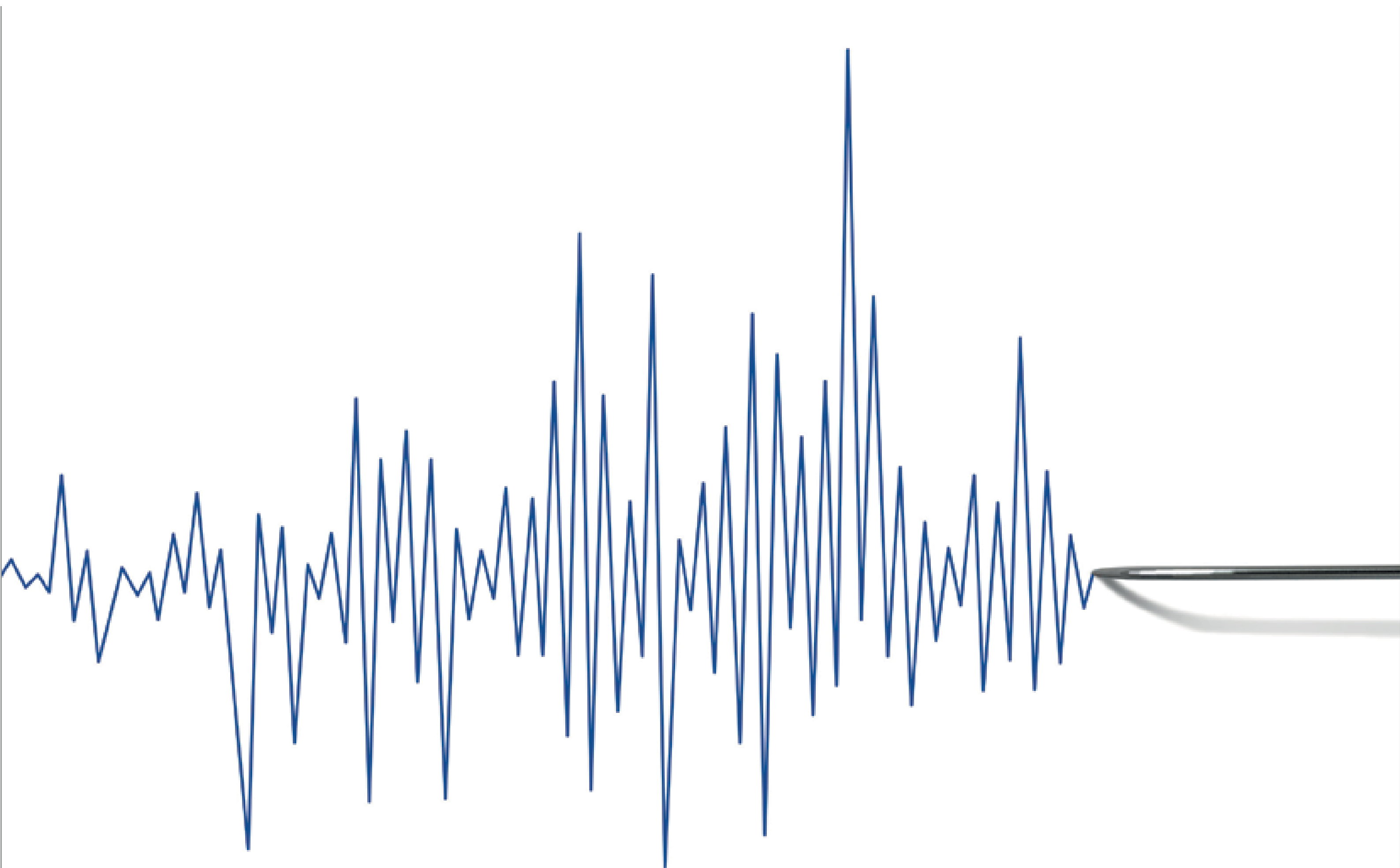
Seismic shifts in investment management
How will the industry respond?



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About this report
This Deloitte report, written by The Economist Intelligence Unit, is based on research and interviews, conducted in January and February 2014, with 11 senior executives at asset managers operating on a global basis from the UK. We would like to thank the following people for their time and insights (listed alphabetically):

David Aird, Managing Director and Head of UK Distribution, Investec
Rod Aldridge, Head of Distribution, Baring Asset Management
Jörg Ambrosius, Senior Vice President, State Street Global Advisors
Hans Georgeson, Chief Executive, Architas
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Tom Rampulla, Managing Director, UK, Vanguard Asset Management
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Deloitte foreword

The UK investment management industry, in all its shapes and sizes, is undergoing vast and continued structural change. It is no longer just a matter of fee pressure driven by institutional clients that investment managers need to contend with – there are some far greater forces radically reshaping the industry.

Against this backdrop, this research, conducted by The Economist Intelligence Unit (EIU) on our behalf, analyses the drivers behind these fundamental changes for UK-based global traditional asset managers. It is clear from the research that the seismic shifts taking place in the industry and across an asset manager's value chain are revealing white-space opportunities – and threats. Asset managers need to understand where the industry is headed and adapt their model for these long-term changes to stay ahead of the competition.

Given the drivers identified in this research, we believe asset management boards have four sets of strategic choices to make:

- What **client** segment mix will be optimal – retail or institutional?
- Which **distribution** model will best achieve goals – direct or intermediated?
- What should be the preferred product and **management style** – active or passive?
- How best to capture **demographic** change – configure for local markets or global?

Building a picture of how these factors will interact will be key to deciding competitive strategy and scenario planning over the next 3-5 years. Throughout this paper, we weigh up what this means in practice for asset managers in the UK.

We are very grateful to the EIU and to all of the interviewees and their organisations for their contribution to this research.

Please do contact us if you would like to discuss any aspect of this report.

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Executive summary

The UK investment management industry is at a turning point. Traditional active managers have already had to adapt to changes in the institutional market, but now they face a confluence of trends – from regulation to pension auto-enrolment to the growth of passive investing – that could radically reshape the retail side of their industry as well.

As the industry experiences these seismic shifts, several key trends emerge.

- **Retail-isation:** With pension liabilities around the world moving from the state and employers to the individual via defined contribution schemes, the retail investor is becoming increasingly important. As retail investors are generally poorly engaged with investment decision-making and often use the default funds offered by their pension provider, becoming the default fund is extremely attractive – regular, large fund flows that are likely to remain in place for decades are an asset manager's ideal. But the market requires scale to penetrate.

- **New intermediation models:** Asset managers who have historically controlled a significant part of the value chain are in danger of losing out as platforms, wealth managers, insurance companies and other parts of the chain all aim to control a greater slice of the cake. These intermediaries – made up of around 150 decision-makers – are acting as "gatekeepers" by standardising the criteria for fund selection and launching their own funds, sub-advised by asset managers. This is significantly concentrating fund flows and putting pressure on fund charges, with many asset managers struggling to differentiate themselves and justify their fees in the eyes of these powerful new intermediaries.

- **Internationalisation:** Asset managers are adapting to demands from UK investors for increasingly global products. At the same time, wealth in emerging markets is growing, creating new client bases for asset managers in these local markets.

- **Pricing and cost pressures:** Pricing pressures are coming from several sources. Platforms, in directly comparing funds, can force down fund management charges. In addition, the continued growth of low-cost passive funds can directly challenge those active funds that only achieve "marginal alpha". Regulatory costs add to the pressure.

Research, including interviews with a number of senior executives at asset managers operating from the UK, suggests that the key industry responses to these trends are as follows.

- Distribution: Asset managers are faced with a choice between building direct retail businesses or strengthening intermediated approaches. The majority of asset managers interviewed stress the importance of building deeper partnerships with their intermediaries as their primary route to market.

- Products: Asset managers targeting foreign markets are using two approaches – either taking out UK-manufactured products via global distribution networks or building a domestic presence in a smaller number of geographies using specifically targeted products. Active managers also are repositioning alpha products in light of the growth of hedge funds and pricing pressures from lower-cost passives, with many choosing to offer either higher, more differentiated alpha performance or lower-cost, semi-active funds with reduced costs.

- Pricing: Interviewees accept that there is significant pricing pressure on UK-focused asset managers, and there is evidence of fees being reduced in places. However, most are seeking ways to reduce prices only selectively by moving to variable pricing models, such as pricing by type of product (actives establishing higher prices for complex products and lower prices where automated processes can be introduced), by style of fund, and by type of distributor (discounting only for the largest independent financial advisers but sustaining price differentials with smaller intermediaries). Avoiding wholesale reductions in pricing is the name of the game.

- Costs: To date, many firms have introduced cost-cutting and more disciplined spending regimes. Although interviewees display an appetite for more radical cost savings through outsourcing, they are struggling to understand which functions are key. Outsourcing data to cap escalating data costs raises concerns about cyber-risk and regulatory requirements.

Section 1: Seismic shifts in the value chain

Continuing changes to the pension landscape will mean that investment decision-making will be firmly placed back in the hands of the individual. However, those individuals are – for the time being – poorly engaged with financial services providers, and trust levels are low.

The market has remained largely intermediated, and retail investors are increasingly using intermediaries with low-cost/high-volume business models. This has left power resting in the hands of an increasingly limited number of key decision-makers – gatekeepers for platform buy-lists or defined contribution schemes, discretionary managers and the investment committees at the major independent financial adviser (IFA) groups, in addition to the traditional investment consultants. Some suggest that just 150 people will hold the fate of the investment management industry in their hands. In many cases they not only control access but also have the same criteria for investment recommendations, creating a "winner takes all" market.

At the same time, many asset managers are recognising that there are opportunities for growth outside the UK's mature markets and are turning their attention to new, higher-growth markets such as those in Asia – while increasingly internationalising the portfolios of their UK clients.

These trends are having a significant effect on the value chain, and asset managers must determine how best to take advantage of these changes in order to survive and succeed.

Retail-isation

Shift from DB to DC pension provision

Demographics are reshaping retirement funding around the world, in turn fundamentally changing investment management. While many populations are supporting a growing number of retirees, governments and employers are shifting pension liabilities to individuals. Asset managers are at the heart of these changes as pension savings move from the public to the private arena and from defined benefit (DB) to defined contribution (DC) pension schemes.

DB schemes have traditionally been the backbone of assets within many investment management markets around the world, and the UK is no exception. Total UK pension assets amount to £1.962tn; of these, 64% are in DB schemes (76% of total workplace pension schemes),[1] which appeal to asset managers because of the sustainability of asset flows. However, DB schemes have low margins compared with retail funds, as institutional clients have significant purchasing power and use it to bring down fund charges. This is reinforced by the fact that the DB market is tightly controlled by consultants – sophisticated buyers who can drive hard bargains. Funds not on consultant buy-lists face challenges in accessing the market and in gaining scale to compete for preferred panel status. So, for all but the largest asset managers the door is often closed.

However, the rapid replacement of DB with DC schemes for new pension savers means that the traditional DB market is diminishing in importance as such schemes mature.[2] For UK asset managers, the fact that what has traditionally been their largest revenue stream can now provide little revenue growth and no net new money is significant. John Troiano, Head of Institutional Distribution at Schroders, says: "The defined benefit business is becoming mature, and there are relatively few opportunities for active managers."

The lure of retail in the new DC world

The DC market has tripled assets under management (AUM) over the past decade, according to Ian Trevers, Head of Distribution at Invesco Perpetual. "Why is that growth continuing?" he asks. "As employers move from final salary pension schemes into contract-based defined contribution schemes, they have taken to using plain vanilla mutual funds."

The number of people in DC schemes is also being given a significant boost in the UK by pension auto-enrolment. By December 2013 more than 2m workers had begun saving into an auto-enrolment scheme, according to the Pensions Regulator, and as many as 10m are expected to auto-enrol over time. Additionally, recently announced increased flexibility over the requirement to purchase an annuity and a 30% rise in the investment limits of ISAs (a UK tax-efficient savings account) will bring new savers and money into the market. Total assets held in workplace DC schemes will triple by 2022, from £276bn in 2012 to £829bn.[3]

The shift to DC pension schemes is a fundamental, long-term change for asset managers. According to Mr Trevers, this has moved investment decisions from the institutional market to retail. "The purchasing decision has moved away from investment consultants and closer to individuals," he says. But what drives those individuals? He believes that as asset management is an intangible product where the outcome is unclear, investors seek comfort through metrics such as size, brand and past performance.

Retail investors are generally poorly engaged with pension investment decision-making and therefore often use the default funds offered by their pension provider. Becoming the default fund is especially irresistible: regular, large, sticky flows that are likely to remain in place for decades are an asset manager's ideal, but the market requires scale to penetrate.

The path to becoming the default fund is not without obstacles. Hans Georgeson, Chief Executive of Architas, a multi-manager investment company that is part of the AXA Group, says that trustees are increasingly guided by high-risk aversion: "It is their personal responsibility. They tend to go to very low-cost solutions, or those solutions with a very long track record. They aim to minimise risk as far as possible." He adds that asset managers wishing to penetrate that market have to cut fees aggressively, build up a lengthy track record as a non-default option on DC platforms and then wait to be chosen. This is assuming that they have the right product in the first place.

Nevertheless, Mr Troiano says: "Defined contribution is an important part of future growth. In the UK, it is the individual making the choice and, as such, is closer to the retail business. The default funds are the Holy Grail, and these are increasingly better designed."

However, as pension assets have been managed by institutions in the UK, wealth managers have been built to interface with these institutional clients. For many, serving the retail client requires a new mindset and infrastructure.

Deloitte view

The retail market is regarded by many as a driving force behind net new money – and can be more profitable than institutional mandates. Competition for new DC-based assets has clearly intensified, especially among the largest asset managers. Embedded managers with a direct access route to retail customers (through their wealth management, retail banking or wealth management arms) or mid-sized players with great retail brands have a distinct advantage.

Mid-size "pure-play" managers may struggle to win in the mass market retail space. Instead they will need to tailor their offerings to specific segments – providing a more differentiated offering based on new products, alpha performance, services or variable pricing.

New forms of intermediation

Sub-advised models reshaping the value chain

For many asset managers and wealth managers, the growth of third-party and sub-advisory solutions is a significant enabler of structural change within the market.[4] Sub-advised and third-party funds allow those who typically own the customer (such as advisers, insurers with wealth-management capabilities and wealth managers) to set up their own funds of funds, bringing in the expertise of other specialist asset managers by involving them as sub-advisers to the fund.

Such third-party arrangements allow wealth manager platforms in effect to become one-stop shops able to fulfil investors' demands for a variety of investment and retirement solutions. For example, Skandia's new WealthSelect proposition offers Spectrum and Generation, two multi-asset solutions which are, respectively, risk- and income-targeted.

Over 20 groups, including Aberdeen, Artemis, BlackRock, Fidelity, Henderson, Invesco Perpetual, J.P. Morgan, Newton, Schroders and Threadneedle, are providing, or planning to provide, sub-advised accounts.

St James's Place, a significant user of sub-advised accounts, has seen assets grow from £15.955bn in November 2010 to £39.681bn in January 2014 – making it the third-largest asset manager, according to the Investment Management Association (IMA), up from 17th position just a few years ago.

In the UK, the value chain in investment management has been changing over the past decade. The partial exit of banking institutions has created a gap filled by asset managers and large, diversified financials (typically wealth managers).

Table 1. Change in assets under management by provider type in the UK

	% 2003	% 2012
Asset manager	11.4	36.9
Insurance company	39.3	28.7
Investment bank	18.9	11.2
Retail bank	18.2	6.0
Pension fund manager	5.7	2.8
Other (including large diversified financials, custodian banks and consultants)	6.4	14.5

Source: Asset Management in the UK 2012-2013, Investment Management Association Annual Survey, 2013

Changes within the investment management sector have further opened up competition. While the major life companies and wealth managers previously acted more as distributors of asset managers' products, moving into sub-advised portfolios is a means for them to move into new parts of the value chain, essentially enabling them to run their own funds. This is both a challenge and an opportunity for traditional asset managers, creating competition as wealth managers in effect become asset managers while also creating a new revenue stream from acting as third-party managers and sub-advisers.

David Aird, Managing Director, UK Distribution at Investec, says: "Distributors are focusing on manufacturing. There's revenue available if you are a distributor, administrator or fund manager. They are looking at the value chain and want to come onto the asset manager's turf. They reason that they own the client relationship, so if they launch their own fund range, fund managers can sub-advise it. They will give the fund manager a bigger chunk of assets, but want to be charged institutional fees."

Deloitte view

Within investment management, the increasing use of third-party and sub-advised mandates opens up the possibility to radically redesign the business model for the new competitive marketplace.

In practice, this can allow funds to offer investors enhanced choice (for example, of asset classes, multi-asset products and beta/alpha performance) by sourcing the broader expertise required from across the supply chain. It can be used to build out new partnerships and supply chains to control costs, grow new product ranges and access new client bases.

Increasing use of sub-advised and third party arrangements can bring opportunities for large and small players alike. Retail mass market players seeking to "own the customer" will use these arrangements to extend their products and services. Traditional UK-based active managers may not be able to "own the customer" but may find opportunities to sub-advise retail-led firms.

Working with platforms becomes key for many

Platforms are disrupting traditional distribution. At £274.4bn, the amount of assets on UK-advised platforms has become significant. Fund platforms continue to gain market share, accounting for 45% of gross retail fund sales in 2012, up from 41% in 2011 and 37% in 2010, according to the IMA. By the end of 2012 the top five platforms had fund holdings of £132bn, up 21% on the year before.

In 2014 the top four platforms were run by asset management firms embedded within larger diversified financial services firms rather than independent asset managers, representing 60% of total assets under administration (AUA) of the top ten platforms, according to Platforum, a UK advisory business.

Table 2. Top 10 UK platforms by AUA as of 31 March 2014

Platform	AUA (£ bn)	Market share
Cofunds (L&G)	£65.61	23.9%
FundsNetwork (Fidelity)	£48.70	17.7%
Skandia	£29.52	10.8%
Standard Life	£20.33	7.4%
Transact	£15.65	5.7%
James Hay	£15.64	5.7%
AJ Bell Sippcentre	£14.08	5.1%
AXA - Elevate	£7.89	2.9%
Ascentric	£7.63	2.8%
Nucleus	£6.78	2.5%
Others	£42.58	15.5%
Total	**£274.41**	**100.0%**

Source: "The Platforum: Which advised platforms are seeing the biggest growth?", Money Marketing, 21 May 2014.

While retail is generally more profitable as wealth manager-style platforms consolidate and grow in power, they in effect "group" retail investors, allowing them to demand institutional-style rates from asset managers. Distributors can beat down managers to institutional fee levels, but still charge retail prices to their clients – the Skandia range has an annual management charge (AMC) of just 0.52%. This could pose a significant threat to asset management fee revenues and profitability.

In fact, some groups have decided that they do not want to participate in the sub-advised market in the retail space – they are not willing to allow the previously high-margin retail client to access them via another channel through which they get relatively low fees. For example, M&G Investments has said that it is unable to provide a sub-advised retail mandate service. Participation is not even an option for many smaller asset managers; it is notable that all the groups in the Skandia range are top 30 players. For those smaller managers that do make it in, acting in a sub-advisory capacity gives access to the growing retail client base without the need for a direct channel. Sub-advised work could represent an opportunity for asset managers with a background in serving only institutional clients.

Deloitte view

We expect that platform growth will be significant in both direct and advised markets for some time to come. The prevalence of embedded asset managers at the top of the platform list speaks volumes. It suggests that those with retail capabilities have a competitive advantage. As platforms intensify their grip on the market, we expect there to be significant threats to asset management fee revenues and, crucially, to profitability. Platforms could represent a significant commoditising force for funds unable to differentiate sufficiently from these low-cost alternatives.

Deloitte view

Mid-sized asset managers are unlikely to be able to build their own relationships with mass-market retail clients, lacking the scale of customer base, the retail branding and customer service infrastructure to win.

Competition to become a default fund on the largest platforms will intensify. However, managers may opt for a segmentation strategy which enables the targeting of specific parts of the retail DC investor market.

Many mid-sized asset managers are likely to reorganise themselves to fit in with the standardised criteria demanded by large platforms. Understanding the gap between the operational capabilities required to compete in each of these spaces compared with the current state should be a key consideration in deciding strategy.

"The sub-advised business is far more institutional in look and feel," Mr Aird says. "Managers will do detailed due diligence, brand doesn't carry any weight, and they are keen to identify an investment skillset. There will be an external gatekeeper, and the reporting requirements are much more of an institutional engagement. They want performance and repeatability, quality and depth of resources and are very interested in the operational and compliance side." For those able to fit these criteria, it is a natural target.

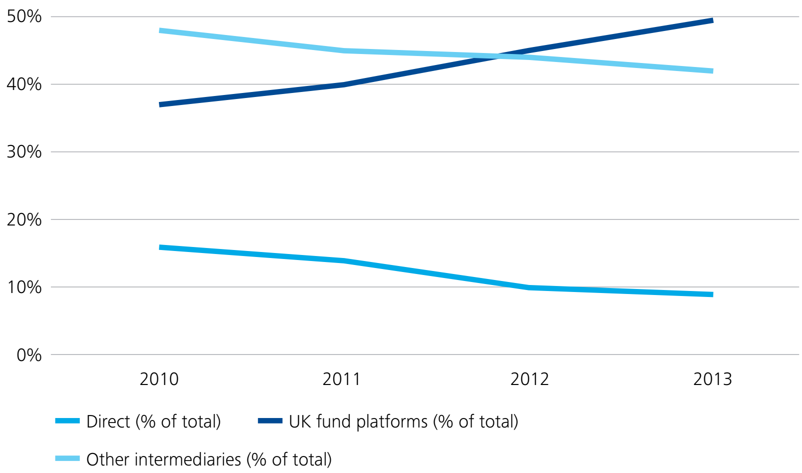
Platforms and consultants become gatekeepers

Sub-advisers are also creating platforms that allow more sophisticated retail investors to build their own portfolios. Hargreaves Lansdown has become a bellwether for this sector in the UK, and it reported 77,000 new clients over the six months to 31 December 2013. Assets under administration on its Vantage platform have leapt by £13bn over the past 12 months.

Precisely how asset managers should engage with platforms is a crucial strategic question. As wealth managers, IFAs and consultants grow their client base through platforms; they exercise greater power over the shape, style and size of funds they offer, and control by gatekeepers is concentrating flows into certain funds.

"There has been an institutionalisation of the fund-buying process," according to Phil Wagstaff, Head of Global Distribution at Henderson Global Investors. "More money is in the hands of fewer people, and often they use similar models to select funds... In this way you end up with a 'winner takes all' market. Last year around 90% of all UK fund flows went into around ten funds [funds of funds/platforms]. If you have one of those funds you can make hay, but the rest will be on the sidelines."

Figure 1. Annual retail sales by distribution channel (UK-domiciled funds)



Source: Investment Management Association – Fund statistics.

Internationalisation

While the retail-isation of investment management offers some opportunities, in general the UK market is mature and, with gatekeepers, it is difficult to enhance market share. Therefore, many larger asset managers are looking beyond the UK as a vital growth strategy.

As wealth rebalances and shifts towards the East, managers targeting foreign markets are using two approaches – either taking UK-manufactured products out via global distribution networks or building a domestic presence in a smaller number of geographies using specifically targeted products.

Mr Wagstaff is clear that the latter is more effective for his business. "European funds will only ever be niche for Asian investors," he says. "They want global equity, global bonds or Asian equity or bonds." While some groups with strong products will be able to generate traction globally with UK-domiciled products, he believes that only a handful of groups have made the switch to being truly globalised businesses.

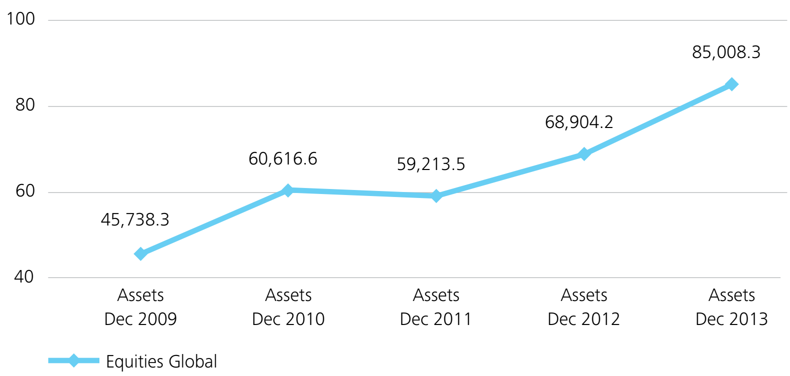
M&G has made a major push for foreign growth; funds under management from outside the UK have doubled to £21.2bn over the past 12 months and now represent 34% of retail funds under management, up from 22% a year ago. Mr Wagstaff says that Henderson Global Investors has even higher targets – the group expects 50% of its AUM to be generated outside the UK within the next five years, compared with 25% currently.

Europe has been extremely important for many groups. J.P. Morgan Asset Management highlights Italy, Germany and the Nordics as particular growth markets, while a recovering Spain also offers opportunities. Other groups, such as Schroders, Henderson and Aberdeen, have looked beyond Europe to Asian markets.

But it is not just in serving foreign investors that UK asset managers are going global. Their institutional clients are increasingly demanding global asset allocation. While retail clients are further behind the curve, they are likely to follow their institutional counterparts in demanding overseas equities to capture emerging market growth and for diversification.

Mid-sized traditional active managers seeking to grow in new geographies need to think carefully about how to build products in global markets, especially if they do not have local infrastructure on the ground.

Figure 2. Growth of global equities funds domiciled in the UK (€ m)



Source: Lipper FundFile.

> "European funds will only ever be niche for Asian investors, they want global equity, global bonds or Asian equity or bonds."
>
> **Phil Wagstaff**
> Head of Global Distribution
> Henderson Global Investors

Deloitte view

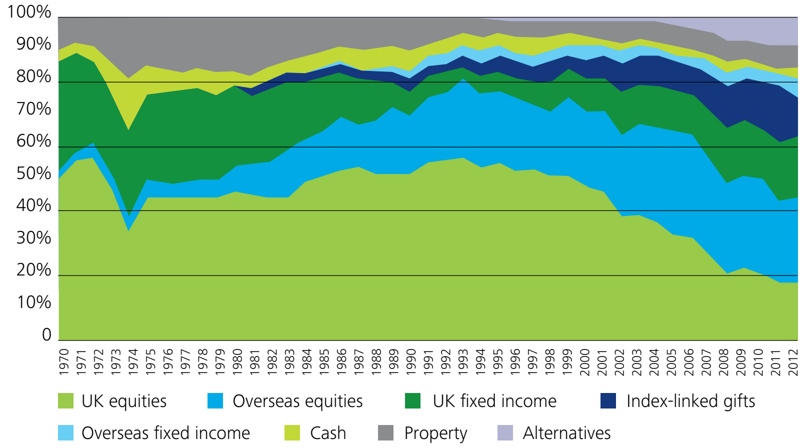
Making a decision on building locally derived product suites or rolling out global products will be a key question for asset managers operating in the global space.

Differentiated products and services may require locally derived product design and roll-out, while more cost-orientated asset management offerings may seek to roll out products in a standardised format across multiple jurisdictions.

The maturity and current capabilities of global operating models (and compliance with UCITs passports) may dictate the success or failure of the chosen strategy.

Growing global product suites (as part of a multi-asset product or portfolio offering) requires asset managers to further build out global networks and bring these local specialists together. A people strategy on how to hire, train and transfer staff and resources from current locations into growth locations will also be required.

Figure 3. Overall UK pension fund asset allocation (1970-2012)



Source: UBS Pension Funds Indicators, quoted in "Asset Management in the UK 2012 – 2013", IMA Annual Survey, 2013

Product development

Aggressive passives challenge actives

In the low-return and volatile environment in the wake of the financial crisis investors have been more risk-averse, and the importance of fees and charges has risen significantly as a key factor eroding already low returns. This has led to the aggressive growth of low-cost, high-volume passive funds using products such as exchange-traded funds (ETFs). Institutional clients have led the way in the take-up of trackers, but retail clients are also likely to ramp up their use.

Overall flows for the global ETF industry were up US$11.2bn in March 2014, having risen by US$28bn in February, according to Deutsche Bank. In the US, ETFs account for about 25% of equity investments, while in Europe they currently make up 7.1%. Passive, which represented 10% of the UK market in 2006, had increased its share to 22% by 2012, according to the IMA.[5]

The growth of passive investing has made Vanguard Asset Management the second-largest asset manager in the world (behind BlackRock, which also has a significant passive business). According to the UK Managing Director of Vanguard Asset Management, Tom Rampulla, who is a leading proponent of passive investing, the group's original business in the UK and Europe was almost 100% institutional. However, while institutional remains its key market in continental Europe, in the UK the retail business has proved the area of strongest growth, where the split is now about 60:40 between retail and institutional. This has prompted a significant focus on the adviser market, most recently seen in the launch of a series of model portfolios to help financial advisers package their ETFs. The group has also expanded its dedicated advisory sales force and transitioned to a field-based sales model with technology and education support. Vanguard Asset Management hopes to replicate the success it has had in the US, where it took 35% of total market net flows in 2012.

The question for many traditional active managers is: How much of a threat does the growth of passive funds represent? At present, 22% of managed funds are passive, with 78% active, according to the IMA. In terms of retail portfolios, Henderson Global Investors' Mr Wagstaff believes that the allocations to active will stabilise, with passive at around 40% of portfolios. If the growth trajectory for passives in both institutional and retail markets continues, this will represent a major market shift for active managers.

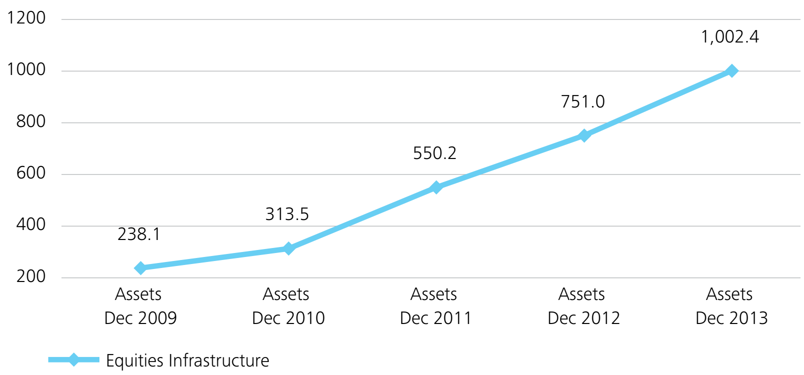
Funds in the active management space largely stick to their focus on areas where they know they can deliver alpha. As such, most asset managers interviewed believe that the market for "bog-standard index-plus retail funds" is diminishing across the board. It is difficult to justify fees of 1-2% when the average fee for an SPDR S&P 500 ETF is just 0.09%.

They also argue that a focus on fewer business areas can leave a fund manager vulnerable to the swings in performance of those asset classes, but that it is difficult to truly claim to deliver alpha across a broad range of areas. Rod Aldridge, Head of Distribution at Baring Asset Management, believes that in the current market "if you have alpha, you can justify the fees."

Multi-asset

Investors have also sought to access a broader base of assets, moving into alternatives such as infrastructure. At the same time, there has been a move to include more "outcome-driven" investing within DC schemes – the counterpart to the liability-driven investments of DB schemes. Asset managers have responded with the development of multi-asset and multi-manager solutions.

Figure 4. Growth of assets in equities infrastructure funds domiciled in the UK (€ m)



Source: Lipper FundFile.

Deloitte view

Traditional active managers are running a fine line – if alpha is too low, then passive funds become a competitive alternative for the investor. If alpha is high enough, then it can compete with hedge funds, which are said to be reducing their charges. The alternative is to deliver alpha through semi-automated processes (semi-active funds).

Deloitte view

Multi-asset products are increasingly important and as these product sets become core, having the right delivery capabilities will become a prerequisite to compete:

Client focus for outcomes-based products – In order to construct a multi-asset portfolio that provides the right outcomes for each client (e.g. specific outcomes such as risk/reward, income stream, low downside volatility, target-dated retirement goals), asset managers need to fully analyse and understand how client needs will change depending on client segment and purpose of investing. Setting out these objectives with the client requires a "client-in" perspective rather than a "product-out" approach.

In the future, alpha and beta performance benchmarks may not be the primary basis on which retail investors will judge fund performance. As outcome-based products grow, active managers are likely to stress the importance of new measures of performance related to achieving or beating those outcomes.

Cross-functional working – Asset managers traditionally working within asset class, product and geographical silos must work together to deliver a superior multi-asset solution.

Collaboration with third parties and sub-advisers – As the value chain shifts, there are opportunities to source a diverse range of skillsets and geographies for multi-asset products through third parties and sub-advisory routes.

In the UK, risk-targeted funds – which attempt to remove some of the uncertainty associated with performance – have been launched by, among others, Old Mutual, Legal & General, SEI and 7IM.

In the institutional market, this has been seen in a shift away from liability-driven investment. Mr Troiano of Schroders says: "Now funds want to improve their funding ratio. To do this, they are looking to maximise returns for the level of risk. Multi-asset gives you the broadest opportunity set, and this is why it has gained traction as an investment solution."

The shift to DC and the expansion of pension savers is helping multi-asset funds to gain ground. It is estimated that between 83% and 90% of the 401k retirement savings market in the US goes into multi-asset funds, and as the UK DC market starts to resemble that of the 401k market, it is fair to assume that individuals and scheme managers may take similar decisions. According to IMA statistics, the contribution of UK multi-asset funds to total UK-domiciled funds under management grew by four percentage points between 2004 and 2013, from 11.1% to 15.1%. "The end employees are rarely equipped to make decisions on the assets in their pension schemes, and they can't afford financial advice. Multi-asset fills that gap," says Mike Webb, Chief Executive of Rathbones Unit Trust Managers.

The UK Retail Distribution Review has also influenced the market. Many financial advisers have recognised that they are not equipped to build client portfolios and have therefore outsourced this activity. A strong multi-asset proposition can also support wealth managers needing a core portfolio for their clients. These multi-asset funds have taken different guises, such as Global Absolute Return products and Targeted Return funds.

Asset managers are also widening their range of offerings as institutional clients seek new asset classes such as infrastructure. Mr Troiano says: "The growth is in the official institutions – central banks, sovereign wealth funds – and among insurance companies which are looking for partners. Central banks and sovereign wealth funds have historically used fixed income only to manage official reserves, but many have reserves well in excess of those needed to protect their currencies and, as such, are investing in a much broader range of assets."

Regulation

While the majority of asset managers suggest that until now regulation has been a drag on efficiency rather than a source of improved productivity, there are possible opportunities inherent in regulation as well.

As Mr Troiano explains: "To date, the proportion of costs in compliance, audit and group risk have all increased, but asset management margins have largely been sustained. Asset managers have either enacted efficiencies elsewhere or passed the costs on to the consumer." However, if asset management fees come under further pressure and price competition intensifies, passing on regulatory costs to customers is likely to get harder.

Some regulation also has the potential to pave the way for future growth. For instance, the majority of asset managers are likely to adopt the Alternative Investment Fund Managers Directive (AIFMD), which provides a pan-European passport for products. Peter Schwicht, Head of Europe at J.P. Morgan Asset Management, says: "The AIFMD will make it easier to sell European alternative investment funds once asset managers have figured out the other issues." But he also suggests that the largest will benefit the most. "High regulation creates barriers to entry. It will become more difficult for small and medium-sized managers to compete."

Also, as EU regulation serves as a template for regulation in other regions, such as Asia, the ability to use the Undertakings for Collective Investment in Transferable Securities Directive (UCITS) as a passport is a distinct advantage for large global asset managers. UK asset managers can offer standardised products, reducing costs. However, if it becomes too onerous to do business in Europe, there is a danger that an Asian UCITS equivalent could emerge.

"The AIFMD will make it easier to sell European alternative investment funds once asset managers have figured out the other issues."

Peter Schwicht
Head of Europe
J.P. Morgan Asset Management

Section 2: Response to change – and solutions

Deloitte view

Partnership approach may require a focused operating model

Mid-size independent "pure-play" managers, in the main, are set to continue to sell through intermediaries and large platforms and consultants. The way in which such organisations set up for partnerships will be fundamental to success.

Understanding how the value chain is reshaping and a company's place within it will be key to defining the intermediary partnership approach. Many interviewees at independent asset managers are seeking to partner with the large retail brands and platforms.

As competition intensifies for a place on these platforms' panels, asset managers will need to organise their businesses for this approach. They will need to optimise efficiency to compete on cost, produce "plug-and-play" product sets and operate across departments for multi-asset provision.

The reshaping investment management market presents a series of challenges to – and opportunities for – revenue growth. How are asset managers responding to these seismic shifts? Strategies for success revolve around four key areas: distribution, products, pricing and costs.

Distribution

Mr Troiano of Schroders believes that forging partnerships with insurance-owned platforms will be a key area of growth for mid-sized asset managers. Insurance companies are increasingly outsourcing to and partnering with asset management groups – Skandia, for example, has recently launched its WealthSelect fund range. Although asset managers are expected to offer services at lower, institutional-style rates, it represents a means to access solid, long-term flows. It is also a relatively non-intermediated channel, with decisions made in-house at the majority of insurance groups.

Mr Wagstaff at Henderson Global Investors adds: "Our strategy is as a branded manufacturer, not a platform provider. While we have direct clients, it is not our intention to offer them the full functionality of a platform to attract new direct clients. We are building long-term strategic partnerships as part of guided architecture offerings for key distributors, including third-party and sub-advised."

Beyond the UK market, geographical diversification is also key – particularly in providing a means to grow without the constraints of powerful platform and consultant gatekeepers. Mr Troiano says: "We do business in 30 countries. We have a domestic business in each of those countries as well as selling international products. Therefore, no one consultant dominates our overall revenues."

Aberdeen in its recent set of results also emphasised the importance of its global distribution: "Our distribution is focused on multiple business and distribution channels with teams operating on the ground in 26 countries and covering a further 34 remotely. We continue to see strong growth in North America, continental Europe and selective markets in Asia."

Asset managers are also adjusting by finding new sources of institutional clients. Some groups, such as Architas, have chosen to build up their institutional business in less consultant-led areas, such as charity mandates, or are seeking out new institutional investors with different objectives entering the market. These include sovereign wealth funds with deep pockets and lengthy time horizons. Such less consultant-led investors represent a significant potential source of fee revenue for those with the resources to service them.

Products

Diversification also extends to product development. Jörg Ambrosius, Senior Vice President at State Street Global Advisors, says: "We see asset managers going into new alternative asset classes, which requires investment and know-how."

In particular, creating higher alpha products is vital to compete with the hedge fund managers. Asset managers with international scale are also seeking to take advantage of AIFMD and UCITS to further expand their product reach into new territories. The focus for the majority of asset managers is to differentiate themselves in the market with new products and services to justify the charges. It is about making sure alpha products genuinely deliver alpha.

Mr Wagstaff also sees quality products enabling pricing power. He says: "Product differentiation is critical. Risk-adjusted returns, combined with a strong process and first-class customer service and a strong brand, will differentiate and enable higher pricing."

Such differentiation is key for traditional asset managers as passive funds continue to develop their offerings. Mr Rampulla of Vanguard Asset Management says: "Across all of our products, we're focused on providing the best possible quality at the lowest possible cost. By quality we mean tight tracking from our index funds, robust product design and first-class customer service and client communications."

Pricing

While strong products may help asset managers justify the fees they charge, they are still under intense pressure to lower pricing, both from gatekeepers' competition and from passive products.

Competition from passives has led to a reduction in fees by the active market, and some managers have attempted to introduce "semi-active funds" – active's answer to the passive industry, essentially providing alpha at a lower cost.

There has been mixed success with this approach. Fundsmith, the fund management group set up by Terry Smith, the former Chief Executive of Collins Stewart, has launched a "semi-active" UK equity fund investing in high-quality companies with low turnover for a relatively low fee of 1% AMC. This has been hugely popular, and the fund is now £1.6bn in size. However, products from J.P. Morgan Asset Management and Schroders have met with less success – the Schroder UK Core targets 1% outperformance of the FTSE All-Share, net of fees, and has a total expense ratio (TER) capped at 0.4%, but has funds under management of just £16.2m. The JPM UK Active Index Plus, meanwhile, has performed better, but is still only £88m in size.

With more traditional products, some asset managers are seeking ways to create more variable pricing with platforms and clients. They also are seeking ways to introduce more sophisticated pricing by type and style of fund, product and distributor (intermediary). "Fund platforms are not distinguishing between the type of client, but are trying to negotiate a single price across all their clients," Mr Webb of Rathbones Unit Trust Managers says. "But fund managers still need to persuade the end user to use their products. It is nonsense to sell to an individual IFA firm with two advisers at the same price as a regional IFA. This was easier in the days of cash rebates, which were simple to administer. It is more complex in the world of unit rebates, and fund managers are unwilling to knock another 10 basis points off their fees."

Deloitte view

Squeezed in the middle

Alpha providers are increasingly squeezed at both ends. From above, they have hedge funds maturing, building greater efficiency and lowering their costs. From below, passives are improving performance, establishing good customer service and building performance history. There has been a push toward building "semi-active" products, with limited success.

Many asset managers who are unlikely to win in a race to the bottom (i.e. based on the lowest cost) will seek to deliver higher alpha to wealthier retail investor segments. They will need to create tailored segmentation strategies and variable pricing to differentiate themselves to this segment.

Behavioural economics in the active/passive debate

Teachings from behavioural economics may suggest that traditional active management is not likely to lose out to passives overnight. The passive market represents 22% of the managed funds market. To many investors, the logic of passive investing makes sense: lower cost for similar performance. However, retail investors and alpha providers may succumb to the human tendency towards "optimism". Investors are optimistic in being able to pick asset managers who will outperform the market, and managers are playing into this desire by communicating a high level of confidence in producing alpha and avoiding losses. This may mean that retail customers are likely to continue to choose alpha funds and pay higher costs despite the intrinsic logic of passive funds.

"We believe that investors are best served by straightforward and transparent pricing models where it's clear what they are paying and what each element of the overall cost relates to."

Tom Rampulla
Managing Director
Vanguard Asset Management

Mr Wagstaff says: "In some cases we are prepared to review pricing – depending on the distribution strength of the client, the stickiness of the assets and the capacity of the product in question. The more complex strategies tend to have higher prices, and the smaller the capacity, the higher the price too."

Mr Schwicht at J.P. Morgan Asset Management is clear that there will be no wholesale reduction in prices, with risk and reward potential the key determinant of pricing. Differentiated pricing remains controversial – he rejects variable pricing according to the client base or the performance of individual products, but believes some differentiated pricing for intermediaries remains appropriate. "We think as long as there is adequate transparency and the intermediary is providing value to clients, some price differentiation is in order."

A couple of asset managers are already laying down the gauntlet to their competitors by offering differential pricing based on the management style. Dalton Strategic Partners recently dropped the annual management charge on its Global fund to 0.25%. Chief Executive Magnus Spence reasoned that the fund was actively managed using a largely quantitative process, was manpower-light and had significant economies of scale. This more nuanced pricing model, based on strategy rather than a blanket 0.75% for equities and 0.5% for bond funds, could be the model of the future.

Steve Kenny, Head of Sales at Kames Capital, agrees, saying there will be variable pricing with a fund manager's product suite, which will reflect alpha generation, or complexity in individual products. He adds: "There is no urgency to sort out a future fee structure; we need to see where the market is going to settle. We will be early followers, not pioneers in this. The pioneers often ended up dead."

Others are viewing changes to pricing as a part of "treating customers fairly". Mr Rampulla of Vanguard Asset Management, a passive provider, says: "We continue to offer our products at the lowest possible cost because we believe that cost is one of the only things investors can control, as well as being one of the best determinants of long-term investment success. We're not doing this in response to the changing landscape; we're doing it because we believe it's the right thing to do."

He adds: "We believe that investors are best served by straightforward and transparent pricing models where it's clear what they are paying and what each element of the overall cost relates to. We've never paid for distribution, and we continue to resist any proposals that go against the spirit, as well as the letter, of the law in this area."

Nevertheless, many active managers interviewed believe performance will continue to justify higher prices, and few believe groups not delivering genuine alpha will be able to sustain pricing at current levels. Mr Trevers of Invesco Perpetual says: "Pricing is sorting out the winners from the losers in terms of managers able to deliver alpha. Those that can will be able to capture premium pricing." It is clear that if active managers are to retain their pricing differential, producing demonstrable alpha will be key.

Costs

In order to lower pricing while maintaining margins, asset managers are looking at their costs. However, there are considerable cost challenges: regulation requires systems upgrades; the war for talent raises staff costs; there is pressure on the value chain; and asset managers need to generate higher alpha to justify fees, which can be more expensive to deliver, and asset managers are seeking to keep a tight lid on costs, which only increased by 2.4% on the year before (2012), according to the IMA.

Most asset managers have employed limited cost-cutting and more disciplined spending, particularly where revenues have fallen. For example, in its latest statement Aberdeen said it would launch a cost-cutting programme over and above that necessitated by its acquisition of Scottish Widows Investment Partnership (SWIP) to deal with falling revenues from its emerging-market franchise.

According to Mr Schwicht, J.P. Morgan Asset Management will not follow suit. For example, it is not looking to outsource, or to move to a more variable cost base. Henderson Global Investors says it is continuously considering all these strategies to keep down costs.

Mr Ambrosius of State Street Global Advisors believes that asset managers are making strong efforts to minimise costs and to think differently about which functions to keep in-house and which to outsource – different types of companies are using outsourcing in different ways.

"The boutiques are in trouble because of new regulatory requirements, and they have to decide whether to renovate their infrastructure totally or go for a one-stop-shop solution and focus on making investment decisions," he says. "The mid-sized asset managers are asking: What is our future business model? If they are too small to play at scale, how can they compete? They are challenged by innovative boutiques and may also struggle on global distribution channels. Some will be acquired, some may get smaller to act like a boutique."

He adds: "The larger asset managers are outsourcing, but it is more component-based outsourcing. They may just outsource a system. Data management is an area where many are outsourcing – asset managers have to produce data for far more recipients, and those recipients are far more sophisticated."

Understanding which functions to maintain in-house and to integrate for greater efficiency and which to outsource is tough and will ultimately depend on the business model each asset manager adopts going forward – for instance, to scale up or have a greater boutique focus. IT functions can often be integrated across various parts of the business and potentially outsourced, but client-facing or highly bespoke and specialised units often remain specific to a fund, customer, product set or management style.

Deloitte view

Margins sustained by asset values

Revenue growth in UK asset management only just outpaced costs in 2012 (3.2% industry revenue growth vs 2.4% increase in costs). Such revenue growth appears to be driven by asset values rather than net new money. This suggests margins are subject to volatile market conditions.

Retail influx may not be a more profitable business over the medium term

After the recent recovery in asset values, operating margins at the end of 2012 were 35% for UK asset managers. Asset managers might think the outlook for margins will improve as revenue growth receives a boost with auto enrolment, DC pensions growth and oversees opportunities, all of which are on the horizon. However, we think the average fee realised per asset managed could decline owing to the role of gatekeepers and passives.

Cost-cutting is key

Asset managers will need to continue cutting costs in response to these revenue pressures and a growing regulatory burden. The largest independent asset managers need to reshape their costs to compete on price with embedded managers. Those who fail to differentiate their offerings sufficiently will probably need to cut much deeper to improve sustainability.

Deloitte view

Cost savings through M&A, business model redesign or outsourcing

In the absence of large-scale M&A activity, cost savings will need to be made through a more fundamental business model redesign or through outsourcing:

Business model redesign – Asset managers need a granular understanding of their cost base. For example, understanding the cost to serve retail clients and the cost of various combinations of products and assets is a prerequisite. Hard choices will then need to be made about which customers, channels and products are profitable, and what value overhead activities really add.

Outsourcing for cost saving – Deciding what functions to outsource will come down to decisions about where to compete in the supply chain and the level of differentiation required in each function. Outsourcing data management can create cost saving, but should be made in the context of a wider data strategy. Any data strategy (whether outsourced or not) must ensure that data is used within the business for strategic decision-making.

The cost of handling increasing amounts of data and being increasingly transparent with investors and regulators is a significant "unproductive cost" (i.e. adding to overheads without providing a means to enhance revenues). Legacy IT systems are often inefficient and expensive to maintain, but even asset managers spending on new information technology find that this can be a self-reinforcing cost. The more systems a group builds, the more the systems need maintaining and updating. To remain competitive, asset managers will need not only to keep a lid on escalating costs, they will also need to actively strip out costs.

One big decision for asset managers is whether to pay up for "star" fund managers. Some, such as Invesco Perpetual, believe that the cost is worth it and it can attract assets. But clearly there is a business risk if that star manager then walks out the door. Invesco Perpetual has already lost around £2.5bn in assets from Neil Woodford's funds, despite having a capable replacement in Mark Barnett.

Active asset managers face this dilemma more acutely – their very existence depends on whether they deliver alpha, but they do not want to build up stars that leave them vulnerable. The credit crisis put a lot of managers back in their boxes, but pressure is reigniting. Mr Webb of Rathbones says: "In the last few years since the financial crisis there has been less pressure on base salaries. But wage inflation will kick in again as the economy improves."

The desire to reduce costs could lead to consolidation, with asset managers – particularly smaller groups which are losing market share to large and medium-sized asset managers – seeking greater scale or differentiation. However, there have long been predictions of widespread consolidation in the UK asset management sector that have largely failed to materialise. While the prevailing climate would appear to favour larger groups with the scale to absorb regulatory costs, crack the direct to consumer market and participate in the defined contribution market, there are only limited signs of increased concentration at the top end of the market. The top ten asset managers made up 47% of the market as of the end of November 2013, according to the IMA. A year ago they accounted for 46%, and three years ago for 41%.

Deloitte view

For asset managers, staff costs form a significant portion of their overall cost base. Managers can no longer afford to pay up for undifferentiated performance, a choice needs to be made: follow a highly differentiated/high-cost approach with star managers or take a low-cost one with core teams to manage passive funds.

The current regulatory environment is also placing pressure on asset managers to reconsider their remuneration approaches, and a generational change is requiring them to focus on succession planning and the retention of the next generation. This is especially true should a star manager approach be employed.

Conclusion

As the line between retail and institutional blurs, gatekeepers gain more power and passives increasingly join the fray, the competition for new money will become fiercer. Short-term opportunities exist for traditional asset managers, but tactical decisions are required. Where revenue growth may be limited in the fragmented UK market, costs will need to be cut and pricing structures altered.

Over the longer term asset managers need to engage fully with the seismic shifts shaking up the industry, such as the internationalisation of their client base. However, the biggest concern is that asset managers, who have historically controlled a significant part of the value chain, will lose out as platforms, insurance companies and other parts of the value chain all aim to get a greater slice of the cake.

The industry must truly understand its own cost base, products and pricing, and those of its competitors. But in this landscape of significant changes, perhaps the first thing to understand is who the competitors are.

How well traditional asset managers adapt their distribution strategies and product mix will determine whether they will keep a place in this new, more concentrated and cost-focused market. And how well they can manage the gatekeepers will determine whether they – or another part of the value chain – are the ones that come out on top.

Endnotes

1 Asset Management in the UK 2012 –2013, The IMA Annual Survey, Investment Management Association, 2013.

2 Market research firm Spence Johnson predicts that most DB schemes will have closed by 2023, with 85% of the approximately two million DB scheme participants having converted to DC schemes by then. Source: Spence Johnson – The Broad Brush publication dated December 2012.

3 Market research firm Spence Johnson predicts that DC assets will grow at 11.6% per annum to triple in size over the next 10 years. Source: Spence Johnson – The Broad Brush publication dated December 2012.

4 In the institutional client market place (worth £2.5trn), £1.7trn is managed under third party arrangements. Of this, 4.6% is managed by sub-advisors. Source: Asset Management in the UK 2012 –2013, The IMA Annual Survey, Investment Management Association, 2013.

5 Asset Management in the UK 2012 –2013, The IMA Annual Survey, Investment Management Association, 2013.

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