



Will the goose keep laying golden eggs?

Is the turbulence behind us?

June 2011 – Highlights of the results of McKinsey's thirteenth annual survey and perspective on the challenges for the European asset management industry

Preface

Welcome to McKinsey & Company's 2011 report on the state of European asset management. This is based on contributions from our asset management practice, interviews with industry leaders, as well as the results of our 13th annual survey of the economics of the European industry.

The 2011 Asset Management benchmarking survey covers North and Latin America, Europe, Asia, and Australia. The profitability evolution is based on benchmarking data collected from more than 300 participants, 100 of which are in Europe. This data is supplemented by McKinsey's research on the industry-level evolution of financial assets and country and segment analysis of assets under management, which we used to size global AuM and flows.

Overview

- The industry has had to weather three challenging years. The good news is that by the end of 2010, global assets under management (AuM) had returned to the level of 2007. However, this was entirely due to market performance, as once again net flows remained close to zero. Over the last three years in Europe, the industry has lost market share amounting to EUR 1.3 trillion of financial assets.
- Inflows vary enormously. Globally, emerging markets grew faster than mature markets. However, when looking at the absolute figures, the UK and Japan performed well even compared with these emerging economies, while India was badly hurt by regulation. In many regions, the institutional segment has been the engine of net new money, with only a few countries (notably the UK and Japan) showing any meaningful retail inflows.
- Profitability has picked up, but at 12.5 bp it is still below 2007 levels. Although the signs are encouraging as revenues are up and cost margins are down, we don't expect profit margins to return to pre-crisis levels until 2013. Total costs (in absolute terms) rose, surpassing the previous high of 2007.
- Although overall industry profitability has recovered, individual participants' performance varied enormously. Winning players over recent years share have tended to be institutionally focused, independent asset managers, and there are players who have been able to improve revenues margins, control costs and grow AuM.
- Despite the improving profitability and the return of AuM to pre-crisis levels, today's situation is different from the recovery phases of previous market cycles. The industry faces three main challenges:
 1. Reversing a fall in market share and sharpening its value proposition to attract again retail and institutional investors
 2. Improving its understanding of clients' needs and expectations
 3. Reshaping business models to capture economies of scale and competence.

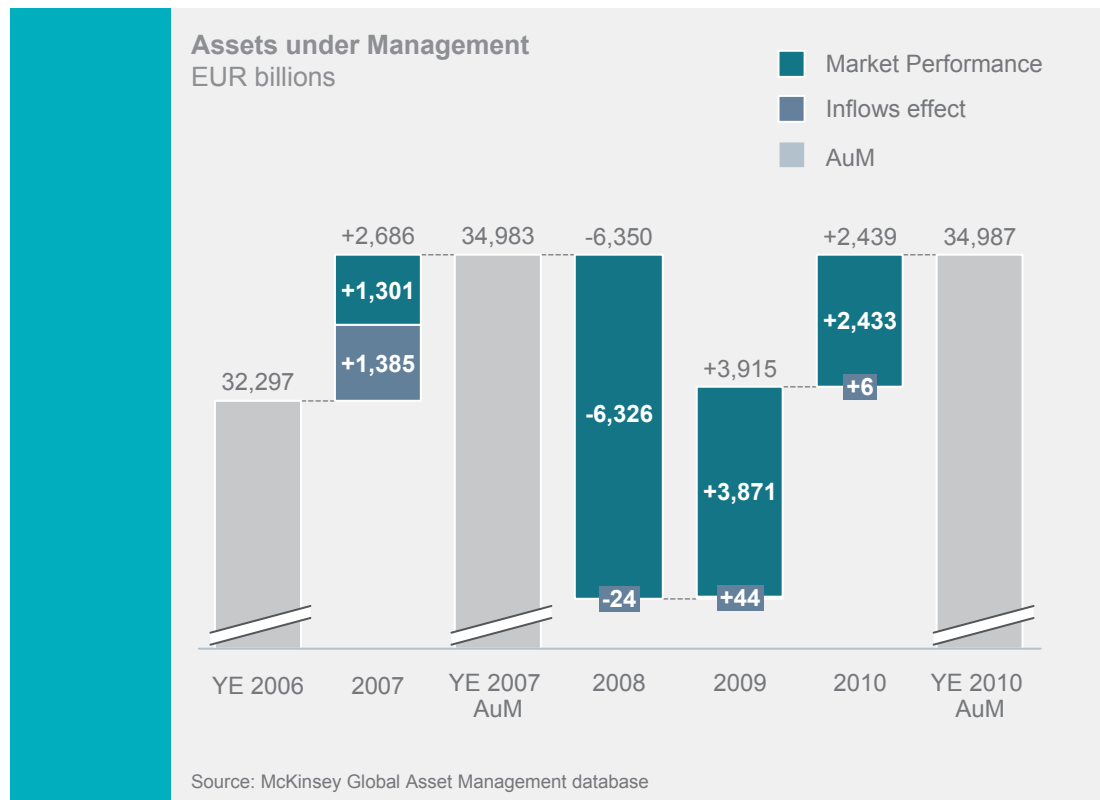
Fragile growth

A three-year view on global markets

When the markets collapsed during the financial crisis, and money poured out of asset managers' hands, global industry AuM took an inevitable tumble. Markets began to rebound in 2009 and 2010 and **now global AuM stand at EUR 35 trillion, about the same level as in 2007** at constant exchange rates.

On the surface, this might look like an encouraging rebound, but delve a little deeper and the situation looks far more worrying. A mere 0.02% of the 2010 recovery comes from inflows. **The rebound is entirely due to market performance.** Stock markets globally may be rising, but it seems investor confidence has a long way to go.

Exhibit 1: Through the crisis, global AuM have recovered but not net inflows



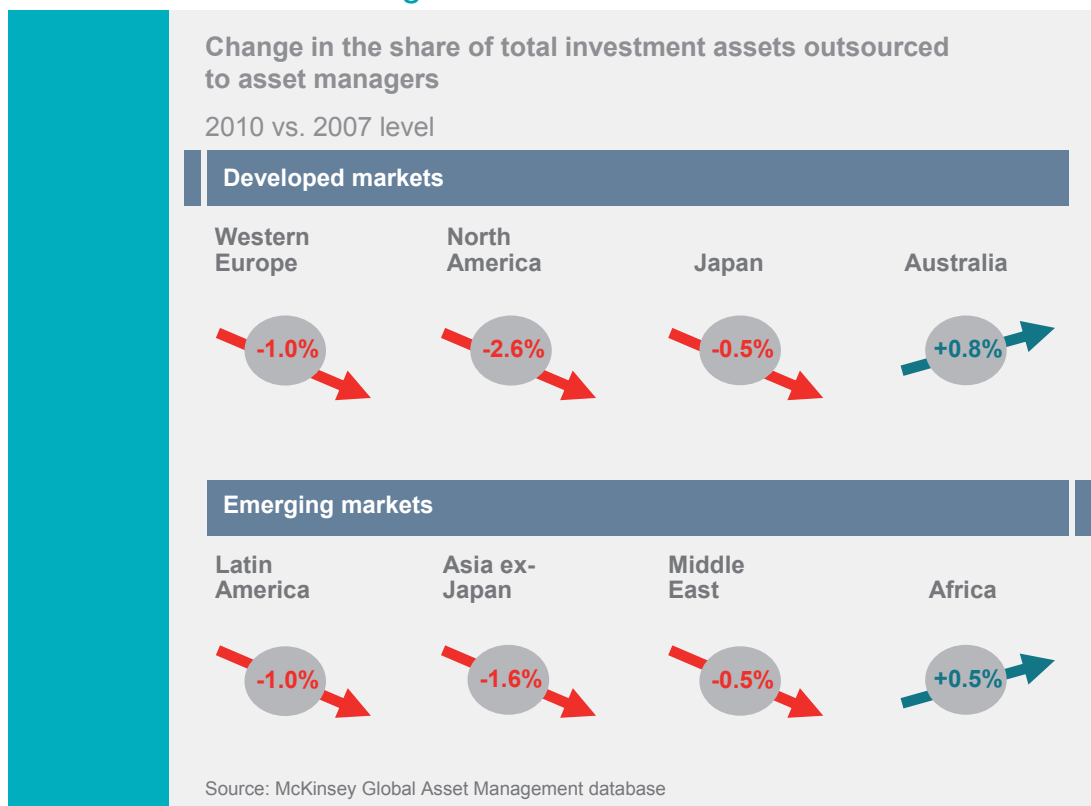
Of course, **markets' performances vary greatly**. Globally, there is an enormous divide between emerging and developed markets. The former have enjoyed stronger market performance. Latin America led the way with a 24% improvement from 2007 to 2010, compared to an unexciting 2% rise in western Europe over the same period. There are exceptions: distribution regulation in India that targeted only asset management products led to a 12% reduction in AuM even though the domestic stock market grew by 17%. Among mature markets, the UK and Japan attracted significant inflows (EUR 134 billion and EUR 101 billion, respectively).

Exhibit 2: Globally emerging markets saw inflows, mature markets did not



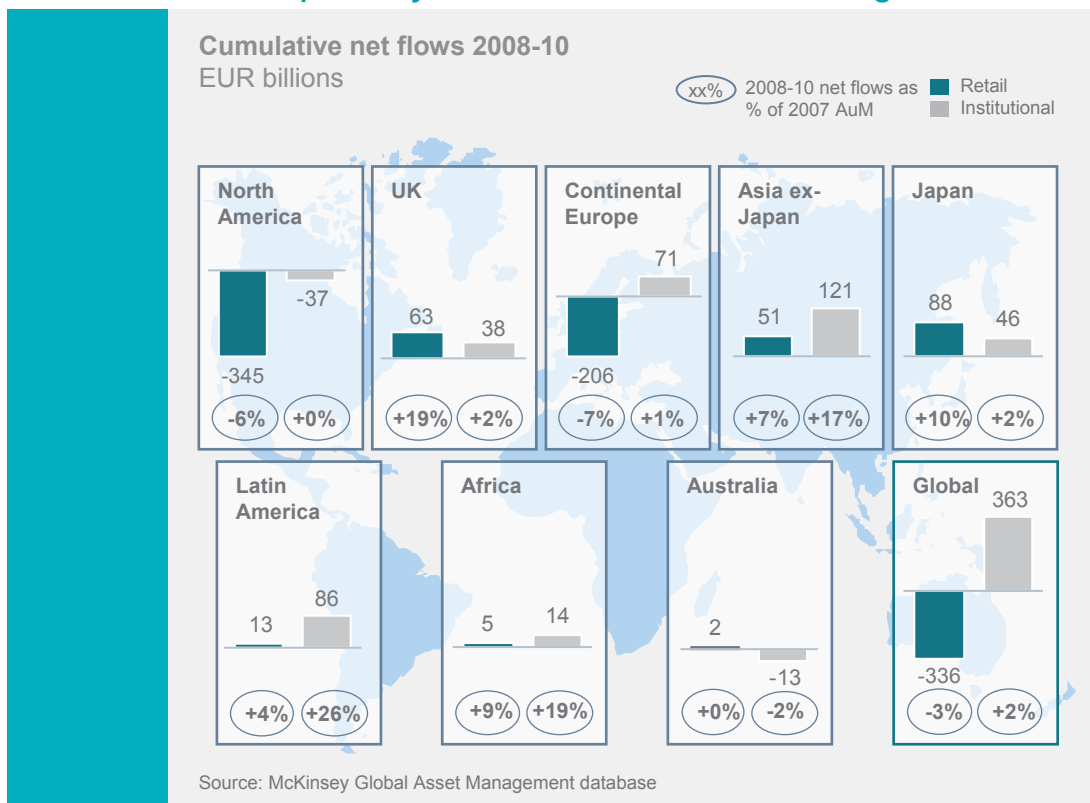
Even more disturbing than the lack of inflows, is the loss of market share. Over this three-year period, both institutional and retail investors turned away from asset managers, and sought alternative investments. Asset managers' share of both these segments fell globally 1–2 percentage points.

Exhibit 3: Asset managers lost share in almost all regions in Institutional segment



Despite losing market share, however, it was still **the institutional segment that generated what inflows there were**. Only in the UK, Japan and Australia did retail inflows outstrip institutional from 2008 to 2010. In total, the institutional segment generated cumulative inflows of EUR 363 billion, while retail generated outflows of EUR 336 billion.

Exhibit 4: Inflows primarily came from the institutional segment

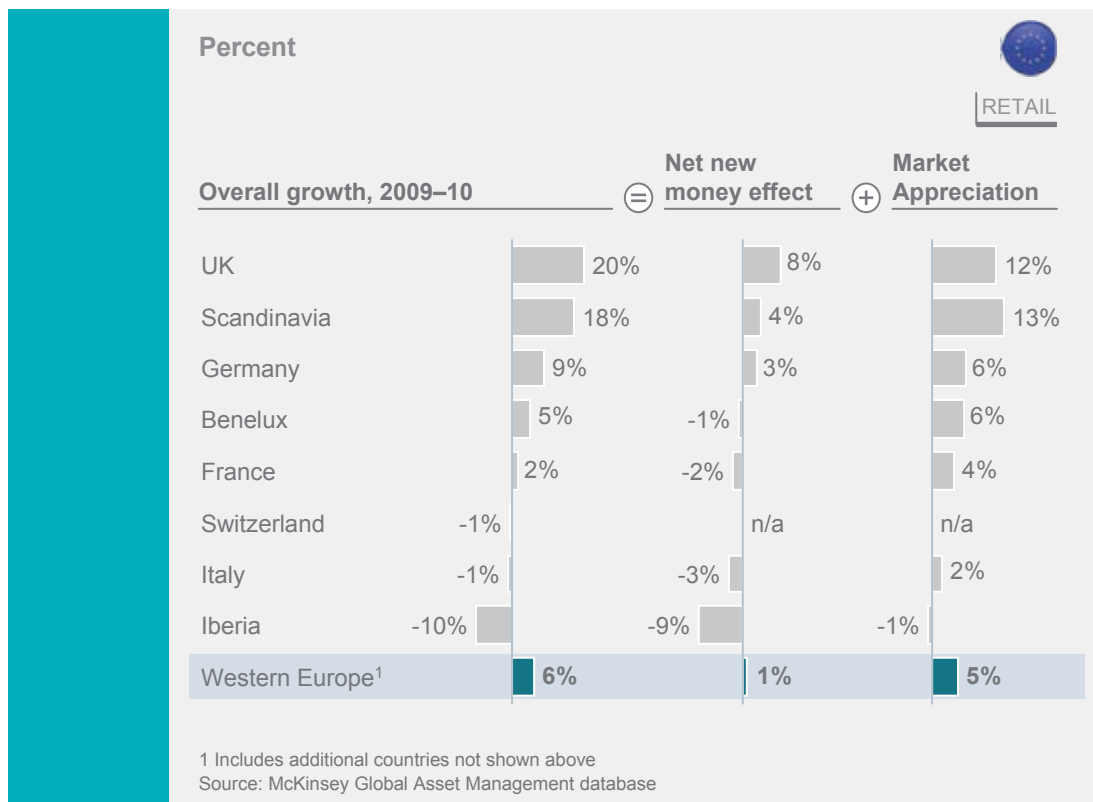


Western Europe in 2010

As in 2009, AuM growth in 2010 in western Europe (7%) was mainly due to market performance (5%), while inflows remained low (2%). However these averages hide **huge variations by country and segments**.

In retail, the UK, Scandinavian countries and Germany had inflows of 3–8% of their AuM base; the UK and Scandinavia achieving high market performance thanks to their traditional high share of equity in the product mix. By contrast, France, Benelux, Italy and Iberia saw outflows, combined with average to poor market performance. The situation is particularly striking in Spain, where banks were even more aggressive than elsewhere in Europe in encouraging investors to switch assets from mutual funds into saving accounts to help shore up their own balance sheets.

Exhibit 5: In Western European retail segment, we saw high polarization of net new money



The pattern was similar for the institutional segment. Here again, the UK and Scandinavian markets saw 2–3% net inflows and very good market performance. Germany had the highest inflows (7% of the AuM base) but the performance effect was low due to the conservative asset mix. France, Italy and Iberia again saw outflows.

Looking deeper into sub-segments, **institutional asset growth was driven by pension funds**, especially in the UK, where they contributed an additional EUR 286 billion in AuM between year-end 2007 and 2010. Insurers in France were the next biggest net contributor with EUR 115 billion. State entities and sovereign wealth funds saw the biggest relative gain of 21%, but the absolute change over the three years was modest at just

EUR 30 billion. By contrast, corporate assets shrank in most markets, except for Germany, as banks chased cash deposits to address liquidity constraints in the Basel III context.

Exhibit 6: In Western European institutional segment, there has been quite the same polarization of net new money



The **significant retail outflows, especially in continental Europe, were from money market (down 47%) and fixed income products (down 5%, although fixed income was actually the most popular asset class in the UK), while structured and alternative products performed relatively well in many markets apart from Italy where all asset classes saw net outflows.**

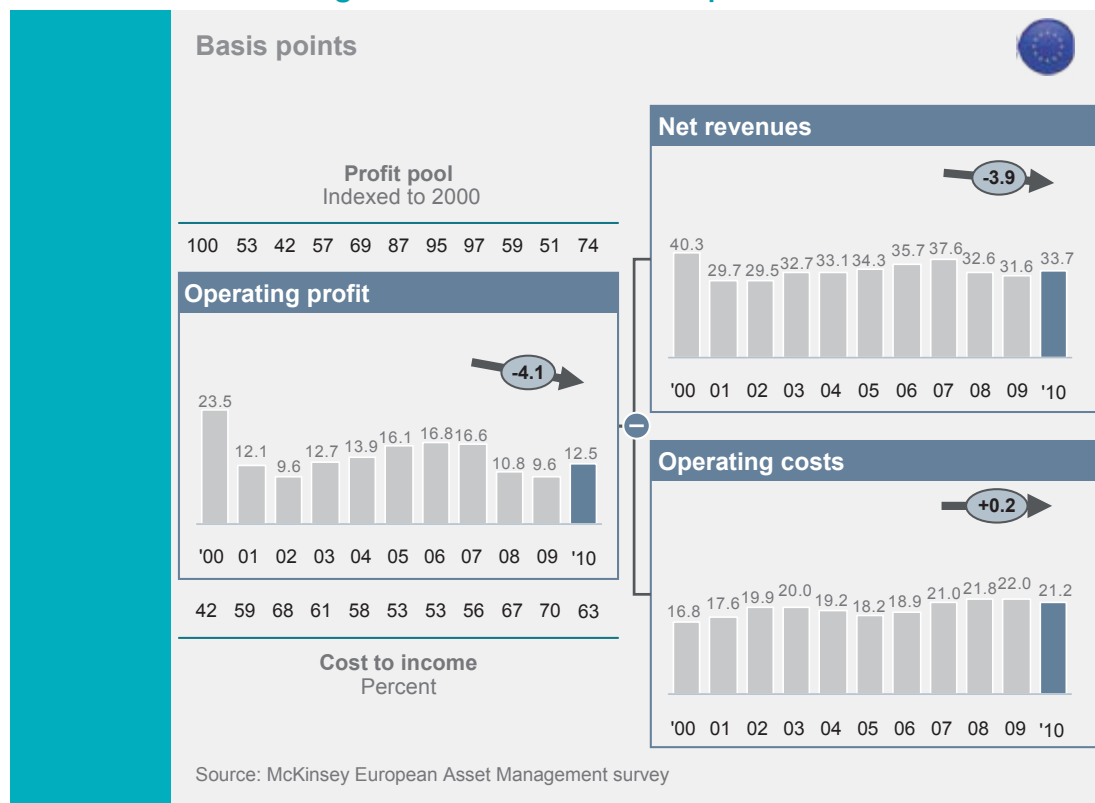
European managers see improving economics

Industry profitability is recovering, although it remains some way off pre-crisis levels.

Operating margin jumped from 9.6 bp in 2009 to 12.5 bp in 2010, which still remains significantly below pre-crisis level (16.6 bp in 2007). Revenue margins rose to 33.7 bp, still down 3.9 bp from 2007. Cost margins were down 0.8 bp from 2009, but slightly up from 2007 at 21.2 bp – still historically high.

In absolute terms, the industry’s total cost base was 75% higher than it was in 2000 and 2% higher than in 2007, when it reached its previous peak. This was largely due to a surge in fund management costs, which grew significantly faster than assets. A similar trend occurred in 2002–05 when a strong recovery in assets was accompanied by a surge in the variable fund management costs.

Exhibit 7: Profit margins still remained below pre-crisis levels



The outlook is for profit margins to remain below pre-crisis levels until at least 2013. We believe revenue margins will stabilize at 2010 levels as assets shift to the less lucrative institutional segment. However, despite growing AuM and regulatory-driven opportunities to capture economies of scale (e.g., UCITS IV), we believe that cost margins will fall only slowly: asset managers have consistently struggled to bring costs under control (and in particular fund management costs).

Diverging performance of industry participants

Disaggregating the numbers throws into relief the variation in how players have coped with the crisis and how well or badly they've clambered out of it.

An analysis of European asset managers with above average profit growth shows that winning firms share some characteristics.

Independent: Independent European players hardly set the world alight achieving just EUR 23 billion net inflows in mutual funds¹ from 2008 to 2010. However, compared to the staggering EUR 187 billion net outflows from captive bank-owned players, this was a relatively strong performance. Independent asset managers enjoyed inflows in all categories, while captive players' outflows were from traditional asset classes – in fact captives saw inflows in beta and absolute return/alternatives. More than two-thirds of independent players managed to attract net positive flows in 2010, compared to less than a third of bank-owned asset managers.

Institutional focus: half of institutional-focused players had above industry average profit growth, compared to only a fifth of retail-focused players. These top performing institutional players not only did better in terms of profitability, but also achieved better inflows.

Geographical footprint: Such strong variations in market performance and inflows meant that a presence in the right markets had an enormous impact on success. As an illustration, the retail inflows in the UK between 2008 and 2010 were equivalent to the combined retail flows of Asia ex-Japan and Latin America; so players with a strong UK retail footprint benefited

¹ Based on a the analysis of the top 50 mutual funds managers in the UK, France, Germany, Italy and Switzerland from SimFunds

disproportionately. As a result, the most profitable UK players managed to return to pre-crisis profitability levels in 2010, while top performers in markets such as Germany are still at just 50% of 2005 levels.

Exhibit 8: The cyclical recovery was driven by a strong lateral stretch



Overall, it is increasingly evident that the ‘winner takes all’. Most winners managed to improve profit margin and AuM simultaneously, achieving superior AuM growth in both retail and institutional segments. Another factor characterized successful players: they grew revenues by improving their asset mix and creating a resilient retail segment, while containing fund management costs and keeping sales and support costs at market levels.

Challenges ahead

Despite the signs of recovery, we would argue that the industry's short-term *performance* is stronger than its long-term *health*. It is true that profitability is improving and AuM have returned to pre-crisis levels, but nevertheless, today's situation is different from the recovery phases of previous market cycles. The industry as a whole needs to address three main challenges.

1. *Falling market share:* Asset managers are managing only 14% of financial assets – and that share has fallen 1-2 percentage points since 2006, depending on the client segment. This translates into a gap of EUR 1.3 trillion AuM in Europe, which equates to almost EUR 4 billion in missed revenues for European asset managers. The industry needs to target the broader pool of financial assets owned by institutional and retail investors, rather than have individual players preoccupied with trying to displace a fellow asset manager from an institutional mandate or a distribution relationship.
2. *Limited understanding of client needs:* Compared to other industries, the asset management industry commits few resources and pays little attention to testing products and researching customer needs – for both institutional and retail investors. It needs to take a giant leap forward to understand these needs and develop appropriate investment solutions. Consumer goods companies such as Procter & Gamble, who sell through distributors much like retail asset managers, test each and every one of their products with end customers – and they test the packaging and the sales pitch. Asset managers need to follow suit.
3. *Inefficient and ineffective business models:* As an industry, asset management has struggled to deliver economies of scale and competence. There is no correlation between size and cost margin, despite meaningful achievements by some individual players. Indeed, the industry is still relatively young and has been growing in “start-up mode” for a couple of decades. Now is the time for players to make significant efforts in improving the efficiency and effectiveness of their business model: stripping out complexity and capturing economies of scale where they exist. Only this will provide the room for maneuver that is much needed to improve the industry's value proposition.

Faced with these challenges, asset managers need to take some bold actions at a time when the industry is changing on multiple fronts. Four themes in particular should be high on the CEO agenda over the next one to two years:

Develop a strategy to mitigate the risks and capture the opportunities from the changing regulatory landscape. More than 25 regulatory initiatives are under discussion. Many do not target asset managers directly (e.g., Basel III, Solvency II, MiFID review), but will nevertheless have a significant impact on the industry. Much uncertainty still surrounds these regulations, but it is already clear that the major impact will not be increased compliance costs, but rather the AuM volumes – and therefore revenues – at risk. However, some of these initiatives will also open up new opportunities. These include capturing economies of scale, and developing products and solutions that meet investors' and distributors' regulatory-driven needs.

Improve sales force effectiveness. Sales teams face the dichotomy of larger opportunities but higher hurdles to win business. Investment objectives have become highly customized, risk appetite is balanced with regulatory requirements, and investors need to regain trust in the solutions provided by asset managers. Asset managers should revisit their sales and marketing organization and review the tools and practices they use to enable their sales force. For asset managers, what is at stake is not only market share at the player level, but the ability to recapture lost share of total investable financial assets.

Review resource allocations in light of granular market segment potentials. Success requires focusing efforts on the most attractive mix of geographies and segment. Thoughtfully reviewing your firm's capabilities and reallocating resources in line with market potential will be critical to ensure above-average growth.

Defining a beta products strategy. The demand for beta solutions and the ETF market continued to grow at a rapid pace, gaining market share vs. traditional asset management products. This trend is becoming meaningful, and asset managers need to assess the impact on their business model, and

develop their own strategy This means taking decisions on target segments, product positioning, pricing, distribution strategy, branding and production setup.

* * *

Will the goose stop laying golden eggs? Not for the time being; but asset managers should not be fooled by the rebound of AuM and the partial recovery of their economics. Important challenges lie ahead if they are to maintain industry performance as well as preserve its long term health.

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 or to follow up on any of the points discussed above, please contact us.

To learn more about McKinsey & Company's specialised expertise and capabilities related to the European asset management industry or for additional information about McKinsey's European AM practice please contact Francesca Rizzi (practice manager) at +39 02 72406855 or email Francesca_Rizzi@mckinsey.com

Our special thanks go to the contributors of this edition of the report: Christian de Boissieu (project leader), Manu Balakrishnan (research team leader), Richa Arora, Ty Chea, Filippo Delzi, Hajar Fadel, Amub Ghosh, Rodolfo Gonzalez, Kevin Huang, Mario Jaimes, Jaspreet Jassar, Owen Jones, Matko Katanec, Vishal Kaushik, Kalika Khanna, Pawel Konieczniak, Hyunjoo Lee, Asako Lijima, Stephanie Liu, Ricardo Marchant, Salil Mathur, Etienne Mayor, Shreya Nagpal, Istvan Nagy, Nicolo Pittiglio, Francesca Rizzi, Daria Rudneva, Yelda Sagirosmanglu, Achim Schlitter, Torben Schmiedeknecht, Manit Seth, Ronnie Tang, Jonathan Turton, Nicolas Zanatta.

