



# Nine key drivers of change for the global wealth and asset management industry



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Tumultuous change may be in store for the global wealth and asset management industry in the year ahead. The US interest rate environment is likely to shift direction before the end of the year, with the first gradual tightening since the global financial crisis (GFC). Concerns over deflation in the Eurozone and an outright recession in many emerging-market economies will also weigh heavily on the fixed-income universe. And the opportunities, or threats, of technology are ever present. A new breed of tech firms is dotting the horizon, offering services at rock-bottom pricing, unparalleled levels of transparency and a digitized customer experience. The inevitable rise of the machines in the form of electronic distribution platforms and robo-advisors may reshape distribution, wealth management and the core business model of many firms – both at the institutional and retail level.



In order of impact, we anticipate the top nine drivers for change in the global wealth and asset management industry will be:

- 1. The year of MiFID II – and transparency.** As the signature post-GFC regulatory legislation in the US, the Dodd-Frank Act restructured the compliance environment for that nation's financial services industry. Similarly, MiFID II will have a widespread effect on the regulatory framework for the European wealth and asset management industry. As Europe is the world's second-largest market in terms of assets under management (AUM), MiFID II will affect most global firms, particularly in how they distribute products, incentivize their client-facing advisors, and communicate and interact with clients. In many cases, 2015 will see asset management firms thoroughly reviewing and possibly rewriting their playbooks on how to win new business in Europe. In the US, the US Department of Labor should shortly issue a decision on whether client-facing advisors will be bound by a highly stringent fiduciary duty of care in respect to retirement accounts, as opposed to the previous standard of "suitability." The new rules and enhanced regulatory framework may very well restructure how total fees are disclosed and how funds are distributed in the enormous retirement-planning space. In short, the complex and changing compliance environment will continue to drive change in the industry.
- 2. The drive to grow the top line will likely accelerate M&A activity.** Growth through traditional organic strategies – such as increased spending on marketing, advertising, enhancing the product suite and hiring strategically – is costly and can take time to deliver tangible results. Shareholders of publicly

traded firms tend to prefer to see results sooner rather than later. Further, valuation premiums of many asset management firms, particularly those that are small to midsize, are becoming highly attractive. As such, strategic M&A activity will likely rise significantly, driven by the desire for asset management firms to rapidly grow their business, but in an economical, efficient and timely manner that adds value for all stakeholders.

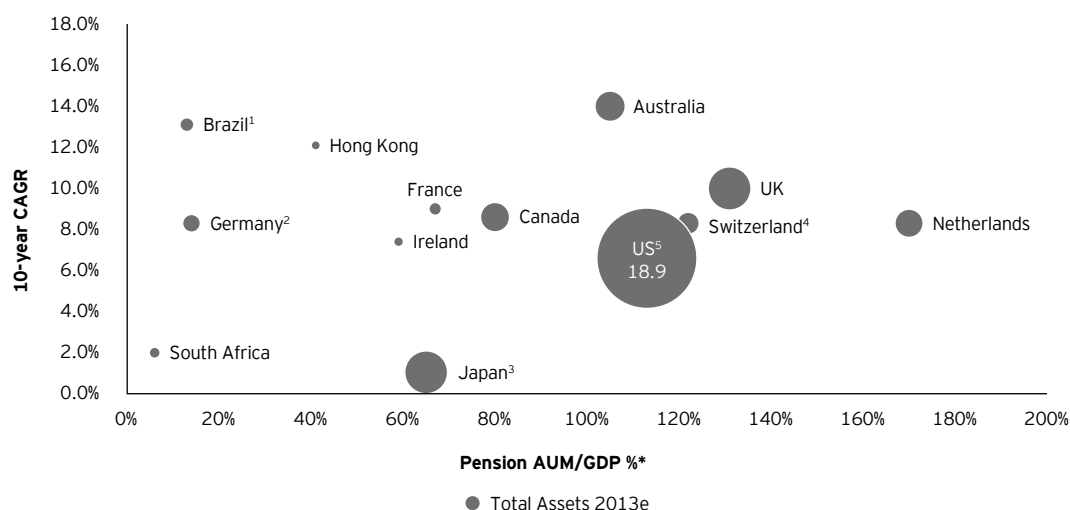
- 3. The spending on private wealth management (PWM) growth will cool – and refocus.** Since the GFC, several firms have been in a veritable arms race of spending to expand their private wealth management businesses in terms of increasing headcount and building out capacity. The highly scalable business model in wealth management offerings made it a logical growth area in the highly risk-averse post-GFC era. For 2015, the frenzy to bring in more and more seasoned advisors and more proven books of business, and the heavy investment in brand equity and marketing that came with the increased capacity, will finally peak. Instead, PWM business strategy will change direction and shift focus toward organic growth, as well as how to improve productivity, profitability and revenues with existing resources and with existing clients by restructuring internal processes and enhancing the client experience. Further, a far more targeted and personalized approach to marketing and client service will slowly be implemented, in which client-facing PWM advisors carefully customize their communication and services to specific market segments, such as affluent women, mass market, mass affluent, high net worth (HNW) and ultra-high net worth (UHNW).





**4. The day of reckoning in pensions is near.** The entire global pensions system – whether public sector defined benefit plans or private individuals saving in a tax-sheltered retirement account – suffers from a vast deficit gap covered by a thin varnish of spray paint. Simply put, great promises have been made, often in legally binding government-guaranteed contracts, and rosy expectations were set about future financial and health care security. Yet, in many cases, far too few assets have been set aside to fund those future promises and expectations. Accounting reform will further incentivize policymakers and stakeholders to address the growing and troublesome deficit in pension funding. The day of reckoning will likely require more public sector debt to be issued to partially fund the current deficit, as well as significantly restructure the benefit system, or at least a greater public debate about how little actual capital has been set aside to safely meet growing expectations of future pension solvency and retirement security.

**All the 13 major pension markets (in the chart below) have experienced an increase in their pension assets during the past 10 years. However, the general litmus test for adequate funding is for assets to be at least 150% of GDP.**



Source: Towers Watson

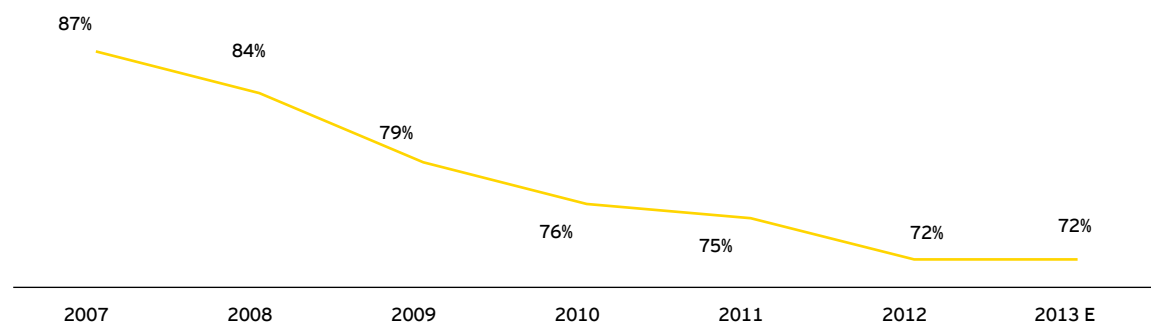
Notes:

\*Assets/GDP ratio for the world is calculated in US\$, and assets were estimated as of 31 December 2013.

1. Brazil's pension assets include only those from closed entities.
2. Germany collects pension assets only for company pension schemes.
3. This does not contain the unfunded benefit obligation of corporate pensions (account receivables).
4. This includes only the total of autonomous pension funds, without considering insurance companies' assets.
5. This includes IRAs.

**But at the same time, liabilities are also rising. In the US, in particular, the funded status (proportion of all future liabilities that can safely be met based upon current assets and actuarial assumptions) is steadily declining.**

Aggregate funded status of US DB public plans^^



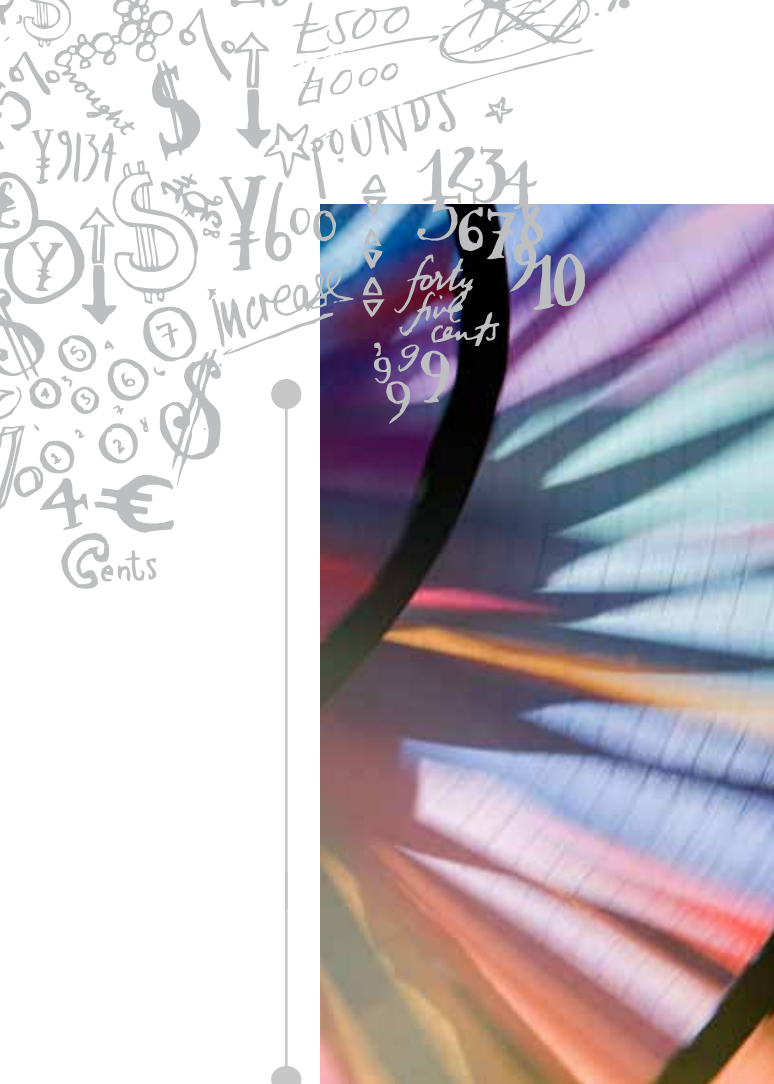
Source: Center for Retirement Research at Boston College

^^ Represents the funded status for 114 state and 36 local pension plans in the US, with 2013 actuarial value of assets of US\$2.9 trillion.

**5. The robo-advisor has arrived.** A number of electronic platforms have achieved noticeable AUM growth over the past few years – and still more will enter the market and see even stronger growth. Featuring online tools and virtual advice fueled by algorithms, these low-cost, automated advisory platforms, offered by both established firms and new technology start-ups, very effectively target the lower- to middle-income segments of the market, which is arguably over 80% of the population in many economies. Further, these platforms are investing heavily in enhancing the client experience, a key area where most firms are looking to drive growth, particularly for tech-savvy millennials. Projecting forward, the challenge for automated advisory platforms will not so much be sustained AUM growth but rather sustainability of the business model and profitability.

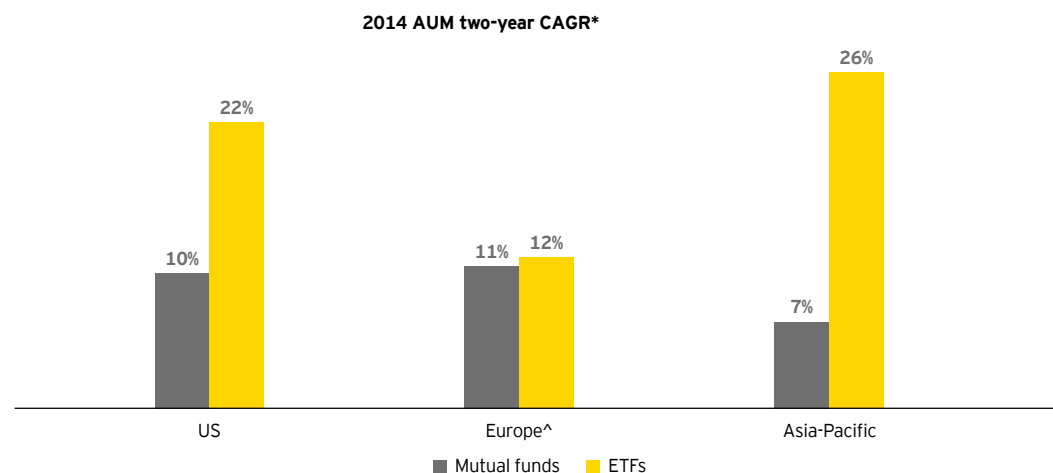
Many market segments are serviced by these automated platforms for free – or for a mere token charge. While it is laudable that a private sector firm is offering a free or loss-making service to lower- or middle-income investors, it is still unclear whether rock-bottom pricing can eventually lead to generating positive and growing operating cash flow, profitability and long-term viability. By comparison, new start-up airlines are launched each year in the global aviation market and grow rapidly due to rock-bottom pricing, and they are ready to sacrifice operating cash flow in the short run to build market share. And every year, there are also airlines that cease operations due to cut-rate pricing and negative operating cash flow.





**6. ETFs have become the giant gorilla in the room.** Net inflows to global exchange-traded funds (ETFs) and exchange-traded products (ETPs) will likely exceed the combined net inflows into all alternative investment products within two or three years. According to ETFGI, a London-based investment industry research firm, new inflows into the ETF industry measured US\$338 billion in 2014, and total AUM are expected to surpass US\$3 trillion in the first half of 2015. By comparison, according to Chicago-based Hedge Fund Research, Inc., hedge fund capital increased by US\$236.6 billion in 2014, which included US\$76.4 billion of net new inflows, to reach approximately US\$2.85 trillion. According to the alternative assets data provider Preqin, the global alternative products industry – including hedge funds as well as private equity, private debt, real estate and infrastructure – increased by US\$690 billion in 2014 and ended the year at around US\$6.9 trillion, up from US\$6.2 trillion in 2013. Clearly, the total alternative investment industry, where several thousand firms operate and no single firm controls more than 1% of total market share, is certainly larger than the ETF universe. By comparison, in ETFs, the top three product providers control over 70% of the global market. However, ETFs are determined to inherit the earth. Investors, from the smallest retail clients to the largest institutions, now better understand what ETFs are, what indices are, and, more often than not, how to evaluate them. Further, most investors can look back at past index performance and benchmark it with the actual results of their own portfolio. As such, any firm offering active management, either as a registered or an alternative product, will be forced to compete for investors' attention and wallet share against ETFs, whether they like it or not.

#### Growth in ETF AUM has surpassed the growth in mutual funds' AUM across the US, Europe and Asia-Pacific



Source: "ETF Landscape," BlackRock, December 2014; "International Quarterly Statistical Releases," EFAMA

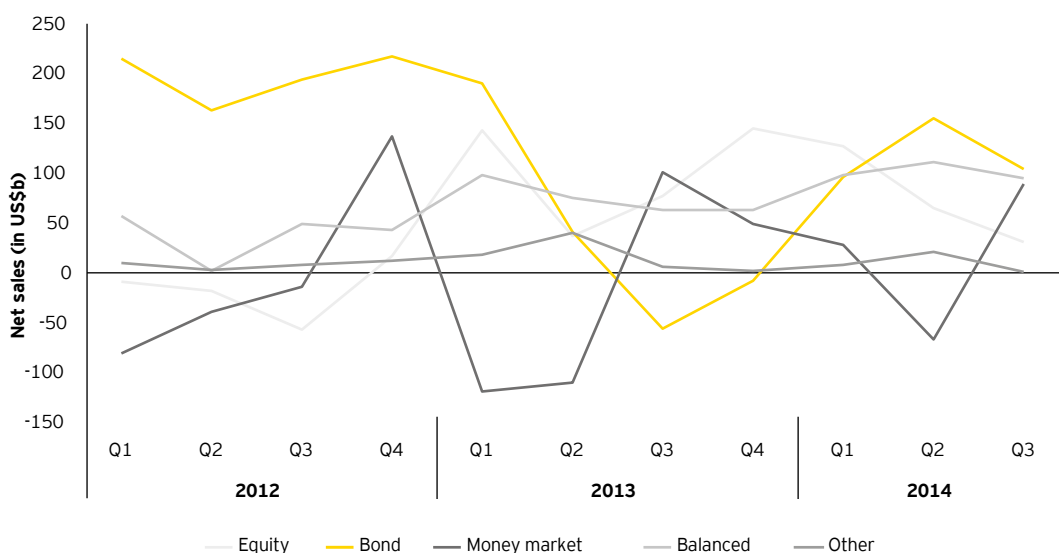
**Notes:**

\*12 months ending December AUM has been taken for ETFs, while 12 months ending September AUM has been taken for mutual funds to calculate the two-year compound annual growth rate (CAGR).

^Represents CAGR for mutual funds' AUM for both UCITS and non-UCITS.

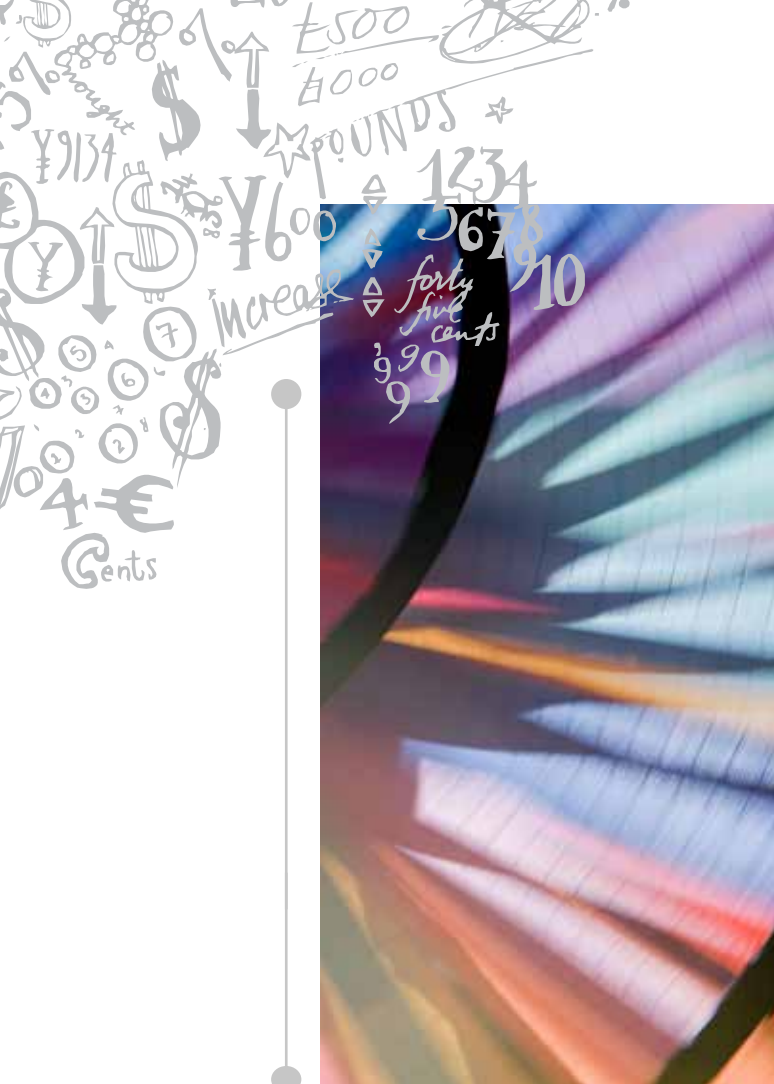
**7. Fixed income is still alive – and very much kicking.** Widespread pronouncements about the imminent demise of the fixed-income asset class were vastly premature. Net inflows into fixed income in 2014 were strongly bullish. The zero-rate environment will likely take a turn in the US this year. Further, demand for capital preservation and income, exhibited most clearly by the growth of outcome-orientated solutions such as target date funds, is stronger than ever, owing to the rapidly growing market segment of pensioners and baby boomers. Demand is booming for bond-like products, such as real estate investment trusts (REITs), preferred shares issued by investment-grade corporates and infrastructure finance partnerships. In short, investors want to buy fixed income, and they want to buy it now. Given the present low-rate environment, the challenge for fixed-income managers will certainly be in achieving an economically sustainable business model, particularly for short- to mid-duration products.

**After a muted 2013, fixed income inflows improved in 2014**



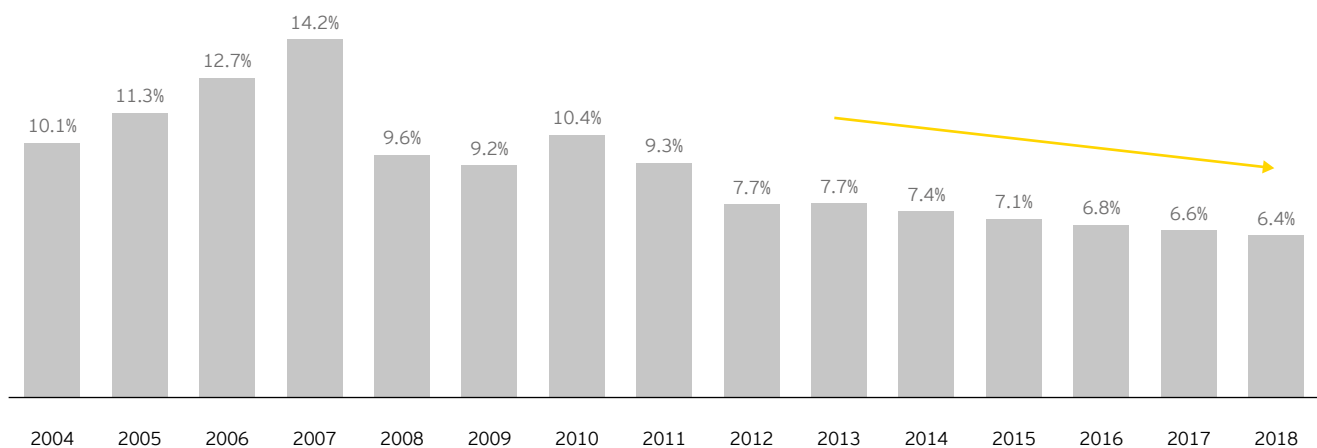
Source: European Fund and Asset Management Association (EFAMA)





**8. Emerging markets (EMs) will see limited growth.** The recent ruble crisis, weakening global commodity prices and the bubble in Chinese equity markets have forced the entire EM investment community to reassess their estimates of future growth. While there will certainly be pockets of rapid growth in certain markets, such as Indonesia and India, most of the EM universe will face reduced investor demand. No doubt investors in emerging and frontier markets are all too familiar with volatility and risk. Inflows will be hot in some years but not in others. For 2015, particularly given the correction in global commodity prices, there will likely be net outflows in the EM asset class, both on the fixed income and equity sides, and asset managers will likely rationalize capacity in terms of spending, product suite and headcount as a result. China, in particular, is such a potentially vast market that it more than merits continued investment and attention, albeit somewhat moderated from recent years. However, increasing concerns about excessive volatility, transparency and regulatory oversight, as well as a general retrenchment of the global EM asset class this year, will limit the bid for exposure to China. One day, China will become a top-five market for the global wealth and asset management industry – but not in 2015.

**After having experienced double-digit growth for years, China is now heading for more muted growth**



■ China's GDP growth rate

Note: 2013-18 are estimates

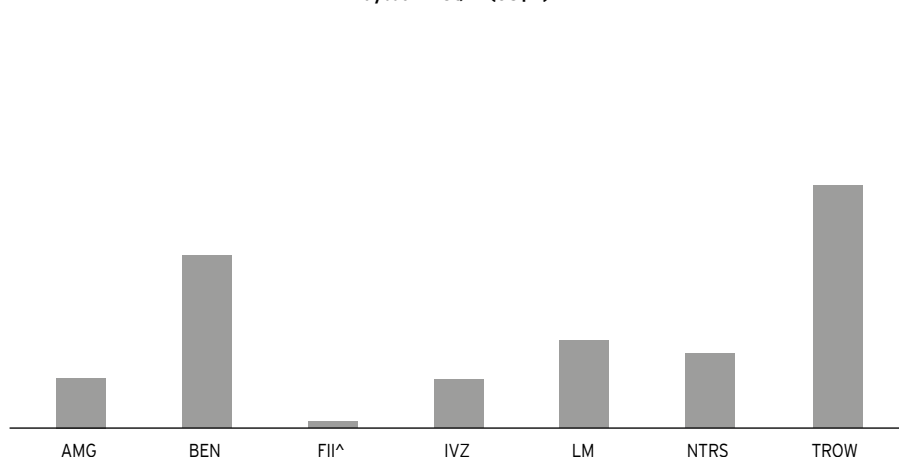
Source: IMF

**9. Share buybacks will accelerate.** There is much debate in the financial media and academia about whether share buybacks are the most effective use of excess operating cash flow – as opposed to dividend increases or more capital expenditure.

That debate will largely remain confined to academia and the media. For the rest of 2015, publicly traded asset managers will look to enhance their capital structure and return cash to shareholders even more rapidly through share buybacks.

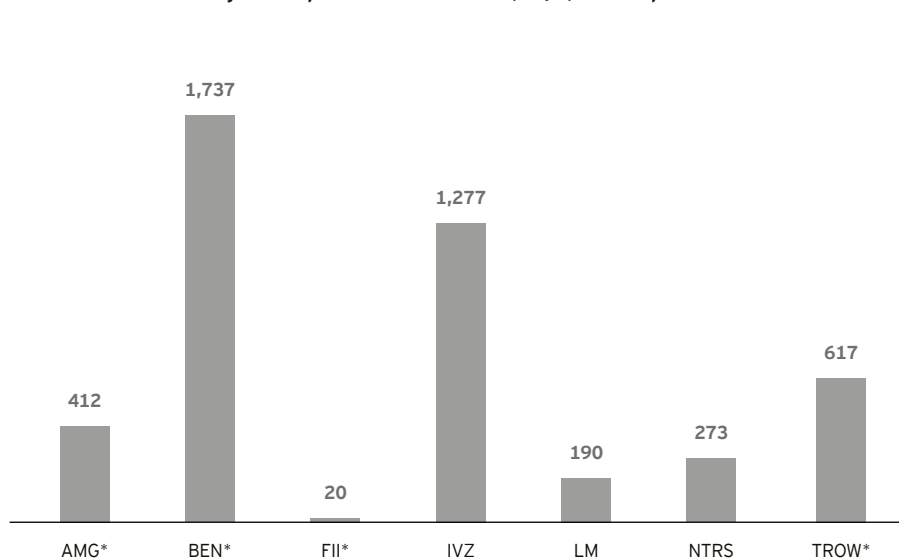
#### Several firms have been using share buybacks as a mode of paying back to shareholders ...

Buyback in 3Q14 (US\$m)\*\*



#### ... and outstanding repurchase authorizations indicate share buyback activity is likely to continue

Outstanding stock repurchase authorization (US\$m) as on September 2014\*\*



Source: Company filings, EY analysis

Notes:

^ 3Q14 dividend and buyback values are indicative, arrived at by dividing the nine-month figures by three.

\* Outstanding stock repurchase authorization (in US\$m) is indicative, arrived at by multiplying the outstanding number of shares to be repurchased, as disclosed by the firm, with the share closing price on 5 December 2014.

\*\*Following is the list of firms examined for the charts above:

Aberdeen Asset Management (ADN), AllianceBernstein (AB), Affiliated Managers Group (AMG), Federated Investors (FII), Franklin Resources (BEN), Invesco (IVZ), Legg Mason (LM), Man Group (EMG), Natixis (KN), Northern Trust (NTRS), Schroders (SDR), T. Rowe Price (TROW)

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