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Global Asset Management 2013

Capitalizing on the Recovery

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Global Asset Management 2013

CAPITALIZING ON THE RECOVERY

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INTRODUCTION

Global Asset Management 2013: Capitalizing on the Recovery is The Boston Consulting Group's eleventh annual worldwide study of the asset management industry. This year's research shows that the global asset-management industry has finally returned to a growth path, winning a welcome respite after four years of stalled growth. Both total assets under management (AuM) and profits as a percentage of revenues nearly returned to precrisis levels.

Although these results reflect the beginning of a recovery, the increase in net new assets is relatively modest overall. In addition, managers face market volatility, weakening of some revenue margins, and wide variations in performance among managers, products, and regions.

The decade since BCG's first annual Global Asset Management report has seen steady growth in the breadth of our market-sizing research and benchmarking studies. The goals of the research, however, have remained steadfast: to probe beneath the surface of the market landscape, identify trends, and provide insights aimed at helping managers build strong and prosperous paths to the future.

Key Market Trends and Recommendations

While traditional actively managed core assets grew in 2012, we believe that this asset class will remain vulnerable to the market's evolution. Managers need a long-term strategy that anticipates those changes.

This report discusses in particular detail the following trends and strategic recommendations:

- The continuing fast growth of solutions and specialties confirms a structural shift in the market. The advance of these asset classes will continue to outpace the growth—and squeeze the market share—of traditional actively managed core assets. Traditional managers hoping to surf these new flows successfully should be ready to face fundamental decisions about how to participate and what capabilities to develop.

- The most successful managers in every region are either specialists or traditional providers who have become "ambidextrous"—that is, they have maintained their active core-asset businesses while also developing capabilities to capture new faster-growth assets. For traditional players, investment in specialties, multiasset skills, or specific services will be a key to participating in the new, faster-growth flows.

- Cost discipline has become an increasingly important focus since the crisis. Although efficiency gains in basis points from 2007 through 2012 were largely driven by the growth of asset values, managers are now more actively managing their cost structure.

- The operating model is a growing source of strategic advantage. For many managers, an aggressive operating-model review will be required to realize their growth ambitions. Operations and IT have been largely bypassed in asset managers' efficiency campaigns, which usually focus on other corporate and front-office functions. That is a costly lapse, strategically as well as financially. Reviewing the operating model—beyond boosting efficiency—is the key to flexibility, scalability, and future growth. A review provides managers the blueprint they need to unlock cash and to free management attention for product innovation, entry into new asset classes, and development of client relationships.

Like its predecessors, this edition of our report reflects a comprehensive market-sizing effort. We covered 42 major country markets (representing more than 98 percent of the global asset-management market), focusing exclusively on assets that are professionally managed for a fee. We also conducted a detailed analysis of the forces that are shaping the fortunes of asset management institutions around the globe.

In addition, this report contains conclusions drawn from a detailed benchmarking study of more than 120 leading industry competitors—representing 53 percent of global AuM—that BCG conducted early in 2013. Our aim was to collect data on fees, products, distribution channels, and costs in order to gain insights into the current state of the industry and its underlying drivers of profitability.

A SNAPSHOT OF THE INDUSTRY

The global asset-management industry achieved a year of substantial growth, winning a welcome respite in 2012 after four years of relative stagnation. Both total assets under management (AuM) and profits as a percentage of revenues nearly returned to precrisis levels.

The global value of AuM rose to a record high in 2012, surpassing for the first time the precrisis level of global AuM that had been reached in 2007. AuM increased 9 percent to $62.4 trillion, compared with $57.0 trillion in 2011, and $57.2 trillion in 2007.[1] (See Exhibit 1.)

At the same time, the growth of the industry's AuM was driven largely by the rise of global equity and fixed-income markets—which pushed up the value of securities underlying managers' assets—rather than by net new asset flows.

Net new assets rose 1.2 percent—their strongest growth since the 2008 financial crisis and a healthier advance than the scant 0.1 percent rise in 2011. Still, the increase was modest compared with annual advances ranging from 3 to 6 percent in the years before the crisis.

Operating margins—or profits as a percentage of net revenues—rose to 37 percent in 2012 from 36 percent in 2011, nearly attaining precrisis levels of 38 percent. Profit in absolute terms was $80 billion, a 7 percent increase from the 2011 level of $74 billion. However, it remained roughly 15 percent below precrisis highs. The lower absolute profits were the result of an overall decrease in revenue margins due to a continuing, structural trend toward lower-margin offerings such as passive and fixed-income products.

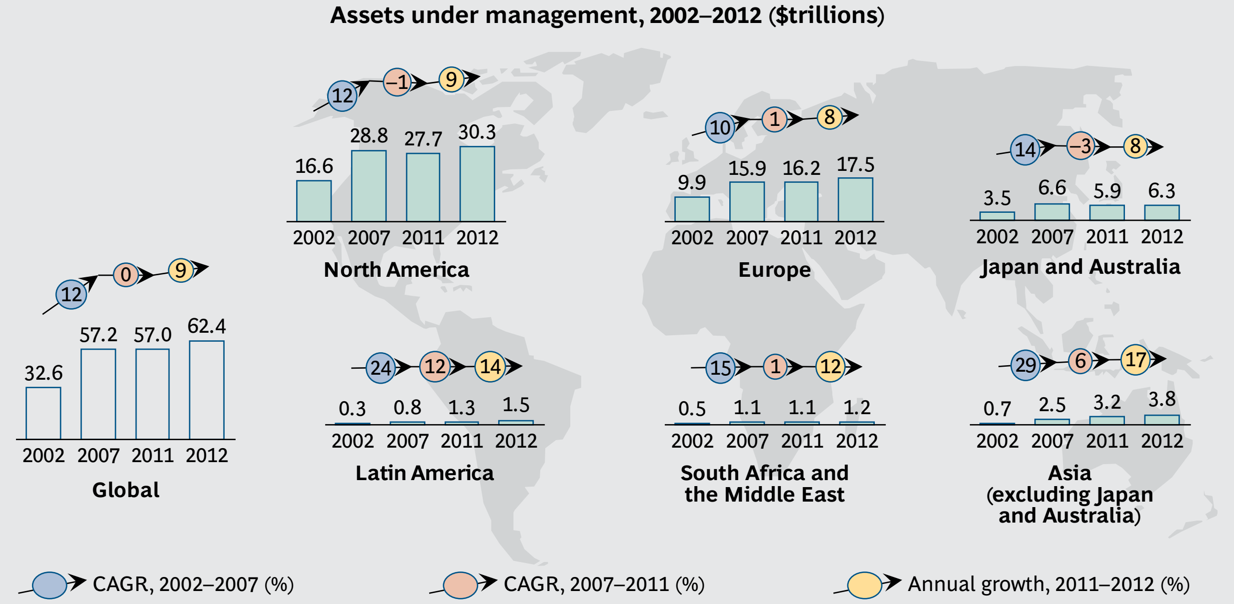
The 2012 results were a positive change from the year before, when the industry's growth remained stalled, as we noted in *Global Asset Management 2012: Capturing Growth in Adverse Times*. AuM had essentially flatlined in 2011, managers failed to attract substantial flows of net new assets, and operating margins remained flat.

Recovery Masks Divergence and Risks to Growth

Yet while 2012 marked a return to growth, the improved economic fundamentals and the rise in total AuM masked wide variations in performance and outlook among regions, products, and asset managers themselves. In particular, we observed the following trends—the first three of which are mutually reinforcing—that are redefining the competitive landscape of asset management:

- A quarter of managers globally experienced significant erosion of their traditional actively managed core-asset base in

Exhibit 1 | Global Assets Under Management Grew to a Record $62.4 Trillion in 2012



Source: BCG Global Asset Management Market-Sizing Database, 2013.
Note: Sizing corresponds to assets under management (AuM) sourced from each region and professionally managed in exchange for management fees; includes captive AuM of insurance groups and pension funds if those AuM are delegated to asset management entities with fees paid; 42 markets covered globally, including offshore AuM. North America = Canada and the U.S.; Europe = Austria, Belgium, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Russia, Spain, Sweden, Switzerland, Turkey, and the U.K.; Asia = China, Hong Kong, India, Indonesia, Malaysia, Singapore, South Korea, Taiwan, and Thailand; Latin America = Argentina, Brazil, Chile, and Mexico. For all countries where the currency is not the U.S. dollar, we applied the average 2012 exchange rate to all years. AuM numbers differ from those in last year's report owing mainly to differences in the exchange rates, as well as revisions of country data. Any apparent discrepancies in growth rates are due to rounding.

2012, despite the broad recovery of AuM.[2] Erosion was particularly pronounced in Europe, where 30 percent of managers lost 5 percent or more of their active core assets through net outflows.

- Solutions and specialties, such as emerging-market asset classes, continued to grow faster than traditional active core assets, a trend favoring managers most involved in those products.[3] We believe that the higher-speed growth of solutions and specialty assets, and of passive and alternative products, represents a structural shift in the market that will continue to outpace and squeeze the market share of traditional products.

- The most successful managers in every region now are either specialists or traditional providers who have become "ambidextrous"—that is, they have maintained their active core-asset businesses while also developing capabilities to capture new faster-growth assets.

- The winner-take-all phenomenon of recent years—with winners taking the lion's share of flows—intensified in the U.S. The top ten U.S. managers took 65 percent of all net new fund assets among managers with positive net flows, compared with 54 percent in 2011. In Europe, the trend stabilized; the top ten managers took 37 percent of fund asset flows, compared with 44 percent in 2011.

- Managers continued to confront a two-speed world in which the smaller, emerging markets grew faster than the developed markets, with higher net flows.[4] At the same time, AuM growth in the developed markets was significantly greater in absolute terms because of those markets' dominant size.[5]

- Among the developed markets, one set of countries—which includes the U.S., Germany, the Netherlands, Australia, and South Korea—showed solid growth of 10 percent or more that was driven by both market impact and net flows. In contrast, Japan and some European countries—including France and Italy—registered high single-digit growth that was largely the result of rising markets. This second set of markets remains under pressure owing to diminished investor confidence following the crisis and the impact of regulatory changes.

Emerging Markets Slowly Expand Their Global Share

The emerging markets once again grew at a faster clip than markets in the developed countries. In 2012, AuM grew 16 percent overall in emerging markets, rising by a compound annual growth rate (CAGR) of 9 percent above its 2007 precrisis level. Emerging markets overall now represent roughly 8 percent of global AuM, compared with 6 percent in 2007.

China and Brazil in particular enjoyed robust growth in 2012, with increases of 23 percent and 15 percent, respectively. The market recovery and the appreciation of bonds were strong drivers. Net flows also contributed to growth—on average 5 percent in Asia (excluding Japan and Australia) and 2 percent in Latin America. That growth allowed those regions to remain significant contributors to global growth in AuM. From 2009 through 2012, they provided 11 percent and 6 percent of global growth, respectively.

- Asia, excluding Japan and Australia, represented $3.8 trillion of AuM—an increase of 17 percent in 2012. Both the retail and institutional segments contributed solid growth: 22 percent and 15 percent, respectively.

- Latin America achieved strong growth of 14 percent in 2012, bringing AuM to $1.5 trillion. The retail segment grew more robustly than the institutional market.

- In the Middle East and South Africa, AuM grew by 12 percent in 2012.

- In the developed markets, which represent roughly 90 percent of global AuM, managed assets grew 9 percent in 2012. On average, developed markets have grown at a CAGR of 1 percent since 2007.

- North America finally managed to surpass its 2007 peak AuM level, reaching $30.3 trillion in 2012, an increase of 9 percent from 2011. Growth was driven by both market impact and net flows of roughly 2 percent.

> North America finally managed to surpass its 2007 peak AuM level.

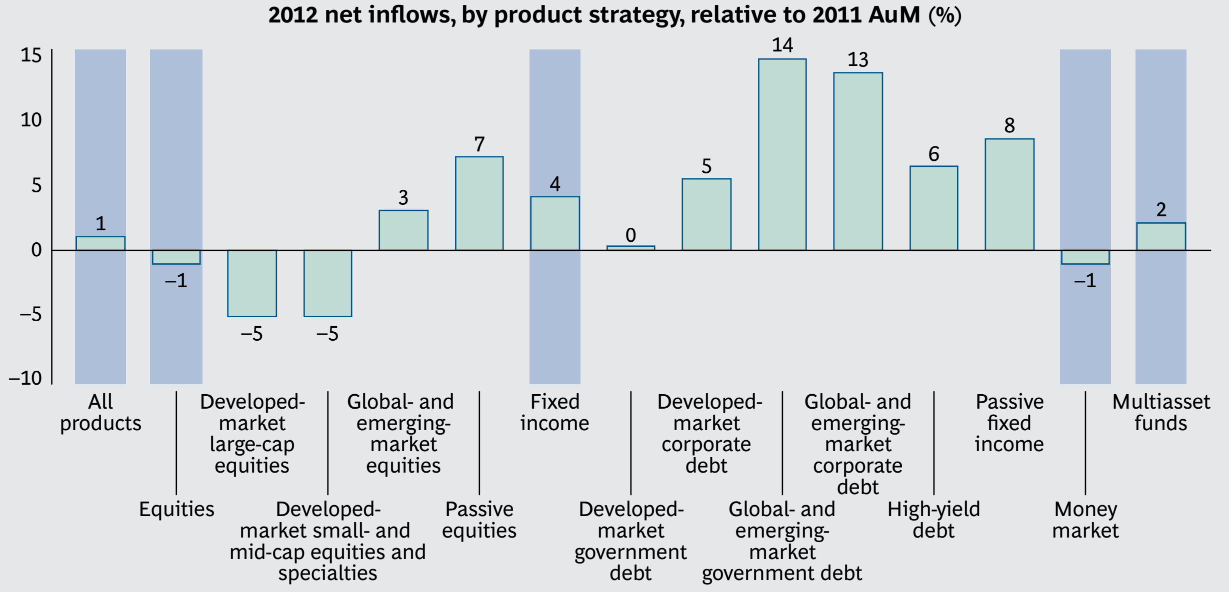
- Overall, European AuM increased 8 percent to $17.5 trillion in 2012, with no net contribution of new flows. France and Southern Europe—including Italy, Spain, Portugal, and Greece—shrank 7 percent and experienced net outflows while northern Europe, including Germany, the Netherlands, and the Nordic countries, grew 11 percent. AuM in the U.K. increased just 6 percent—owing to the lower appreciation of equity and bond values and despite relatively strong positive net flows of 2 percent—the best performance in Europe. France, Germany, Italy, Switzerland, and Spain registered net outflows.

- Japan and Australia together accounted for 10 percent of global AuM at the end of 2012, growing by 6 percent and 14 percent, respectively.

Investor Appetite Grows for Nontraditional Assets

Persistently lower interest rates and shifting investor preferences expanded the already growing appetite for specialties, solutions, and passive products. (See Exhibit 2.) Investors continued to divest developed-market equities and money market assets, while net flows into passive strategies, fixed-income specialties, and high-yield and emerging-market corporate debt were strong. Net flows into traditional developed-market government debt stabilized.

EXHIBIT 2 | Investors Continued Their Shift from Traditional Actively Managed Core Assets to Specialties and Passives



Source: BCG Global Asset Management Benchmarking Database, 2013.

The demand for specialties and solutions in 2012 was also evident in the ranking of mutual-fund product strategies that received the highest net flows. In both the U.S. and Europe, the top ten strategies included target date funds, emerging-market equities, emerging-market bonds, high-yield bonds, and global funds—such as global allocation in the U.S. and global bonds and global equities in Europe. (See Exhibit 3.)

The shift in investor preferences helped intensify the winner-take-all trend in the industry again in 2012, particularly in the U.S. The top ten U.S. and European players captured 94 percent and 51 percent, respectively, of all net new fund asset flows, similar to their dominance in recent years. This was driven partly by the higher concentration of those leading players in specialties and passive products than in the slower-growing traditional products. (See Exhibit 4.)

Intense competition has driven the winner-take-all trend down to the product level, particularly in the U.S. and in specialties markets. (See Exhibit 5.)

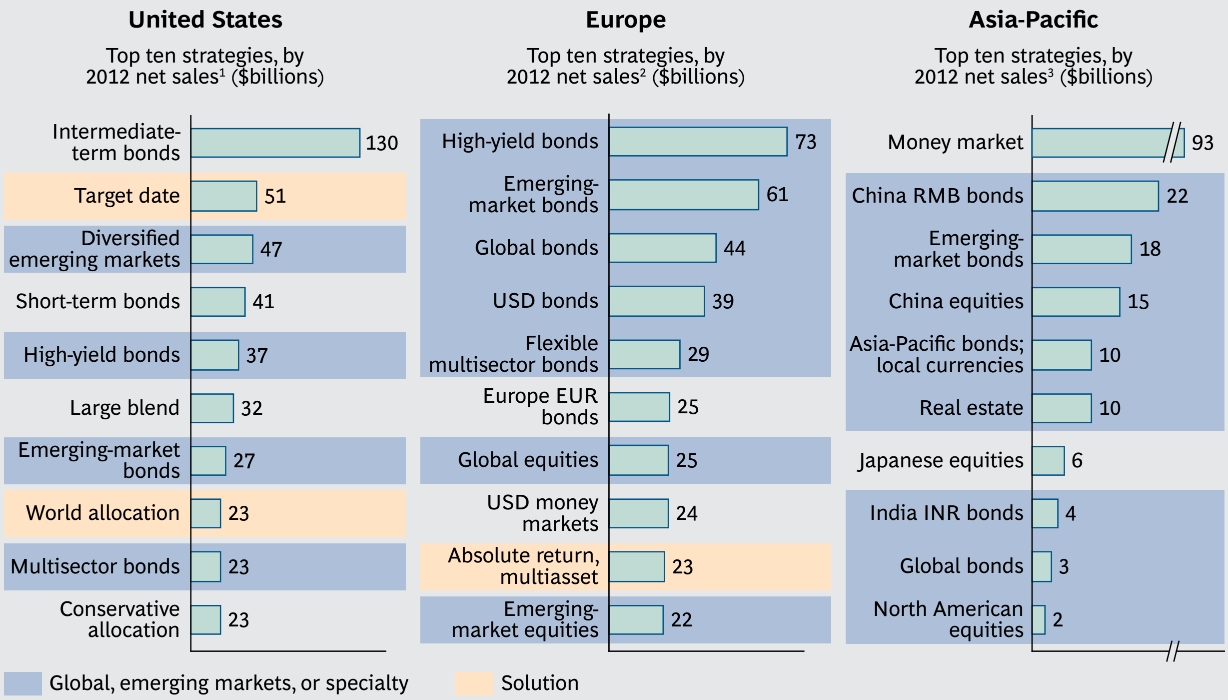
In the U.S., 73 percent of AuM of active core strategy mutual funds is in the hands of the top ten equity-specialty managers, compared with 65 percent of AuM for equity core strategies. That ratio reaches 76 percent for fixed-income specialties, 72 percent for core fixed-income products, 72 percent for other specialties, and 44 percent for other core products.

In Europe, the contrast in control of specialties and core products is even stronger, even if overall concentration is not as high as in the U.S. In equities, 29 percent of core products are in the hands of the top ten providers, compared with 49 percent for specialties. In fixed income, 31 percent of core strategies are held by top-ten providers, compared with 56 percent for fixed-income specialties. Other products are divided 35 percent and 53 percent, respectively, between other core and other specialties providers.

In this competitive environment, many traditional asset managers have little choice but to try to identify specific areas in which they can build more relevant capabilities.

The threat looms particularly large for managers in continental Europe and Asia-Pacific. There, due to the smaller presence of pension funds and endowment businesses, specialties did not develop as much as in the U.S. or U.K. markets: they weren't as relevant

EXHIBIT 3 | In Every Region, Most of the Top Ten Strategies Were Specialties or Solutions



Sources: Strategic Insight; BCG analysis.
[1]Based on mutual funds and exchange-traded funds, excluding, for instance, assets of mandates.
[2]Out of 28 strategies defined by Strategic Insight.
[3]Out of 27 strategies defined by Strategic Insight.

EXHIBIT 4 | The Winner-Take-All Trend Favored Large Passive and Specialty Firms—Winners Changed Little in 2012

United States

Asset manager	Mutual-fund net flows, 2012 ($billions)	Cumulative share of total market net flows (%)	Cumulative share of net flows of players with positive net flows (%)
Vanguard	139	35	24
PIMCO	65	51	35
BlackRock	57	65	45
JPMorgan Chase & Co.	25	72	49
DoubleLine Capital	22	77	53
T. Rowe Price	15	81	56
MFS Investment Management	14	85	58
Dimensional Fund Advisors	14	88	61
State Street Global Advisors	13	91	63
Lord Abbett	12	94	65
Total market	401		

Europe

Asset manager	Mutual-fund net flows, 2012 ($billions)	Cumulative share of total market net flows (%)	Cumulative share of net flows of players with positive net flows (%)
PIMCO	44	13	9
BlackRock	29	21	15
AllianceBernstein	20	27	20
Nordea	16	32	23
M&G Investments	13	36	26
AXA	13	40	29
BNY Mellon	11	43	31
Standard Life	11	46	33
Aberdeen	9	49	35
JPMorgan Chase & Co.	9	51	37
Total market	339		

Five U.S. players were in Europe's top ten, compared with three of ten in 2009

Xx = New player in top-ten ranking, 2012 (compared with 2011 rankings)

Sources: Strategic Insight; BCG analysis.
Note: This analysis is based on mutual funds and EFTs, excluding money market funds.

Exhibit 5 | Competition Has Driven the Winner-Take-All Trend Down to the Product Level in the U.S. and Specialty Markets

Sources: Strategic Insight; BCG analysis.
Note: Based on mutual-fund data; money market, guaranteed and protected, and smaller than $50 billion categories in the U.S. are not included; Europe includes offshore markets.

to mass-retail investors or insurance companies and other institutions with restrictive investment guidelines. This gap set the stage for U.S. and U.K. managers to expand successfully, investing beyond their home markets in continental Europe and Asia-Pacific.

For traditional players, investment in multi-asset-class skills and specific services is the key to participating in the continued growth of solutions in both the retail and the institutional segments. Already, a small set of pioneering managers have stepped into the solutions vanguard to capture and dominate the market's strongest flow of new assets, and their revenues are expected to rise at 2.5 times the rate of those of actively managed core assets, as we discuss in this report's concluding chapter, "Harvesting Rewards by Offering Solutions."

We believe that passive, alternative, and specialty products such as emerging-market asset classes and solutions will continue to grow. That will further shrink and squeeze the traditional-product share, which now represents 50 percent of total AuM and 33 percent of global revenues.

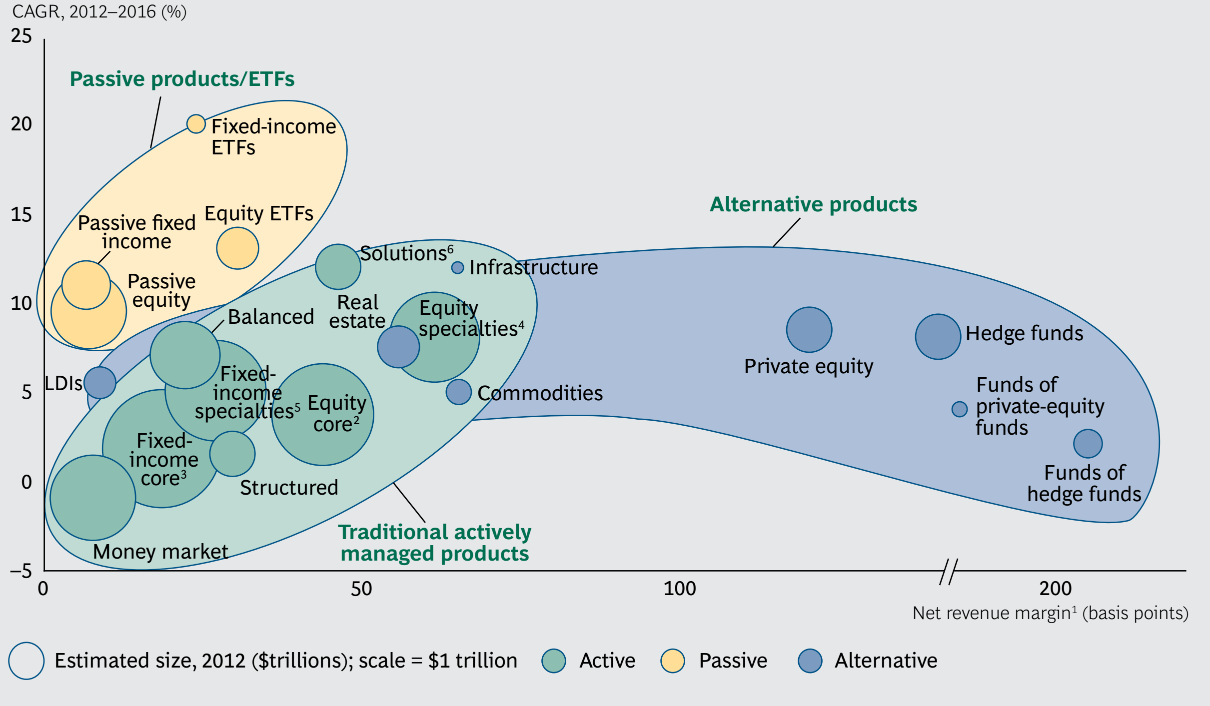
We estimate that by 2016, traditional products will represent 44 percent of AuM and 30 percent of revenues. (See Exhibit 6.)

The Industry Remains Attractive as Profitability Drivers Shift

Asset management profitability improved significantly in 2012, nearly rebounding to pre-2008 levels. In absolute terms, profits climbed 7 percent, rising to $80 billion—15 percent less than the historical peak of $94 billion in 2007.

The 2012 increase was driven by 5 percent growth in average AuM. Net revenues

Exhibit 6 | Traditional Active Core Assets and Managers Will Continue to Be Squeezed by New Faster-Growing Assets



Sources: BCG Global Asset Management Market-Sizing Database, 2013; BCG Global Asset Management Benchmarking Database, 2013; ICI; Preqin; HFR; Strategic Insight; BlackRock ETP report; IMA; OECD; Towers Watson; P&I; Lippers/Reuters; BCG analysis.
Note: ETFs = exchange-traded funds; LDIs = liability-driven investments.
[1]Management fees net of distribution costs.
[2]Includes actively managed domestic large-cap equity.
[3]Includes actively managed domestic government debt.
[4]Includes foreign, global, emerging-market equities, small and mid caps, and sectors.
[5]Includes credit, emerging-market and global debt, high-yield bonds, and convertibles.
[6]Includes absolute return, target date, global asset-allocation, flexible, income, and volatility funds.

improved by 4 percent, and costs increased by 3 percent. As a result, operating margins rose to 37 percent of net revenues. (See Exhibit 7.)

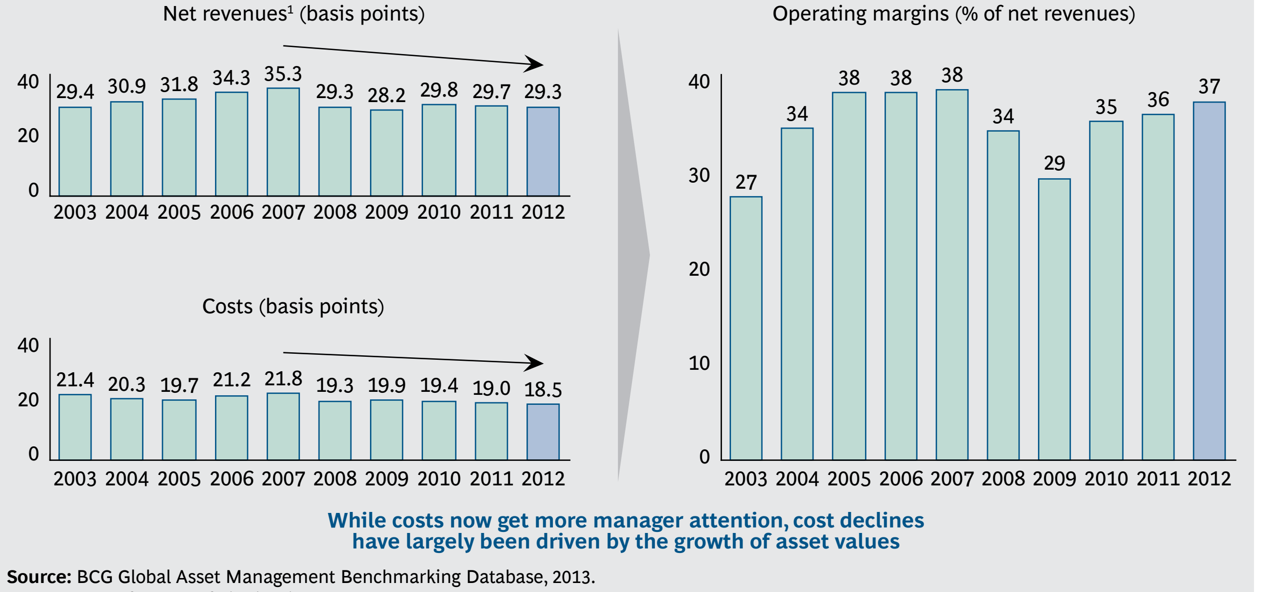
In the years since the crisis, managers have changed the way that they achieve profit improvement. Before 2008, AuM growth and high margins were the unique drivers of profitability. Nowadays, in a context of overall flat revenue margins, cost discipline has become a top-of-the-agenda concern of CEOs as well. And even if the decline of costs, in basis points, was largely driven by asset growth from 2007 through 2012, costs in 2012 in absolute terms were also 5 percent below the 2007 level in 2012. During 2012, despite the AuM recovery and the fact that two-thirds of players managed to increase their profitability, only 33 percent of asset managers did reduce their costs, including 13 percent who managed to increase revenues at the same time.

Overall, there was no profit improvement for European players. Despite strong market growth, there was increased competition from U.S. managers. The profit pool of European managers in 2012 remained 31 percent below precrisis levels, while the pool for U.S. players averaged 10 percent above those levels. A key reason for this disparity, as discussed in detail in the next chapter of this report, is that U.S. managers are now more adept than their European counterparts at developing specialist capabilities that allow them to expand both domestically and internationally, especially in Europe.

Notes

1. Asset values for all currencies in all years are based on 2012 average U.S. dollar exchange rates to prevent currency swing distortions. The figures here do not directly correspond with those in our past annual reports owing to currency rate adjustments, as well as to updated historical source data and methodology changes.
2. Active core assets include traditional strategies such as active domestic large-cap equities, active domestic government debt, and active balanced and active structured products.
3. Specialties comprise equity specialties—among them foreign, global, emerging markets, small caps, mid caps, and sectors—as well as fixed-income specialties, including credit, emerging markets, global, high yield, and convertibles.
4. Emerging markets include Argentina, Brazil, Chile, China, the Czech Republic, Hungary, India, Indonesia, Malaysia, Mexico, the Middle East, Morocco, Poland, Russia, South Africa, Thailand, and Turkey.
5. Developed markets include Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Luxembourg, the Netherlands, Norway, Portugal, Singapore, South Korea, Spain, Sweden, Switzerland, Taiwan, the U.K., and the U.S.

Exhibit 7 | Profitability Has Returned to Precrisis Levels, but Net Revenues Remain Flat



Source: BCG Global Asset Management Benchmarking Database, 2013.
[1]Management fees net of distribution costs.

THE ASSET MANAGER'S QUANDARY

TODAY'S ASSET MANAGERS FACE a quandary: Should they remain rooted in their traditional, still profitable business of actively managing investors' core assets and ignore the lure of fresh opportunities? Or should they follow the money, explore new revenue sources, and divert attention and resources to faster-growing but less predictable noncore products such as passives, solutions, and specialties?

Paradoxically, that dilemma deepened in 2012, as recovering economies and rising markets offered the first year of substantial growth in actively managed core assets since the financial crisis of 2008. The reinvigorated growth strengthened the enduring perception of the value of active core assets, which composed 50 percent of global AuM in 2012. (See Exhibit 8.)

Although active core AuM continues its slow decline as a share of overall AuM, it has grown in absolute terms by $2.8 trillion since 2008 and by $6.1 trillion since 2003. In fact, for 57 percent of the top 100 fund providers in the U.S. and the top 100 in Europe, active core assets still constitute at least 50 percent of AuM. Just 19 percent of managers have less than 25 percent of active core AuM.

Recurring Revenue Streams Retain Their Profit Power

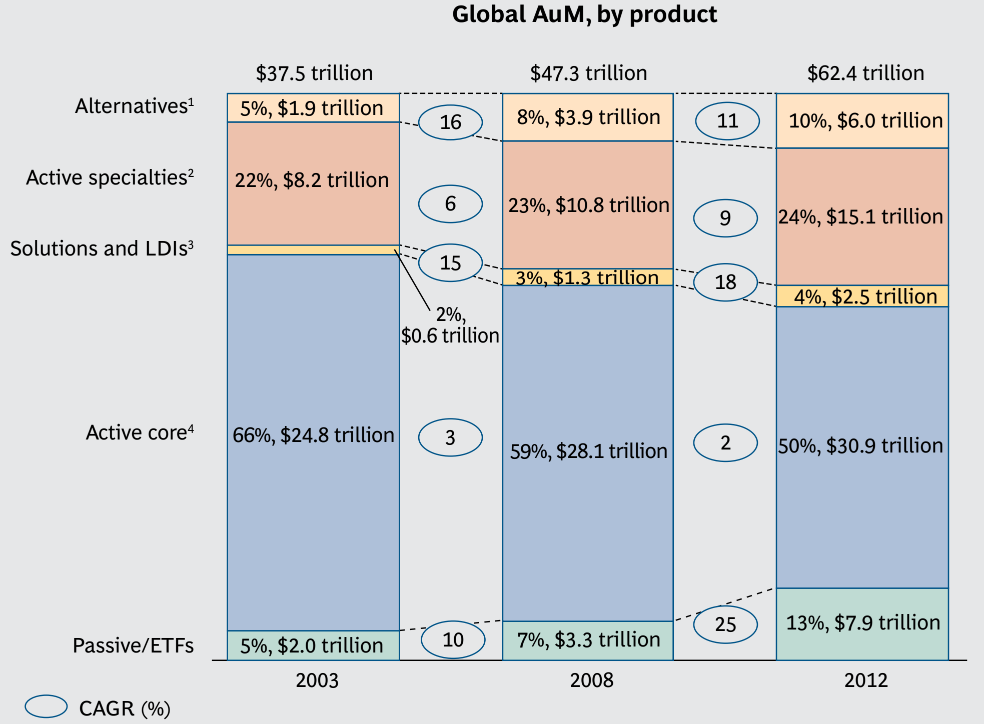
Recurring revenue streams—from a manager's existing assets—are largely derived from active core assets and continue to provide most of the industry's revenues and profits. In 2012, recurring revenues totaled $170 billion—about 80 percent of the global industry's total $215 billion revenue pool. Through market appreciation alone, active core revenues are expected to increase from $68 billion in 2012 to $79 billion in 2016, as overall industry revenues rise from $215 billion to $279 billion. (See Exhibit 9.)

Traditional managers' recurring revenues mask any urgency to chase new, faster-growing flows.

The dominant share of active core assets in the overall asset pool continues to generate the industry's largest single revenue stream today. This stream will remain significant despite those assets' continued slow retreat as a share of the overall pool—at least for managers that successfully shield their active core-asset business from erosion. Managers facing rapid erosion must quickly move to stabilize their asset base, as we discuss below.

For most traditional managers, this seemingly guaranteed stream of recurring revenues masks any urgency to confront the hurdles

EXHIBIT 8 | Active Core Assets Continue to Lose Share but Still Represent 50 Percent of AuM



Sources: BCG Global Asset Management Market-Sizing Database, 2013; BCG Global Asset Management Benchmarking Database, 2013; ICI; Preqin; HFR; Strategic Insight; BlackRock ETP report; IMA; OECD; Towers Watson; P&I; Lippers/Reuters; BCG analysis.
Note: ETFs = exchange-traded funds; LDIs = liability-driven investments. Any apparent discrepancies in totals are due to rounding.
[1]Includes hedge, private-equity, real estate, infrastructure, and commodity funds.
[2]Includes equity specialties (foreign, global, emerging markets, small and mid caps, and sector) and fixed-income specialties (credit, emerging markets, global, high yield, and convertibles).
[3]Includes absolute-return, target date, global asset-allocation, flexible, income, and volatility funds, and LDIs.
[4]Includes active domestic large-cap equity, active government fixed-income, money market, and traditional balanced and structured products.

involved in chasing new, faster-growing flows. Chief among these challenges are the difficulties traditional managers face in achieving recognition as credible providers of new products and strategies. Designing and fielding a credible suite of new offerings can be challenging. Managers face an ongoing inherent risk: their leadership teams are unfamiliar with the new terrain where the winners are investing in innovative pipelines and strong capabilities.

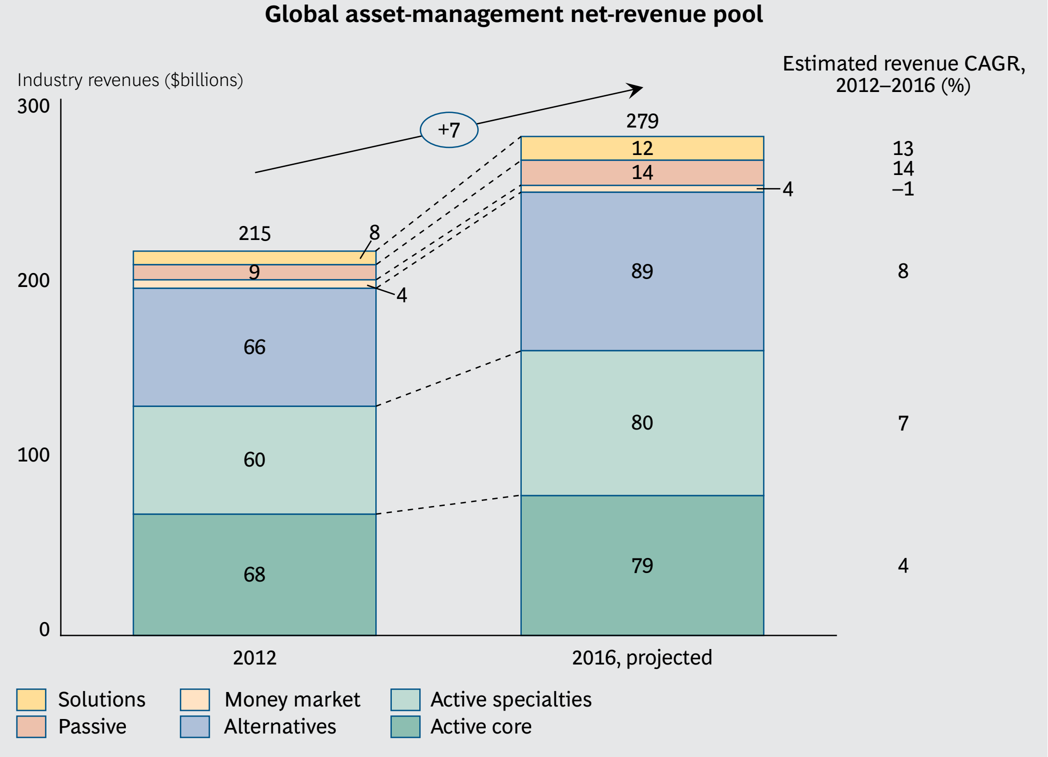
To compete, traditional managers must learn to differentiate their offerings, strengthen distribution, and make big bets on new strategies, markets, channels, and capabilities. All this requires strong focus and investment in innovation—which carries risks and, in many cases, requires cultural change. Their record of success to date has been limited.

Furthermore, chasing new asset flows may be rewarded only gradually. Although the AuM of high-growth products has advanced quickly, the increases have been built on relatively small bases. Since 2008, the CAGR of AuM for solutions has increased 18 percent; for passives, 25 percent; for alternatives, 11 percent; and for active specialties, 9 percent. Combined, however, these high-growth but small products have reduced the active core-asset share of global AuM by just 9 percentage points, from 59 percent to 50 percent.

Finally, most managers do not experience declining revenues or profits from their active core assets in absolute terms. In fact, both will likely continue to rise at low single-digit rates.

Given the limited threat to recurring revenues and profits, why can't managers just sit

EXHIBIT 9 | Active Core Revenues, While Slow-Growing, Are Forecast to Rise to $79 Billion in 2016 from $68 Billion in 2012



Sources: BCG Global Asset Management Market-Sizing Database, 2013; BCG Global Asset Management Benchmarking Database, 2013; ICI; Preqin; HFR; Strategic Insight; BlackRock ETP report; IMA; OECD; Towers Watson; P&I; Lippers/Reuters; BCG analysis.
Note: Solutions include target date, absolute-return, income, flexible, world allocation, and volatility funds, as well as liability-driven investments; passive includes exchange-traded and passive funds and mandates; alternatives include hedge and private-equity funds, real estate, infrastructure, and commodities; active core includes active core equity (local large-cap equity), active core fixed-income (developed-market government debt), traditional balanced funds, and structured products; active specialties include other active equity and fixed-income products. Any apparent discrepancies in totals are due to rounding.

back, relax, and not worry about asset growth?

The answer is that traditional actively managed core assets—whether they rebound for a single year or prosper for a decade—remain vulnerable to the market's continuing evolution. All managers need a long-term strategy to deal with those changes into the future, as discussed below.

Some managers are more vulnerable and need a plan for immediate action. The situation is most urgent for a subset of these managers: those with little choice because of rapid asset erosion.

Although most managers don't face rapid erosion of their active core assets, about 25 percent of managers are experiencing 5 percent or greater outflows from their active core-asset base. In the face of declining revenues and profits, these managers must invest in the development of new capabilities. And they must act quickly before time runs out. As an immediate step, they should consider a thorough review to identify and eliminate any operating inefficiencies in order to free up cash and refocus management attention on product innovation, entry into new asset classes, and development of client relationships. (See the sidebar "Efficiency's Next Frontier: The Target Operating Model.")

Specialists and the Ambidextrous Gain the Advantage

Another set of managers have already chosen to invest the cash and profits generated by their active core-asset base to build new capa-

EFFICIENCY'S NEXT FRONTIER
The Target Operating Model

For the leadership teams of most asset managers, improving efficiencies has been a top-of-mind goal for a number of years. And they have the scars to prove it. Given the long succession of campaigns many managers have already pursued, the prospect of making additional big leaps in efficiency might seem far-fetched.

The reality can, however, be different when it comes to operations and IT, where efficiency improvement efforts generally weren't pursued with the same gusto as elsewhere in the organization. Indeed, while asset managers' operations and IT costs remained unchanged from 2009 through 2012, managers reduced front-office costs by an average 0.9 basis points and head-office costs by 0.7 basis points.

Asset managers pay a price for this uneven focus on productivity. But the real loss goes much deeper than higher costs and reduced efficiencies in operations and IT.

By failing to establish a target operating model, managers undermine a substantial set of opportunities to improve competitiveness—for example, by moving into new and faster-growing asset classes such as solutions and specialties.

Furthermore, inattention to chronic inefficiencies in operations and IT, in addition to having a direct business impact, risks failure to meet the increasingly high bar set by consultants and institutional investors in today's tough business environment.

The result can be a critical setback at the crucial moment when a manager needs to expand into a larger space, is ready to introduce innovative new products, or has an opportunity to trade new asset classes. Truly deep operational and IT efficiencies are requirements for supporting the carefully laid groundwork necessary to scale operations as an organization grows.

Efficiency isn't just about belt-tightening. It requires fundamental changes to the model, which involve reviewing end-to-end processes, sourcing models, shared-service structures, and the global footprint. In fact, true efficiency requires an examination of the manager's entire organization and the very backbone of its structure. Scrutiny this deep may be frightening at first, but managers can remain focused and productive if they start with clear agreement and a disciplined understanding of key objectives and deliverables.

Efficiency isn't just about belt-tightening. It requires fundamental changes to the model.

The potential opportunity is a material one. On the cost side, savings can reach 20 to 35 percent or more, depending on the breadth and depth of approach. And, in addition to cost savings, operating-model transformation can help deliver operational excellence, including improved client service and satisfaction, shorter response times, lower error rates, and quantified and reduced risk, as well as critical areas that are identified and monitored and resources that are appropriately and strategically deployed.

When it comes to designing a target operating model, one size does not fit all. The appropriate operating model depends on the business model, and it requires making early choices related to key dimensions such as customer experience, flexibility, operating risk, and cost. Location and product mix are among the primary drivers of model variance.

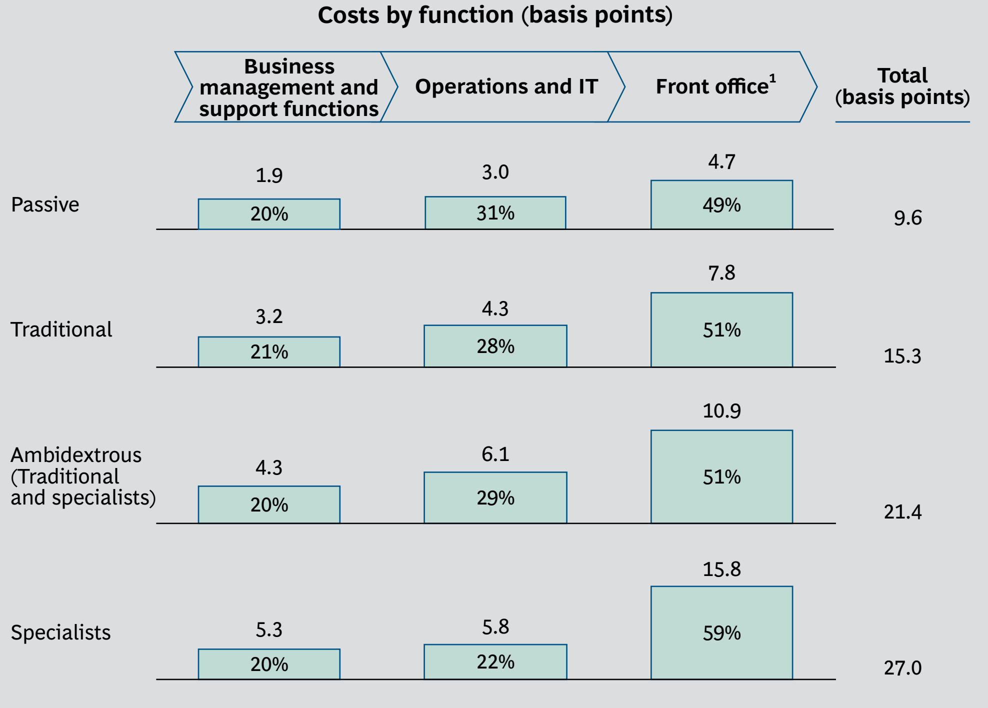
Asset managers, depending on their specific business model, spend as much as one-third of their total costs on operations and IT alone. The target operating-model opportunity appears particularly compelling for traditional managers and for "ambidextrous" managers. They spend 28 percent and 29 percent, respectively, of their total costs on operations and IT, compared with 22 percent for specialists. Passive managers also can be rewarded with efficiency gains. They spend nearly one-third of total costs on those two functions, owing to the higher IT investments required by their business model. (See the exhibit below.)

For ambidextrous players, higher costs can be a result of the increased complexity involved in offering both traditional and more sophisticated financial products or of focusing on growth and development at the expense of organizational efficiency. A review of the operating model can, of course, stimulate investment by lowering costs and freeing up cash. But there are other crucial benefits, including the ability to scale operations as the organization grows.

For traditional managers, the high cost of operations and IT can preempt investments in front-office capabilities, undermining strategic opportunities. Front-office expenses average only 8 basis points for traditional managers, compared with 11 basis points for ambidextrous players and 16 basis points for specialists.

An operating-model review offers a powerful way for traditional players either to rekindle profitable growth or to make the strategic front-office investments required to build new product capabilities.

As Much as 31 Percent of Asset Managers' Total Costs Are Dedicated to Operations and IT



Source: BCG Global Asset Management Benchmarking Database, 2013.
Note: Any apparent discrepancies in totals are due to rounding.
[1]Includes sales, distribution, client service, product specialists, investment management, and trade execution.

bilities and participate in asset growth. These players—and there are only a few of them—have found a way to win. They, and the specialist managers, are capturing most of the net flows into the market.

Specialists and ambidextrous managers will continue to wield significant advantage.

The most successful of these managers, as noted earlier, are either specialists or traditional players who have become ambidextrous by continuing to build and maintain the margins of their traditional active assets while capturing new asset flows in fast-growing products. Over the past two years, ambidextrous and specialist managers have been the most successful players, generating high fees and margins. Their profits have grown at a CAGR of 10 percent, while the profits of traditional managers declined at a CAGR of 2 percent. (See Exhibit 10.)

The specialists and ambidextrous managers will continue to wield significant advantage in the short to medium term. The remaining players—a large group, experiencing little asset erosion and strong cash flows—should nonetheless remain alert. They must identify the key capabilities required to extend the retention of their active core-asset base: the specific products and services that will be required by their investors and the solutions that they are positioned to provide.

These remaining managers should take advantage of their relatively privileged situation to invest in improving efficiency and enhancing the profitability of their active core-asset business. This would allow them not only to expand profitability of this business but also to fund innovation and to build capabilities that will support new growth in the future.

The cost of staying focused only on active core assets is potentially twofold. First, given unpredictable future product shifts, there is a medium-term asset-retention risk. Second, there is the impact of low growth on the manager's ability to attract strong talent and maintain

Exhibit 10 | Specialists and Ambidextrous Managers Fared Better Than Traditional Players

Key ratios	Passive[1]	Traditional[2]	Ambidextrous (traditional and specialists)[3]	Specialists[4]
Net revenues (basis points)	15	24	37	46
Profits (basis points)	5	8	15	20
Profitability (% of revenues)	35	36	41	42
AuM CAGR, 2010–2012 (%)	5	5	5	7
Revenue CAGR, 2010–2012 (%)	4	1	6	8
Profit CAGR, 2010–2012 (%)	7	–2	10	10

Product innovation and expertise are drivers of success

Source: BCG Global Asset Management Benchmarking Database, 2013.
[1]Passive players include asset managers with more than 40 percent passive assets. Profits as a percentage of net revenues do not reconcile with revenues and profits in basis points because not all players report profitability in the same way, making comparisons meaningless.
[2]Traditional players include asset managers with more than 70 percent of assets from developed-market large-cap equities, developed-market government debt, money markets, structured products, and balanced funds.
[3]Ambidextrous managers are traditional and specialist players with more than 30 percent traditional assets and more than 20 percent specialties.
[4]Specialists include players with more than 50 percent equity and fixed-income specialties and alternative assets but exclude alternative players and players with mostly captive assets.

high levels of employee engagement. This could jeopardize the business's performance and strength now and in the future.

Simply clinging to traditional business and avoiding the risk and discomfort of change means that these active core-asset stalwarts will be competing for just $11 billion of an estimated $64 billion increase in total revenues from 2012 through 2016.

U.S. Managers Take the Lead

Among the specialist and ambidextrous players, U.S. managers have shown the most leadership and have won the rewards. They have become more adept than their European counterparts in taking bites from both sides of the apple: retaining active core assets at home and using their specialty capabilities to develop internationally, especially in Europe.

Active core assets at home provide a familiar, low-risk, high-return terrain that offsets any wariness about placing bets on new strategies, markets, and channels or gambling on the investments required to build fresh capabilities.

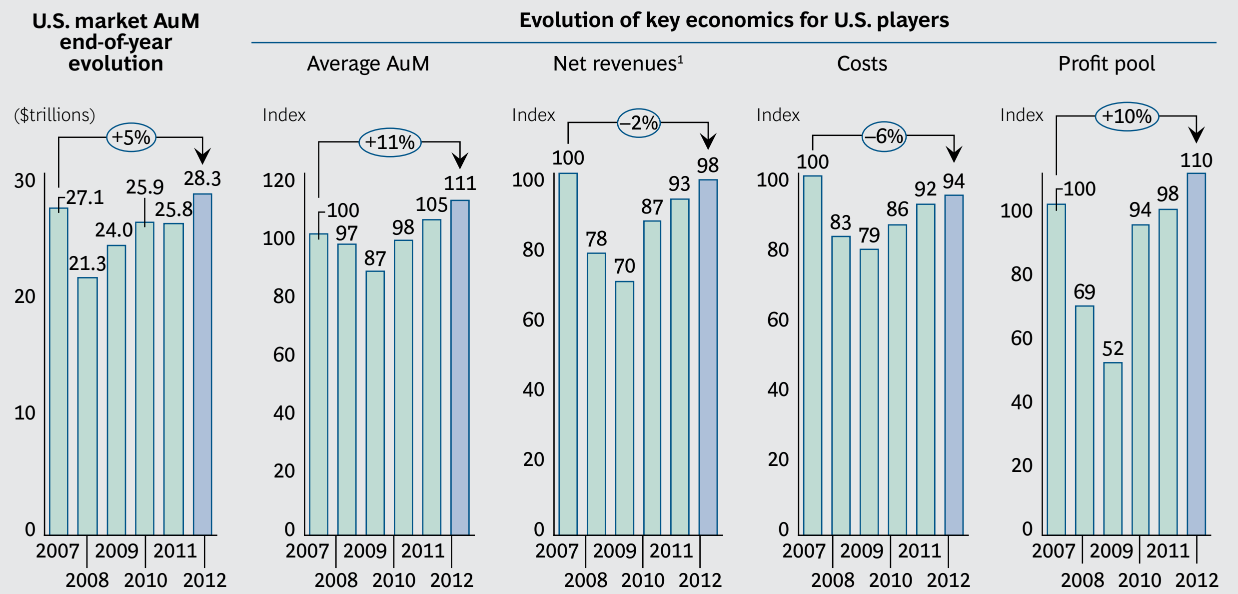
As a result, although U.S. domestic assets have grown only 5 percent since 2007, U.S. managers' average AuM grew by 11 percent, and their profit pool grew 10 percent above its 2007 precrisis level. (See Exhibit 11.)

U.S. managers' profit pool grew 10 percent above its precrisis level; the Europeans' remains 31 percent below.

By contrast, and despite the recovery of AuM since the crisis, the profit pool for European managers remains 31 percent below precrisis levels. (See Exhibit 12.) Meanwhile, some U.S. managers have been more successful in pursuing specialties, taking advantage of the more pronounced erosion of the active core-asset base in Europe while defending the revenues and profits from their traditional and specialty assets at home.

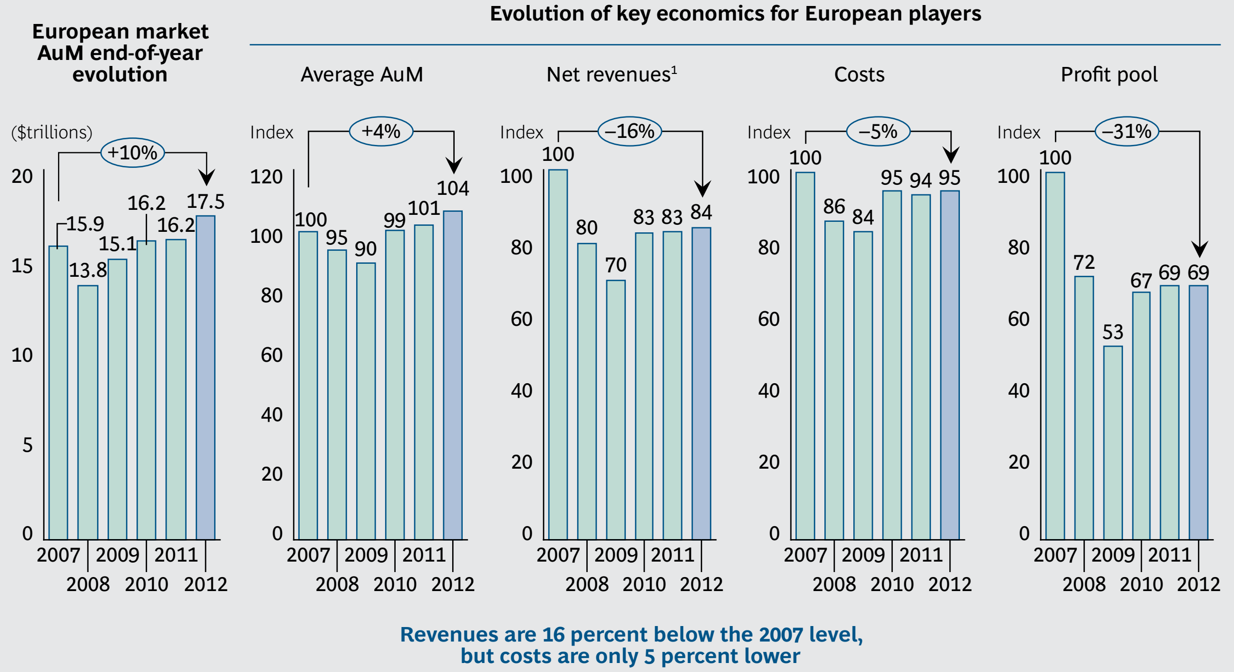
This ambidexterity has helped those U.S. managers make substantial gains in capturing

Exhibit 11 | U.S. Managers' Profit Pool Surpassed Precrisis Levels



Sources: BCG Global Asset Management Market-Sizing Database, 2013; BCG Global Asset Management Benchmarking Database, 2013.
Note: Evolution for end-of-year AuM is based on market-sizing analysis, evolution of average AuM, net revenues, costs, and profits from our benchmarking sample. Values with fixed exchange rates use the average 2012 rate.
[1]Management fees net of distribution costs.

Exhibit 12 | European Managers' Profit Pool Remains More Than 30 Percent Below Precrisis Levels



Sources: BCG Global Asset Management Market-Sizing Database, 2013; BCG Global Asset Management Benchmarking Database, 2013.
Note: Evolution for end-of-year AuM is based on market-sizing analysis, evolution of average AuM, net revenues, costs, and profits from our benchmarking sample. Values with fixed exchange rates use the average 2012 rate.
[1]Management fees net of distribution costs.

new asset flows in Europe. In 2009, only three U.S. managers were among the top ten recipients of new asset flows of mutual funds in Europe. In 2012, as in 2011, there were five: PIMCO, BlackRock, AllianceBernstein, BNY Mellon, and JPMorgan Chase, as illustrated in Exhibit 4.

In order to truly confront their quandary, asset managers must reassess their operating models to identify opportunities for improving the efficiency and profitability of their current business and conduct an honest assessment of their strengths to identify how to invest in innovation and capability building—where they have a right to win. That will position them to forge ahead with the necessary investments in future growth.

HARVESTING REWARDS BY OFFERING SOLUTIONS

Today, most asset managers remain firmly focused on defending and building actively managed core assets, the traditional business that has long provided their recurring revenues. They do so even as the market evolves and the share of those actively managed assets slowly shrinks as a portion of the whole.

A smaller group of managers, meanwhile, are capitalizing on the market's recent evolution, successfully building capabilities in solutions—the asset allocation offerings that, along with passives and specialties, now capture a disproportionately large share of the market's growth. By placing bets on solutions, these pioneering managers have stepped into the vanguard to dominate the market's strongest flow of new assets: revenues are expected to rise at 2.5 times the rate of those of actively managed core assets.

These managers are tapping a trend toward solutions that has accelerated since the financial crisis, driven by several factors:

- Investors have grown frustrated and disillusioned with the performance of traditional, benchmark-pegged actively managed core assets. When a benchmark is down 15 percent, outperforming it by 3 percentage points still produces a loss. A poor return is a poor return.
- Investors' historical focus on maximizing risk-adjusted returns was undermined by the volatility of both equity and fixed-income markets during the crisis. A rethinking of investment goals has produced a stronger recognition that asset pools exist to satisfy future liabilities—such as pension plan obligations and retirement expenses—not just to maximize immediate returns.
- The traditional diversified asset-class strategies have failed the financial-crisis test. Correlations between traditional classes converged, and results suffered. The winning strategies were more oriented toward macro trends and strategies that shifted allocation dynamically to take advantage of opportunities across asset classes—not only within them.
- The increasing complexity and internationalization of financial markets—and the growing difficulty of navigating them—has created new, specialized asset classes along with the need for greater asset-allocation expertise. The days of the simple 60-40 domestic equity-bond portfolio are over.
- Small investors have joined institutional and other large investors in seeking exposure to esoteric, nontraditional, and uncorrelated asset classes. They now want access to hedge funds and private-equity

funds embedded inside solutions, because they lack the scale or expertise to make those investments directly themselves.

Identifying and Tapping the Drivers of Asset Growth

As a result, both retail and institutional investors are increasingly turning toward outcomes or solutions that are specifically oriented to their investment needs. The complexity of managing these solutions while reacting quickly to market developments has opened an opportunity for pioneering asset managers to capture net new flows if they can develop the appropriate capabilities. In the past, these solutions have often been the traditional realm of wealth managers, financial advisors, and investment consultants.

> Solutions have become increasingly customized and complex in both the institutional and the retail spaces.

As the solution market has grown and evolved, the nature of solutions themselves has evolved. They have become increasingly customized and complex in both the institutional and the retail spaces.

On the institutional side, increasing numbers of large plans are turning to full and partial plan-outsourcing services, which, in many cases, are delivered in a customized fashion rather than in comingled funds.

True liability-driven investment (LDI) solutions—such as those implemented by a growing number of U.K. and Dutch pension plans—are increasingly customized for pension funds. These LDI solutions are being tailored to manage interest rate, credit, market, and liquidity risks in order to meet anticipated liabilities. As the market continues to grow and deepen, we expect holistic LDI solutions to grow and replace partial LDI solutions, which are often no more than portfolios of long-term bonds that attempt to address liability and risk profiles.

The key capabilities required for developing and launching truly holistic LDI solutions are built on a foundation of deep technical knowledge. They include actuarial and analytical capabilities, risk management capabilities, and an understanding of liability cash flows. It is interesting that there are only a few insurance subsidiaries among the leaders. While insurers generally have the required core capabilities, they often lack relationships with the investment consultants who intermediate most of the new business in major pension-fund markets, including the U.K. and the U.S.

In Retail, an Explosion of Thematic Solutions

On the retail side, in which packaged solutions have traditionally been more common, the market is seeing the development of more custom solutions, as well as an explosion in the types of thematic solutions. Increasingly, the latter target specific outcomes for retail investors, such as inflation-hedged funds, income funds, liquidity management, tail risk management, and volatility-managed, tax-managed, and absolute-return or risk parity funds.

Target date funds (TDFs), with a more specific asset-allocation glide path, have largely replaced the earlier generation of target risk funds for retirement planning in many defined-contribution (DC) plans. TDFs currently total $400 billion in the U.S. and are expected to grow to $1 trillion by 2016 because they are the main default-option funds in most DC plans.

Notably, within the high-growth TDF category, there is a rising demand from DC plans for customization. The demand is driven by specific needs, as well as the desire for greater diversification and a growing interest in alternative investments.

Many large corporations are investing in TDFs tailored to the varying needs of specific employee groups. These include expected retirement ages, corporate beta exposure, promotion and income curves, and employee-stock-option-plan variations in participation rates and stock portfolios.

Custom TDFs are expected to grow from $46 billion to $218 billion—a CAGR of 36.5 percent—from 2011 through 2016, as more large companies with significant resources discover the benefits of tailoring multiple glide paths for employees. Highest adoption rates are expected for larger plans—those with more than $1 billion in AuM.

Most of this demand will be for semicustom TDFs, which could meet 80 to 90 percent of plan needs, with just 9 percent of demand for truly custom TDFs. Semicustom TDFs provide such benefits as greater fee transparency, more diverse asset allocation, and more control of underlying managers.

The market for solutions is likely to evolve at a fast pace; innovation will be critical.

While custom TDFs are currently dominated by a few managers, this wide range of potential benefits suggests opportunities for other players to differentiate themselves. They might do so, for example, by offering access to real estate investment trusts and commodities, using ETFs and passive management to reduce fees, or by introducing multimanager and open-architecture construction.

We believe that the market for solutions is likely to keep building and evolving at a fast pace and that innovation will be critical for players that aim to share in its success. Beyond the current offerings, potential future trends include the following:

- Thematic, personalized solutions
- Enhanced TDFs and risk funds
- Cheaper beta
- Sophisticated alpha generation
- Access to private assets
- Coinvesting with the manager's own assets
- Blurring lines between consultants and asset managers
- Outsourcing investment decisions

Building Capabilities to Surf the Solutions Wave

Managers hoping to successfully surf the growing solutions wave face fundamental decisions about how to participate and what capabilities they should focus on developing.

As a starting point, managers need to assess their capabilities in a number of dimensions, including from a manufacturing perspective. Do they have the ability to manage money other than against a defined benchmark? Do they have an asset allocation capability—strategic, as well as tactical and dynamic? Do they have capabilities across multiple asset classes? Can they manufacture all the elements of a solution themselves, or do they need to outsource some asset classes? Do they have a manager search and oversight capability?

From a distribution perspective, managers must give careful thought to the design of the go-to-market model; traditional managers are unlikely to have existing channels or people capable of selling solutions. The solution sales cycle is often longer than a single asset-class sales mandate. Managers must also consider how to circumvent potential channel conflict with investment consultants and other gatekeepers offering competitive solutions. It is critical for solutions managers to develop and maintain relationships with end customers and home offices—without disintermediating investment consultants.

Finally, managers must develop a thorough understanding of their cost structure and maintain rigorous discipline in the pricing of solutions. This is the case particularly for custom solutions, which may be difficult to scale across multiple clients. Additionally, managers need to have nimble middle and back offices to facilitate creating and operating a solutions offering.

Managers that succeed in getting these elements right will have the key to unlock enormous growth opportunities.

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The Boston Consulting Group has published other reports and articles that may be of interest to senior financial executives. Recent examples include those listed here:

Maintaining Momentum in a Complex World: Global Wealth 2013
A report by The Boston Consulting Group, May 2013

Survival of the Fittest: Global Capital Markets 2013
A report by The Boston Consulting Group, April 2013

Committing to Customers in the "New New Normal": Operational Excellence in Retail Banking
A report by The Boston Consulting Group, February 2013

An Inflection Point in Global Banking: Risk Report 2012–2013
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Capturing Growth in Adverse Times: Global Asset Management 2012
A report by The Boston Consulting Group, September 2012

Tough Decisions and New Directions: Global Capital Markets 2012
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NOTE TO THE READER

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