



WHITE PAPER

Asset Management in Germany—The Problem Goes Deeper Than the Crisis

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This paper refers to the impact of the crisis on the financials and business model of asset managers. Beyond this, and more significantly, the COVID-19 crisis poses enormous challenges to personal health, society and the economy in general which are not discussed in this paper.

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Executive Summary

Quo vadis, Asset Management? The German asset management market grew at an impressive rate over the past decade, with AuM rising by 7% annually, driving up profits across the industry. Now, however, the turbulence caused by COVID-19 has put fund managers in crisis mode. The current period will hurt asset managers, and if they don't act decisively to stabilize operations and engage with clients, it will have a more severe impact on profitability than necessary. However, even in light of the crisis, asset management is a fundamentally strong business model and the crisis per se does not seem to pose an existential threat to asset managers.

MAYBE THE PROBLEM GOES DEEPER THAN THE CRISIS.

The real threat to the industry is not the crisis; it is underinvestment in true innovation. Just 20% of asset managers globally (few of them in Germany) have embarked on fundamental, technology-driven transformations. The past decade of growth has overcompensated pressures such as fee erosion, performance challenges, and growth in fixed costs, and has led to underinvestment in innovation. It might take a crisis to highlight the need to upgrade decades-old business models.

THE CRISIS MIGHT BE A CATALYST.

In times of crisis, two areas commonly see cuts: costs and investments. Investments of German asset managers are especially at risk. Many German asset managers are affiliated with a bank or an insurer—two segments that are generally struggling with regulatory burden and margin pressures and have been hit hard by the COVID-19 crisis.

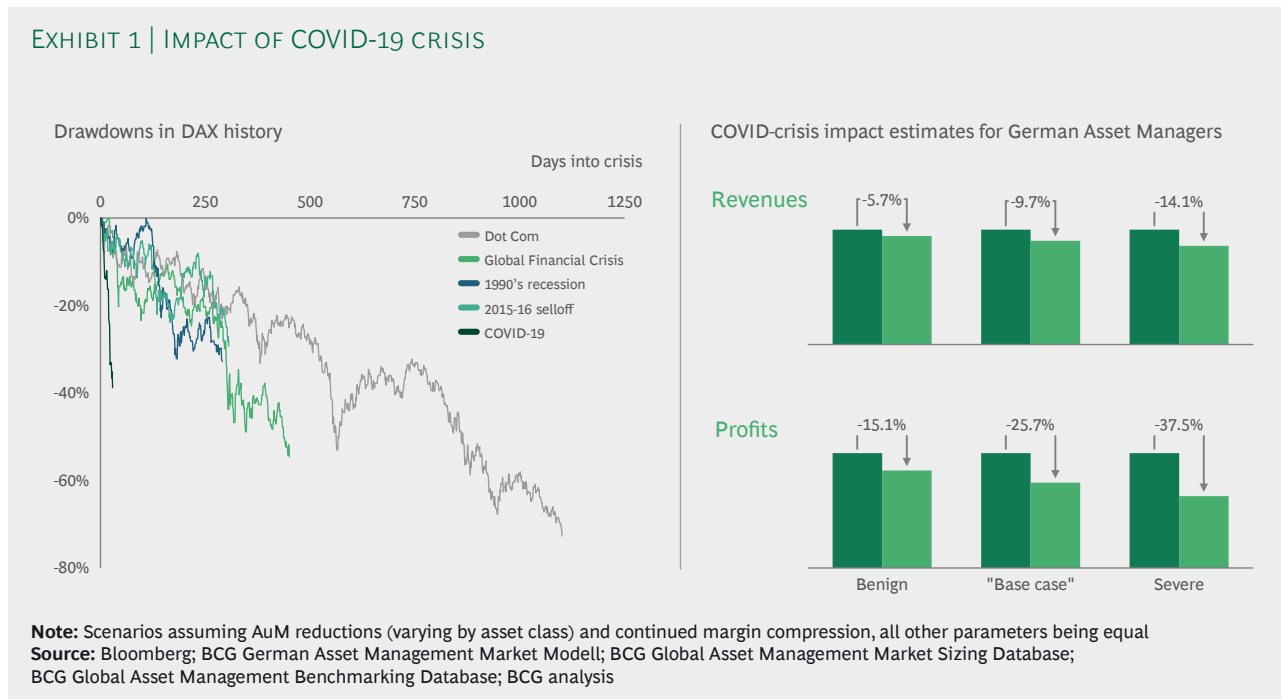
Paradoxically, this time of crisis may be the most important time to invest. We believe the inflection point for change could come from two scenarios: First, if there is a time when the dominance of proprietary retail distribution channels can be challenged, it's a time when people stay at home and have an opportunity to explore digital alternatives. Second, if international asset managers are planning on entering the German market, a time at which incumbents are not significantly investing would be the best time to do so.

We believe that only those asset managers that think strategically about critical investments for their future competitiveness will come out stronger from this crisis. To do this, we recommend adding a dedicated element to asset managers' COVID-response: The assessment of strategic investments and opportunities. Acting in the midst of the crisis is tough but will prove worthwhile, as the experience from other crises has shown.

The Business Model is Fundamentally Strong

Over the past decade there was hardly a week without a new article predicting the end of asset management as we know it. Passive investing is putting pressure on fees, AI and big data analytics are fundamentally changing the investment approach, and consolidation will banish mid-sized players, was the common understanding.

Yet, despite all this, and despite COVID-19, the industry is still alive. To be sure, the crisis will hurt asset managers, and restoring profitability to pre-crisis levels will take time. The industry has seen the sharpest downturns in equity indices since the 1950s, with the German DAX-30 dropping by 39% in just 29 days. This impacts earnings. In our base case scenario, German asset managers are likely to see a 9.7% drop in revenues and a 25.7% reduction in profits, given the high share of fixed costs. It hurts. But for being such an outlier event, the magnitude of this crisis is far milder for asset managers than the impact of similar rare events on other industries—remember the rate of survival of tech players in the dot.com crisis.



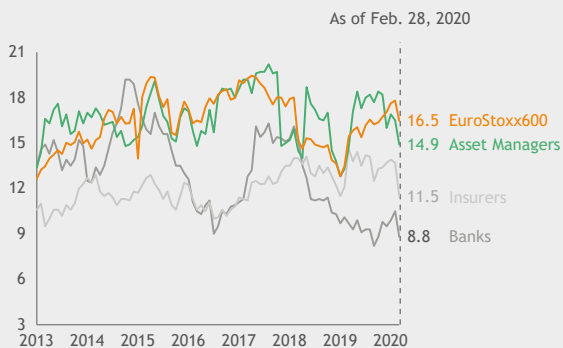
One of the beauties of the asset management industry is that client assets deliver recurring revenues. And those assets are sticky—over the past decade the net flow rate explained just 7% of variation in profit growth, BCG analysis shows¹. Revenue models in other industries are not that forgiving. When airlines do not fly, their revenues drop to zero. When OEMs halt production, suppliers' razor thin margins turn negative.

1. BCG Global Asset Management Benchmarking Database 2019

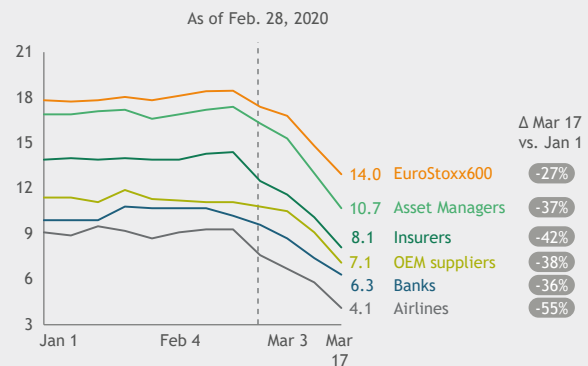
The industry's underlying strength is reflected in valuations. While European asset managers trade at 10.7x their earnings, insurers and banks trade at only 8.1x and 6.3x respectively². European Airlines, on the other hand, trade at a PE ratio of 4.1x, down by 55% since the beginning of the year, and OEM suppliers are at 7.1x earnings, down by 38% over the same period. Asset managers are also relatively profitable, turning 37.6% of every euro earned into profit³.

EXHIBIT 2 | PRICE-EARNINGS RATIO DEVELOPMENTS

Monthly PE ratios of European Asset Managers, Insurers and Banks



Weekly PE ratios of European Industries



Source: Refinitiv Datastream; BCG analysis

Of course, asset managers must take swift action to manage the crisis. If they do so, the crisis might be a set-back but not a fundamental threat. The business model of (even active) asset managers remains solid and stable client franchises and proprietary distribution channels pose barriers to entry. All is good. Anyway, how likely is a disruption of the industry that incumbents do not see coming?

2. As of March 17, 2020

3. BCG Global Asset Management Benchmarking Database 2019

The Problem Goes Deeper Than the Crisis

Some industries fundamentally changed in recent years, even in the absence of a crisis. This was change that most did not see coming. However, when it happened, it happened very fast. It is hard to know when real transformation is necessary. In the beginning new models and technologies are questionable, unstable, or at best experimental. Then, at some point, everything changes fast. Very fast. Application of new technologies becomes exponential and those that missed boarding have to take the bus (ask some OEMs).

Change in the asset management industry has been coming for a long time. Technology has unlocked many opportunities, and other industries have provided examples of innovation in customer engagement. However, on the back of a decade of growth and high barriers to entry from proprietary distribution channels, the German asset management market has been protected—firms were missing a “burning platform”. The result was that many German asset managers under-invested in true competitiveness.

On a global basis, we see only about 20% of asset managers embarking on large scale digital and analytics transformations. They differentiate their offerings, brands, and customer interaction, exploit analytics at scale, and relentlessly drive operational excellence to create the required room to invest. The remaining 80% of fund managers are not this far along the road. Among a larger list of potential focus areas, we see four in particular which can make a difference.

#HOW MUCH DO YOU (REALLY) KNOW ABOUT YOUR CUSTOMERS?

Other industries led the way. The more knowledge a firm has about its customers, the better and more targeted it can make its product design, marketing, and customer relationships. What makes this kind of virtuous cycle harder to achieve for German asset managers is the fact that they have little knowledge about their retail customers because they do not have direct customer access or decided not to invest in the necessary tools and channels. Thus, market segmentation has taken the form of offering new funds. The result is over 14,000 funds for sale in Germany. Pressing more and more funds into the market has been a way to differentiate and segment the market.

Even those asset managers with affiliated distribution channels could nurture and further invest in their channels. Their distribution channels hold a substantial amount of customer data, but asset managers barely tap into this data pool as most have not negotiated direct access to the customers or their data. One solution could be to provide their channels with a distribution analytics solution “as a service”. Asset managers could also actively help their channels to improve the customer experience and platform usability around fund products (online and offline) or negotiate direct customer access. All that is required is that they make the strategic decision to do so.

In contrast to their German counterparts, many fund managers in the US and elsewhere have established direct retail channels at scale. In Germany, robo-advisors, wealth-techs and fintechs are picking up the baton, and recording high growth rates from small bases. However, it's probably only a matter of time until larger competitors create direct-to-customer retail franchises.

#PRODUCTS THEY WILL LOVE

German asset managers were strong in capturing customer demand for ESG investing. They could now differentiate by strengthening the full integration of ESG factors (all of the three letters) into the investment processes. They could go further and embed ESG factors in private market investments, strengthening asset managers' purpose when funds are invested in projects customers deem value-adding in a social context, e.g., community investing. Other opportunities include new private market investments, cost efficient SAA wrappers, and investment allocation advice rather than mere product advice.

#ADVANCED ANALYTICS@SCALE

Capital markets today are dominated by professional investors. Legions of CFAs work at asset owners and managers and the majority of trades on global markets are performed by computers. These computerized trades reflect new information through automated processing almost instantaneously – and we expect information aggregation of markets to continuously accelerate. On the investment side, fully automated and AI-supported investment decisions are increasingly becoming mainstream. Around 20% of asset managers have made the transition, leveraging applications such as natural language processing, sentiment analyses, and computer vision, and processing new information at lightning fast speed. Others need to catch up. The secret sauce to make this work is not only to hire data scientists that look for the needle in the haystack and find algorithms that outperform. It requires a clear perspective on a fund manager's alpha framework, support from portfolio managers complementing data scientists' teams, and, fundamentally, access to (alternative) data.

Beyond portfolio management, investment in operational analytics is a no regret move that can be undertaken in all climates. Potential applications include higher levels of self-service and bot functions in central teams, AI-based identification and screening in risk management and compliance, agility in product and IT development, and faster data management across the organization. These together can help firms cut costs by 15%-30%⁴. At the current time, many asset managers are experimenting with advanced analytics, but few are committed to applying technology to fundamentally transform their companies at scale, i.e. in all elements of the value chain.

4. See BCG Global Asset Management report 2019

#COST CONSCIOUSNESS

While the revenues of European asset managers grew at 3.7% annually over the past decade, cost rose almost in parallel at 3.2% a year⁵. This narrow difference is surprising as most of asset managers' expenses are fixed, personnel costs. However, when revenues are down, the largest share of costs does not evaporate but instead directly hits profit margins. Asset managers are well aware of that. But as in all industries, upturns allow more room for budget increases, which are often spread across all units without true big bets. And because culture is such an important aspect at fund managers, nobody likes to rigorously address costs in these times. The high variance of cost-income-ratios, ranging from 54% in the first quartile to 77% in the third quartile globally, is one result of this, and an indication that operational excellence has not yet been fully implemented across the industry.

CHANGE IS HARD

None of these points above should come as a surprise. Over 60% of companies in our 2020 transformation survey state that digital transformation has a high, or the highest, priority. Yet, only 20% of companies feel prepared for the challenge. In asset management, many firms have created digital teams and are experimenting with use cases. But just like a good compliance department cannot create a "compliant" company, even the best digital teams cannot create a digital transformation by themselves. Successful transformations are complex, multi-faceted, and leverage capabilities across the organization. Essential ingredients include i) a highly-focused strategy, ii) the mobilization of the entire organization to build skills and develop the necessary culture, and iii) the commitment of senior management and stakeholders. A transformation is a journey that needs to be nurtured and should not be stopped half-way through.

The crisis might be a catalyst

In times of crisis, two areas commonly see cuts: costs and investments. The costs and inefficiencies that crept into systems in upturns are now being addressed. However, due to the high share of fixed costs in the industry, fundamental cost reductions are slow to take effect. Cutting investment is faster.

Most managers will argue that investment during downturns is critical to coming out stronger. And this is true. However, two realities often impact this noble notion: The first is that two thirds of German asset managers are affiliated to banking or insurance groups, both of which are suffering from regulatory burden and margin pressures in general and have been hit hard by the crisis—banking PE ratios down by over 36% and insurers PE ratios are down by over 40%⁶. The second is psychological; if a firm has failed to tackle fundamental investment needs before the crisis, it is unlikely it will be motivated to do so during a crisis. Rather, it is liable to reduce budgets across the board, making it harder to execute bold moves.

The paradox is: While many asset managers' ability to invest in a downturn are limited, this crisis may be the most important time to invest—for two primary reasons:

- The German retail asset management market is dominated by captive distribution channels. If there is one scenario in which captive distribution channels can be attacked, it's a scenario when everybody stays at home. Customers may learn that certain direct channels may offer the same benefits without the need for a middleman.
- If international firms plan to enter the German market, a time at which incumbents are not investing much would be the best time to do so. In addition, foreign fund managers (especially US managers) have structural advantages. Labor protection laws allow faster implementation of restructuring, therefore tying up less management attention. Moreover, they embarked on fundamental transformations much earlier than their German peers, given the extreme competitiveness of the US asset management market.

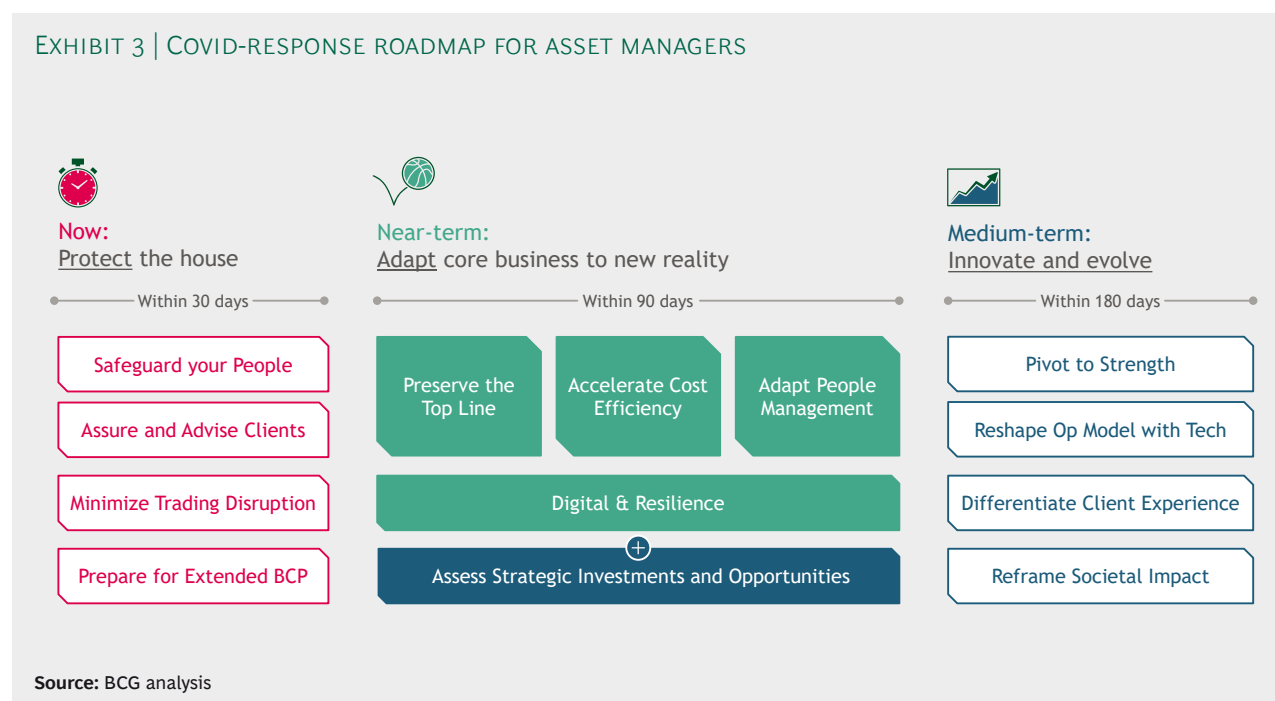
A decisive turning point for asset managers will be whether they think strategically about the critical investments for their future competitiveness and react with enough strength and persistence even in the midst of the crisis. How can they achieve this?

Getting There—Giving Your COVID-response a Strategic Element

All asset managers across the globe have started to tackle immediate priorities in the COVID-crisis. They have set-up crisis-response teams, ensured employee safety as well as operational continuity, and engaged in discussions with their clients around the resilience of their investments. While those activities continue, many are starting to move in a second phase to preserve top-line and cash-flows, and reinforcing operations in light of travel restrictions.

We believe asset managers should include one critical element in this phase: The assessment of strategic investments and opportunities. In a separate team from the crisis-PMO, firms should, on the one hand, assess the strategic investments that will make a long-term difference to their firms' competitiveness. On the other hand, they should assess whether strategic opportunities have opened up, for example as valuations have been hit or other firms cut investment or withdraw from potential bids.

The discussions CEOs need to have with their management teams and, where applicable, holding companies, should lay out a strategic roadmap toward future competitiveness and the market forces these countercyclical investments address. Many managers know that holding companies can be tough negotiators for cash flows, especially in times of crisis.



BOX: A ROADMAP FOR COVID-RESPONSE

Taking decisive but structured action during the crisis should be on top of asset managers' minds now. At the same time, a crisis is also a decisive turning point, partially deciding how each individual firm will be able to compete in the future. Therefore, we suggest including the assessment of strategic investments and opportunities, run by a dedicated team, as an essential element of each fund manager's crisis response. Overall, the crisis response should entail these elements:

1. Protect the house on four fronts:

- **Safeguard your People:** Establish remote and agile ways of working, create clarity and security around the operating model and support those in need
- **Assure and Advise Clients:** Prepare the salesforce for difficult client discussions and create a COVID-19 investor hub for firm insights
- **Minimize Trading Disruption:** Ensure access to trading platforms and liquidity; continually monitor counterparty health; strengthen processes for issue resolution (e.g., failed trades) to protect firm in volatile markets
- **BCM/Operations:** Mobilize a "war room" for rapid decision-making, ensure the back and middle office are equipped for increased volumes; check cybersecurity

2. Assess investments and opportunities alongside other critical activities:

- **Preserve the Top Line:** Defend revenue stream by using advanced analytics to identify at-risk clients and deploy targeted retention efforts
- **Accelerate Cost Efficiency:** Undertake an end-to-end review of cost structures; track bottlenecks under reduced capacity to understand true capacity needs
- **Digital & resilience:** Train the sales force in virtual selling
- **Adapt Talent Management:** Drive performance in the new environment (e.g. invest in virtual teaming technology, promote mental health, and maintain a strong culture)
- **Assess Strategic Investments and Opportunities:** Ring-fence budget for targeted investments in future competitiveness; evaluate potential M&A or team lift-outs

3. Build on the previous phase and plan for new realities post crisis:

- **Pivot to Strength:** Evaluate and execute organic and inorganic growth opportunities
- **Reshape Operating Model with Technology:** Review the operating model; harmonize and digitize processes along the value chain
- **Differentiate on Client Experience:** Leverage digital, data & analytics to unlock personalized client experiences across products
- **Reframe Societal Impact:** Revisit firm mission and translate purpose in context of crisis; accelerate integrating ESG in core investment processes

CHALLENGING BUT WORTHWHILE

It is no easy task to overcome the temptation to cut costs across the board. Achieving the right mix between earnings management and investing for future competitiveness requires highly structured and unbiased discussions.

Some room for investment could come from existing COVID-response measures and beyond. For instance, most asset managers have put in place first measures to save discretionary spend. Out of necessity, most firms are also applying remote working at scale and managing their operations at reduced capacity in several functions. Asset managers should leverage the learnings from this phase to gain an enhanced understanding of real capacity requirements and real need for discretionary spend.

The most important question will be where to invest in this time of crisis. The answer is “boring”: The fact that business models have not fundamentally changed over the past decades and that most firms have not acted decisively enough leaves the same topics on asset managers’ lists for many years now. Exhibit 4 gives an overview of areas in which the top players in the industry engage and we have described the key areas in which most German asset managers have room for improvement. To leave this crisis in a position of strength, a laser sharp focus on the very few investments that will fundamentally improve future competitiveness is now of utmost importance. We recommend identifying those high impact investments in the context of the COVID-response plan, which can be done most effectively by setting up a dedicated team for this specific task. Acting in the midst of the crisis is tough but worthwhile, as the experience of other crises has shown.

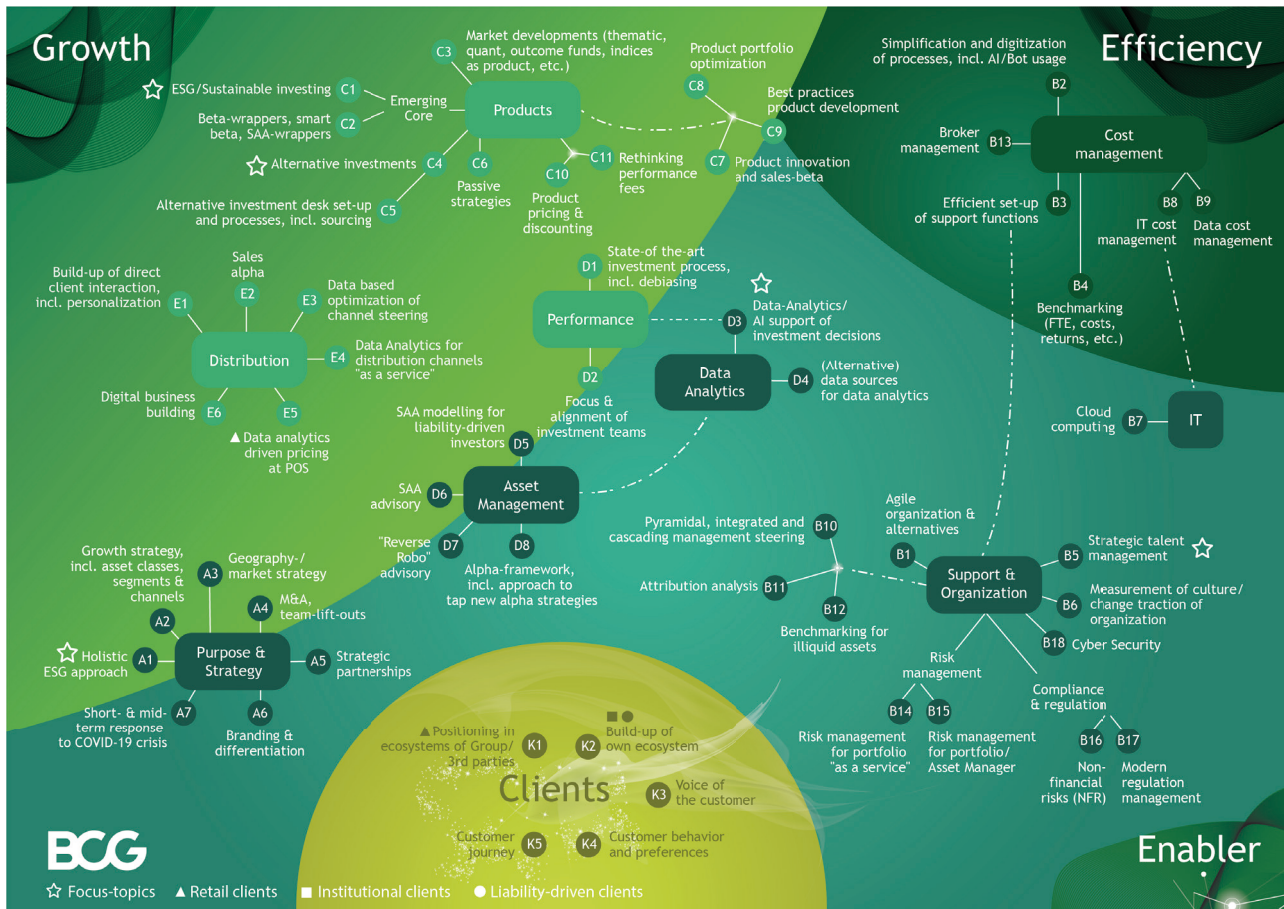


EXHIBIT 4 | Overview of core-themes for Asset Managers

Conclusion

Under current assumptions, most asset managers will survive this crisis. Their earnings and valuations will be hit, but they will not be forced to close their shops. At the same time, some asset managers will be able to use this period of crisis to nurture and build a competitive advantage, creating a tailwind for when they come out of the crisis.

Many, however, will be restricted by other than direct business reasons to reduce investments and will therefore need to achieve future earnings targets in their current operating models. Expect, however, that asset managers that have the resilience to act along several dimensions proposed above, and that do so with a clear perspective on how they want to compete in the future, will be those that lead the industry on profitability in the future.

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