a more client-centric view. These channels are thus a vital testing ground and source of feedback for new products.
04 Effective distribution

"Pure" asset managers can exploit the increasing split-up between Investment Managers and distribution by building stronger relationships with distributors.

To accommodate the needs of institutional investors and/or high-net-worth individuals, many European banks implemented open architectures via which they distribute both proprietary products and funds from external providers. For retail investors, however, banks still tend to operate the traditional approach and routinely push their in-house products. However, as investors become ever more demanding, market and regulatory requirements grow stricter and distributors are forced to limit product and provider risks, guided architectures have emerged as the approach of choice for all parties going forward.

This approach allows distributors to focus on the control of a limited number of providers in order to limit product liability risks and regulatory costs. To do so, they cooperate with a certain number of preferred - and thoroughly vetted - partners. Consequently, a culture of trust and mutual understanding between Asset Managers and distributors can be fostered.

To leverage this trend, asset managers must offer the right mix of product depth and breadth, operational and risk management excellence and superior client servicing capabilities, backed by adequate financial resources. Asset managers who can leverage these qualities to develop genuine "trusted advisor" relationships with distributors, demonstrate an authentic understanding of their clients' needs and develop appropriate solutions are likely to attract the largest share of new fund flows from their distributors.

In the retail market segment, regulatory initiatives (MiFID II, RDR, PRIIPS) will also contribute to the opening of large proprietary distribution networks to include third-party funds. Moreover, to avoid conflicts of interest resulting from biased product recommendations, some large banks may choose to divest their asset management arms and focus entirely on distribution. This will create opportunities for pure asset managers to gain better access to efficient distribution channels.
05 Outsourcing of non-core functions

Continuous pressure on margins and ever closer scrutiny from investors demand a level of efficiency that is not easy to achieve. Asset managers should rethink their operating model and make more use of outsourcing of non-value-adding business units.

As regulatory, risk management and reporting requirements mount up and IT costs spiral, many asset managers in administration and custody business are seeing their margins and profitability come under pressure. Operations and information technology costs account for an estimated 40% to 50% of firms’ total expenses – almost as much as they spend on the core activities of investment management, sales and marketing.

Larger players have used outsourcing extensively for years, while at the same time concentrating other functions at regional or global centers of excellence. In contrast, mid-tier players have focused merely on outsourcing back-office functions to providers who can deliver services more cost-efficiently and more flexibly.

In today’s market environment, mid-tier players should focus on the key pillars of their value proposition and consider outsourcing as many non-core functions as possible to a limited number of full-fledged service providers. Non-core activities can include middle-office functions such as reconciliation and valuation, and even certain front-office functions such as lower-level data management. A sound outsourcing strategy not only contributes to cost efficiency, but also helps a company gain access to specialized capabilities, extend its geographic reach and reduce IT and regulatory risks. At the same time, it can give a company greater flexibility to respond to changing market circumstances.

To contain the potentially negative side-effects of outsourcing, asset managers must create an effective vendor management capability, establishing a culture of collaboration with external suppliers. This relationship should include all affected functions in the organization, not just the IT department or other outsourced services. Decision rights and information flows need to be clearly defined; key services and capabilities should be proactively monitored.

Small and medium-sized asset managers need to outsource more non-core middle-office and front-office functions.
06 Relationships with financial intermediaries

Asset managers should work closely together with financial intermediaries. This can help them benefit from their partners’ customer intelligence and respond better to their clients’ needs.

The US’ retail distribution segment is witnessing rapid growth in the independent advisory channel. While retail banks continue to dominate distribution in Europe (excluding the UK), changes are expected here, too, in the wake of new regulations restricting rebated dependent models (MiFID II/RDR). Financial intermediaries in Europe are likely to gain ground on banks’ captive distribution networks in some key markets. At the same time, they will increasingly shift toward fee-based relationships with customers and spend more time providing financial guidance, particularly with regard to retirement income decisions. Asset managers should therefore carefully review their current go-to-market strategies to align themselves more closely with the needs of both financial intermediaries and their end customers.

Cultivating close partnerships with skilled financial intermediaries that provide expert advice and financial guidance to retail investors can only be a win-win situation. Precisely because of their intimate relationships with investors, financial intermediaries can help asset managers to understand retail end customers’ needs and provide focused solutions to these clients. Conversely, the asset manager’s expertise and service offerings should improve the advisor’s ability to respond to client needs and, as a result, grow assets under advice.

The number of advisors who outsource their investment management capabilities to asset managers and themselves focusing exclusively on client relationships is expected to grow prior to and after implementation of regulatory changes such as RDR and MiFID II, which will once again raise the bar for both transparency and compliance. Asset managers who are able to develop tailor-made service offerings in time and successfully position themselves as outsourcing partners stand to benefit.

To nurture contact with the scattered network of financial intermediaries, asset managers can set up dedicated sales teams and use dedicated websites or focused video content to provide intermediaries an with in-depth knowledge of product and market trends, portfolio design and relevant regulatory changes. Alternatively, platforms that help bring financial intermediaries together with smaller external asset managers can be another way to develop new business in this area without the need to build up a sizeable sales force.
07 Industry consolidation

Asset managers should sharpen their value proposition by selling parts of their business or acquiring capabilities that fit their skill set.

The biggest players in the industry are getting bigger, because they rely on large volumes to get the most out of their costly IT and distribution platforms. Players who lack critical size and profitability risk being marginalized or taken over. In the medium to long term, low market growth and profitability could indeed drive consolidation in the asset management industry.

Although most asset managers currently consider acquisitions or divestments only as a last resort, proactive players should move swiftly to sharpen their value proposition by defining suitable opportunities and targets.

The more asset managers are forced to specialize in one or more business models, the more opportunities arise for potential buyers to cherry-pick certain competencies they would like to add to their portfolio. Another factor driving consolidation among small players is that regulators are seeking to ramp up regulatory oversight of external asset managers. This may well diminish their asset base while increasing their costs.

While all this is happening, some universal banks and insurance companies will try to get rid of their asset management arms and focus purely on distribution. Doing so will help them avoid conflicts of interest, reduce costs and free up capital to meet regulatory requirements. As a result, though, they will have to rely on the production services of sufficiently large asset managers (see 04).

08 Demographic requirements

Innovative solutions for lifecycle products can empower asset managers to benefit from demographic trends.

Aging societies in developed economies are leaving state pension systems increasingly underfunded. This effect is being magnified by the fact that the generation of baby boomers is now on the brink of retirement, requiring cash in order to maintain their lifestyle. As pensions are frozen and real incomes decline, younger people in these countries are waking up to the fact that financial security in retirement age is their own responsibility. This implies an ever greater role for private pension solutions – and the expansion of assets invested in these solutions.
At present, the market is dominated by insurance-linked products, most of which follow rigid accumulation and pay-out plans. Flexible, non-insurance solutions that also take account of potential liquidity events, lengthy retirement periods or changing income levels are not very common. Furthermore, the practice of combining different (i.e. public, company and private) pension buckets and adding real assets (such as real estate) to the pension planning equation is still underdeveloped. Asset managers should therefore focus on lifecycle investment products and real asset divestments to serve these specific needs during the accumulation and decumulation phases respectively.

And they should also keep an eye on the fact that clients today prefer readily comprehensible solutions rather than complex structures. The products on offer should therefore not be excessively sophisticated.

**09 Culture of innovation**

Asset managers can rebrand themselves as innovation leaders and thus arouse the interest of the investor community – if they listen to their customers and implement a culture of constant innovation.

The word "innovation" does not necessarily have a positive connotation in the context of financial products. Investors have realized that some of the innovations introduced during the boom years were not necessarily beneficial to them. Although product development in the asset management industry still tends to be vendor-driven, market power is increasingly gravitating toward the client. According to the Ernst & Young survey "Reflections from the European Asset Management Market" published in June 2012, client acquisition, satisfaction and retention will be the top drivers of innovation over the next three years.

Generally, innovation in asset management includes at least one of three types of changes:

> The development of new products or new investment themes. Recent examples include inverse exchange-trade funds (ETFs), new over-the-counter (OTC) investments such as variance swaps and tax-efficient packaged products.

> The opening of new channels to improve access for clients. One recent example is an investment platform that gives institutional investors direct access to assets that have not been marketed up to now.

> The creation of a new value-added service, e.g. asset managers offering capital requirement modeling in response to the new Solvency II requirements.
Of course, a new way of combining two or more existing elements – products, channels and/or services – also qualifies as innovation. One example from the institutional world is the development of liability-driven investing (LDI), which combines a range of strategies, asset classes and hedging instruments with new distribution channels and client services.

While retail innovations focus on general trends that can be translated into high-volume, low-cost products, innovations for the institutional segment focus instead on customized, high-margin investment strategies. In either case, however, it is important to cultivate a keen understanding of the market and anticipate clients' needs.

To become innovation experts, asset managers must foster a culture of constant innovation. Dedicated innovation budgets and specialized innovation boards with high-ranking decision makers could be established to this end, allowing asset managers to brand themselves as market leaders in innovation and nurture growing interest among investors.

**10 Dynamic pricing**

*Asset managers can boost margins by offering customized solutions and service levels.*

Both clients and regulators are putting pressure on the fee system in asset management. A growing number of clients are increasingly unwilling to tolerate hidden fees, expecting full transparency instead. At the same time, new regulatory instruments such as MiFID II specifically aim at reducing retrocessions and kickbacks.

To increase margins under close scrutiny from regulators and clients, asset managers must link their fees to tangible added value – and investigate clients' willingness to pay for that value. Offering different service levels at different prices to specific target groups allows asset managers to leverage their product offerings. In particular, different price structures should be offered to institutional and retail clients.
Business with institutional clients is always a step ahead of the retail business and already reflects thin margins and transparent fee structures. Asset managers will thus find it very difficult to ask for extra fees unless they are clearly perceived to add specific value in the form of performance and/or diversification. Broadly speaking, institutional clients are reluctant to pay for value-adding services such as reporting, although this may change in the long run. Given the extreme pressure on margins, most asset managers are no longer able to even cover their costs – at least not with plain vanilla products. The solution is for them to develop more efficient fee models, such as combinations of fixed fees with what are known as "shock absorber" fees, which oblige the asset manager to shoulder liability in the event of poor performance.

Retail business still offers greater leeway on margins. Here too, however, increasing scrutiny will force asset managers to come up with new pricing strategies. Acceptance of performance fees is generally low among retail clients. On top of all-in pricing structures, asset managers should therefore seek to put a separate price on services that add value for both clients and distributors.

Mark-ups are possible for outstanding value propositions, superior performance and an excellent brand reputation. Value that stands out could be attributed to a product featuring sustainable investment assets or is consistent with Islamic banking rules, for instance. Superior performance can be offered by transferring aspects of risk to the asset manager, who will thus take a loss if the product performs badly.

As a general rule, fixed fees ensure stable income in asset management, while earnings from investments can be highly volatile. Offers should thus be based on an increased cost of production price and a performance fee for active investment solutions. Additional services such as reporting, asset allocation and research should follow the cost-plus method or be aggregated in transparent packages.
Conclusion

The asset management industry is moving toward more transparent, more client-/ product-focused and more specialized business models. Anticipating trends, serving clients' needs and focusing on core competencies will be essential if market players are to survive in a consolidating industry. It goes without saying that strategic choices must be carefully adapted to the asset manager's individual situation, size, market position and core competencies. Not every asset manager can turn into a successful alpha hunter, become a recognized demand expert and innovation leader or conquer the growth markets of Asia. Rather, it is essential to identify one's existing strengths and find the right niche within which to evolve. New regulations and major social trends alike should be considered as opportunities.
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