The Asset Management Industry in 2010

Bigger, sometimes better – and the best pulling away
The Asset Management Industry in 2010

Bigger, sometimes better – and the best pulling away
EXECUTIVE SUMMARY

When viewed from 30,000 feet, the pace of change in the asset management business can appear almost glacial. Year after year, it seems, the industry turns out enviable, solid performance – indeed, our research shows that overall profit margins have held remarkably stable over the past market cycle, just shy of the 30 percent mark. And while their relative positions may shift modestly, the same roster of familiar names tends to resurface time and again in the industry’s annual rankings of dominant players.

But that’s only the bird’s eye view. Drill deeper, and a very different picture emerges – one in which a handful of powerful forces is already spurring dramatic change at the individual firm level. Customer needs are changing fundamentally, driven on the retail front by the looming retirement of the biggest demographic wave in our country’s history, and on the institutional side by a combination of worsening pension deficits and a significantly different approach to evaluating – and paying for – performance. And all of this is taking place amid an uncertain market environment that is breeding enormous levels of anxiety among investors of all stripes.

These forces have already begun to make their mark on industry structure. The big, for instance, are getting considerably bigger: just 5 years ago, an average top-ten player managed about $500 billion in assets; today, that figure is closer to $1 trillion. And while the industry as a whole remains extraordinarily healthy, the profit gap between winners and losers – regardless of size or customer segment served – continues to widen. But we believe the action is just getting started: looking ahead to 2010, we see an asset management industry that looks markedly different than it does today.

What’s driving this belief? McKinsey & Company has made an extensive research commitment to understanding the changing dynamics of the asset management industry and identifying the critical factors for achieving long-run success. Our analysis has cut across multiple customer and competitive segments, geographies and time horizons. We have conducted surveys and interviews with retail and institutional investors, top executives with mutual fund and alternatives firms, as well as key influencers and decision makers across all relevant distribution channels. We also conduct, in conjunction with Institutional Investor’s U.S. Institute, the most in-depth annual study of the economics of the U.S. asset management business.
Our research points to conclusions in three key areas:

- We have identified eight trends that will increasingly shape the sources of industry growth and profitability over the next few years. The way in which money is managed will be significantly altered and aligned with a new definition of "performance" that incorporates risk management, income generation, and alpha/beta separation. The increasing institutionalization of the retail sale will require asset managers to take a new approach to third-party distribution and client service. And new growth will come from different sources, requiring a retooling of the business development and investment management functions.

- These trends will combine to have a truly profound influence on the asset management industry's structure and dynamics. By 2010, we expect to see major changes in five areas: As much as 25 to 30 percent of leading firms' earnings will be derived from products they aren’t even offering today and pricing on traditional products could decline by 10 to 20 percent; the need for scale will intensify, with the very largest players easily topping $2 trillion in assets; the alternatives world will experience a shakeout of non-alpha generators; the asset management industry will be crowded, with investment banks and insurers playing a much more visible role; and mergers and acquisitions will continue, albeit at a measured pace.

- Finally, the changes in industry structure and dynamics will have significant implications for the management agenda of virtually all asset managers. Strong investment performance alone will not be enough to drive growth and profitability. We have identified five key management initiatives that will ultimately separate winners from losers: seizing the retirement opportunity, retooling the investment management process, reinventing retail distribution and product management capabilities, reorienting new business development toward future growth opportunities, and driving scale to generate operating leverage. These are the crucial issues that we believe should account for the bulk of senior management’s attention moving forward.

The good news is that the asset management industry today is remarkably healthy, with ample capacity to tackle many of the challenges that lie ahead. Now is the time, therefore, for senior executives to assess whether their existing competitive strategies and operational methods will be enough to place them among the winners in tomorrow’s changed environment.
The Asset Management Industry in 2010
Eight major trends that will shape industry growth and profitability

Trends often have a habit of appearing incremental, particularly when measured on a yearly basis. But when viewed over a five-year timeframe, a dramatically different picture can emerge. This will unquestionably be the case in the asset management business over the next half-decade as powerful forces – not the least of which include the impending retirement of some 76 million baby boomers – are already making their presence known. We believe that we are at a point of inflection: Looking ahead, we see eight major trends that will increasingly shape the sources of industry growth and profitability over the next few years.
1. MOVE FROM ACCUMULATION TO INCOME AND RISK MANAGEMENT

As the biggest demographic wave in our country’s history transitions out of the workforce over the next two decades, the retirement opportunity will represent the single largest driver of growth and profitability for the financial services industry. For asset managers, this unprecedented demographic shift will bring with it some crucial implications. Foremost among these is that investable assets controlled by retirees and near-retirees will balloon to almost two-thirds of all assets by 2010 (Exhibit 1). As a result, the financial products and advice demanded by millions of investors will shift dramatically, from an almost exclusive focus on savings and accumulation, to a much heavier emphasis on income generation and principal protection.

EXHIBIT 1
Two-thirds of all investable assets will soon be controlled by households in the income/protection/preservation mode

This presents a distinct challenge to asset managers, as the business models of most are still firmly rooted in accumulation mode, with the primary focus on products, not customer needs. Some insurers, meanwhile, have begun to take direct aim at these burgeoning consumer

---

* Investable assets include financial assets held in pension accounts such as 401(k) and IRAs
Note: Totals may not add up perfectly due to rounding
Source: Survey of Consumer Finances 2004; U.S. Census Bureau; McKinsey analysis
demands by aggressively rolling out such products as principal protected funds, which guarantee the investor’s original investment. Others have begun to offer innovative income-oriented solutions, such as "income bridge" annuities, which enable investors to defer the age at which they begin receiving Social Security benefits, thus increasing their ultimate monthly payments.

But demographics merely amplify an even more fundamental change to the consumer risk profile. As millions of baby boomers move headlong into retirement, they will be forced to bear a whole array of financial risks that previous generations didn’t even have to contemplate. A key reason, of course, is the continuing decline among today’s workforce of defined-benefit pensions and retiree healthcare. Our research indicates that consumers are now actively interested in purchasing financial products that will not only limit their exposure to market risk, but also to inflation, taxation, health care and other risks (Exhibit 2).

EXHIBIT 2
The retirement wave is fuelling demand for investment products that mitigate risk

Question: “How interested would you be in purchasing financial products that would protect you against each of the following risks?”
Percent answering “extremely” or “very” interested

1. Market performance risk (risk of poor market returns decreasing retirement assets)
2. Health care risk (risk of poor health and medical bills diminishing retirement assets)
3. Inflation risk (risk that the rising cost of living will erode the buying power of assets)
4. Longevity risk (risk of outliving financial assets/wealth)
5. Interest rate risk (risk that retirement assets will be adversely impacted by changes in interest rates)

<table>
<thead>
<tr>
<th>Risk</th>
<th>Interest Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market performance</td>
<td>45</td>
</tr>
<tr>
<td>Health care risk</td>
<td>41</td>
</tr>
<tr>
<td>Inflation risk</td>
<td>36</td>
</tr>
<tr>
<td>Longevity risk</td>
<td>33</td>
</tr>
<tr>
<td>Interest rate risk</td>
<td>33</td>
</tr>
</tbody>
</table>

Source: McKinsey Affluent Consumer Survey

Here again, asset managers face a major challenge: Today, most seek to manage risk exclusively through diversification and pay scant attention to
either hedging or insuring risk. As consumers become much more interested in products that contain risk-mitigation features, insurance companies – with their large balance sheets and risk management expertise – and investment banks, with their structuring expertise, will be formidable competitors. Indeed, several have already begun to market products to address these risks; some insurers are now offering so-called "longevity insurance," for example, a product which guarantees a stream of income starting at a specified future age, in return for a relatively modest lump-sum payment today. Investment banks, meanwhile, are developing structured products that mimic some of the principal-protection and income-generation features of annuities, often at a lower cost. We expect insurers and, to a certain extent, investment banks, to accelerate the pace of new product development along these lines over the next few years.

2. MOVE FROM RELATIVE PERFORMANCE TO OUTCOME ORIENTATION

A defining characteristic of the mutual fund business over the past decade has been the "relative performance" game that now dominates the industry. In the process, style proliferation has also become pervasive: Morningstar now classifies funds into 63 separate categories, up from 44 a decade ago. There's little question that both relative performance and style proliferation have played nicely into the marketing efforts of many asset managers. But paradoxically, the fund business has in many ways become a victim of that marketing success.

Leading firms will break away from style categorization.

Abundant evidence suggests that style proliferation has not served either asset managers or their investors particularly well. For instance, according to a recent study by Lipper, narrowly defined mutual funds have significantly underperformed more broadly classified, multi-cap funds in virtually every measurable period over the past decade. Many asset managers, meanwhile, have responded to the popularity of style proliferation by developing far too many products, causing a drag on profitability. Our benchmarking research shows that the profit margins of
firms with less than $1 billion in AUM per product strategy typically lag far behind the rest of the industry.

We believe that successful firms of the future will break away from the pack and offer fewer products that are also more broadly defined, cutting across current style categories. These winning players will expand the definition of "asset class" by marketing specific outcomes, such as target retirement dates, tax minimization, and income generation. Many of these products are still in the nascent stage, but consumers have already exhibited a strong willingness to purchase them: the average annual growth rate among outcome-oriented funds has been over twice that of traditional funds in recent years (Exhibit 3). We believe this trend will continue unabated, fueled by retirees making the transition from asset accumulation to income generation. These investors will find the concept of relative performance insufficient for their needs – after all, you can't spend a benchmark.

**EXHIBIT 3**

**Outcome-oriented funds are growing much faster than the mutual fund industry**

<table>
<thead>
<tr>
<th>Growth rates of outcome-oriented funds vs. industry</th>
<th>CAGR 1994 – June 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal protected</td>
<td>16</td>
</tr>
<tr>
<td>Risk-based lifecycle</td>
<td>20</td>
</tr>
<tr>
<td>Tax managed</td>
<td>33</td>
</tr>
<tr>
<td>Target-date lifecycle</td>
<td>69</td>
</tr>
<tr>
<td>Inflation indexed</td>
<td>72</td>
</tr>
</tbody>
</table>

Total outcome-oriented assets, June 2005 = $251 billion

Source: Strategic Insight, McKinsey analysis
3. SEPARATION OF ALPHA AND BETA

The move to deemphasize relative performance and focus on outcome is not, of course, being made only by retail investors. Indeed, institutional investors have already begun to employ fundamentally different approaches to asset allocation and performance measurement. In particular, many sponsors of defined-benefit pensions are now actively separating alpha and beta performance, as they attempt to cope with worsening plan deficits amid a persistently low-return environment. These leading-edge pension plans are constructing their portfolios with the aim of achieving specific risk and return objectives, using alpha and beta as the building blocks. About 40 percent of all large pension sponsors are now making this distinction, according to a recent survey by JP Morgan (Exhibit 4).

EXHIBIT 4
The separation of alpha and beta is taking hold among institutional investors

The smart funds-of-funds guys are trying to isolate alpha. What is difficult to hedge out is what people will be willing to pay for.
– Co-founder, hedge fund

We are seeing a more bifurcated industry along these lines. People are buying beta through ETFs and complementing that with alpha-adding managers.
– CEO, investment company

The separation of alpha and beta carries with it some crucial implications for asset managers. No longer are pension sponsors awarding mandates strictly along the lines of traditional equity and fixed income asset classes. Instead, they are selecting managers on their ability either to generate alpha consistently or provide cheap sources of beta. As a result, the
battleground upon which individual asset managers compete for institutional mandates is continually expanding, encompassing players from multiple, overlapping asset classes. Moving forward, we expect to see alpha being generated from an even broader range of sources, including commodities, real assets, and structured products.

For asset managers, this carries not only important product development implications, but also serious pricing ramifications. As the distinction between alpha and beta performance becomes more transparent, investors will likely be willing to pay less and less for beta. Meanwhile, only true alpha generators will command premium fees. Our benchmarking research indicates that the divergence in pricing has already begun, with declining fees for lower alpha-generating products driving large-cap equity pricing down 5 to 15 percent in 2004, both for retail and institutional players. Pricing for stronger alpha-generating products, on the other hand, generally remained robust.

4. PENSION RESTRUCTURING

While defined-benefit pensions have long been on the decline in struggling industries, a more recent development is the freezing of pension plans by financially healthy companies. In a bid to insulate themselves from the significant balance sheet and income statement risks associated with DB plans, these sponsors are increasingly opting to move their employees out of DB plans and into 401(k) plans. Barring a dramatic near-term spike in market returns, we see this trend accelerating among corporate DB sponsors over the next few years - and even gaining traction among public sector employers, the vast majority of which still offer DB plans to their workforces.

For asset managers, this trend to shed DB risk carries with it two important implications. First, employers that continue to offer defined benefit plans in the years ahead will be looking to asset managers for more sophisticated products and advice, particularly around asset/liability management. To address these changing needs, leading asset managers...
will offer a much broader range of pension restructuring products aimed at reducing the volatility of contributions and better aligning assets and liabilities. We expect this to lead to a wave of product innovation that will integrate derivatives, insurance, and other structured products (Exhibit 5).

EXHIBIT 5
Pension plan sponsors are seeking more sophisticated solutions from asset managers

Meanwhile, those employers who make the transition from DB to DC plans will expect much more from the asset managers who operate in the latter channel. On the product front, many 401(k) sponsors will be seeking investment products that mimic the best features of DB plans, including guaranteed income and protection against longevity risk. We expect to see more demand for outcome-oriented funds – such as lifestyle and target-date retirement funds – and far more call for income-generation and principal protection products. There will also likely be strong demand for low-cost annuities and more flexible annuitization structures, particularly those that offer multiple circumstances (including health care needs) which permit withdrawals without penalty.
We believe that next-generation DC plans will also provide employees with options for seeking professional advice. More plan sponsors are likely to strike arrangements with third-party advisors to help employees with crucial issues like asset allocation and portfolio management. Others may opt to provide their workers with a yearly stipend to be applied toward sessions with an independent advisor of their choice. Either way, asset managers operating within the 401(K) space will soon find the performance and cost of their products coming under much more scrutiny from these crucial influencers.

5. INSTITUTIONALIZATION OF RETAIL SALES

In recent years, the process of selling to large broker-dealers has evolved into a multi-layered endeavor for asset managers. Serving wirehouses has become much more complex, with purchasing decisions taking place across multiple levels and regions and encompassing not only front-line advisors, but also regional and national gatekeepers.

Home-office gatekeepers will wield far greater influence.

But we believe significant changes are in the offing. First, broker-dealers are increasingly packaging products at the home-office level, motivated largely by the fee-based income streams they can reap on wraps and other managed account products. We see this trend accelerating over the next few years, with major consequences for asset managers serving this channel. Second, a combination of consumer pressure and regulatory changes are leading some players to ask whether they have obligations of "fiduciary duty" in addition to their traditional responsibility to ensure "suitability" of products. As the former becomes more prominent, the role of the home-office gatekeeper will grow in importance, with individual advisor recommendations becoming more controlled and part of a detailed client planning process.

So what does this mean for the future of the retail sales process in advisor-driven channels? We see four important implications:
• As more purchases are vetted by home offices, the performance of retail mutual funds will be scrutinized much more closely than it is today. Moving forward, broker-dealer gatekeepers will evaluate retail funds in much the same way as institutional investors. Due diligence will be more extensive, team stability and track record will matter more, and performance metrics will be more sophisticated.

• At the same time, we anticipate a further narrowing of choices for retail investors – and a greater concentration of "winning" asset managers operating in this channel. In fact, we are already seeing a strong tendency among individual financial advisors to concentrate their purchases: our research indicates that the average advisor currently allocates almost two-thirds of his or her assets to only three fund families (Exhibit 6).

EXHIBIT 6
Advisors have a limited universe of products that dominate share of mind

Advisors' allocation of mutual fund assets
Percent

Other managers 36
No. 1 manager 37
No. 3 manager 10
No. 2 manager 17

64% of AUM to top 3 managers

I don’t want to keep track of more than five or six products. I call this “simplification and focus.”
– Financial advisor

Source: ICIMC-McKinsey Financial Advisor Survey; McKinsey interviews

• Leading asset managers will also respond to the increasing influence of the gatekeeper by revamping their wholesaling approaches. To comply with the institutional-like demands of the home office, asset managers will bolster their investment and sales processes, while investing in
more resources to manage these relationships more thoughtfully and profitably. At the individual advisor level, successful firms will move to a more consultative wholesaling model that involves less focus on pure relationship management and more time spent in specific discussions around particular strategies that could help advisors adapt their book to changing consumer needs.

- Finally, we see pricing for retail products coming under greater pressure. Looking ahead, deals will be struck based on large, multi-product offerings that carry more institutional-like features and pricing levels, rather than retail economics.

6. INCREASING ROLE OF MARKETING AND CLIENT SERVICE

As the sales process becomes more institutionalized, the marketing and client service capabilities of asset managers will become of paramount importance. While investment performance is clearly an important driver of flows, it is hardly enough. In 2004, even the majority of "5-star" funds collectively experienced negative outflows (Exhibit 7). We believe that as distribution becomes more gatekeeper-centric, and traditional mutual funds become increasingly commoditized, winning asset managers will be those who forge a superior reputation and capabilities for service and sophisticated advice.

Asset managers that excel in client service and retention management are often highly successful in retaining assets in both retail and institutional settings, even when investment performance is less than stellar. Our research shows, for example, that firms with an above-average spend in client service experienced outflows in 2004 that were a full 4 percentage points lower than those firms with a below-average spend. At the bottom of the bear market, that gap was even wider, at 10 points. Leading retail firms in retention management have built sophisticated call centers, typically staffed with Series 7 licensed professionals to field redemption calls. They have also actively segmented and subsequently managed the behavior of advisors. Innovative institutional managers, for their part, are increasingly employing similar methods. The most successful firms carefully prioritize the highest-value (and most at-risk) accounts, while delivering a variety of value-add services to improve the "stickiness" of assets.
7. CONVERGENCE AND EVOLUTION OF ALTERNATIVES

As they seek out ways to stabilize their capital base and future cash flow, many alternatives managers are likely to expand into both traditional investment areas and other alternative asset classes. These players will be particularly drawn to the large pools of institutional investor assets that currently reside within the traditional long-only space. And for good reason: institutional investors have been continually increasing their allocations to absolute return products and now account for 40 to 50 percent of all new flows into hedge funds – and will likely constitute the majority of flows over the next few years (Exhibit 8).

To attract these investors, we expect hedge funds to roll out new "lower-octane," higher-capacity products that are designed to have lower volatility than the typical hedge fund, but still employ many of the same characteristics, including shorting, leverage, and "black box" investment strategies. We are likely to see much larger funds (e.g., $20 billion and...
up) emanating from these players, but with lower fees. And many will take larger, longer-term, and more active stakes in target companies, resembling private equity investments.

Traditional asset managers, meanwhile, have continued to lose ground to alternative players – their share of new flows has dropped from 93 to 78 percent over the past 4 years alone. We expect this trend to continue, due to increasing demand from institutional investors and ramped-up efforts by alternatives manufacturers to make their products more accessible to the affluent (and even mass-affluent) segments of the retail market.

All of this will put enormous pressure on traditional players to break out of their long-only strategies and take on more alternative-like characteristics. We expect some firms, particularly those on the institutional side, to do so through direct acquisition of hedge funds. Other players will begin to embed hedge-fund characteristics into their existing suite of traditional products, incorporating features such as performance fees, leverage, and

EXHIBIT 8

Institutional investors are likely to account for the majority of flows into hedge funds over the next few years

Hedge fund flows by source

Percent

Source: Casey, Quirk & Acito, “Institutional Demand for Hedge Funds”; McKinsey analysis
shorting. We have already begun to see a small but rapidly growing number of traditional players enter this arena.

8. **CHANGING SOURCES OF GROWTH IN RETAIL AND INTERNATIONAL**

During the stock market boom of the late 1990s, it often seemed as though an asset management firm needed only to be an active participant in the game to generate impressive asset and profit growth. Much has changed since then, of course. Indeed, our benchmarking research reveals that while industrywide assets under management are still increasing, the primary reason is market appreciation, not new inflows – a cause for concern, especially if future markets drift sideways. An equally important implication is that asset managers must now have a solid understanding of the major drivers of industry growth in the coming years – and how best to capitalize on them – in order to maintain their current levels of profitability.

As mentioned, we anticipate strong growth for income-generation, risk-management, and outcome-oriented products over the next few years. Alternatives sales will continue to rise at a fast pace, driven by institutional demand, particularly on behalf of pension sponsors. And as alpha-beta separation becomes even more prevalent, we foresee significant growth in ETFs, enhanced index and other low-cost beta-producing products.

That's all on the product side. In terms of channels, the IRA rollover channel will unquestionably represent one of the most significant areas of opportunity for asset managers over the next few years. Bolstered by the assets of retiring baby-boomers, net new flows into the IRA market are forecasted to grow at a compound annual rate of 5 percent through 2010 (Exhibit 9). Over the next 5 years alone, rollovers from defined contribution plans to IRAs will generate approximately $1.5 trillion in new assets flows. We estimate that asset managers stand to gain more than $10 billion in AUM for every percentage point of IRA rollover flow share captured. In particular, opportunities abound for players who can effectively target the roughly 25 percent of assets that retirees leave parked within their former employers' defined contribution plans, often for up to 3 years.
Although it will experience a high degree of churn from IRA rollovers, the 401(k) channel will continue to offer opportunities as well, boosted in part by the increasing DB-to-DC transition among large corporations. We also anticipate that inflows will be further accelerated by the growing tendency among large employers to enroll their workers in 401(k) plans automatically and, increasingly, to ratchet up employee contribution rates in conjunction with pay increases. Within the 401(k) space, we expect growth of investment-only funds to outpace overall plan growth and estimate that the IODC market will represent a $1 trillion money-in-motion opportunity over the next 5 years, driven by an increased emphasis on open-architecture platforms. We believe the most promising opportunities in IODC await those asset managers who succeed in building a distinctive offer to record keepers around institutional-type, embedded-advice products, such as lifecycle funds. Winning firms will also be those who develop a compelling offer to plan sponsors, including bundled DC/DB-type offers and institutional-quality investment advice.
Looking beyond the American landscape, international markets have long represented an enticing opportunity, but one that has also been exceptionally tough to crack for U.S. asset managers. Looking ahead, we see major changes on this front, particularly in Europe and Japan. The European market, long a bastion for proprietary funds, is finally beginning to embrace open architecture in a meaningful way, a movement that we see accelerating over the next few years (Exhibit 10).

EXHIBIT 10
Open architecture is beginning to take hold in previously “closed” European markets

For many U.S. players this is good news indeed; moving forward, we see significant advantages accruing to those managers who already have a foothold in those markets. On the other hand, U.S. players without an existing presence in European markets will likely face a difficult path, due to lack of channel relationships, poor brand recognition, and inexperience with local product development and packaging.

We also see a very promising source of growth in the Asian asset management markets. And while China and India tend to dominate the spotlight, we believe that Japan will present a much greater opportunity for
US players over the next five years, largely because it will continue to dwarf other Asian countries in terms of investable assets – for instance, personal financial assets in Japan now total about $13 trillion, compared to China’s $2 trillion.

Even more important, Japan’s asset management market still has ample capacity for growth. Although it is the world’s second-largest economy, Japan currently ranks only ninth in terms of its mutual fund market. About half of total Japanese personal financial assets are currently held in cash and deposits, versus less than 15 percent in the U.S. At the same time, less than 3 percent of all Japanese household assets are held in mutual funds, compared with nearly 20 percent of all American household assets.

Moving forward, we see the bank channel, particularly regional banks, as the most promising source of growth for US asset managers. In addition, Japan Post, which holds about a quarter of all Japanese household financial assets, is now opening itself to private investment and to partnerships with a range of businesses, including domestic and foreign asset managers. As this move into the private sector progresses, we predict that a large proportion of consumers will turn to mutual funds in an effort to beat the virtually zero percent interest they are now receiving on their bank accounts. Given that even a modest shift in consumers’ asset allocations could ultimately produce trillions of dollars in new flows, this will present another major opportunity for many US asset managers over the next five years.
The Asset Management Industry in 2010
The asset management industry in 2010

The trends described in Part 1, while each powerful in their own right, will combine to influence both the structure and dynamics of the asset management industry in profound ways over the next five years. By 2010, leading players will look very different than they do today in terms of size, capabilities, and products offered. Specifically, we see five major differences that will characterize the industry and its leaders.
1. DRIVING SCALE TO GENERATE A WINNING EDGE

Our industry benchmarking research, conducted annually in conjunction with Institutional Investor’s U.S. Institute, reveals that three distinctive winning strategies – scale, multi-boutique and focused-asset players – are emerging in the asset management industry. Firms pursuing one of these strategies generate, on average, pre-tax profit margins of around 35 percent – about twice those attained by firms taking a broad, but not deep, approach to any one area. Indeed, winning firms are outperforming so-called "stuck in the middle" firms on just about every major dimension (Exhibit 11).

By 2010, the unique attributes that characterize each of these three winning models will become even more important, and the profit gap between winners and stuck-in-the-middle firms will be even wider. Within each model, the new leaders will use scale in different ways to create competitive advantage.

EXHIBIT 11
Three “winning” strategies outperform on most dimensions

* Assets per IM and sales professional
Today, the ten largest industry players manage, on average, just under $1 trillion in assets. By 2010, we expect nearly all top 10 firms to have over $1.5 trillion in assets, with several players – largely indexers – surpassing the $2 trillion mark. This will be accomplished through a combination of mergers and acquisitions, as well as organic growth. The leaders in this segment will use their large overall size to drive volume through distribution reach, product breadth, and brand. Their sheer size will allow them to generate a cost advantage that more than offsets the burden of maintaining a corporate center to manage the enterprise. These players will also be well positioned to endure the effects of intensifying pricing pressures, especially in commoditizing products.

The multi-boutique model will hold a much more prominent position within the industry in 5 years' time, as it emerges as a preferred model for absorbing and integrating acquisitions. We expect to see many more multi-boutiques, with average sizes reaching the $100 to $200 billion AUM range by 2010, compared to $60 billion today. These players will continue to exploit the scale advantages resident within each of their constituent firms, enjoying the high sales and investment productivity that comes with focusing on a limited set of products. And like the scale players, the larger multi-boutiques will reap some of the benefits of large size (e.g., diversification of earnings), while limiting the negative aspects (e.g., loss of focus).

Focused asset class competitors are likely to face many challenges from the trends described in Part 1, but we still expect a significant cadre of players (likely those in the $50 to $100 billion AUM range) to hold strong positions within the industry landscape in 5 years' time. They will continue to use the scale and expertise they possess in certain investment strategies to drive distinctive performance in those areas. We also expect many of these to emerge as leading "alpha engines." Like multi-boutiques, they will also continue to enjoy many of the productivity advantages associated with product focus.

Firms pursuing one of these three models will generate profits that increasingly outstrip those stuck in the middle. This latter group is neither large nor focused, possessing an average AUM of about $760 million per product strategy, less than half that of the industry norm. They must spread their resources across a diversified set of asset classes, resulting
in higher costs and lower productivity than their peers. Our most recent benchmarking results suggest a pretax profit margin gap of about 15 to 20 percentage points been these stuck-in-the-middle players and the rest of the industry; we believe the gap could grow to as much as 20 to 25 points within 5 years.

2. A SIGNIFICANTLY DIFFERENT EARNINGS PROFILE FOR TRADITIONAL ASSET MANAGERS

As the traditional asset management industry continues to mature, firms must cope with increasing product commoditization and downward pressure on pricing. We believe that recent price declines in traditional actively managed products are likely to continue, particularly if the low-return environment persists, and we expect average expense ratios for these funds to be 10 to 20 percent lower by 2010.

Pricing for traditional products could decline by 10 to 20 percent over the next 5 years.

The implications for the asset management industry, which has enjoyed double-digit asset growth and consistent annual price increases for most of the past two decades, are profound: For a typical firm, a 10 percent decline in price would decrease pre-tax margins by 20 percent. Given these threats to future profitability, winning players will be those who succeed in cultivating entirely new sources of growth. We predict that by 2010 many leading players will draw as much as 30 percent of their earnings from products they don’t offer today.

Some evidence of this earnings shift is already emerging in the alternatives arena. Over the past several years, a number of traditional managers have either developed or acquired alternatives capabilities, often in the form of hedge funds, private equity arms, or fund-of-funds vehicles. This trend will only accelerate, due primarily to the increasing appetite among investors (particularly institutional) for such strategies. Alternatives will shift from being a “special case” for many traditional managers to becoming a core asset class.
But even within asset managers’ traditional range of product offerings, alternatives strategies will begin to play an increasingly important role. Leverage and shorting – usually the exclusive purview of hedge funds – have begun to make their way into ‘40 Act funds, as managers seek new sources of alpha in a commoditizing world. As the separation of alpha and beta continues, the use of such strategies will increase, transforming some traditional investment teams into "alpha engines" for the firm.

Driven largely by the retirement trends described earlier, income-generating, risk-management, and outcome-oriented products will make up another significant component of the average managers’ product portfolio. Some of these products will be based on traditional strategies with "overlays" added to provide different risk management characteristics. Others will be entirely new products that incorporate different capabilities (insurance, for instance) either by means of internal expertise or external partnerships.

For most players, the implications of these changes will be profound, requiring many to revisit the very foundations of their business models. We expect to see far more complex organization structures and processes, designed to effectively manage a broader range of products, particularly those acquired through M&A. We will also see new compensation models that give firms much more flexibility to reward a wide range of talent and capabilities, while retaining the existing culture. Taken together, these changes will result in firms that look different not only from a financial perspective, but also in terms of organizational fabric.

3. A SHAKEOUT – OF SORTS – IN THE ALTERNATIVES INDUSTRY

As they continue to attract an additional share of institutional flows, many alternatives players will face pressure to "professionalize" their business models - that is, develop more scale, build more traditional products, and broaden their approach to distribution. Simultaneously, the increasing
transparency with respect to performance is beginning to expose many players who have actually been selling beta products disguised in alpha packaging and pricing.

We expect these forces to cause two major changes to industry structure. First, underperformance will drive a number of alternatives players out of business. We expect that the recent proliferation of hedge funds will stall and then actually reverse itself by 2010. A recent study by Bridgewater Associates highlighted the emerging performance challenges that we believe will lead to this shift. Within four of five leading investment strategies (e.g., long/short equity), hedge fund managers collectively failed to outperform a synthetically constructed "passive index," suggesting that these managers were essentially producing beta masquerading as alpha. Institutional investors will increasingly recognize such performance and be unwilling to pay for it. Instead, they will shift flows to the true (and fewer) generators of alpha.

We also anticipate that within 5 years the industry will have experienced a substantial "barbelling" among remaining players, with very large-scale firms at one end and boutique alpha generators at the other. We’re already witnessing the beginnings of this phenomenon: the market share of the top 100 hedge fund providers now stands at close to 60 percent. And the largest firms are, as a group, growing assets at more than double the annual rate of their smaller competitors (Exhibit 12).

The relatively concentrated number of large-scale players (e.g., those with assets in excess of $20 billion) will possess a broad range of new capabilities and offerings to drive growth and serve institutional investors more effectively. These are likely to include multi-strategy funds, a broad range of single strategy funds, and/or fund-of-funds offerings to accommodate single-point-of-contact diversification. These players will possess more professional sales and client service capabilities to reach a wider distribution channel, as well as more transparent operations, including performance reporting, risk management, compliance, and investment management. We also expect these players to experience some fee erosion, due to institutional client pressure and product commoditization.

The other end of the barbell will be dominated by top-performing "alpha boutiques" (e.g., players with AUM less than $5 billion), focused on specific asset classes or investment strategies. We anticipate continued high personnel
turnover in these firms, as they remain coveted destinations for entrepreneurial, top-flight investment talent. Their primary client targets will likely remain high-net-worth and other highly risk-tolerant investors, including some endowments and foundations. The alpha boutiques will be less likely to suffer future fee erosion – assuming, of course, that their underlying performance remains superior.

4. A MORE CROWDED AND COMPLICATED INDUSTRY LANDSCAPE

In the first half of this decade, traditional asset managers continued to lose ground to alternative players – their share of new flows dropped from 93% to 78 percent from 2002 to 2004 alone, as hedge funds, venture capital, and private equity firms reshaped and redefined the industry. Much of this was driven by cyclical short-term market conditions, but the impact is likely to be long-lasting nonetheless. Moving forward, many of the secular changes described in the previous section – demand for income-generating and risk-protection products, pension restructuring, international expansion – are likely to lead to even more dramatic and lasting changes in the industry landscape. By 2010, the very definition of "asset management" will be amorphous, as a host of players ranging from insurance companies to
investment banks to pension consultants play much broader and more creative roles for retail and institutional investors than they do today.

One clear impetus for this change will be the fact that many asset managers simply do not possess many of the requisite capabilities – balance sheet strength, risk management, product structuring – to deliver on the changing needs of investors. Within the retail market, for example, insurance companies will likely play a much more important role, either alone or in combination with asset managers. Some asset managers will choose to expand their traditional sub-advisory business to package investment products within such vehicles as variable annuities and variable universal life. This will result in a variety of co-marketing relationships, in which products are jointly manufactured and potentially distributed through both the asset managers’ and insurers’ platforms.

We further envision a new wave of alliances between insurance companies and asset managers designed to meet the changing needs of defined benefit pension sponsors. In the near term, these alliances will provide traditional investment management solutions to pension plans, with "riders" to mitigate shortfalls or contribution risk. Within 5 years, however, the alliances will evolve to feature a full range of next-generation solutions for addressing plan sponsors’ needs, including immunization, plan takeouts, or complex hedging and/or insurance strategies for more comprehensively offsetting liabilities.

The world of underfunded pension plans will also prove to be fertile ground for investment banks, pension consultants, and even private equity firms to play new and more prominent roles. The banks, for their part, are already moving quickly to develop a wide array of new structured solutions for plan sponsors to compete with traditional insurance and other takeout solutions. Simultaneously, many of the largest pension consultants are launching brand new divisions explicitly designed to provide more sophisticated advice and solutions focused on better understanding true liability exposure and

---

Investment banks and insurers are taking aim at the asset management landscape.

---

The Asset Management Industry in 2010
identifying appropriate asset allocation strategies. Perhaps most intriguingly, private equity firms have shown early interest in creative deals that could allow them to take equity stakes in some of these plans.

Given all the activity in this market today, asset managers who do not take a proactive role in restructuring their own existing market may awake in 2010 to find that it has been restructured for them – by someone else.

5. A MEASURED PACE FOR MERGERS AND ACQUISITIONS

Although the asset management industry has recently been characterized by a spate of high-profile mergers and acquisitions, we predict a more measured pace for these deals moving forward. While the industry’s structure is highly fragmented, we do not believe that M&A activity will redefine the asset management business in the same way as it has reshaped other financial services sectors, such as retail or investment banking. Moreover, we view the most recent industry transactions as attempts by players to capture the benefits of scope – for instance, expanding international operations, retail distribution or alternatives businesses – rather than scale.

Our more restrained outlook on mergers and acquisitions is based on several factors. For starters, asset management integrations have historically been notoriously difficult to pull off – cultural issues, customer aversion to large-scale change, and the risks involved with integrating independent investment operations have often outweighed any perceived efficiency benefits.

Second, compared to other financial services sectors, the rationale for merging is not as compelling for all players: asset management firms do not typically require the same degree of large-scale capital as investment banks, and they don’t reap deal efficiencies to the same degree as in retail banking. And as detailed in the prior section, smaller, more focused asset managers can be just as profitable as their large-scale counterparts.
Finally, we believe that the "trend" to separate manufacturing and distribution has been overplayed by many industry commentators. While there is clearly a movement afoot to separate proprietary fund businesses from their broker-dealer owners, we do not see this separation playing out across the entire industry. For example, the asset management operations of private banks are deeply integrated into the client value proposition around customized investment management, making them tremendously difficult (and frequently undesirable) to split off.

That said, we do see mergers and acquisitions playing out in four central ways over the next 5 years:

- For large-scale players, the primary driver will continue to be increased scope (for example, domestic firms going international, institutional managers branching into retail, traditional managers expanding into alternatives). For firms looking to rapidly expand their reach, M&A will provide a natural extension of their business.

- For small and mid-size asset managers there are, in fact, real benefits to acquiring scale: our benchmarking research shows that the cost per asset of the industry's smallest players far exceeds that of their larger competitors across a range of functions (Exhibit 13). For these firms, we see a much stronger rationale for M&A moving forward, particularly as increased pricing pressures and rising distribution costs continue to squeeze margins.

- The case for separating manufacturing and distribution will be strong in a limited number of situations. For instance, we see this being the case for distributors with proprietary fund families, but little third-party business; firms with small fund families that are not core to their overall business; and players that could unlock value from spinning off or selling their asset management businesses.

- The dominant business model for post-merger integrations will continue to be the multi-boutique, which provides some of the benefits of scale (for instance, common operations, retail sales forces, marketing) while at the same time allowing each unit to maintain its independence and mitigating the parent's overall risks.
EXHIBIT 13
For small and mid-size players, acquiring scale can result in significant cost savings across a range of functions

<table>
<thead>
<tr>
<th>Cost per asset</th>
<th>Firm size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bps</td>
<td>&lt;$25 billion</td>
</tr>
<tr>
<td>----------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Investment management</td>
<td>34</td>
</tr>
<tr>
<td>Management, administration, and other</td>
<td>10</td>
</tr>
<tr>
<td>Sales and marketing</td>
<td>5</td>
</tr>
<tr>
<td>Technology and operations</td>
<td>6</td>
</tr>
</tbody>
</table>

Putting the pieces together: A five-part management agenda

The trends we have outlined, coupled with the resulting changes in industry structure and dynamics, have important implications for the management agenda of any asset management firm. Strong investment performance alone won't be enough to drive growth and profitability: in the new world, winners and losers will be separated by the degree to which they successfully pursue a five-part management agenda.
1. SEIZE THE RETIREMENT OPPORTUNITY

Winning firms will have in place both the product and distribution capabilities vital for capturing the massive money-in-motion retirement opportunity and meeting the changing needs of boomers.

- On the product side, this will entail next-generation mutual funds, structured products, and other investment vehicles that address the income-generation and risk management needs of consumers. Within the 401(k) space, leaders will enhance their current products to simulate the best features of defined benefit plans.

- On the distribution front, a crucial requirement for success will be a strong IRA rollover process both to retain share of existing assets in DC plans and to capture a disproportionate share of rollover flows. In the critical advice-driven channels, leaders will develop the retirement-specific expertise required to help advisors adapt their book to changing needs.

- Institutional asset managers, for their part, will develop solutions that mitigate the risks associated with traditional defined benefit pension plans. In its simplest form, these solutions will include innovative asset/liability management; more advanced versions will limit contribution risk (or even remove it altogether) through plan take-out solutions. The successful implementation of these solutions will often require asset managers, insurance companies, investment banks, and even pension consultants to enter into strategic partnerships.

2. RETOOL THE INVESTMENT MANAGEMENT PROCESS

To meet retail investors' increasing demand for outcome-oriented products, leading players will build risk management overlays into their existing lineup of funds, while developing entirely new products and investment processes that do not adhere to traditional style categorizations. More fundamentally, firms must also determine both their willingness and ability to assume risk on behalf of retail investors – as is required, for example, when offering structured or inflation-hedged products.

Institutional asset managers, meanwhile, must consider the fundamental changes that would arise from developing products that separate alpha from beta. Key personnel requirements could include:
- Low-cost investment teams dedicated to creating a wide range of "beta" exposures (e.g., enhanced index, quantitative strategies);

- Higher-cost "alpha engine" managers, pursuing a number of non-correlated, market-neutral strategies;

- Portfolio construction teams, specializing in building tailored portfolios (e.g., developing asset characteristics that match those of liabilities).

The restructuring of investment teams will undoubtedly be fraught with organizational challenges for many players. The most successful firms will carefully balance evolving client needs with the organization's ability to absorb change.

3. REINVENT THE WHOLESALING APPROACH

As the retail sales process becomes increasingly institutionalized, and as pricing pressures continue to take their toll, asset managers will need fundamentally new approaches for working with distributors.

- At the gatekeeper level, leading players will focus on deepening relationships with fewer, more profitable distributors and building strategic alliances based on institutional-like processes, including greater use of investment specialists and more rigorous account planning. Product innovation, particularly around retirement, will be an important differentiator for firms.

- Pricing pressures will also cause firms to reassess their cost-to-serve model. Leading firms will experiment with lower-cost approaches including expanding parts of their internal wholesaling operations.

- For high-priority front-line advisors, the new sales process will involve such consultative services as evaluating his or
her book of business and jointly devising strategies to better meet the needs of key clients. Field wholesalers will also need to bring new levels of content expertise, particularly around retirement issues and managing the total balance sheet.

These changes will force asset managers to reexamine how they deploy, manage, and compensate their wholesaling organizations. Serving the home office will likely require new, higher-priced resources, which in turn may create pressure to re-tool the field into a leaner, more focused organization. This will necessitate a much more rigorous segmentation approach for identifying and "covering" the highest potential advisors.

Compensation will also be a hot issue: As more dollars are absorbed by key account managers, and pricing pressures continue, leading players will devise better performance-based compensation systems – for instance, increasing the proportion of variable pay tied to net (rather than gross) flows or to net revenues. This will represent a fundamental shift for many wholesalers.

4. DEVELOP NEW BUSINESSES TO CATCH THE NEXT WAVE OF GROWTH

As the traditional asset management industry continues to mature and flows keep concentrating, capturing growth in traditional products and channels will become increasingly difficult. Critical focal points in the coming years will include:

- Developing approaches for entering or strengthening existing positions in the faster-growing IRA and investment-only DC segments. Across both of these channels, product innovation will be a key driver of success.

- Creating a strategy for international expansion as open architecture actually begins to take hold. This will entail not only the right product portfolio, but may also involve a new range of partnership strategies to build local expertise and secure distribution.

- Pursuing an alternatives strategy, elements of which may include: the incorporation of alternative techniques into existing products; the development or acquisition of freestanding alternatives capabilities; and the formulation of defensive strategies against alternatives players entering the long-only space.
Integrating alternatives into the business model from an organizational, cultural, and economic perspective will likely be a major issue.

- Developing a range of risk management capabilities and products to advise and execute on pension restructuring and packaging new solutions for retirees.

5. DRIVE SCALE TO GENERATE OPERATING LEVERAGE

Our benchmarking research reveals a profit gap of nearly 20 percentage points between the industry’s best and worst performers and three to five times variability in performance across a range of productivity and operating metrics. How can lagging firms close the gap? Building product and channel scale is a big part of the answer, and it involves a two-step process.

The first step is to exit areas where the firm does not have the critical mass to compete effectively. This involves pruning sub-scale product strategies and taking a disciplined approach to new product development. Within distribution, it means taking a hard look at advisor and firm profitability and channels in which the firm does not have a meaningful presence, and has little chance of capturing significant share in the near term.

The second step is to consider doubling-down in core areas of strength, whether they are based on product, distribution, or some other functional capability. These areas may overlap with some of the growth trends and opportunities described earlier. We expect M&A to be high on the agenda for many asset managers, as they look to build scale quickly and capture these opportunities.

* * *

By 2010, we see a markedly changed industry landscape, one with a far greater profit gap between winners and losers. The risk of complacency is significant: Asset managers that choose to stand still over the next 5 years face the very real possibility of becoming irrelevant to both their customers and other players within the industry. Winning players will be those that position themselves ahead of the major forces which will shape the industry over the next half-decade, and execute successfully on the critical management initiatives outlined above.
ABOUT MCKINSEY & COMPANY

McKinsey & Company is a management consulting firm that helps many of the world's leading corporations and organizations address their strategic challenges, from reorganizing for long-term growth to improving business performance and maximizing revenue. With consultants deployed in more than 40 countries across the globe, McKinsey advises companies on strategic, operational, organizational and technological issues. For eight decades, our primary objective has been to serve as an organization's most trusted external advisor on critical issues facing senior management.

For more information about McKinsey & Company's initiatives within the asset management industry, please contact:

**David Hunt**  
Director  
(212) 446-7708  
david_hunt@mckinsey.com

**Salim Ramji**  
Principal  
(212) 446-7393  
salim_ramji@mckinsey.com

**Steve Vanourny**  
Associate Principal  
(617) 753-2090  
steve_vanourny@mckinsey.com

**Janice Revell**  
Practice Knowledge Specialist  
(212) 446-8447  
janice_revell@mckinsey.com
The Asset Management Industry in 2010:

Bigger, sometimes better – and the best pulling away