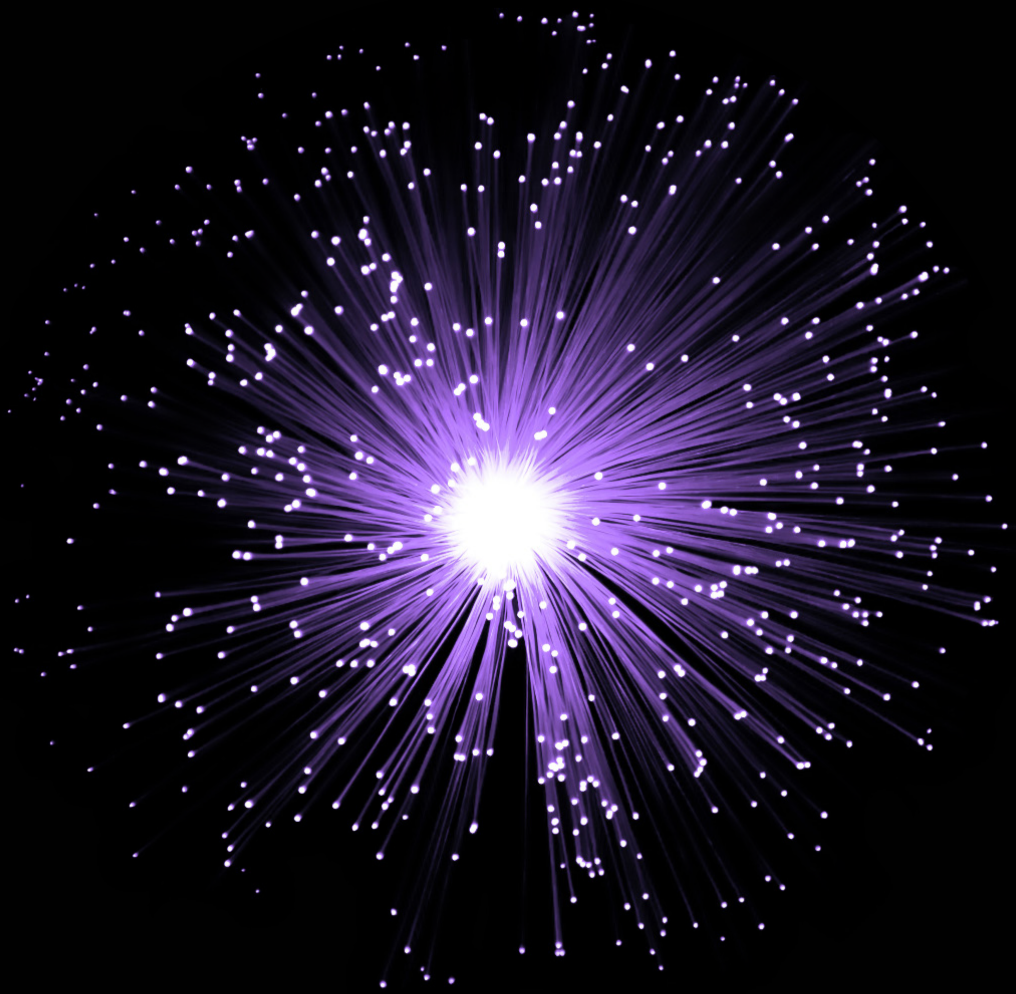
Deloitte.



South African investment management:
Preparing for disruption

“The key to effective innovation is not only to try invent new products, but rather to couple this with an attempt to pre-empt the next move of the market...”

Author:

Angela Costandius
National Asset Management Key Account Manager

Contributors:

Anton van Zyl
Audit Manager: Financial Services

Gregory Tomaselli
Investment Management Assurance Expert

Thomas Burgers
Investment Management Assurance Expert

Contents

Deloitte annually **shares** an examination of the global investment management industry with our clients[1], giving them an **in-depth view of the challenges** and opportunities within the market which assists with their **vision of growth.**

In South Africa, investment management has evolved significantly over the past five years, and in an environment where there is increased emphasis on lower fees, cost and the ever-changing investor needs, it is difficult to find a competitive advantage and remain ahead of the pack. Yes, Investment management is a profitable and exciting business, but there seems to be a blind spot for disruption as the core disruptors go against a set of entrenched principles that have characterised the industry thus far. Therefore, more than ever, it is critical to evaluate the key disruptors in the investment management market to effectively formulate a plan for long-term growth.

Cognisant of these key challenges, we isolated the following key disruptors in the South African market to three elements:

- The Fintech Flurry: The Fintech surge is reshaping the financial sector on a global scale.[2] New technologies have emerged, forcing a change in the current operating models of investment managers.
- The Consumer Conundrum: Macro and Micro: The marketing approach of investment management firms is evolving to meet new demands as Generation X and the Millennials enter the market – these investors have little tolerance for traditional customer engagement, are sceptic, tech-centric and always connected. In addition to the micro-investor, to which target groups should investment management firms direct their efforts given current economic turmoil?
- The Reign of Regulation: Due to the global financial crisis, along with an impending downgrade, the regulators are increasingly focused on transparency, customer rights and timely fund distribution.

The key to effective innovation is not only to try invent new products, but rather to couple this with an attempt to pre-empt the next move of the market, the consumer or the regulator. The question is then only how to do it successfully, while still remaining risk-averse and ensuring that the assets of clients are well-protected.

In order to gear your business for the future, we will unpack these core principles by posing the questions you should consider when devising a strategy for the future regarding your customers, your systems and the regulation that looms.

We hope that this report enables this process in an insightful manner. Please share your feedback and questions with us.

Roger Verster
National FSI Leader

Dinesh Munu
National Investment Management Leader

Angela Costandius
National Asset Management Key Account Manager

1. Deloitte: Investment Management Repositioned: Capitalising on the disruptive forces, 2016
2. Deloitte: How can Fintech facilitate fund distribution, 2016.


Analytics
Audience
Country
City
Home
Dashboard
Reporting
Daily Product Sales by Country

The Fintech Flurry

When applying the technology boom to South Africa, there have been great movements, but as any developing country, we are not on par with our European and American counterparts.

Fintech is a portmanteau of financial technology that describes an emerging financial services sector. Since the end of the first decade of the 21st century, the term has expanded to include any technological innovation in the financial sector, including innovations in financial literacy and education, retail banking, investment and even crypto-currencies like bitcoin[3].

Consequently, there has been exponential investment into this phenomenon, resulting in an explosion of opportunities and threats to the status quo of investment management.

When applying the technology boom to South Africa, there have been great movements, but as any developing country, we are not on par with our European and American counterparts. The major challenge for South Africa is therefore whether we have the right infrastructure when technology does eventually take over.

At this stage, the three most prominent Fintech disruptors out of a South African perspective are crowd funding, the movement from active portfolio management to passive digital algorithms and turning human "silos" of fund management (administration, custodianship, distribution) into technological solutions.

Crowdfunding (Blockchain technology)
Crowdfunding provides investors with a digital platform to pool their money and invest in individual assets at extremely low minimum investment amounts with virtually no costs [4].

Globally, crowdfunding has been making significant waves, with BNP Paribas Group and other similar companies leveraging Blockchain technology to enable private companies to issue securities [5].

Year	Fintech Investments in $ billion
2014	$12.04
2013	$4.02
2012	$2.74
2011	$2.37
2010	$1.82

Source: Silicon Valley Bank Fintech Report 2015.

The crowdfunding platforms usually pass all the benefits and risks on to the investor and charge a small administration fee on the asset value invested through the platform and have developed comprehensive digital CRM solutions that incorporate smart websites and mobile apps that allow the investor to view their portfolio in real time anywhere and anytime.

This significantly appeals to the rising younger generation attracted to direct real time information on hand. Investable assets within current global crowdfunding platforms include global properties of all scales, equity in private businesses, start-ups and other assets that are hard to access for investors that are not ultra high net worth individuals. Equity crowdfunding has already been legalised and regulated in the United States, China, Canada and Europe, which already offers businesses an easier and cheaper way to raise capital than listing on stock exchanges. It also offers individuals alternative platforms to purchase equity stakes in promising businesses.

Direct property investments, which is not offered by traditional asset management, is seen as one of the best investments by most individuals around the globe. As crowdfunding platforms currently offer this type of investment at affordable price points, it has a competitive advantage above vanilla asset managers. In addition to this, crowdfunding offers equity units into commercial properties that are set up as a buy to let model, entitling the investors to the income earned from rentals and any capital growth resulting from upward property valuations.

3. http://www.investopedia.com/terms/f/fintech.asp#ixzz4BOMa0uxS
4. Some platforms offer units in individual investments at a price point of 100 US dollars. There is a further drive to push this down to 1 US Dollar per unit, making it accessible to almost every individual around the globe.
5. http://www.coindesk.com/bnp-blockchain-crowdfunding/

Where investors do not want the risk attached to equity, they also offer debt units into properties, where the investor essentially purchases units into bonds that are issued by property developers and consequently earns interest from the bonds. Examples of the property crowdfunding model include Fundrise and Wealth Migrate.

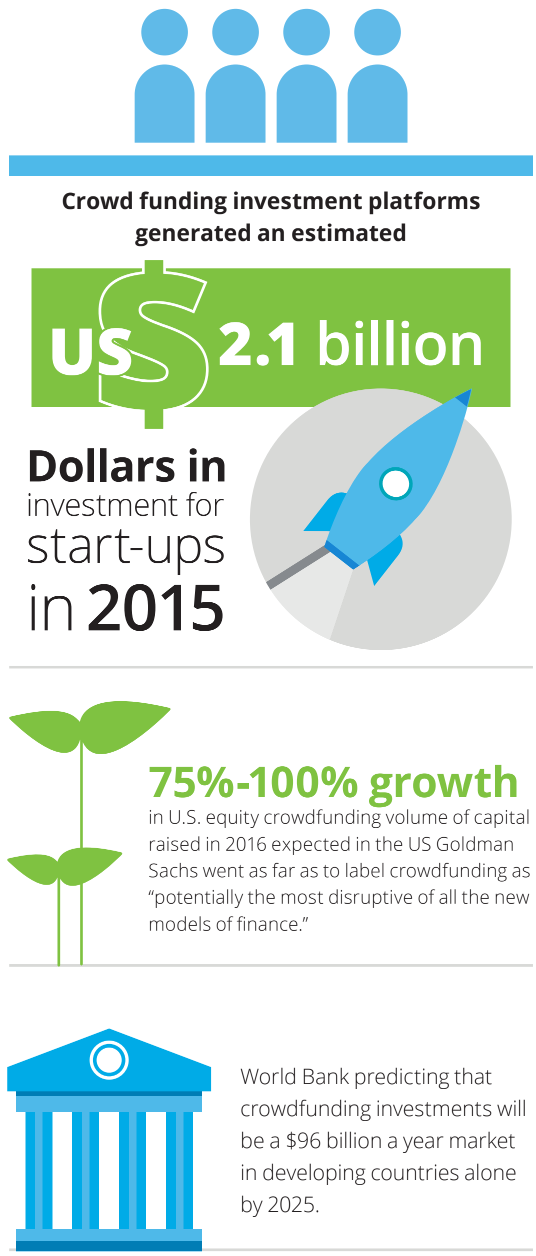
They both employ large professional teams that source and scrutinise properties with their investment grade criteria, providing comprehensive risk management and sourcing the property deals for the individual investors.

Fundrise only operates in the USA, whereas Wealth Migrate is a global company run from South Africa. Wealth Migrate is currently working with the FSB alongside the African Crowdfunding association to implement regulation for the new rising industry in South Africa [6].

Should these regulations therefore be promulgated, it would cause large disruption to the industry.

Crowdfunding is set to be a large disruptor in the investment industry as it has the potential to take market share from traditional investment managers, by offering an alternative approach to investing and exposure to different asset types at a lower cost than traditional asset managers.

Some crowdfunding platforms have gone as far as to offer investors the chance to support or invest in everything from legal battles to travelling around the world, with a potential return on investment. Its appeal to individual investors tired of traditional investment returns will only grow with global capital markets under continued pressure, which is perceived to continue for the next three years.



Source: crowdexpert.com

6. http://propertywheel.co.za/2015/11/crowdfunding-needs-to-come-to-south-africa-says-scott-picken/

While there is a global movement to adopt Blockchain-operated investment management solutions, this is still not widely adopted in South Africa. While the South African government does not view Bitcoin (which was the starting point of Blockchain technology) as a legal form of tender [7], some developed countries, such as the Isle of Man, is currently labelled as Bitcoin Island [8], where bitcoin is used as a currency for everyday transactions.

The movement from active portfolio management to digital algorithms

The biggest change in modern finance was the introduction of the tracker fund in the 1970s. This probed a new school of thought – where the digital processing of mass amounts of data could potentially outperform the active management of funds by human analysts. While active management is long from dead, technology has however enabled the analysis of multiple companies in multiple jurisdictions – enabling the analyst to make more informed decisions than analysing each company manually.

Algorithms are not merely built on past history and mathematical assumptions – many investment managers have combined these models with crowdsourcing data. An example could potentially be an investment manager's holdings in a medical aid company – medical aids become more profitable as their members are healthier, equating to fewer claims. Data collected from medical aid partners such as gyms, supermarkets, health practitioner subscriptions and BMI records could be analysed to determine in-depth probabilities of claim pay-outs, more accurate pricing models and possibly further innovative industry related solutions. The possibilities are endless.

The volume of data worldwide was estimated at 2.8 zettabytes in 2012 and expected to grow to around 40 zettabytes by 2020. New intelligent technologies have emerged to help process vast amounts of data (Big Data). With investment managers now investing in building more advanced analytics and data management capabilities, the industry is going through the same transformation. [9]

Digital algorithms could potentially replace analysts entirely – enabling asset managers to focus on building intelligent algorithms instead of making difficult micro-investment decisions, which is in line with the global move toward technological reliance. Imagine the effect thereof – an algorithm so advanced it mimics the human brain characteristics closely, except it evolves every millisecond.

In an industry where information is power, it is not hard to see how firms that use these technologies may be the long-term winners, nor is it difficult to imagine how such technology could materially drive down the cost of active asset management [10] with leaner and more efficient operating models. In an economic climate where the investor puts pressure on the investment manager relating to costs – the combination of the human mind and technology could be a power tool in creating a competitive advantage.

The rise of the Robo:

Currently there are minimal South African digital back-office solutions, or digital custodians, the current participators in the market are anticipating disruption. Smaller investment managers are cutting costs to remain competitive, and having a digital back office could potentially realise that goal in totality.

A major aspect of the South African investment management landscape currently in transition is the movement from a traditional human investment advisor to a robo-advisor. South Africa's first robo-advisor, Bizank, made large waves in the Investment advisory industry within its first week. SmartRand, InvestOnline, Beanstalk and Sygnia RoboAdvisor followed shortly to participate in the hype.

While investment managers are moving towards an algorithm-based investment decision-making process, there have been large local investments in providing clients with real-time CRM solutions comprising automated advice tailored to the specific needs of the prospective investor.

Historically, an investment advisor would take 3-5% fees off the top of your investment, and the options provided to investors would not necessarily consist of all the humanly available options. Robo-advisors, on the other hand, can currently be accessed as low as 20bps and even free in some cases.

They are currently new on the block, but should be seen as an opportunity for your business to create a completely new investment and digital experience that relates to the new-age investor.

7. A position paper on virtual currencies: South African Reserve Bank Position Paper number 02/2014
8. https://www.cryptocoinsnews.com/isle-man-became-bitcoin-island/
9. Deloitte: How can Fintech facilitate fund distribution, 2016.
10. Deloitte: Investment Management Repositioned: Capitalising on the disruptive forces, 2016

So why does the robo-advisor offer a more attractive option for investment than the traditional salesperson?

- Digital advice is significantly cheaper and less likely subjective investment advice. As the FSB requires the companies that operate the robo-advisors to be licensed [11], it adds comfort around the algorithm and process for the investor.
- It provides a specifically tailored investment solution that aligns to the needs, goals and questions of the customer.
- A robo advisor, as it is based on an algorithm, provides real-time data based on real-time results, paired with real-time advice– enabling the investor to make decisions on real-time events. It also removes the "human" judgement element which may be prone to behavioural biases.

Individuals on the edges of the wealth spectrum

A local barrier to robo-advisors is the unfair spread of investor funds. On the one side, the majority of individuals in South Africa live in poverty, and even though they are the individuals that should benefit the most from lower costs, they are limited as they do not have access to as many computers, smartphones or as much data as these are expensive. [12] This barrier is however becoming less of an issue as smartphones and data become cheaper and poor households adopting a priority for smartphones and internet connections. This increases opportunities for the robo-advisor industry to increase a new segment of customers and assist the poor majority overcoming poverty using this technological revolution.

On the other side, the high net-worth individuals in South Africa, with the most investable funds, are familiar with the screws and cogs of the investment management industry, and would not necessarily engage with traditional financial advisors.

This gives rise to two situations in which innovation can play a great role – how can investment managers get the robo-advisor product to the masses, but also engage the individual with the most investable assets, and convince them to rely on a computer? We do however predict that this is only the beginning of the robo-advisor and that fund managers should react sooner rather than later as robo-advisors present the potential for significant market disruption. The robo-advisor will most likely not replace the human investment advisor entirely, but will provide a platform for individuals on both sides of the South African wealth spectrum an opportunity to engage with an advisor thus expanding the financial-advice market.

Fintech is here to stay – many large investment-management firms are dedicating significant amounts of capital to innovation on a technological front, while small investment-management firms are using technology to replace human capital while still remaining competitive. The solution is to critically evaluate the effect technology could have on your business over the short, medium and long term and plan a pro-active rather than reactive approach – as the reaction could possibly come too late.

Key Questions:

- How is crowdfunding going to affect the investment management industry?
- Are there aspects of the crowdfunding model that traditional investment managers could adapt and adopt?
- How are investment managers going to react to this new entrant and its disruptions?
- How can asset managers remain competitive? How can they lower fees and the minimum investment barriers?
- How can investment managers use information to make better decisions?
- How can investment managers have better data fluency?
- How can investment managers effectively harness Fintech to adapt to their changing customer base and needs?
- How can investment managers engage all investors in South Africa?

11. http://citizen.co.za/1101101/fsb-wants-robo-advisors-licensed/
12. http://businesstech.co.za/news/general/94849/shocking-levels-of-poverty-in-south-africa-revealed/

The consumer conundrum: Macro and micro

Macro

Following the economic crisis of 2008, the debt crisis of 2014, Nenegate and the exceptionally turbulent ZAR/Any other currency exchange rate, investable asset growth have most definitely been turbulent and unpredictable over the past few years. Investment managers have to deal with an unpredictable economic and political situation in South Africa, which follows none of the norms prescribed by traditional economic principles.

This brings forth a few key questions to address when devising a plan for the future – which alternative jurisdictions offer solutions should the downgrade realise and where will future economic growth come from?

The short answer is that there are currently no straight-forward "safe havens" to put capital to work. This being said, due to the South African Rand being relatively cheap at the moment, it does make South African investments look more attractive for foreigners that believe in the return to mean principle. However, for our local investors, due to interest rate hikes, inflation and adverse exchange rates, the average man on the street has very little to no disposable income to invest at this point in time.

South Africa is on negative watch by two of the world's largest rating agencies, Moody's and S&P, therefore there is a risk of downgrade to junk status by the end of 2016.

Should the downgrade occur, it is expected to be felt most by businesses from six months to one year thereafter [13]. This would increase the likelihood of South Africa following the same path that Russia and Brazil did ever so recently. In both these countries, US Dollar denominated bond yields recovered after the initial shock, however they did not return to the same levels prior to the downgrade. Investment managers should thus take proactive steps to make their organisations resilient by looking at possible hedging techniques and innovative solutions.

The investment manager should thus develop a point of view in terms of where the world and consequently South Africa is headed due to the global debt issue (short- and long-term) and how they can effectively trade to capitalise on downturns but also capture the subsequent upsides. Robo-advisors and algorithms can aid the process, but ultimately, following the economic and political developments are crucial to pre-empt the availability and willingness of sovereign creditors to pay their debt [14].

Key Questions:

- What has my business done to ready itself for the impending downgrade?
- Is there something else we can do? Something more?
- How can Investment managers effectively pre-empt and prepare themselves for further economic and political instability?
- How can investment managers structure products to organically grow business despite investors having marginally less disposable income?
- Should local investment managers opt to domicile additional products in an offshore location in addition to their local operations to maintain a flow of money from foreign investors should local products become sub-investment grade?
- Should the impending downgrade occur, how can I reengineer my business to save costs? Automation, value-chain reengineering, or leveraging partnerships?

13. http://www.engineeringnews.co.za/article/businesses-must-avoid-a-knee-jerk-response-to-crisis-events-like-a-ratings-downgrade-says-deloitte-2016-06-08/rep_id:4136
14. Deloitte: Investment Management Repositioned: Capitalising on the disruptive forces, 2016

Micro

In order to efficiently and effectively sell a product, one needs to understand the market and the customer. With a population of approximately 54 million people, close to 60% of whom are under the age of 35[15], investment management companies cannot merely rely on the retirement money of ageing individuals.

The up and coming group of individuals are vastly different from the Baby Boomers – Generation X and Millennials, labelled as a quirky bunch of sceptical individuals, do not follow the norms of old – and to prevent these individuals from becoming competitors rather than customers, it is imperative that their needs be understood and business models realigned.

Millennials are tech-centric, ever-connected and prefer technological communication rather than human interaction.

They want to feel special and consequently require investment advice that is tailored to them specifically, and they want to be in the position to control the resulting investment.

As a consequence, robo-advice is expected to gain traction in the coming years, due to the mind shift of the individuals entering the market.

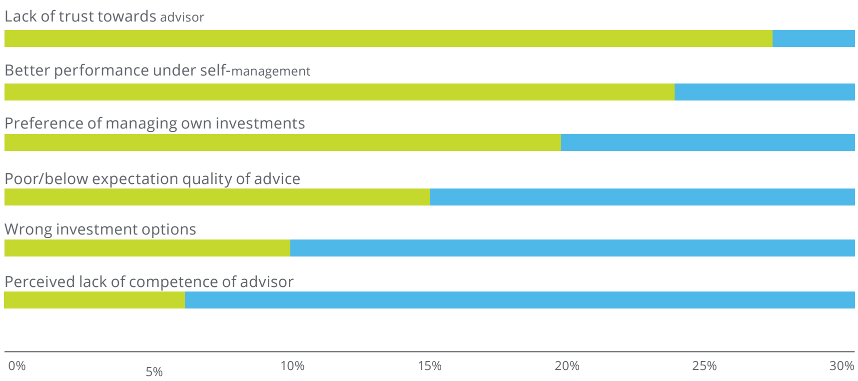
These investors are more sceptical of traditional advice than previous generations – they believe in the wisdom of their peers and consequently procure as much information from as many sources as possible before making a decision. This information could potentially include experts but in more situations include google, their friends or colleagues.

They expect to access their investment information at any time, at any place and through various channels – and this challenges current investment managers to invest in their online client experience and service level.

Key Questions:

- How can investment managers own the customer experience in a world of new entrants?
- Will my business be relevant in 10 years' time? How?
- Does my business understand, and is it geared to serve a younger population?

Source: Deloitte: How can fintech facilitate fund distribution: 2016



Mentalities of the Re-wired Investor	Implications to IM firms
Just me	*Tailor-Made* Investment advice and products perceived to be tailored to individuals on at a time
Stay in control	*Multi-channel* Access to multiple channels and several advisory models at the same time
Do it yourself	*Multiple sources of advice* Not just from one advisor, but from other advisors, peers, experts and social media
Anywhere, anytime	*Rich digital front end* Expectations formed interacting with non-FIs; must be simple, intuitive, self-directed
Digital & Personal	
Wisdom of my tribe	*Risk Management as Hedging* Downside protection and hedging more diversification
Sceptical of authority	
Risk defied as downside	*Democratisation of Investments* Access to same high yields assets & strategies once available only to wealthier investors
Not a second Class Investor	

15. http://www.investinginsouthafrica.co.za/downloads/en/Webber_Wentzel_Investing_in_South_Africa_complete.pdf

The Reign of Regulation

Due to the global financial crisis, and an impending downgrade, the regulators are increasingly focused on transparency, investor rights and fund distribution. Since 2008 there have been great changes in the regulatory landscape with increased focus on investment managers.

Regulation shouldn't be an act of just ticking boxes – it should be an act of regulating behaviour. That said, the more economic or political issues arise in the world, the more regulation follows with boxes to tick. The question is then, how investment managers can ensure that their businesses are continuously compliant?

The simple answer is to look around the world – if the past repeats itself, pioneer regulation in Europe and the US will follow suit in South Africa. For example, Europe has regulations similar to POPI in play at this point in time, where businesses are not allowed to transact with European businesses unless they comply with these regulations – lessons can thus be learnt from European companies regarding the implementation of these regulations that could be used when POPI is promulgated in South Africa. Another example would be robo-advisors – the SEC has regulated certain algorithm elements of investment models – at this stage, the only regulatory requirement of a robo-advisor in South Africa is that the company that owns and operates the robo-advisor should be licensed, but as (the inevitable) loopholes and crime perpetuates, additional regulation will come into play.

Due to the many financial crimes in South Africa [16], political and economical instability, there's a lot of distrust in the investment management market – investment managers therefore need to think how they can use regulation to rather incorporate an element of trust than view it as a grudge purchase. That being said, distrust in the investment management market is not unique to South Africa – there is a sentiment shared among worldwide investors that investments "over promise, over charge and under-deliver" [17]. Therefore, in addition to changing the minds of sceptical investors, investment managers should employ a prospective approach in terms of regulation – not a remediating one. Looking at developed countries and the movement in those markets creates a great platform for proactive innovation in local markets.

The solution is fairly simple in all circumstances – having a system that is flexible, which can facilitate change – such a system would give one investment manager competitive advantage over another, merely because time is money. Take the introduction of FATCA as an example – some investment managers had systems to facilitate the specific identification of US investors right away, whereas other investment managers had to create completely new systems and consequently carry hefty fines on their income statements. A future-proof, innovative system really can make all that difference. In addition to this, pro-actively engaging with regulators through co-operative feedback on regulations could ensure that your business is on the forefront of new regulatory developments. European players have employed a Fintech solution, called Regtech [18], a technological solution for regulatory compliance.

These products evaluate regulatory changes across the world and provide compliance officers with a global and local view on compliance, aiding a prospective approach to compliance and consequently increasing investor trust.

Regulation is not a disruptor that can be tested or ignored – non-compliance can cause the destruction of a business, as the investment manager is responsible should one of the elements of an investment product not function.

Key areas that investment managers should be looking at in terms of regulations and compliance is fee arrangements, payment for distribution, trading, valuation, consumer protection and the selection of third-party service providers [19]. These topics have been the major themes of the regulation of developed markets during the past year.

Therefore, this disruptor provides a unique opportunity for investment managers to change a grudge purchase into a competitive advantage by merely looking at the world and various market developments.

Key Questions:

- How can investment managers "always" be compliant?
- What is the cost of compliance and how can investment managers lower it over the long term?
- How can investment managers learn from others to pre-empt regulatory change?
- Is the system in my business geared for change?

16. http://www.mie.co.za/articles/press-office/white-collar-crime-a-threat-to-sa-businesses/195
17. http://www.institutionalinvestor.com/article/3544388/asset-management-equities/asset-managers-prepare-to-have-your-business-disrupted.html#/.V13XvLt95D8
18. Deloitte: How can Fintech facilitate fund distribution, 2016
19. Deloitte: Investment Management Repositioned: Capitalising on the disruptive forces, 2016

Conclusion

The three disruptors explored open up many questions and debates – who will be first? Who will fail? What is going to happen?

It's simple. For example, in a job interview, if you state the same skills as everyone before you, you will most likely not get the job. What makes you different? Do you understand the people who are interviewing you? What do they want and how are you aligning yourself to that? Which skills set you apart from everyone else?

When applying that to the investment management space, it's an exact parallel. Investment managers who are unwilling to change will be left behind – people are changing, the technological landscape is changing and regulators are becoming more involved. The choice is simple – investment managers who have a large range of products, but don't particularly excel in each will most likely lag behind – specialise, and communicate that specialisation.

The key to effective innovation is not only to try inventing new products, but rather to couple this with an attempt to pre-empt the next move of the market, the consumer or the regulator. The question then is how to do it successfully, while still remaining risk-averse and ensuring that the assets of the clients are well-protected and preserved. Consideration should be given to improving existing products, but an absolute reliance should not be placed thereon.

Consequently, the reality is that asset managers who are weak due to not embracing innovation, will most likely be absorbed by the ones who embrace it or face going out of business. Similarly, large and successful investment managers that underestimate the amount of change might become weak over the medium term.

Large and small does not predict success – sharp focus, and forward thinking does. Disruption is not an option, it's not a maybe. It's a definite.

Deloitte.

Designed and produced by Creative Services at Deloitte, Johannesburg. (812248/ame)