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Deloitte 2017 Investment Management CFO Symposium

Beyond the horizon

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Opening letter

Few periods have proven as challenging to the investment management industry as the present. A relentless focus on fees and seismic shift toward passive investments is pressuring active managers. Greater demands by regulators and investors are driving up costs. Absent any change in these trends, the industry is almost certainly facing the prospect of further margin declines.

But change is, in fact, attainable. This was one of the biggest takeaways from Deloitte's 2017 Investment Management CFO Symposium held in New York on June 26–27. The event brought together some of the brightest minds in the investment management industry. Finance leaders from a wide spectrum of leading and emerging firms shared their experiences about navigating the current operating terrain.

The Symposium also launched the latest Casey Quirk/McLagan Performance Intelligence Survey of investment management firms representing more than half of the world's assets under management. Among the survey's key findings: The pace of margin compression over the next five years depends on the actions of individual firms and the choices they make to realign their resources, products, and organizations.

Increasingly, finance chiefs are being called on to steer this important transformation. In planned talks and breakout sessions, attendees shared their approaches for leading this charge through consolidation and acquisition, new technology solutions, product realignment, and cost rationalization.

This report is a collection of insights from the Symposium and the Performance Intelligence Survey. It identifies steps investment managers should consider taking to successfully transform their operations to meet industry challenges. It also highlights the increasing importance of CFOs in driving this transformation. We hope you find it helpful as you chart your own firm's course through this time of dynamic change.

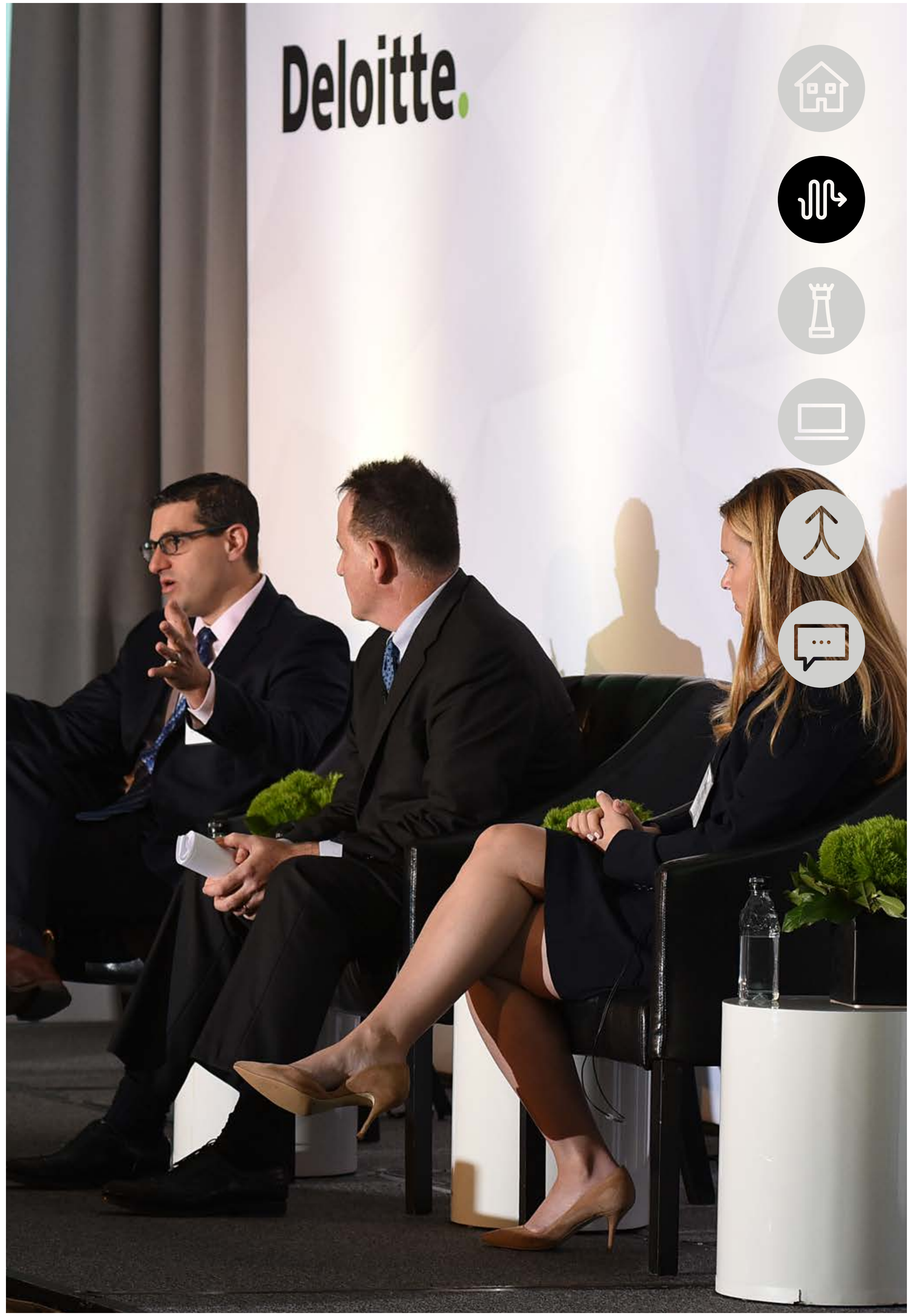
Sincerely,

Patrick Henry
Vice Chairman
US Investment Management Practice Leader
Deloitte & Touche LLP

Kevin Quirk
Principal
Casey Quirk

Under pressure

By any measure, organic growth in the investment management industry has become more difficult. The Casey Quirk/McLagan Performance Intelligence Survey captured this downward trend: After growing at 3.7 percent in 2012, net new flows as a percentage of assets under management fell to 1.6 percent in both 2013 and 2014. They dropped again, to 0.5 percent, in 2015 and rebounded only slightly, to 0.6 percent, in 2016.



An industry panel discusses challenges and opportunities ahead for investment management firms.

Under pressure

The story is well known by now: Most actively managed funds failed to keep pace with the bull market's performance since the global financial crisis, and many investors aren't seeing the merits of paying higher expenses when cheaper index-tracking alternatives abound. Passive US stock mutual funds and US equity exchange-traded funds (ETFs) now account for 42 percent of all US stock fund assets, up from 24 percent in 2010 and 12 percent in 2000.[1]

The Performance Intelligence Survey showed that pressure on fees is accelerating against this backdrop, with global implied industry fees declining 5.9 percent from 2015 to 2016—more than double the annualized rate of decline from 2012 to 2014. With respondents to the survey now expecting market returns to be only half their average trailing five-year return going forward, asset managers will face increasing demands from investors who are not willing to pay as much for performance. "Unless you can point to sustainable alpha generation, your fees are coming down," said the CFO of a large asset manager that has recently made big investments in ETFs.

A partner in a global asset management practice described the current operating environment as "slow-melting ice," with industry revenues now shrinking after years of steady growth and costs still rising. According to the Performance Intelligence Survey, securities and investment operations, as well as legal and compliance are among the industry's fastest-growing expenses.

Regulatory changes have almost certainly turned up the heat on most asset managers in recent years. Last October, the Securities and Exchange Commission (SEC) voted to adopt new and amended liquidity risk management rules governing mutual funds and ETFs. This came after the industry was already scrambling to comply with the Department of Labor's (DOL) fiduciary rule, which is costing billions to implement by some estimates. Tom Davis, a former US representative and now managing director of government relations for Deloitte LLP, expressed optimism that key provisions of the DOL rule will be rolled back under the Trump administration, once the formal process for reviewing agency regulations is completed.

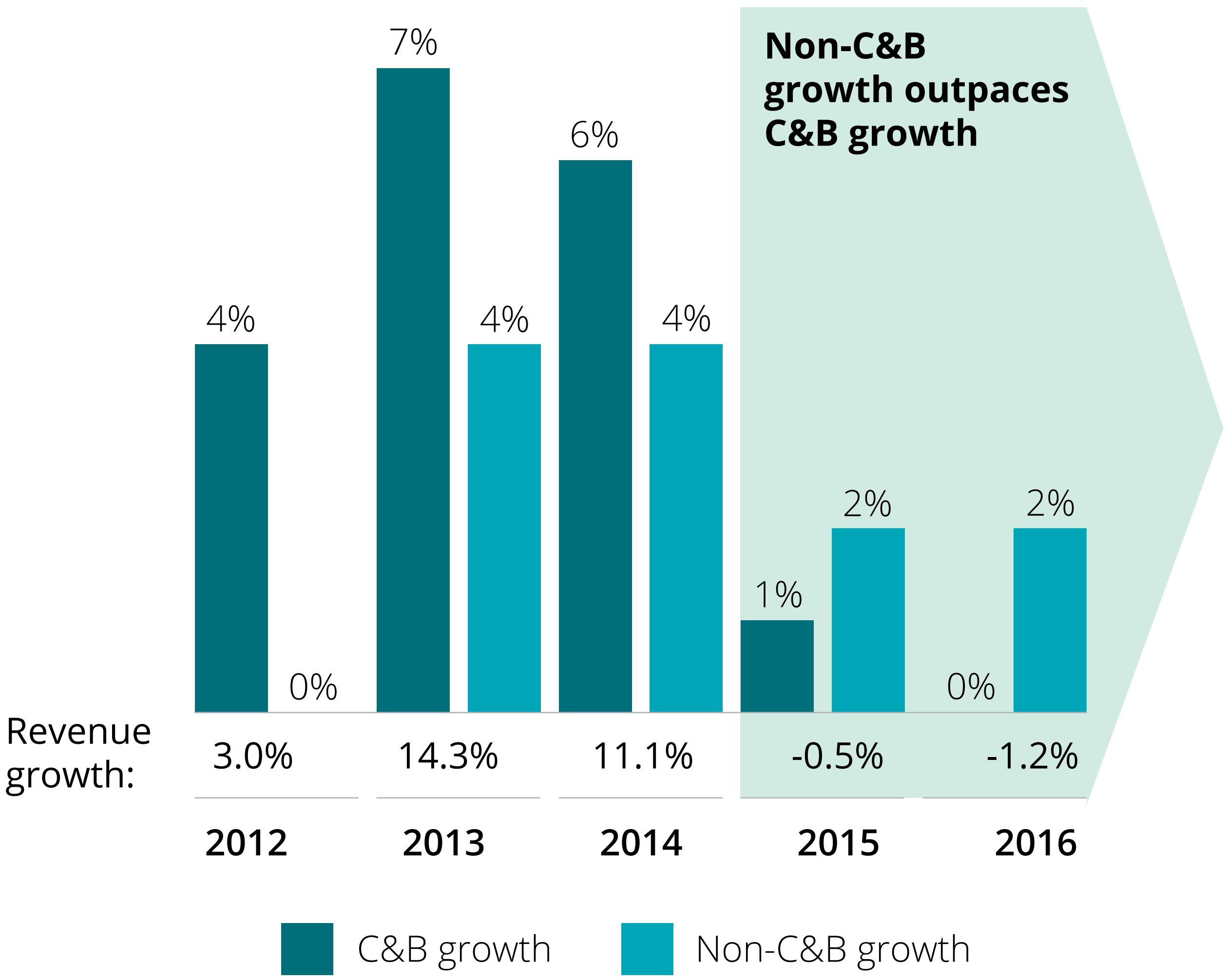
Robert Zakem, a managing director in Deloitte's Risk and Financial Advisory practice, said he is urging his investment management clients to use this time to look for ways to improve their compliance operations and make them more efficient and effective. While the current administration appears to favor less regulation, administrations "come and go, and so do the policies that come along with them," said Mr. Zakem.

"If there is in fact some [regulatory] relief coming, don't fritter it away, but rather use the breathing space to play catch up and look at improvements you could make."

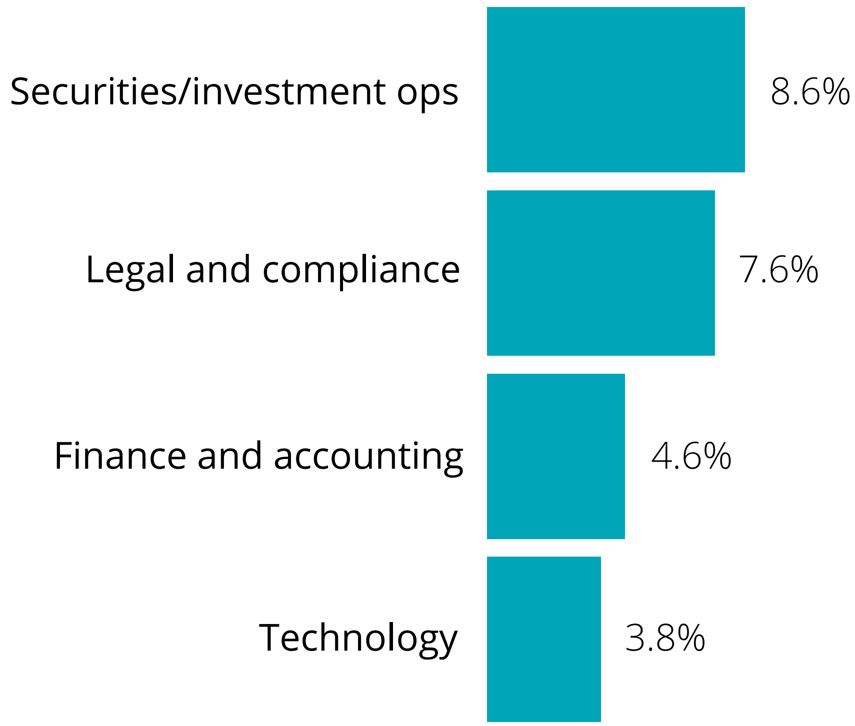
Robert Zakem, Deloitte

Revenue pressures are compounded by cost growth

C&B and non-C&B cost growth
2012–2016



Non-C&B functional expense growth
2015–2016



Source: Casey Quirk/McLagan Performance Intelligence Study, Casey Quirk analysis

Under pressure

Getting ahead of the industry's pain points was a common theme expressed at the Symposium. None are as pressing as the murky outlook for future inflows. "The embedded growth that most firms have counted on is gone," said Jeffrey Levi, principal at Casey Quirk. "Now is the time to take action. For many firms, it's going to require a hard look at all aspects of the business."

Despite the challenges the industry faces, many expressed optimism that asset managers can still compete profitably.

"I still like this business over the medium term," said a longtime investment banker who is now a research scholar and a distinguished visiting fellow for an Ivy League School. "If you run the firm well, if the investment product is of high quality, and if you embrace technology, then this business can continue to be one of the best businesses to be in for some time to come."

Over the course of the event, presenters and attendees frequently cited three main solutions for alleviating margin pressure and attracting new assets once again: strategic rationalization or realignment, technology, and mergers and acquisitions.

About the Performance Intelligence Survey

Performance Intelligence is a benchmarking study for asset managers to assess their competitiveness. Approximately 90 independent firms—representing more than half of the world's assets under management and more than two thirds of the assets of the top 40 global managers—participated in the 2017 study. The survey's fact-based, quantitative approach focused on assessing key competitive drivers within the industry—including strategy, finance, operations, and human resources—and generated granular data on new approaches to outsourcing, technology, and distribution.

CFO as catalyst and strategist

If current trends hold and fee compression continues at the same pace of recent years, operating margins across the industry could fall by a third—from 31 percent to 20 percent—over the next five years, according to scenario analysis included in the Performance Intelligence Survey findings. But there is also a more conservative scenario in which operating margins decline to only 26 percent over that time. Some select firms may be able to buck the trend and hold margins steady.

Sanford A. Cockrell III, national managing partner for Deloitte LLP's US CFO Program and Global CFO Program leader, leads an industry panel at the Symposium.

CFO as catalyst and strategist

Amanda Walters, senior manager at Casey Quirk, provides CFOs with in-depth analysis and high-level implications of the Performance Intelligence Survey.

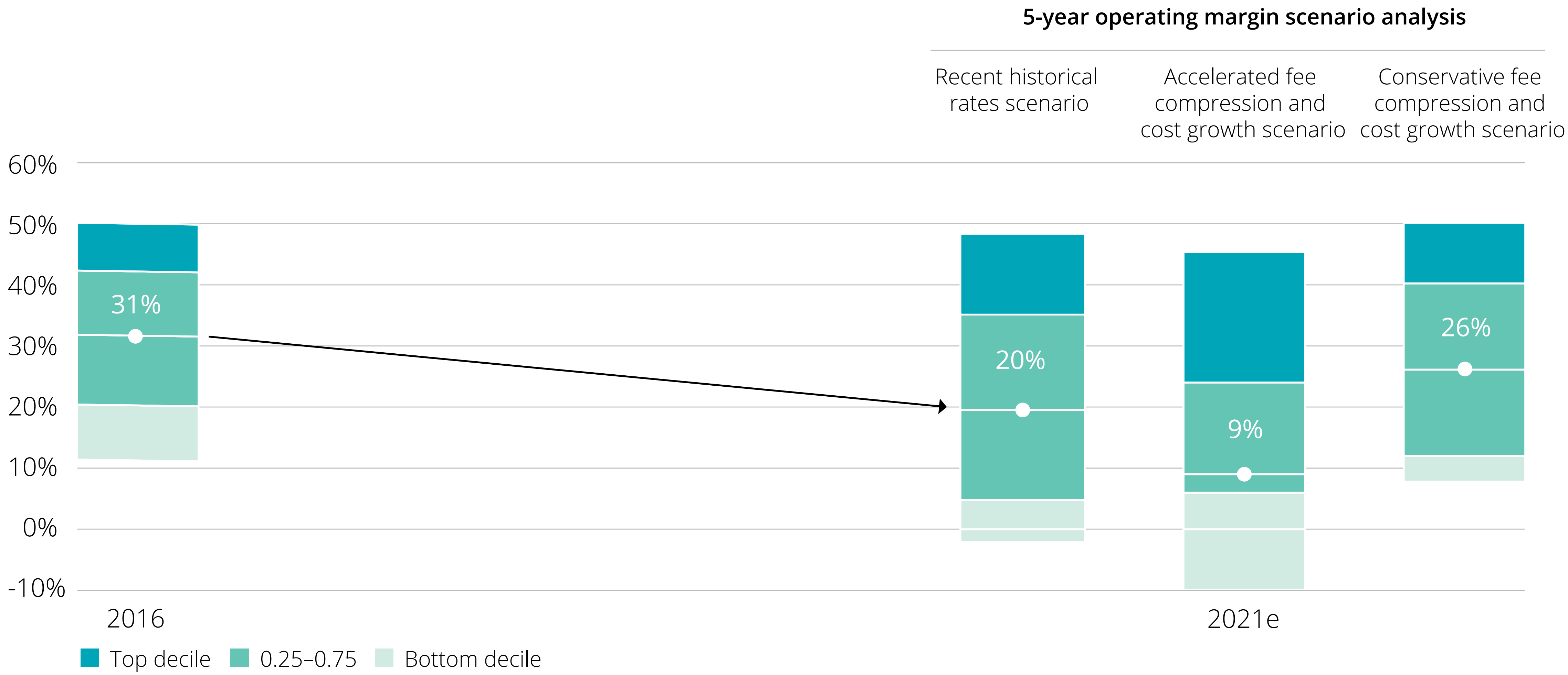
"A lot is going to depend on how successful managers are in terms of controlling their cost base," said Amanda Walters, a senior manager at Casey Quirk. The survey found the biggest potential for cost reductions may come from cost-driven mergers and acquisitions, as combinations replace outmoded business lines, consolidate front-office personnel, and generate various synergies. Other changes in order of potential cost reductions, include changing market or product lineups adjusting the compensation mix, and "trimming the fat"—paring excess costs through process automation and other tactics.

Increasingly, the chief financial officer is the one who helps firms get fit and drives their transformation. Historically, finance chiefs were viewed within their organizations as either "stewards" or "operators," said Sanford A. Cockrell III, national managing partner for Deloitte LLP's US CFO Program and Global CFO Program leader. They were primarily charged with protecting and preserving critical assets and balancing resources and costs in the most efficient ways possible. But today, they are being called on to act as catalysts and strategists, according to Mr. Cockrell. As such, a bigger part of their role is spent catalyzing behaviors and change to help execute strategic and financial objectives, as well as providing financial leadership in determining strategic business direction.

"CEOs are asking their CFOs to help them look through the windshield instead of the rearview mirror. The CFO is now the No. 2 executive in the C-Suite."

Sanford A. Cockrell III, Deloitte

Without significant change, industry margins may fall by a third



An oversupply of undifferentiated managers will face collapsing economics, accelerating the pace of firms seeking either scale or specialization.

Source: Casey Quirk/McLagan Performance Intelligence Study, CQ Public Firms Analysis, Casey Quirk analysis

The attraction and cultivation of new talent was a theme discussed throughout the Symposium.

Many asset managers that face collapsing economics are forced to choose one of two paths: scale or specialization. The first path means a diversified portfolio that spreads risk but drives up costs, and the second means lower costs but higher risks. The Performance Intelligence Survey found that investment management firms who can refocus their resources around their top revenue-generating products and segments can push operating margins as high as 40 percent and boost organic growth rates to 4.5 percent.

One CFO from a top 10 investment management firm said he is willing to accept lower margins in the short run if he feels the investments will contribute to long-term success. He cited the addition of different strategies to the firm's offerings by lifting out portfolio management teams. Another finance leader attending the session agreed, stating that his midsized asset management firm has benefited from being patient and analytical about such decisions. He cited a fixed income product that was unprofitable for its first six years and now represents 80 percent of his firm's profits.

Several finance chiefs said the industry is entering a difficult stage in which layoffs will likely be necessary. While other industries have much more leeway to cut costs without cutting jobs, asset managers rely primarily on people to generate profits. Terminations can have a chilling effect on morale and the firm's culture. The bull market has helped hide cost inefficiencies, but with organic flows evaporating, pink slips might not be far behind.

> "The tough decisions will happen," said the CFO of a New York-based investment management firm. "It's just a matter of time."

One question discussed at length throughout the day was how the industry's current state of play is likely to affect asset managers' cultivation of new talent. Such firms have had difficulty winning a protracted war for emerging talent among Millennials, whom many in the industry see as pivotal for reaching and retaining new assets.

Technology: Savior or disruptor?

Millennial talent will also be essential for unlocking the promise of new technologies that many see as a linchpin for the industry's future success. The time required for new technologies to reach mainstream adoption has shrunk dramatically in recent years. Companies in every sector of the economy are struggling to keep up.

Working sessions allowed CFOs to delve into many pertinent topics with their industry peers.

Cloud solutions, once a breakthrough innovation used only by a minority, are now table stakes. Cloud applications have spread from customer relations and sales functions to finance, streamlining many processes and pulling data from disparate businesses to improve financial planning and analysis tasks. Increasingly, technologies that employ robotics and cognitive automation are also finding their way into more industry applications, most notably in document review.

Michael Borawski, a technology, strategy, and architecture principal with Deloitte Consulting, cited an example in which a client was able to shrink the time for reviewing compliance documents from one year to one month. Emerging automation technologies are even able to synthesize investment performance data and churn out regular written commentaries for investors. Then there is dark analytics, the term used for technologies that sift through tons of unused data in companies' IT systems, looking for insightful information.

Technology agenda challenges

The constant introduction of new technologies can be head-spinning. The technology agenda is amounting to a distraction for the upper management of some fund companies. As a result, many are succumbing to isolated investments that support only one aspect of the business. One typical pain point reported by many investment managers is an inconsistent client experience. This is characterized by disparate sites, tools, and client data that make it difficult to provide seamless and personalized content.

Jib Wilkinson, a principal in Deloitte's Consulting practice, advises the clients he works with to focus not on the specific technologies themselves but on the anchoring themes driving their adoption.

Mr. Wilkinson said asset managers should emulate Silicon Valley startups and their "zoom out/zoom in" approach to technology investments. The planning strategy involves looking at a time horizon of 10 or more years and trying to predict the market landscape and customer expectations (i.e., "zoom out"). It then "zooms in" to address the next six to 12 months in identifying the business initiatives that have the greatest potential for accelerating the organization's progress toward the longer-term goal.

> "Technological change is no longer constant—it's accelerating. There's pressure on everybody."
>
> **Longtime investment banker who is now a research scholar and a distinguished visiting fellow for an Ivy League School**

Discussions on technology and its implications on the investment management industry were front and center at the Symposium.

Cyber risk concerns

Some finance chiefs reported challenges in accounting for technology in risk governance. Cyber risk is chief among their top concerns. High-profile cyberattacks across multiple industries have garnered the attention of the media, the public, boards, and executive management, moving onto CFO agendas as the issue goes beyond one of compliance to business continuity and financial and reputational harm. In fact, as the Symposium was getting underway, a new ransomware attack dubbed "Petya" hit computer systems in the Ukraine before spreading to Europe and the United States. Mark Nicholson, a principal with Deloitte Risk and Financial Advisory, said such attacks can actually set back cyber preparedness efforts because they convince organizations that the biggest threats are external.

Increasingly, cyber risk is being introduced internally through the development of new technologies, entry into new markets, and connected devices. "Organizations are under pressure to grow and innovate at a very rapid pace and that agile process is introducing a lot more risk from a cyber perspective," he said.

The chief information security officer of one asset management firm said organizations with “poor security hygiene” are particularly vulnerable. A vast majority of the IT systems that are hit have software that has not been updated in the past year. Another common issue is that too many employees are still succumbing to traditional cyber ploys such as phishing. “The weak points are not the firewalls,” he said. “The weak points are the people. They are the most powerful tool in your arsenal for addressing cyber risk.”

Employee training on cyber risk has shown great potential in addressing these basic weaknesses, much like citizens are now much more aware of suspicious bags in transportation centers, said the CIO. CFOs can help their organizations identify which systems and data are most critical to maintain operations. Finance chiefs need to work with the individual business units to understand which systems are most important and devise workarounds in the event they are compromised.

High-profile cyberattacks across multiple industries have garnered the attention of the media, the public, boards, and executive management. They are moving onto CFO agendas as the issue goes beyond one of compliance to business continuity and financial and reputational harm.

“Think about the big picture and then about breaking off pieces into manageable bites.”

Jib Wilkinson, Deloitte

Urge to merge

With organic growth in the industry stalling, it is not surprising that more firms are entertaining potential deals to attract more assets. Many publicly traded asset managers still have low valuations despite the run-up in the stock market.

Panelists explore options on how to drive growth in the current marketplace.

Historically, the industry has traded at a 20–25 percent premium to the S&P 500, but now it is trading at a discount of the same magnitude, said a managing director from a top investment bank. Traditional valuation premiums have flip-flopped in private markets as well.

"Valuations are not quite at all-time lows, but they haven't been this low since 2009."

Head of the global asset management arm of a large bank

Other factors are supporting increased activity among buyers. Traditional competitors for takeout candidates, such as banks and insurers, have retrenched amid new regulatory requirements on their use of capital. Asset managers are also looking at less-than-ideal options for using their cash. Returns on those positions are still close to zero, so "paying even double-digit EBITDA in an acquisition is a better alternative," said one investment banking principal.

While combinations are seen as holding the greatest potential for generating cost reductions in the Performance Intelligence Survey, they are not the primary driver of deals. Cost-focused combinations "do nothing for existing customers," said the CFO of a longstanding fund provider. "Most CFOs are good at modeling cost savings, but they always tend to underestimate revenue loss." He said many clients believe that investment managers are too easily distracted by integrating big deals. "The safest thing to do in those instances is to move your assets."

According to the Performance Intelligence Survey, more than half of asset management M&A activity in 2016 was driven by firms seeking new capabilities, with many seeking bolt-on additions of innovative investment products and technology solutions. Buyers remain particularly focused on taking advantage of promising, subscale products that would benefit from wider distribution, smaller businesses that have access to robo-investing platforms, or other technologies that can take too long to develop internally.

M&A panel participants said cross-border transactions are piquing more interest these days for several reasons. For one, most international markets have fewer regulatory hurdles. There are typically fewer competitors in such deals. And the shift to passive investments has gained far less traction overseas.

Conclusion

Disruption in the money management industry is arguably at an all-time high, and profit margins could dip into negative territory for some managers.

The CFO's role in this next stage of the industry's evolution is bound to take on new significance—and urgency. It is more important than ever that finance chiefs take an active role in framing strategic opportunities and driving the planning process.

Despite some pessimism going forward, investment management CFOs attending the Symposium were generally optimistic about growth opportunities for the industry.

Conclusion

Deloitte hosts lead the networking opportunities among CFOs in attendance at the Symposium.

But as the Performance Intelligence Survey concludes, there are steps industry participants can take to focus their businesses, achieve scale, and continue to grow. It's not about making the melting ice cube bigger, but about stopping the melting process altogether. And that's going to take a combination of cost-cutting, reinvestment, and truly transformative investments and strategies.

The converging issues asset managers face require a financial leader who can not only provide analytical support on request, but also challenge the organization to get ahead of these issues and create new platforms for long-term success.

Sample of firms in attendance:

- Barclays
- BlackRock
- BNY Mellon
- Brown Advisory
- Credit Suisse
- Deutsche Bank Asset Management
- Eaton Vance
- Goldman Sachs
- J.P. Morgan
- Lazard
- Legg Mason
- Lord, Abbett & Co.
- McLagan
- MetLife Investment Management
- MFS Investment Management
- Morgan Stanley
- Natixis Global Asset Management
- New York Life
- Northern Trust Asset Management
- OppenheimerFunds
- PGIM, Inc.
- RBC Global Asset Management
- State Street Global Advisors
- Sun Life Investment Management
- T. Rowe Price
- Vanguard
- Wellington Management Company
- Wells Fargo Asset Management

Staying ahead of disruption: Questions to consider

What could disrupt our organization, and how will we respond?

What is the dominant uncertainty facing our organization, and how can we help structure and navigate it?

What should we have on our list to stop doing?

What are the dominant constraints on the growth of our organization, and how can we use finance to push back these constraints?

What are the areas of investment with the greatest uncertainty on returns, and how can we reduce uncertainty in the value of these investments?

If we double or halve the size of our organization, will we rescale flexibly or create more value for stakeholders?

Endnote

[1] Version:1.0 http://www.latimes.com/business/la-fi-investing-quarterly-index-funds-20170409-story.html.

Patrick Henry
Vice Chairman
US Investment Management
Practice Leader
Deloitte & Touche LLP
+1 212 436 4853
phenry@deloitte.com

Kevin Quirk
Principal
Casey Quirk
+1 203 899 3033
kpquirk@deloitte.com