

CloserLook

2017 Investment Management Outlook



Several major trends will likely impact the investment management industry in the coming year. These include shifts in buyer behavior as the Millennial generation becomes a greater force in the investing marketplace; increased regulation from the Securities and Exchange Commission (SEC); and the transformative effect that blockchain, robotic process automation, and other emerging technologies will have on the industry.

Economic outlook: Is a major stimulus package in the offing?

President-elect Donald Trump may have to depend heavily on private-sector funding to proceed with his \$1 trillion infrastructure spending program, considering Congress ongoing reluctance to increase spending. The US economy may be nearing full employment with the younger cohorts entering the labor market as more Baby Boomers retire. In addition, the prospects for a fiscal stimulus seem greater now than they were before the 2016 presidential election.

Steady improvement and stability is the most likely scenario for 2017. Although weak foreign demand may continue to weigh on growth, domestic demand should be strong enough to provide employment for workers returning to the labor force, as the unemployment rate is expected to remain at approximately 5 percent. GDP annual growth is likely to hit a maximum of 2.5 percent. In the medium term, low productivity growth will likely put a ceiling on the economy, and by 2019, US GDP

growth may be below 2 percent, despite the fact that the labor market might be at full employment. Inflation is expected to remain subdued. Interest rates are likely to rise in 2017, but should remain at historically low levels throughout the year. If the forecast holds, asset allocation shifts among cash, commodities, and fixed income may begin by the end of 2017.

Investment industry outlook: Building upon last year's performance

Mutual funds and exchange-traded funds (ETFs) have experienced positive growth. Worldwide regulated funds grew at 9.1 percent CAGR versus 8.6 percent by US mutual funds and ETFs. Non-US investments grew at a slightly faster pace due to global demand. Both worldwide and US investments seem to show declining demand in 2016 as returns remained low.

Hedge fund assets have experienced steady growth over the past five years, even through performance swings.

Private equity investments continued a track record of strong asset appreciation. Private equity has continued to attract investment even with current high valuations. Fundraising increased incrementally over the past five years as investors increased allocations in the sector.

Shifts in investor buying behavior: Here come the Millennials

Both institutional and retail customers are expected to continue to drive change in the investment management industry. The two customer segments are voicing concerns about fee sensitivity and transparency. Firms that enhance the customer experience and position advice, insight, and expertise as components of value should have a strong chance to set themselves apart from their competitors.

Leading firms may get out in front of these issues in 2017 by developing efficient data structures to facilitate accounting and reporting and by making client engagement a key priority. On the retail front, the SEC is acting on retail investors' behalf with reporting modernization rule changes for mutual funds. This focus on engagement, transparency, and relationship over product sales are integral to creating a strong brand as a fiduciary, and they may prove to differentiate some firms in 2017.

Growth in index funds and other passive investments should continue as customers react to market volatility. Investors favor the passive approach in all environments, as shown by net flows. They are using passive investments alongside active investments, rather than replacing the latter with the former. Managers will likely continue to add index share classes and index-tracking ETFs in 2017, even if profitability is challenged. In addition, the Department of Labor's new fiduciary rule is expected to promote passive investments as firms alter their product offerings for retirement accounts.

Members of the Millennial generation—which comprises individuals born between 1980 and 2000—often approach investing differently due to their open use of social media and interactions with people and institutions. This market segment faces different challenges than earlier generations, which influences their use of financial services.

Millennials may be less prosperous than their parents and may need to own less in order to fully fund retirement. Many start their careers burdened by student debt. They may have a negative memory of recent stock market volatility, distrust financial institutions, favor socially conscious investments, and rely on recommendations from their friends when seeking financial advice.

Investment managers likely need to consider several steps when targeting Millennials.

These include revisiting product lines, offering socially conscious "impact investments," assigning Millennial advisers to client service teams, and employing digital and mobile channels to reach and serve this market segment.

Regulatory developments: Seeking greater transparency, incentive alignment, and risk control

Even with a change in leadership in the White House and at the SEC, outgoing Chair Mary Jo White's major initiatives are expected to endure in 2017 as they seek to enhance transparency, incentive alignment, and risk control, all of which build confidence in the markets. These changes include the following:

Reporting modernization. Passed in October 2016, this new requirement of forms, rules, and amendments for information disclosure and standardization will require development by registered investment companies (RICs). Advisers will need technology solutions that can capture data that may not currently exist from multiple sources; perform high-frequency calculations; and file requisite forms with the SEC.

Liquidity risk management (LRM). Passed in October 2016, this rule requires the establishment of LRM programs by open-end funds (except money market) and ETFs to reduce the risk of inability to meet redemption requirements without dilution of the interests of remaining shareholders.

Swing pricing. Also passed in October 2016, this regulation provides an option for open-end funds (except money market and ETFs) to adjust net asset values to pass the costs stemming from purchase and redemption activity to shareholders.

Use of derivatives. Proposed in December 2015, this requires RICs and business development companies to limit the use of derivatives and put risk management measures in place.

Business continuity and transition plans. Proposed in June 2016, this measure requires registered investment advisers to implement written business continuity and transition plans to address operational risk arising from disruptions.

The Dodd-Frank Act, Section 956. Reproposed in May 2016, this rule prohibits compensation structures that encourage individuals to take inappropriate risks that may result in either excessive compensation or material loss.

The DOL's Conflict-of-Interest Rule. In 2017, firms must comply with this major expansion of the "investment advice fiduciary" definition under the Employee Retirement Income Security Act of 1974. There are two phases to compliance:

- **Phase one** requires compliance with investment advice standards by April 10, 2017. Distribution firms and advisers must adhere to the impartial conduct standards, provide a notice to retirement investors that acknowledges their fiduciary status, and describes their material conflicts of interest. Firms must also designate a person responsible for addressing material conflicts of interest monitoring advisers' adherence to the impartial conduct standards.
- **Phase two** requires compliance with exemption requirements by January 1, 2018. Distribution firms must be in full compliance with exemptions, including contracts, disclosures, policies and procedures, and documentation showing compliance.

Investment managers may need to create new, customized share classes driven by distributor requirements; drop distribution of certain share classes post-rule implementation; and offer more fee reductions for mutual funds.

Financial advisers may need to take another look at fee-based models, if they are not using already them; evolve their viewpoint on share classes; consider moving to zero-revenue share lineups; and contemplate higher use of ETFs, including active ETFs with a low-cost structure and 22(b) exemption (which enables broker-dealers to set commission levels on their own).

Retirement plan advisers may need to look for low-cost share classes (R1-R6) to be included in plan options and potentially new low-cost structures.

Key technologies: Transforming the enterprise

Investment management poised to become even more driven by advances in technology in 2017, as digital innovations play a greater role than ever before.

Blockchain. A secure and effective technology for tracking transactions, blockchain should move closer to commercial implementation in 2017. Already, many blockchain-based use cases and prototypes can be found across the investment management landscape. With testing and regulatory approvals, it might take one to two years before commercial rollout becomes more widespread.

Big data, artificial intelligence, and machine learning. Leading asset management firms are combining big data analytics along with artificial intelligence (AI) and machine learning to achieve two objectives: (1) provide insights and analysis for investment selection to generate alpha, and (2) improve cost effectiveness by leveraging expensive human analyst resources with scalable technology. Expect this trend to gain momentum in 2017.

Robo-advisers. Fiduciary standards and regulations should drive the adoption of robo-advisers, online investment management services that provide automated, portfolio management advice. Improvements in computing power are making robo-advisers more viable for both retail and institutional investors. In addition, some cutting-edge robo-adviser firms could emerge with AI-supported investment decision and asset allocation algorithms in 2017.

Robotic process automation. Look for more investment management firms to employ sophisticated robotic process automation (RPA) tools to streamline both front- and back-office functions in 2017. RPA can automate critical tasks that require manual intervention, are performed frequently, and consume a significant amount of time, such as client onboarding and regulatory compliance.

Change, development, and opportunity

The outlook for the investment management industry in 2017 is one of change, development, and opportunity. Investment management firms that execute plans that help them anticipate demographic shifts, improve efficiency and decision making with technology, and keep pace with regulatory changes will likely find themselves ahead of the competition.

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