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State of the European asset management industry: Adapting to a new normal

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State of the European asset management industry: Adapting to a new normal

Asset management industry economics in Western Europe have remained relatively resilient, buoyed by the short duration of periods of downside market performance and asset values remaining near the current cycle's highs (Exhibit 1, next page). However, the industry is clearly continuing to contend with persistent structural shifts: lower returns due to interest-rate dynamics, the shift to passive and alternative asset classes, slowing organic growth, continued fee pressure, elusive operative leverage, and aggressive competition from within and outside the industry.

Any discussion of the state of the industry must begin with an acknowledgement of the macroeconomic environment, which is typically responsible for 50 to 80 percent of growth, and which has swung the industry between extremes over the last few years. An environment of uncertainty has prevailed, leading to market conditions which are also testing investor convictions; for example, in the fixed-income markets, where more than €7.8 trillion in European bonds are currently negative yielding. Following the exuberance of 2017, when assets under management (AUM), revenues, and profits all hit record highs for European asset management, 2018 brought more challenging conditions, particularly in the public equities market in the fourth quarter. Market valuations have since recovered with a vengeance, as European AUM have reached a record €22 trillion, though revenue and profit pools for the year are not likely to reach 2017's high-water mark. While year-over-year 2019 AUM is up by approximately 10 percent, we expect average AUM to be up by only 3 percent. Most importantly, however, we expect profit margins to be down by approximately 2 percentage points based on our interim estimates—the result of persistent pricing pressure and absolute cost growth, confirming the continuation of the trend in which cost growth exceeds organic revenue growth net of capital market performance.

Organic growth has slowed on a global basis, influenced primarily by Asia, and China in particular. While Western Europe also has been a strong contributor to organic growth, averaging 3 to 5 percent per year since 2014, in 2018 the net-flow effect fell to approximately 1 percent, more in line with structural economic and personal financial asset growth in developed economies.

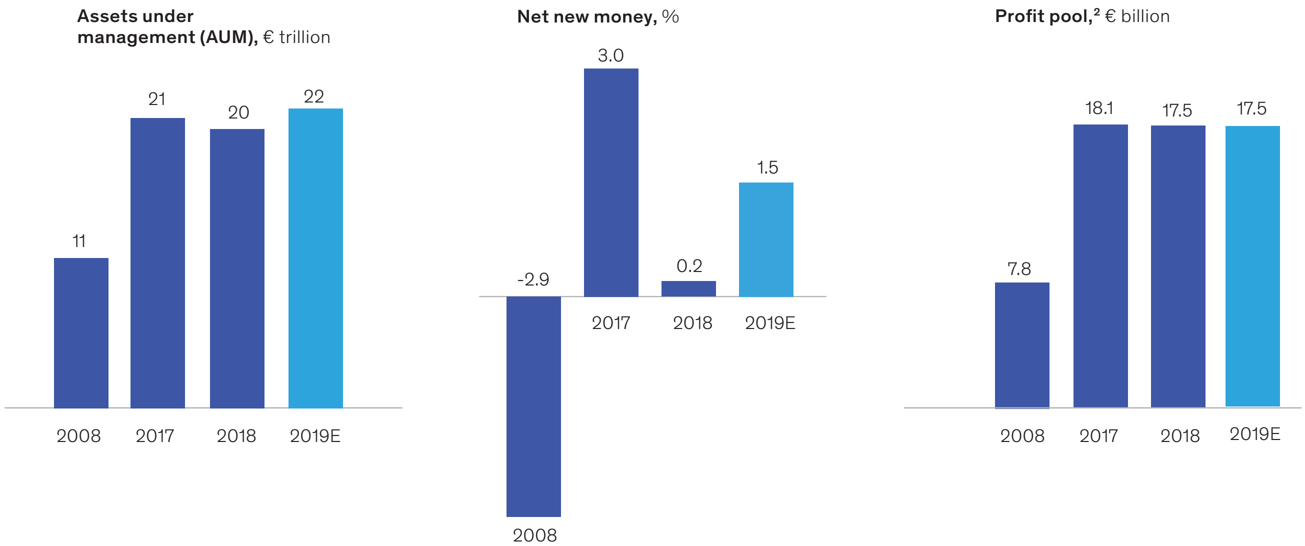
Pressure has been persistent on revenue yields, with fee compression responsible for about 80 percent of the decline in revenue yields year-over-year (asset class and style-mix shifts are responsible for the remaining 20 percent). While passives are certainly growing faster than other investment styles, the pace of the shift to passives has been more muted in Europe than in North America, with significant variance in the rate of passive adoption across markets and client segments.

While asset managers' ongoing cost-reduction efforts have received recent press attention, sustained operating leverage has remained elusive for the industry overall. Despite diminished growth and market performance expectations coming out of an exuberant 2017, overall spending by European

Exhibit 1

Europe has reached news highs in assets under management, but not in profits.

Western Europe[1]



[1] Includes Austria, France, Germany, Italy, Netherlands, Switzerland, United Kingdom, Denmark, Finland, Norway, Sweden, and Spain.
[2] Third-party assets only; excludes alternative investments.
Source: McKinsey Performance Lens Global Growth Cube

asset managers grew by 2 percent year-over-year (though functional spending in investment management, distribution, and operations was flat to slightly below 2017 levels). As a silver lining, European managers did demonstrate more discipline than their North American peers on average, where cost growth was twice as fast and increased across virtually all functional areas.

Averages aside, there remains significant dispersion in asset manager profitability and growth across and within different business models. As we contended last year, deliberate business model choices and alignment of clear value propositions matter. We do not believe there are just one or two winning formulas; however, achieving disproportionate growth will require asset managers to take proactive and bold actions in response to the forces continuing to reshape the industry ecosystem:

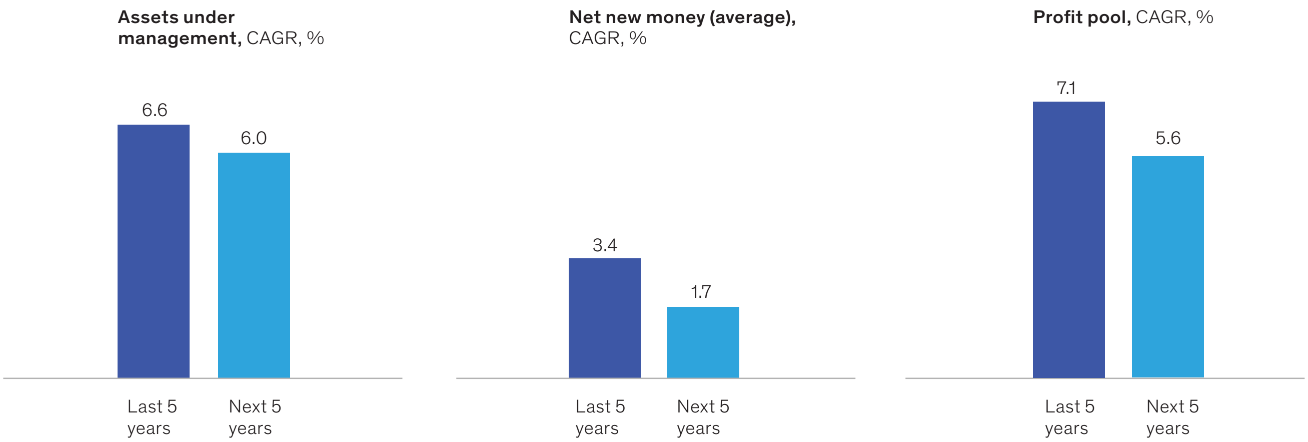
— **Lower growth and returns:** Investors face the realities of a "lower for longer" environment for global economic growth and interest rates (Exhibit 2, next page). Consistent alpha remains hard to generate (at least without significant decreases in fee levels), and while Europe has seen a relatively lower degree of "barbelling" of investor behaviors in terms of asset mix, this could change amid sustained demand for yield-generating assets (buoying flows across fixed income, private credit, infrastructure, and real estate) and the consistently growing share of passive strategies (particularly with significantly accelerated outflows in active equities to date in 2019). Market reactions to macroeconomic shocks have also elevated the importance of portfolio construction and risk management as a source of returns and resilience.

— **Growing transparency from regulatory implementation:** The impacts of MiFID II are emerging across the industry, including: distributors narrowing manager buy lists, and raising the bar on performance; fragmentation of research with large managers driving a 20 to 30 percent reduction in broker research spending (and redeploying spending to niche/specialist research providers, contributing to alpha generation); transparency increasing fee

Exhibit 2

The next five years are expected to be more modest for the industry.

Global figures,[1] percent



[1] Includes top 28 markets globally, covering ~98% of global AUM; average growth scenario for next 5 years.
Source: McKinsey Performance Lens Global Growth Cube

sensitivity in the industry, amplifying product commoditization and buoying ETF growth in retail; and improved profitability of some banking captives, which are benefiting from fee unbundling and cost savings on market data.

— **Competition increasing with both greater concentration and fragmentation:** Growth continued favoring managers with scale and scope, and consolidation gathered steam as managers sought to build their presence in high-growth areas and invest in technology to create more efficient operating platforms. However, despite the largest managers having achieved higher AUM growth, industry fragmentation has been sustained particularly amongst managers with less than €100 billion in AUM (Exhibit 3, next page).

— **Innovation outside the industry creating new sources of competitive edge and disruption:** The explosion in the availability of data and new sources of insight was also fueled by growing consolidation and competition amongst financial data providers. Asset managers are just beginning to mine these data sources at scale, as middle- and back-office platforms are modernized or outsourced to innovative market infrastructure providers. These innovations include providing more integrated investment, research, trading, and analytical platforms; the continuing electronification of flow products, including corporate and sovereign fixed-income trading; and promising initial blockchain uses in investment and trade operations.

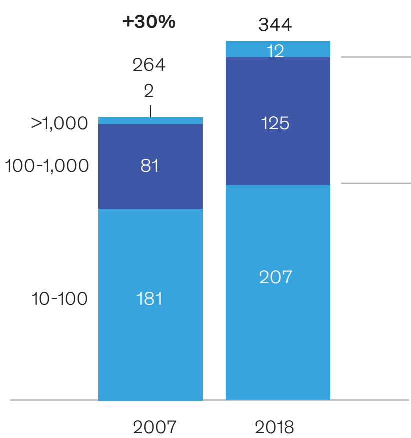
Against this backdrop, we believe there are several strategic imperatives that European asset managers urgently need to focus on starting today.

Emerging symptoms of structurally slowing growth

The vulnerability of Europe's asset managers to the macroeconomic environment remains elevated, as an historic asset boom powered by cheap and plentiful capital and rapid economic development in emerging markets gives way to slower structural growth and uncertainty (Exhibit 4, next page). Market conditions are also testing historical assumptions (e.g., the market value of negatively yielding European bonds reached nearly €3 trillion in 2018 and has hit record highs of nearly €8 trillion in 2019), intensifying the search for new sources of yield and diversification. In this context, client needs for investment advice and stewardship are arguably as great as they have ever been.

Exhibit 3

Globally, competition is increasing, and industry fragmentation continues.



Average AUM, 2007 vs. 2018,
€ billion

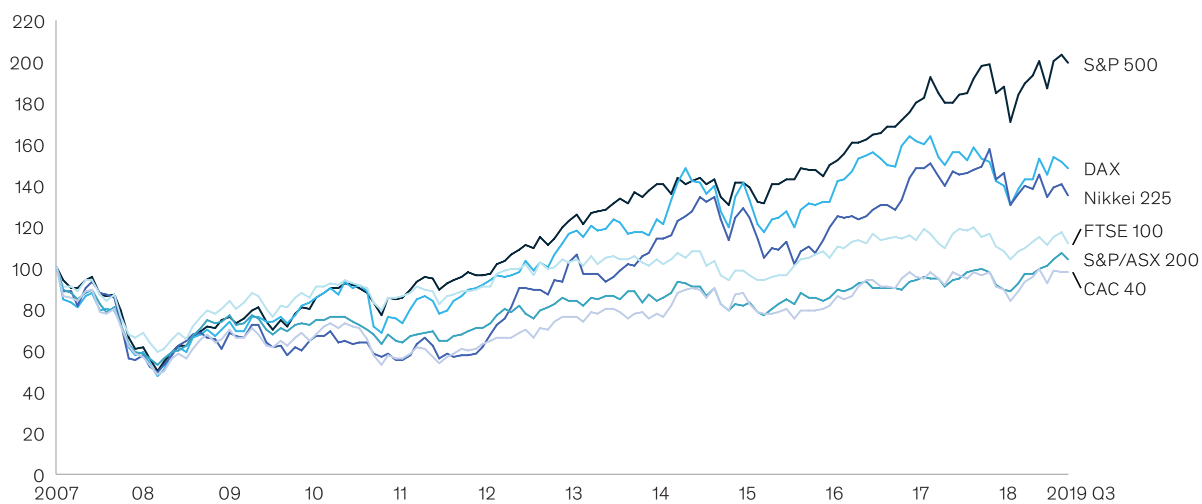
1,250	**2,042**	+63%
315	**294**	-6%
36	**42**	+16%

[1] Excluding small asset managers with AUM under €10 billion
Source: IPE

Exhibit 4

The surge in equity markets across the globe in 2017 powered growth in assets under management.

2007 index priced evolution, indexed to 100 in local currency

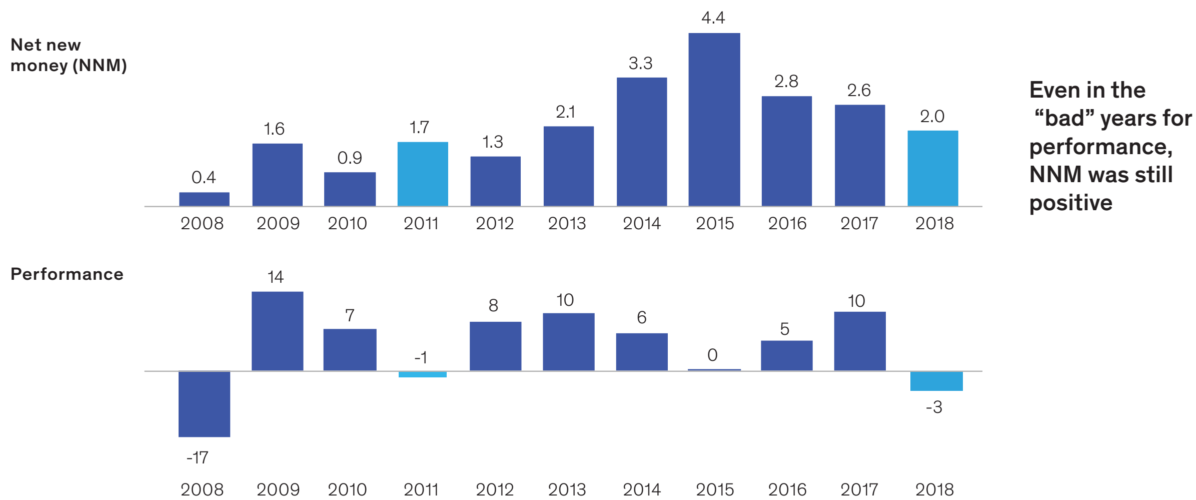


Source: Bloomberg

Exhibit 5

Globally, industry fundamentals have been very stable.

Percent of beginning of year global AUM[1]



[1] Includes 42 countries from North America, Western Europe, CEE, GCC, Developed and Emerging Asia, Latin America, and Africa.
Source: McKinsey Performance Lens Global Growth Cube

In 2018, global AUM fell year-over-year by approximately 1 percent, the first overall annual decline since the financial crisis (Exhibit 5). The decline was driven by negative market performance, as organic growth remained solidly positive, albeit at the lowest level since 2012 (about 2 percent net-flow effect vis-à-vis 2017 AUM).

Asia-Pacific has been the largest regional driver of global industry growth, with China alone generating half of global net flows last year, primarily in fixed income and private markets (private equity, real estate, infrastructure), in addition to money market funds. Over the last five years, China and Western Europe contributed over 60 percent of global net flows, generated from a mix of retail and specific institutional client segments like insurance general accounts and corporates increasing assets outsourced to third-party investment managers (Exhibit 6, next page).

Western Europe's asset managers experienced challenges in overall AUM growth in 2018 (-3.2 percent), largely due to poor market performance stemming from macroeconomic uncertainty (for example, monetary policy outlook, soft corporate earnings and guidance, trade uncertainty).

However, the net-flow effect remained positive at 0.2 percent, albeit at a muted rate (the second-lowest in the past decade) compared to the 3.8 percent average between 2014 and 2017 (Exhibit 7, next page).

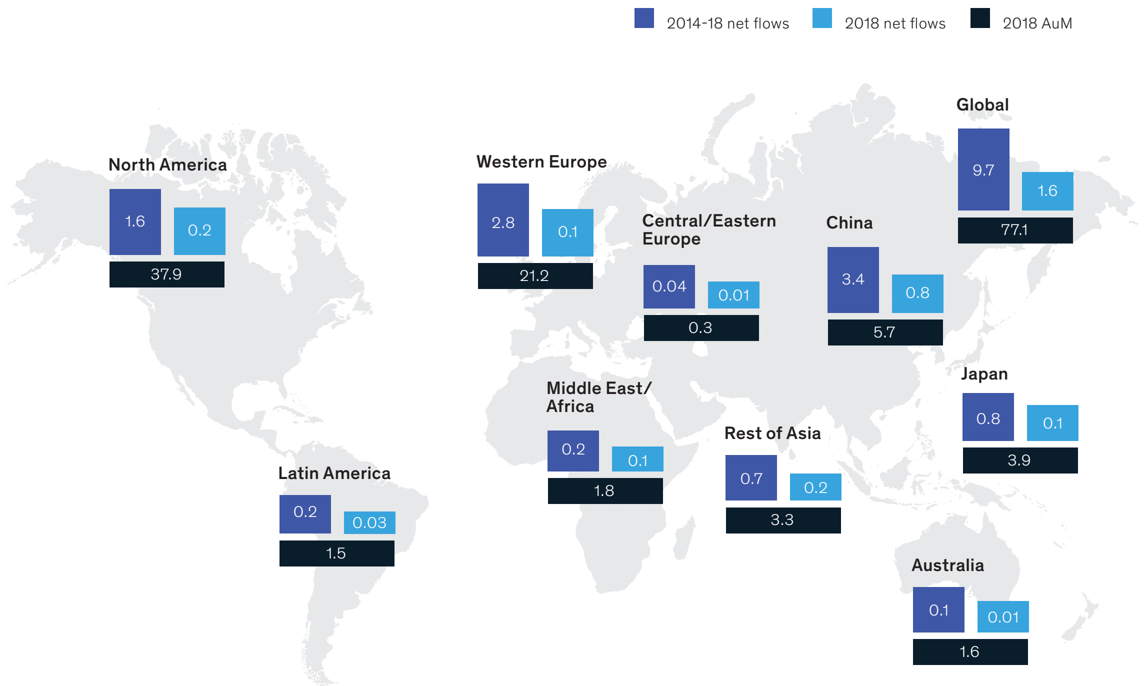
Growth dynamics in the largest European markets paralleled those of the overall region. Uncertainty around Brexit impacted growth in the UK, which was the sole outlier with negative net-flow effect, as institutional investors adopted a wait-and-see approach.

European asset manager share of overall European financial assets was at 27 percent in 2018, with managed retail assets gaining two percentage points of share since 2014 and managed institutional/DC remaining flat. As a potential offset to slower structural economic growth, there remains a massive opportunity for asset managers to increase conversion of unmanaged and internally managed assets, particularly in the institutional market, where internally managed assets reached €44 trillion in 2018, nearly three times larger than institutional managed assets (Exhibit 8, page 8).

Exhibit 6

Over the last 5 years, net flows to China and Western Europe represented over 60% of €9.7 trillion global total.

2014-18 net flows by region, € trillion[1]

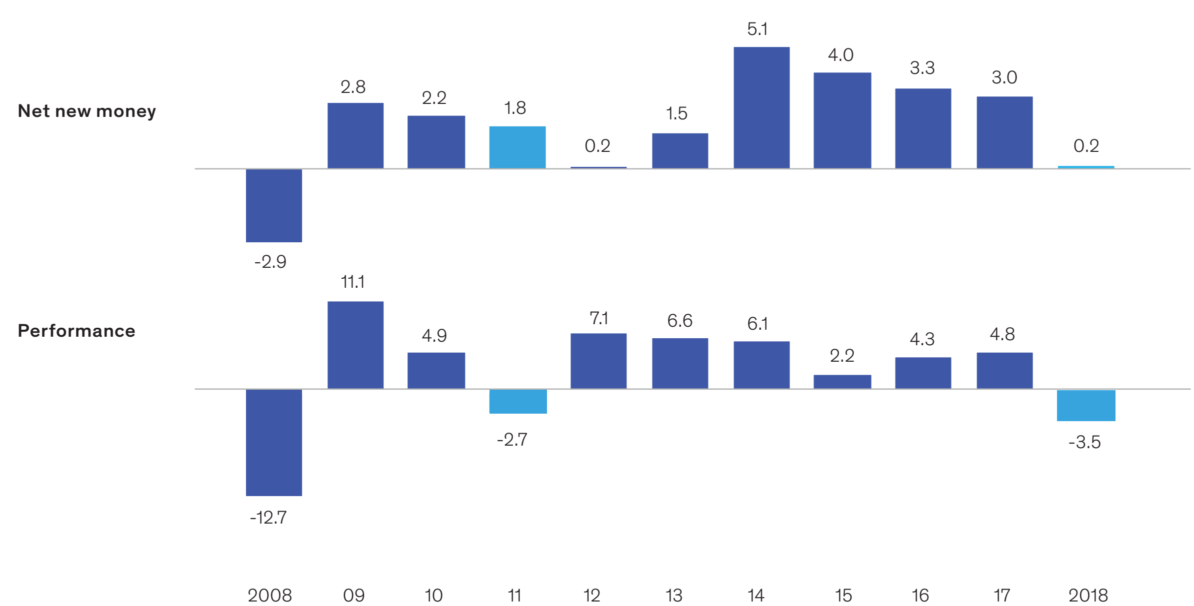


[1] Includes 42 countries from North America, Western Europe, CEE, GCC, Developed and Emerging Asia, LatAm and Africa
Source: McKinsey Performance Lens Global Growth Cube

Exhibit 7

Western European net flows slowed in 2018, following 4 consecutive years of strong growth.

Percent of beginning-of-year Western European AUM

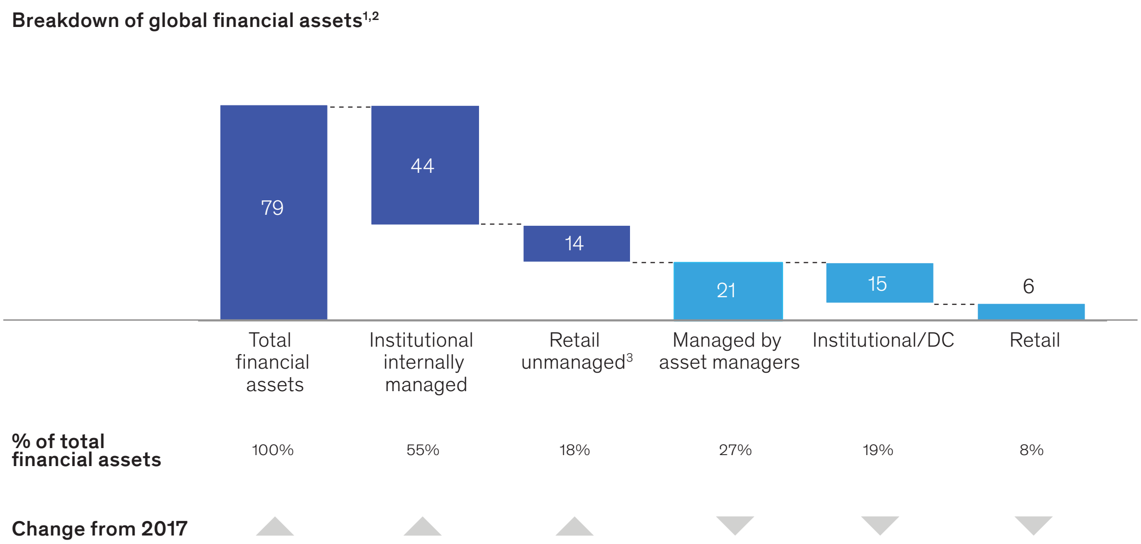


[1] Includes Austria, France, Germany, Italy, Netherlands, Switzerland, United Kingdom, Denmark, Finland, Norway, Sweden, and Spain.
Source: McKinsey Performance Lens Global Growth Cube

Exhibit 8

About 27% of Western Europe financial assets are managed by external asset managers.

€ trillion, year-end 2018

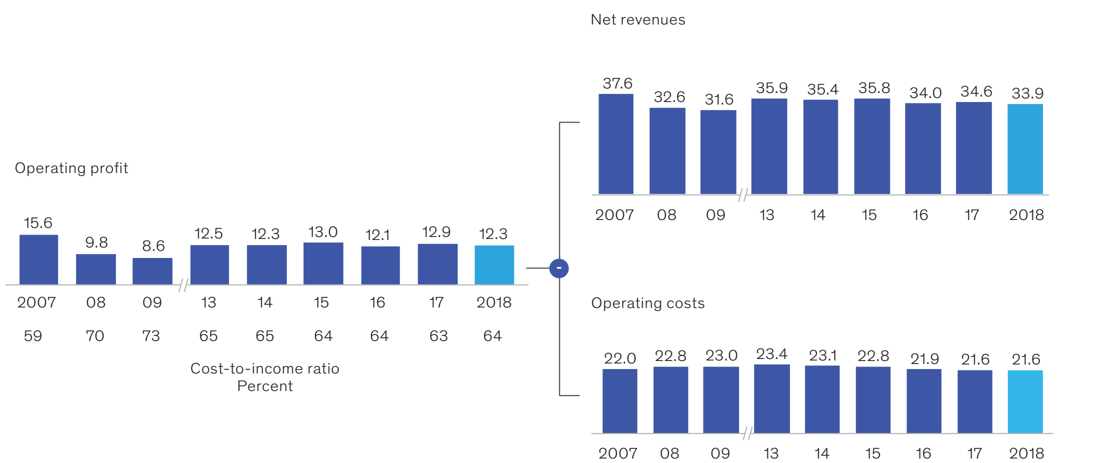


[1] Includes 16 countries from Western Europe.
[2] Numbers have been rounded.
[3] Includes directly held securities, cash, and deposits
Source: McKinsey Performance Lens Global Growth Cube

Exhibit 9

Western European asset manager profit margins declined slightly in 2018, led by a 2% drop in net revenue margins.

Bps of average AUM



Source: McKinsey Performance Lens Global Asset Management Survey

Industry economics resilient, but vulnerable

In our report last year,[1] we asked how asset managers would fare in a significant market downturn. This what-if scenario was tested (if temporarily) in the fourth quarter of 2018.

From a financial performance standpoint, Western European asset managers experienced a roughly 2 percent decline in overall profit pools. This decline is more muted than many have expected from the poor market performance experienced year-over-year.

Western Europe profit margins benefited from higher average AUM over the year. However, net revenue margins still declined by 0.6 basis points while cost margins remained flat (Exhibit 9, previous page). The key driver for the decline in revenue pools was fee compression, with revenue margins declining by about 10 percent in retail and 2 percent in institutional.

If Q4 2018 market conditions had sustained for the full year, profit pools would have declined by approximately 10 percent, reducing Western European asset manager operating margins from about 36 percent to 32 percent.

Differentiated asset mix dynamics amid persistent fee pressure

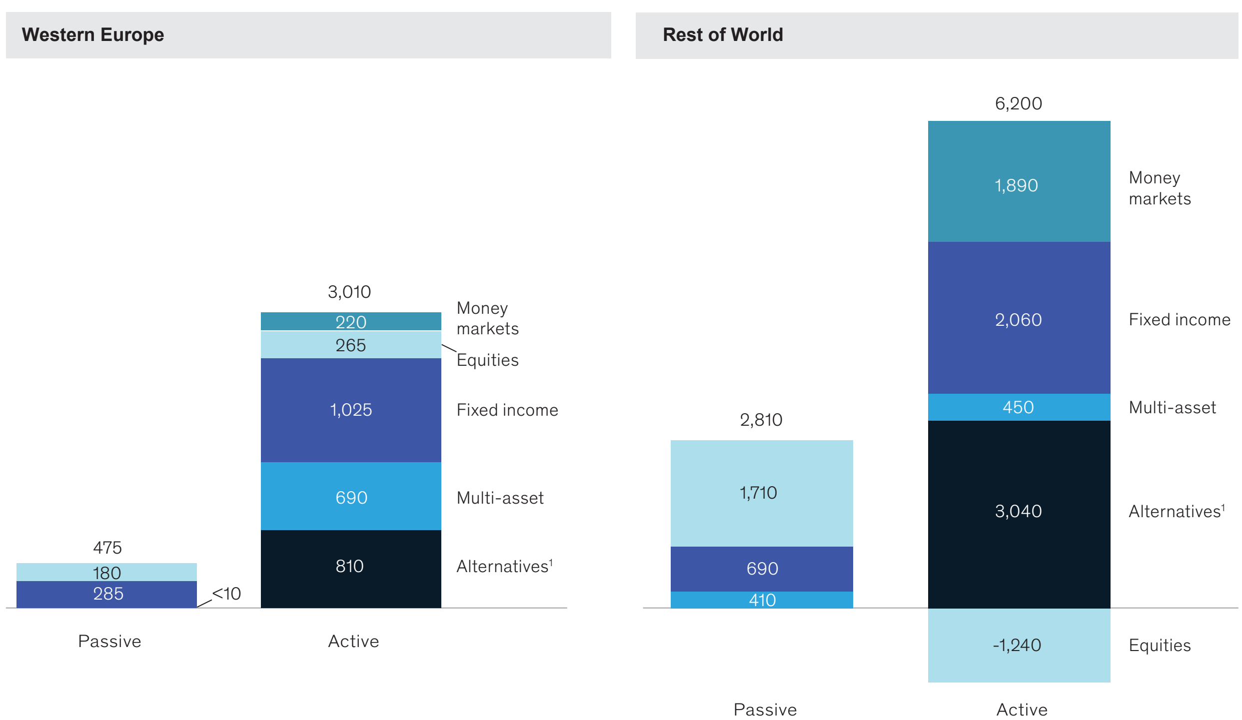
From an asset-mix perspective, between 2013 and 2018 Western Europe did not experience the same market share displacement by passive strategies as the rest of the world (and specifically the US). Active strategies still play a relevant role in capturing net flows especially in fixed income and multi-asset (Exhibit 10).

[1]Cristina Catania, Felix Germann, and Christian Zahn, "Full speed ahead in European asset management," November 2018, McKinsey.com.

Exhibit 10

Western Europe has not experienced as much displacement of active strategies by passive than other geographies, and in particular has not embraced passive multi-asset strategies.

Cumulative net flows (2013-18), € billion, figures rounded



[1] Includes hedge funds, absolute return, other liquid alternative strategies; private markets (based on cumulative fundraising from 2013-18; includes private equity, real estate, infrastructure, natural resources).
Note: Includes 28 countries/regions from North America (2), Latin America (2), GCC (1), Western Europe (12), Developed Asia (2) and Rest of Asia (9), accounting for ~96% of global AUM; analysis does not include CEE, Africa, Chile, Argentina, Belgium, Ireland, Portugal, and Luxembourg.
Source: McKinsey Performance Lens Global Growth Cube

Exhibit 11

Passive's rise is playing out in very specific places, with adoption rates varying dramatically across and within regions.

Passive market share of assets

% of third-party managed AUM, 2018

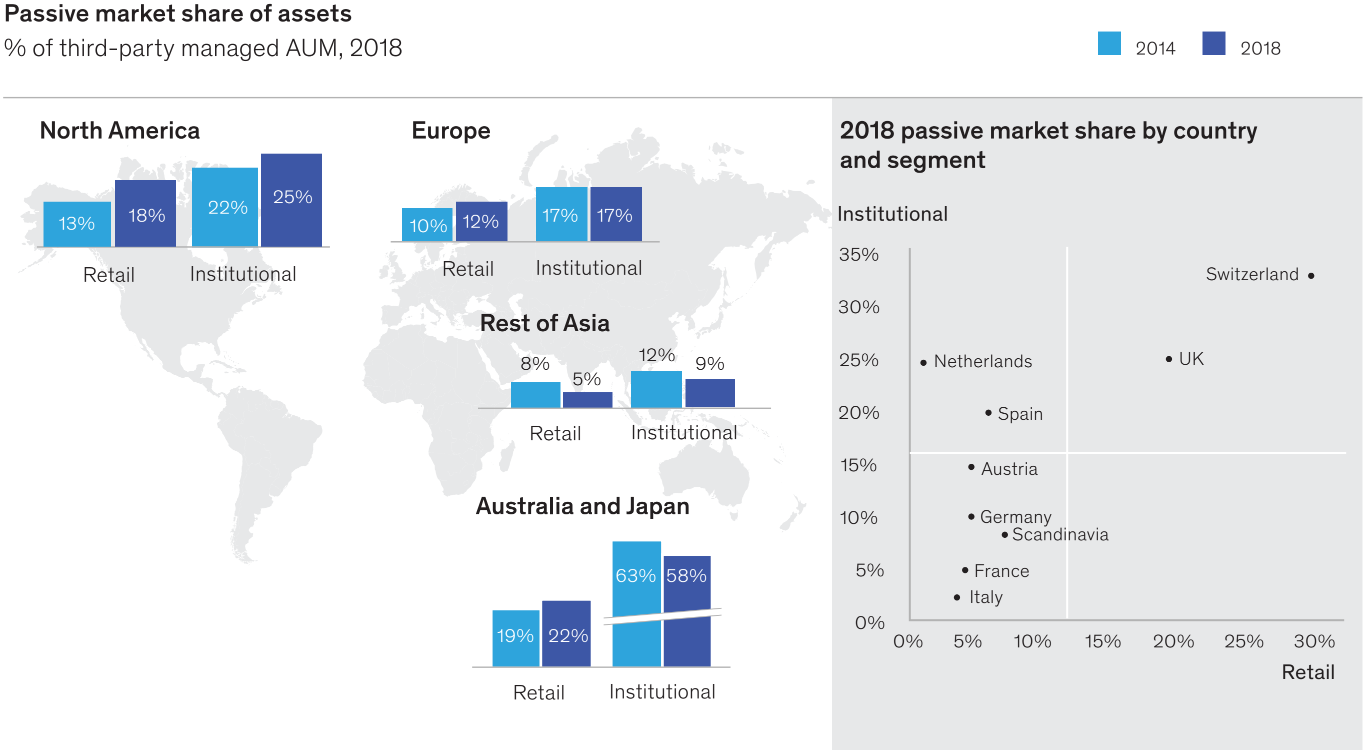
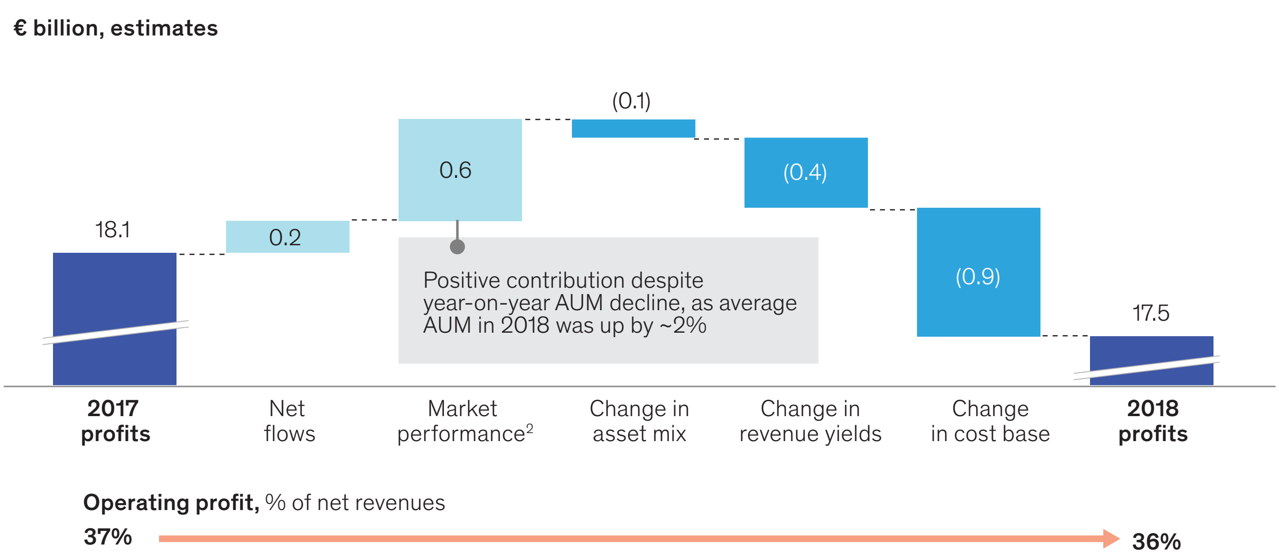


Exhibit 12

In Western Europe, revenue yield compression nearly offset profit pools growth from market performance, while cost growth outpaced net new revenue contribution.

Asset management profit pools,[1] Western Europe



[1] Estimate for combined third-party and proprietary.
[2] Impact based on average AUM in 2018.
Source: McKinsey Performance Lens Global Growth Cube, McKinsey Performance Lens Global Asset Management Survey

The adoption of passive strategies varies largely from region to region, with North America, Australia, and Japan making up the majority of passive assets and growth (Exhibit 11, previous page). Western Europe passive market share lands somewhere between North America and Rest of Asia, with relatively moderate increases in share over the last five years across retail and institutional segments. Moreover, the penetration of passive assets still differs significantly by country, reinforcing the need for asset managers to consider local dynamics and not fall into painting regional opportunities with a broad brush.

As in the rest of the world, private markets continued their rise as private fundraising has remained near record levels with significant tailwinds from client demand for alternative sources of return and yield.

Even with less mix shift to structurally lower-priced passive strategies, pricing pressure remains a challenge across asset classes in Europe, with declines in yields across all strategy categories nearly offsetting market performance effect in 2018 (Exhibit 12, previous page).

We anticipate continued pricing compression in Europe driven by: (1) competitive pricing by vertically integrated business models favoring proprietary managed strategies; (2) implications of MiFID II driving fee compression in institutional, wholesale/business-to-business (B2B), and increasingly even in retail; and (3) growing aggregation of demand enabling distributors and intermediaries to flex pricing power across retail and institutional channels.

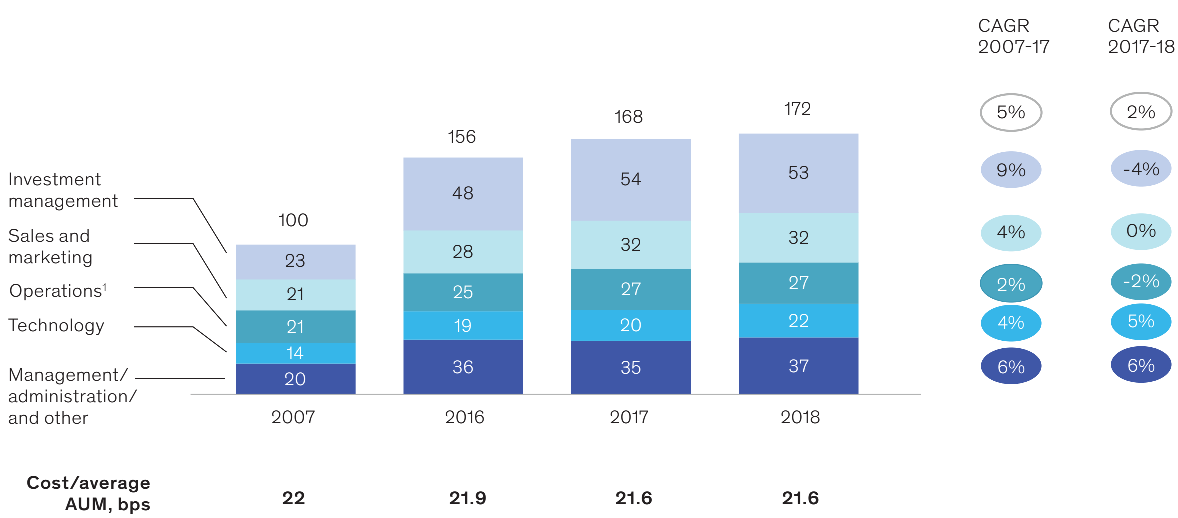
Fighting for sustainable operating leverage

Asset managers continue to struggle to improve efficiency at scale and to demonstrate sustainable operating leverage—a trend that has consistently challenged the industry to various degrees since the financial crisis. Western European managers increased overall spending by about 2 percent in 2018 despite the much more muted

Exhibit 13

While Western European functional cost growth decreased in investment management, distribution, and operations, overall spending levels continued to rise in 2018.

Cost pool by function
Indexed to 2007



[1] Western Europe Operations includes ~1 bp of expense from associated TA costs
Source: McKinsey Performance Lens Global Asset Management Survey

growth environment. This was, however, a slower cost growth rate than in prior years (5 percent average annual growth between 2007 and 2017), largely due to slower or declining functional cost growth in investment management, distribution, and operations (Exhibit 13, previous page). In comparison, North American managers fared even worse on cost discipline, with overall costs growing twice as quickly (4 percent year-over-year) as those of Western European managers, with significant increases in investment management (3 percent) and distribution (8 percent).

Unlocking vectors of new growth

We believe there is ample room for European managers to achieve top- and bottom-line growth, if they can execute across the following three strategic imperatives and potential levers (Exhibit 14):

Compete within the core: "Tighten up the ship"

— Meet clients' urgent needs in the "lower for longer" economic environment

- Recast the value proposition of the product lineup to meet the changing portfolio needs of institutional clients (e.g., alternative sources of yield to meet liabilities; access to private markets; more efficient vehicles with reduced drag on returns; becoming a services provider instead of only a product provider—for instance by developing portfolio construction and advisory capabilities)
- "Institutionalize" retail wholesale client offerings (e.g., alternative sources of yield to meet retirement income requirements; higher margins of safety with slightly lower returns; alternative solutions for capital-protected retail savings and products)
- Make the investment process more robust by testing successful use cases in advanced analytics (e.g., de-biasing investment and trade decision-making; leveraging new sources of data to unlock opportunities such as in ESG and thematic investing)

— Double down on sustainability and impact investing

Exhibit 14

Three innovation and ambition levels to unlock value.

				Average value creation for a ~€200 billion player € million (percent of total value)
Redefine the game	EBITA multiple[1]	12x	**14x**	**300-400 (~15%)**
Move the boundaries; innovate selectively	Net new money	1%	**4%**	**450-550 (~20%)**
Compete in the core; tighten up the ship	Cost-to-income ratio[3]	65%	**60%**	**450-550 (~20%)**

[1] Based on operating profit.
[2] Over 5-year period.
[3] Median of Western European companies participating in McKinsey Annual Asset Management Survey.
Source: McKinsey Performance Lens Global Asset Management Survey; expert estimates

- Fully integrate ESG factors in the investment process, with the adoption of the Principles for Responsible Investment and the introduction of metrics to assess, measure, and manage ESG risk across asset types
- Contribute to structurally increasing the stewardship ability of the industry, to achieve impact at scale in the real economy
- Partner with distribution networks to shape an ESG-compliant product range and contribute to embedding of ESG culture in advisory models
- Explore possibilities to enlarge the impact investing market as a means to further diversify portfolios and achieve outsized returns

— Get front-line tactics right (e.g., distribution effectiveness driven by targeted training/upskilling to improve client proactiveness, client experience, B2B/B2B-for-consumer [4C] opportunities)

— Transform your operating platform and cost structure

- Rapidly transition middle- and back-office capabilities to meet the needs of the front office and clients (e.g., technology and automation to accelerate efficiency and time-to-delivery and enable customization at scale)
- Radically simplify operating models, leveraging technology, data, and analytics to streamline costs, improve client experiences, and open channels to new growth

Move the boundaries: "Innovate selectively"

— Realign business models to capture growth in retail "hot spots" (e.g., democratizing access to high-quality products for retail investors, direct-to-consumer)

— Unlock the tremendous white space for growth in internally or unmanaged financial assets in institutional (e.g., meeting liquidity needs of corporate balance sheets; mid-sized insurers managing their proprietary books of assets and thus not benefiting from economies of scale or scope)

— Identify beneficial new partnerships in the shifting distribution ecosystem (e.g., platforms that can boost the value proposition with network effects by accessing new clients and sources of growth)

Redefine the game: Become a disruptive player

— Expand "beyond asset management," for instance by creating a platform or ecosystem building on privileged access to clients (e.g., a fund selection and distribution platform, wealth manager/credit provider, market maker, technology provider, or B2B marketplace)

— Radically innovate (e.g., take the lead in using distributed ledger technology in asset management to tokenize previously illiquid assets)

Historically, succeeding in asset management was relatively straightforward, matching sources of structural wealth creation and growing retirement and liability needs, with sources of capital appreciation, income, and yield. However, the success factors behind the industry's growth have become more uncertain, and will continue to evolve. The asset management industry's current challenges are real and must be confronted, and managers must seek a new narrative and ambition for growth. Significant upside exists, whether it be within the current scope, or through pushing boundaries and creating new opportunities. The future belongs to those who can execute to their ambitions. The gauntlet has been thrown. Will European asset managers take it up?

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