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North American asset management in 2018: The New Great Game

Global Wealth & Asset Management Practice

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Introduction

The North American asset management industry is undergoing a major shift in competitive dynamics. Even as the secular tailwinds of demographic change, wealth creation, and financial deepening continue to bolster the industry's long-term attractiveness, a set of countervailing trends in product demand, fee compression, and regulation are creating new challenges for asset managers.

Amidst these shifts, a number of forward-thinking firms are making bold moves to grow their share in ways that are fundamentally reshaping the market. Pricing is being deployed as a strategic lever to attack new markets, product innovation is unlocking new categories of demand, technology is being leveraged at scale to turbo-charge core investment and distribution activities, vertically integrated business models are supporting new client value propositions, and acquisitions are being used to accelerate capability-building and deliver efficiencies.

The rules of the game, in short, are being rewritten. Akin to the original geopolitical "Great Game" of the 19th century, a complex strategic ballet that saw two great powers, Britain and Russia, wrestling for control of Central Asia amidst a constantly shifting array of regional alliances and proxy wars, the competitive landscape of the asset management industry is being reset by a small group of visionary firms. These competitors are jockeying to deliver distinctive propositions at meaningful scale, whether low-cost manufacturing, scalable alpha generation, or end-to-end delivery of client needs.

The North American industry's performance in 2017 portended a major shift in this direction. Record-setting market performance, spurred by a return of the retail investor and sustained flows from emerging markets, made 2017 a banner year for the industry as a whole. Global assets under management (AUM) grew to an all-time high of $88.5 trillion, industry profits increased by 20 percent, and net new money entering the industry rose to $2 trillion. North American managers pulled in a record of more than $683 billion in net new flows to managed assets while industry profits (excluding alternatives) grew some 20 percent to $44.5 billion.

Yet, this rosy picture masked a gap between the haves and have nots that grows ever wider, particularly when viewed through the prism of organic growth. In 2017, the growth gap between top- and bottom-quartile firms in North America was 21 percentage points, up 6 points from 2016. More strikingly, the industry's largest firms accounted for a disproportionate share of growth, with a set of "trillionaires" generating over 80 percent of all positive organic growth and several making significant gains in share even outside of passive products.

The New Great Game of asset management brings with it a new logic of scale. This is not scale in the conventional sense of managing the largest pool of assets, but rather the ability to marshal a set of distinctive capabilities and leverage them across the entire enterprise for competitive advantage, whether by creating massive operating efficiencies, building broad and sustained client access, or generating superior investment insights and consistent outcomes. Size alone does not determine destiny. Trillionaire firms that act like a disparate collection of small firms have not set themselves up for success, while smaller firms that pick their spots, find the right partners, and leverage their competencies are on a winning path.

We expect scale to grow in importance as the broader investment management ecosystem evolves in the coming years. The vast network of retail intermediaries through which a significant portion of the industry's future growth will funnel is becoming increasingly institutionalized as home offices acquire greater sway over manager selection and portfolio construction decisions. Institutional clients are increasingly adhering to a credo of "fewer but more strategic relationships," while demand from the long tail of smaller institutions is concentrating more tightly within a smaller set of consultant relationships and a growing outsourced CIO (OCIO) marketplace.

Regulatory developments (e.g., MiFID II) and the need for scaled investments to take advantage of new data sources and technology are together making a strong case for a more centralized investment research function. Finally, two new sets of at-scale competitors with big ambitions for growth—mega alternatives firms and vertically integrated retail firms—are making a move toward the heart of the industry.

These structural shifts place a new set of demands on asset managers. Firms urgently need to build strategic relationships rooted in a deep understanding of underlying client needs, deliver for clients in a way that cuts across silos, develop new data and analytics capabilities to generate both sales and investment alpha, and leverage technology, data, and analytics to forge an integrated, highly scalable end-to-end client experience.

These new demands are turning the longtime dominant operating model of asset management on its head. What was once a predominantly vertical model organized around asset classes and well-defined functions is being transformed horizontally to build greater alignment with the needs of clients, embrace a set of investment opportunities that fall between the lines of traditional asset classes, and take advantage of new technology-enabled capabilities that lead to drastic increases in the effectiveness and efficiency of every function across the enterprise.

Still in its early stages, the New Great Game promises to dramatically reshape the landscape of asset management. A new set of winners will emerge and some existing "great powers" that fail to respond will likely fall by the wayside. This will lead to consolidation within the constellation of smaller firms that, separately, cannot keep up with the pace of change, but at the same time it will prepare the ground for the rise of innovative insurgents that can either establish more specialized niches or forge productive alliances with the bigger firms. The new logic of scale will sustain the wave of industry consolidation and lead to a new wave of partnerships and alliances across regions and industry segments.

Asset managers that want to thrive in this new environment face a set of imperatives, not dissimilar from the choices faced by the great powers in the original Great Game. They will need to make a deliberate set of decisions: to clearly define their role in the ecosystem, to pick their spots (that is, where to compete) in a way that clearly aligns with their strengths, to build strategic alliances in areas where they choose not to compete, to back up their choices with deliberate resource allocation, and to create an operating model that delivers sustainable and scalable economics.

The industry in 2017: Winds of change

The asset management industry enjoyed a banner year in 2017. With broad-based global economic growth seeming to finally take root and economic policy taking a decidedly investor-friendly course, global capital markets surged across all regions and all asset classes. At year's end, the S&P 500 and MSCI World index stood 19 percent and 22.4 percent above 2016 levels as risk appetites revived globally.

Asset managers benefited handsomely from the markets' rapid advance. Global assets under management (AUM) grew some 11 percent, hitting a record $88.5 trillion (Exhibit 1). While market appreciation accounted for a significant proportion of this growth, the industry sustained healthy levels of organic growth with about $2 trillion of new money flowing into the system, also an all-time high.

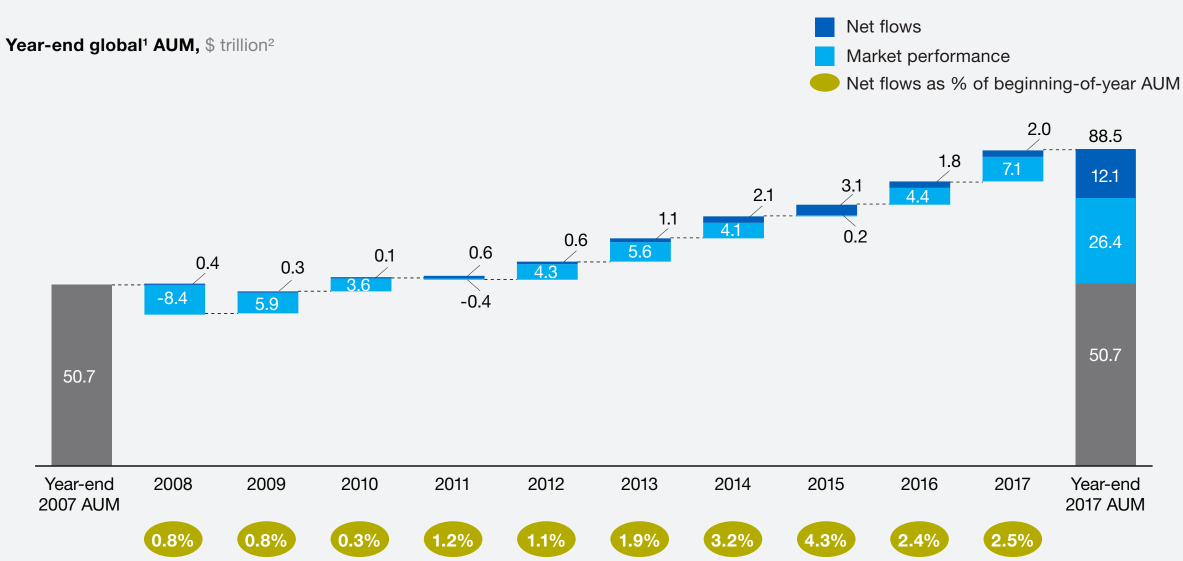
An industry at peak performance?

The asset management industry's strong performance was broad-based. Three of four major regions—North America, Western Europe, and Emerging Asia—took in substantial new money, each accounting for approximately a third of global growth (Exhibit 2, next page). Asset managers were rewarded with surging profit pools, in the range of 18 to 20 percent in each of these markets (Exhibit 3, next page).

North American asset management was particularly robust in 2017, bouncing back from a tepid performance the previous year (Exhibit 4, page 7). North America-domiciled clients added a record $683 billion of new money to their pool of managed assets, revenues grew to $188 billion, and profits grew to $62.7 billion, including alternatives. Profitability expanded to 33 percent of

Exhibit 1

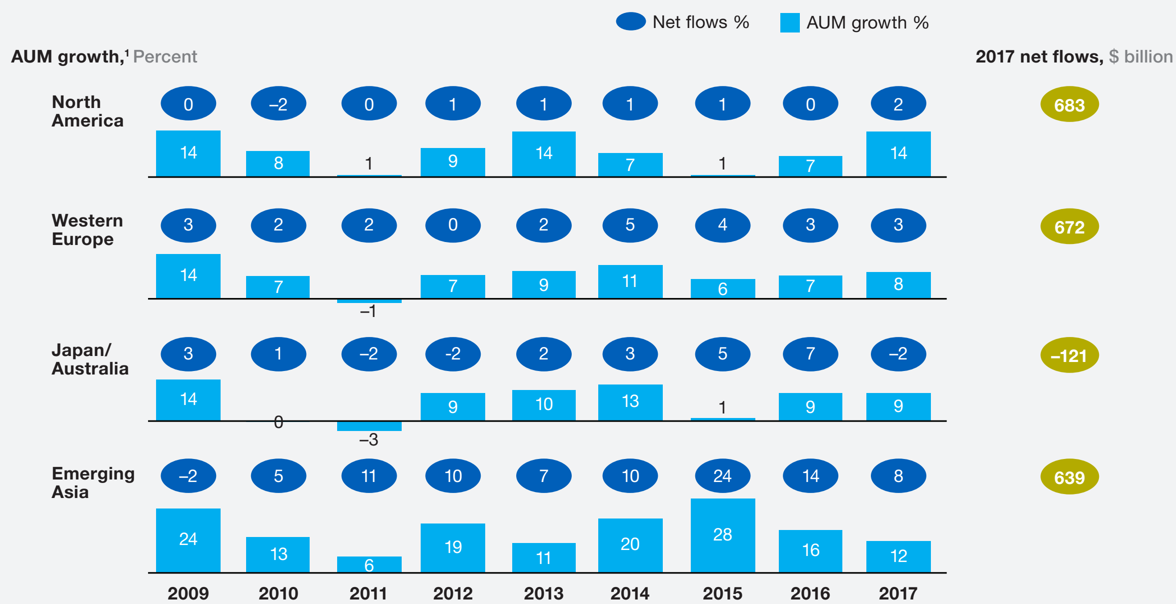
The global asset management industry hit an all-time high in terms of assets under management in 2017.



[1] Includes 41 countries from North America, Western Europe, CEE, GCC, Developed and Emerging Asia, Latin America, and Africa.
[2] Numbers have been rounded off.
Source: McKinsey Performance Lens Global Growth Cube

Exhibit 2

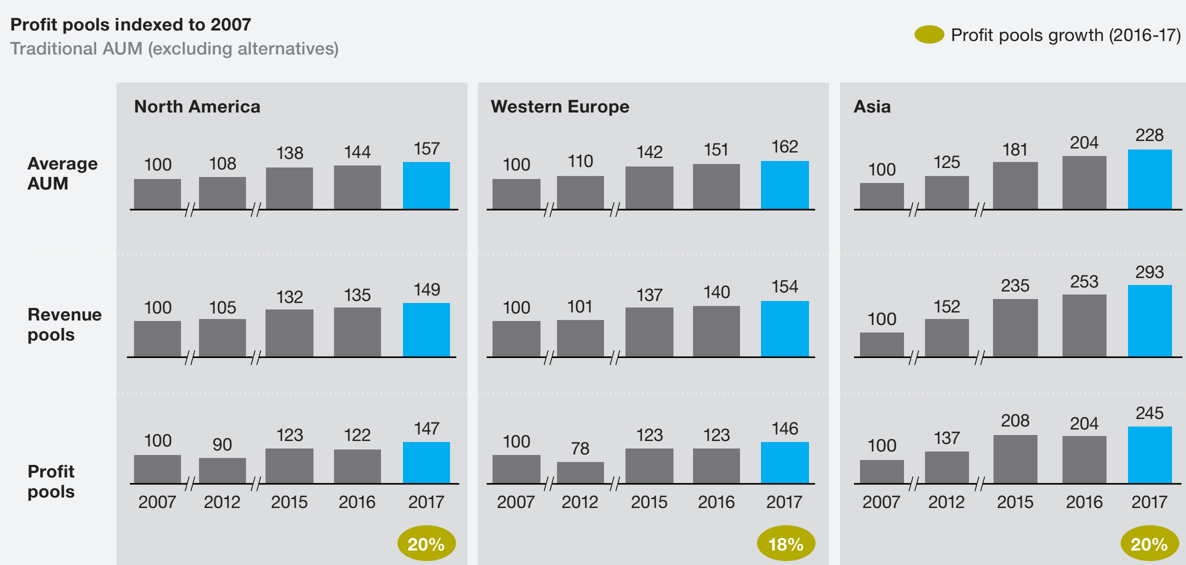
2017 was a banner year for industry economics in all major regions.



[1] Includes 29 countries from North America, Western Europe, Developed and Emerging Asia (accounting for ~96% of global AUM).
Source: McKinsey Performance Lens Global Growth Cube

Exhibit 3

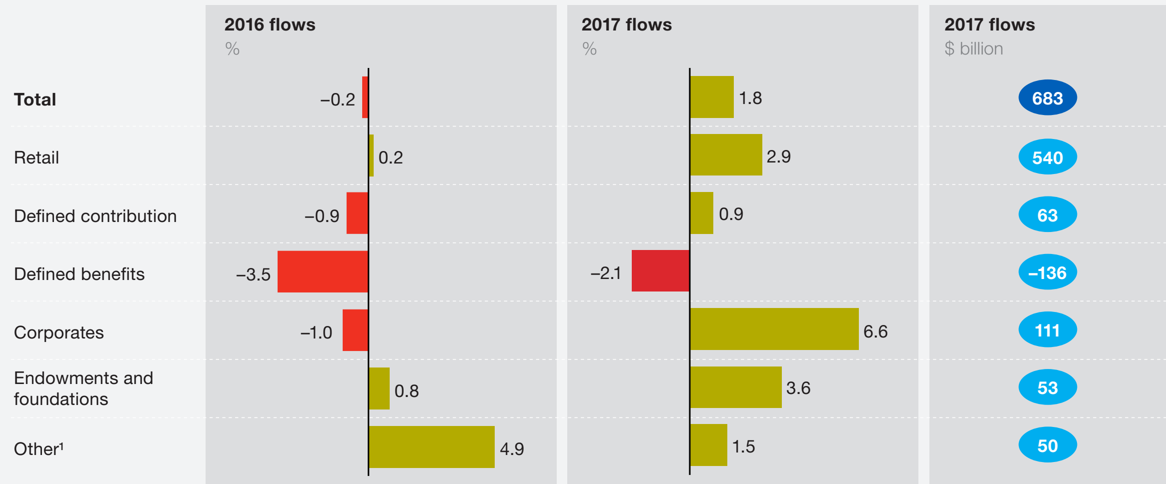
Profit pools surged in three major regions.



Source: McKinsey Performance Lens Global Growth Cube; McKinsey Performance Lens Global Asset Management Survey

Exhibit 4

Recovery in North American asset management flows was broad-based, but particularly strong in retail.



[1] Includes insurance, sovereign wealth funds, and state entities.
Source: McKinsey Performance Lens Global Growth Cube

revenues, up from 30 percent in 2016 and marking only the second year in the last ten that they have equaled their pre-crash 2007 performance (the other was 2014).

Organic growth increased in almost every client segment in North America. A longer-term shift in the industry toward a larger presence for individual investors asserted itself, with retail investors accounting for $540 billion or some 80 percent of flows in 2017. The corporate sector bounced back from several years of outflows with $111 billion of new money deployed in managed assets, led in large part by increasing demand for cash management products as interest rates edged up. Resisting the headwinds of baby-boom retirements, defined contribution assets had a similar bounce-back into positive flow territory as a greater proportion of retirement assets remained managed in-plan rather than rolling over into IRAs. The endowment and foundation segment experienced healthy growth of $53 billion as buoyant markets and new wealth creation drove an uptick in giving.

Defined benefit pension funds remained the one area of persistent outflows, posting a decline of $136 billion in assets. Yet even this marked an improvement from the rate of decline in 2016, as corporations took advantage of record corporate profits to improve the funded status of their plans (and enjoy the attendant tax benefits of pension contributions).

But performance isn't the same as health

If we look past the industry's outstanding economic performance, we observe a growing dependence on the momentum of the market. Of the $8.5 billion that was added to the traditional (i.e., excluding alternatives) asset management industry's profit pools in 2017, less than 30 percent (or $2.4 billion) was attributable to organic growth, compared to $11.8 billion resulting from market appreciation (over 100 percent of the gain in profits) (Exhibit 5). A rising cost base shaved away $4.5 billion of profit gains (-53 percent), mix shifts in favor of lower-fee asset classes took away $1 billion (-12 percent), and fee compression reduced profits by a further $200 million (-3 percent).

It's important to recognize the industry's heavy dependence on market appreciation as we turn to 2018, which thus far has been characterized by greater geopolitical and macroeconomic turbulence, with interest rate hikes and threats of political gridlock on the domestic front, trade wars and currency crises in several large emerging markets, and uncertainty around the timing and final shape of Brexit in Europe.

Furthermore, a set of long-standing structural trends that have been pressuring the industry's economic model continued to play out in ways that were familiar, while incorporating some new twists.

The ongoing active-passive shift

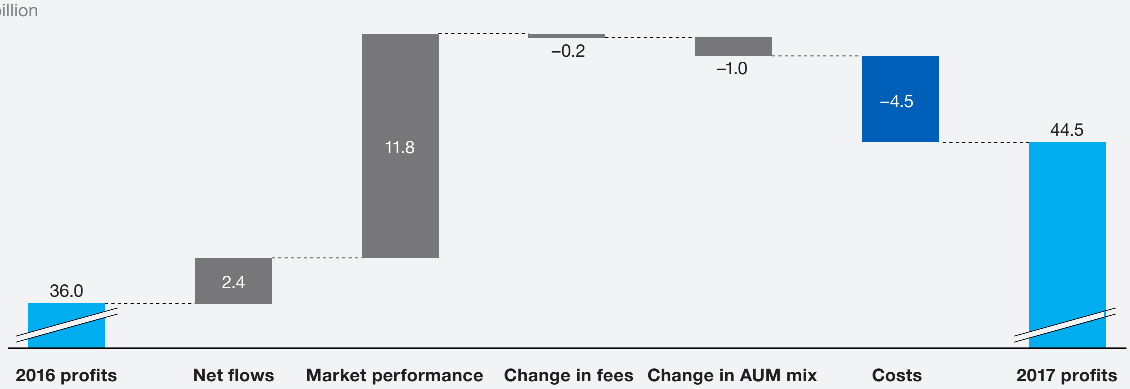
The year 2017 marked the eighth straight in which aggregate outflows from actively managed investment products were coupled with parallel (and often explosive) growth in passive funds. Three of the fastest-growing asset classes in 2017 were passive equities (again), passive fixed income, and passive multi-asset funds, all of which grew at double-digit rates but with revenue margins in the 8- to 11-basis point range. The biggest outflows were from active equities—both core and specialty categories—where revenue margins dropped about 7 percent and 3 percent, respectively, while producing yields in the range of 45 to 55 basis points.

The active-equity shakeout, which we have discussed at length in previous reports,[1] continued in 2017 despite a mild uptick in active performance (Exhibit 6, next page). Over the course of the

Exhibit 5

The vast majority of growth in industry profit pools was driven by the massive tailwinds of the market.

Traditional (excluding alternatives) asset management industry profitability in North America, 2016-17
$ billion



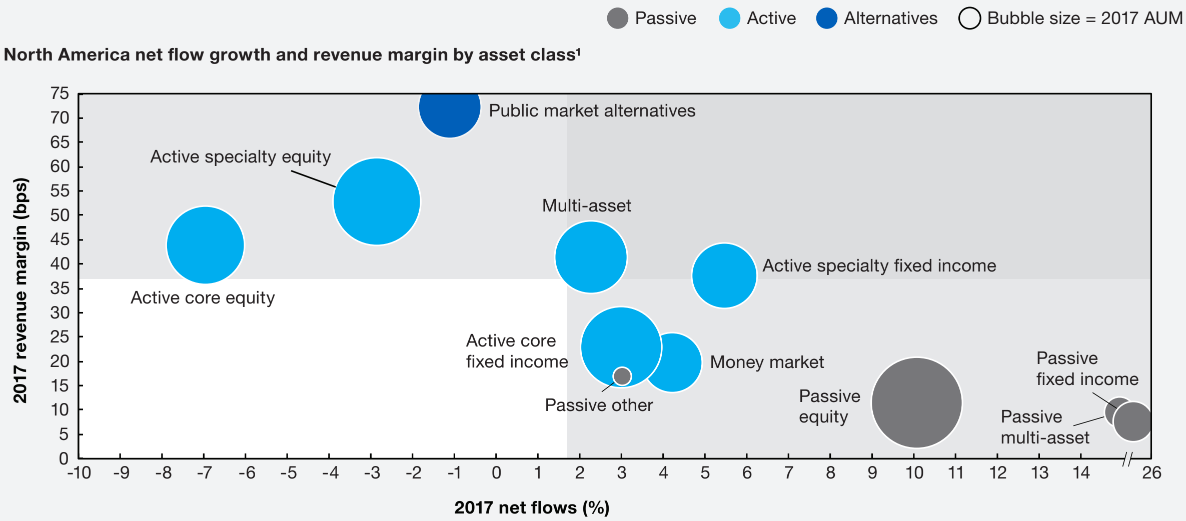
Source: McKinsey Performance Lens Global Growth Cube

[1] Pooneh Baghai, Onur Erzan, Ju-Hon Kwek, and Nancy Szmolyan, "Thriving in the new abnormal," November 2016, McKinsey.com; Pooneh Baghai, Onur Erzan, Ju-Hon Kwek, "The best of times, the worst of times," December 2017, McKinsey.com.

Exhibit 6

Longstanding shifts in product demand continued to play out.

North America net flow growth and revenue margin by asset class[1]



[1] Active core equity includes US large cap and yield/income equity; active core fixed income includes core, core plus and municipal bonds; active specialty equity includes foreign, global, emerging markets and US small/mid-cap; active specialty fixed income includes global, emerging markets, high yield, TIPS and unconstrained.

Source: McKinsey Performance Lens Global Asset Management Survey and Global Growth Cube

year, approximately 45 percent of active equities strategies outperformed their passive counterparts: an improvement over 2016, but not enough to convince investors to return to the market. Active equity outflows moderated somewhat, but were still severe: $653 billion lost, compared with $843 billion in 2016. Passive equities boomed, by contrast, more than doubling inflows to $505 billion from $234 billion as investors overwhelmingly chose ETFs and index funds as their preferred route for riding a buoyant market.

Meanwhile, rotation away from actively managed public equities in favor of private markets continued in the institutional segment. Private equity posted a record fundraising year, with $397 billion of new money becoming available for deployment at margins that typically exceeded 100 basis points. These gains, however, were concentrated with pure-play alternatives firms; only a small number of asset managers with sizeable private-market franchises benefited meaningfully.

Steady demand for fixed-income investments continued in 2017, with $511 billion of new money entering the asset class. In contrast to the unidirectional flow from active to passive experienced in equities, fixed-income flows were spread almost evenly across active and passive funds. Active fixed income continued to deliver value to clients, with some 60 percent of strategies outperforming their passive counterparts over the course of the year amidst concerns over the direction of interest rates.

At the same time, 2017 marked the emergence of passive fixed income as a meaningful category in its own right, with $257 billion of new assets flowing into the market. Indeed, a larger role for passive fixed income appears to be hard-wiring itself into investor practices and end-client demand patterns. The “technology” of fixed income indexing is improving and the range of vehicles, like ETFs, that can be used to express particular macro views or stake out precision exposures is broadening. Meanwhile, the underlying illiquidity of bond markets is driving passive demand as investors embrace greater use of ETFs to replace individual bond holdings and to serve as a tool for price discovery in non-transparent over-the-counter markets.

What these results demonstrate is that the much-referenced wholesale "active vs. passive" shift is something of an oversimplification (Exhibit 7). End clients and investors who deploy capital on their behalf continue to embrace active strategies in areas where they can deliver demonstrable value. And the rapid adoption of passive vehicles like ETFs, while sometimes undercutting demand for active products, in many cases represents a parallel and complementary trend as they are deployed against new use cases and client segments.

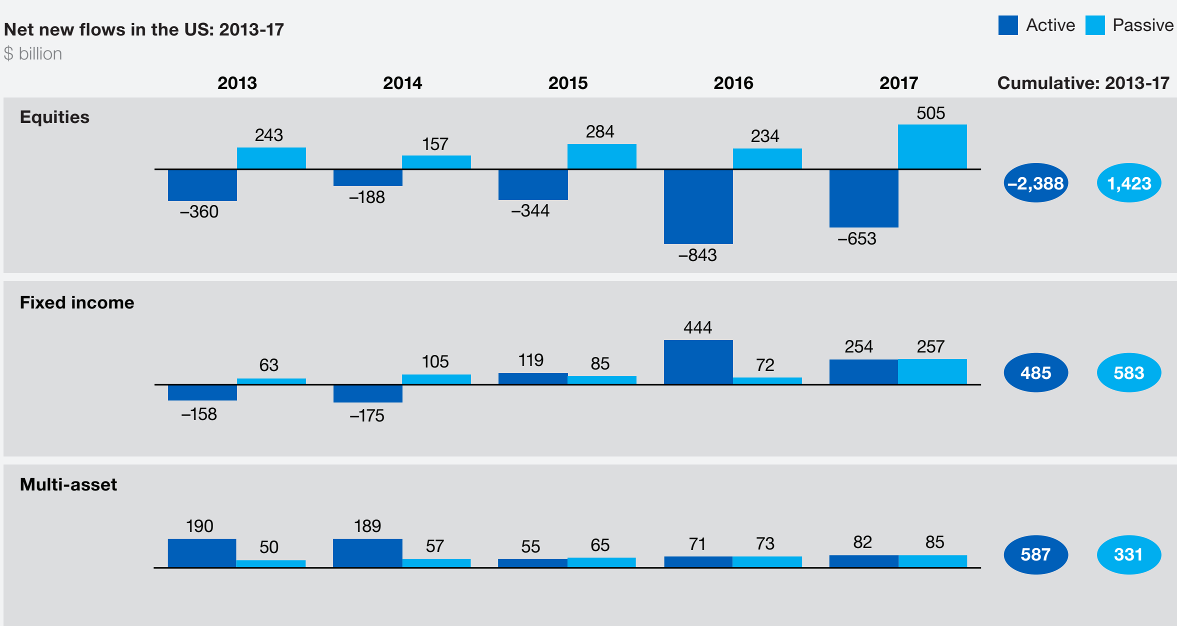
Fee pressure is real, but it's not always what it seems

The past 12 months have brought longstanding concerns over fee compression into sharp focus. In 2017, a mix of incumbents and new entrants jostling for position drove a series of well-publicized price cuts in the ETF market. In the first half of 2018, we witnessed a crossing of the Rubicon from "low fee to no fee" as one major firm launched a series of index funds that effectively offered to manage client money for no underlying fee. Concerns about a race to the bottom have reached fever pitch in some quarters.

We agree that pricing is becoming an area of profound structural change in the asset management industry, but the details of this change are not precisely what they are often thought to be. While fee compression is real, it is a much more

Exhibit 7

"Active vs passive" is somewhat of a false dichotomy.



Source: McKinsey Performance Lens Global Growth Cube complicated phenomenon than a race to the bottom—and by no means affects all categories of managers the same way.

To be sure, the past eight years have been a great time to be a client of the asset management industry; total fees paid by end investors have fallen by an average of 27 percent (Exhibit 8). But fee compression has been felt to a vastly different degree across different asset classes. Pressure has been greatest in the world of passive, as a number of large producers enjoying clear economies of scale have moved to reinforce their competitive position. Fees on passive equities have come down 43 percent while fees on passive fixed income have fallen 34 percent. In contrast, fee levels have held up relatively well for active strategies, with active multi-asset and active specialty fixed income showing the greatest resilience over this period, posting reductions of only 6 percent and 13 percent, respectively.

While fee pressure is a real phenomenon, then, the degree of direct impact on asset manager economics is often misunderstood. Instead of outright cuts to management fees, which have a direct impact on asset managers' bottom lines, the real story is about a shift in product and share class mix as money flows into lower-cost vehicles and products. Only 44 percent of active-equity fee compression, for example, resulted from direct fee cuts; the remainder was accounted for by flows to lower-cost share classes, new launches, and liquidations of high-cost share classes. As this suggests, fee compression was largely an equity management phenomenon; within active fixed income, the average fee decline was just 2 percent.

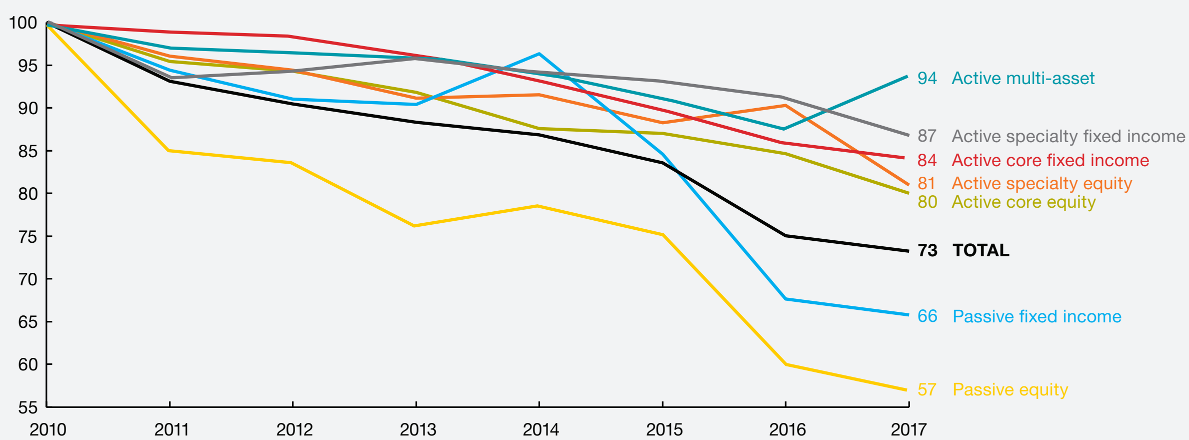
The key structural change for fees in 2017 was not about management fees themselves but the transfer of money to more efficient vehicles that unbundle ancillary fees, typically put in place

Exhibit 8

Average fees paid by investors have declined more than 25% in the past 8 years.

AUM-weighted average total fee,[1] 2010-17

Indexed to 2010; includes US-domiciled open- and closed-end mutual funds and exchange-traded funds



[1] Total fees as reported at the share class level.
Source: Strategic Insight Simfund Mutual Fund

to fund distribution. This important shift could not have revealed itself more dramatically as funds without loads or embedded distribution fees—e.g., ETFs, no-load mutual funds, zero/zero-share classes, and separately managed accounts—benefited from inflows of just over $1 trillion, while “loaded” vehicles experienced outflows of $268 billion. ETFs and zero/zero share funds both lost nearly one-fifth of their assets. This massive mix shift opened up a $3.3 billion “gap” in distribution fees that would otherwise have been paid out to intermediaries or financial advisers (Exhibit 9).

Most significantly, this mix shift in vehicles represents a major change in the cost burden for the industry; an unbundling of the costs of distribution from underlying products and a shift of those charges from end clients to asset managers. While the gap can be partially made up by the more efficient economics that wealth managers enjoy in their fee-based advisory relationships, it will likely create upward pressure on revenue share, data fees, and the no-transaction-fee platform fees that asset managers pay.

When management fees do decline, the effect is to drive flows increasingly into funds at the bottom of their category by price, but with actual price sensitivity varying by asset class, most intensely in passive and active equities (Exhibit 10, next page). In other categories, performance matters quite a bit more. Understanding which categories face which sets of pressures and how to respond to them will be critically important to asset managers in the years ahead.

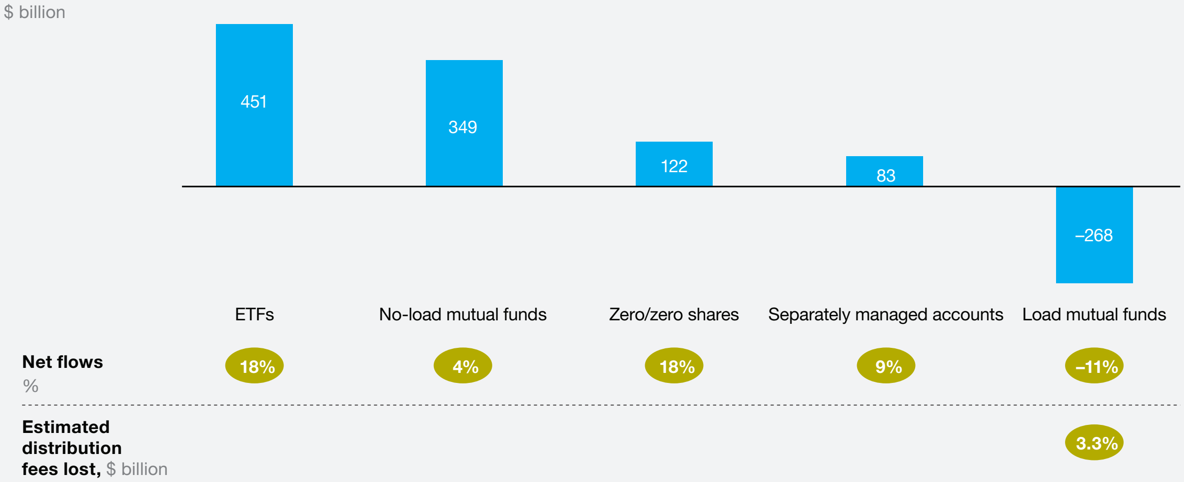
A new era of strategic pricing

If pricing trends do not represent simply a race to the bottom, then what is it that we are witnessing? Our view is that the significant change in the

Exhibit 9

A massive shift towards more efficient product vehicles is leading to an “unbundling” of distribution fees.

Mix shift across product vehicles, net flows, 2017
$ billion

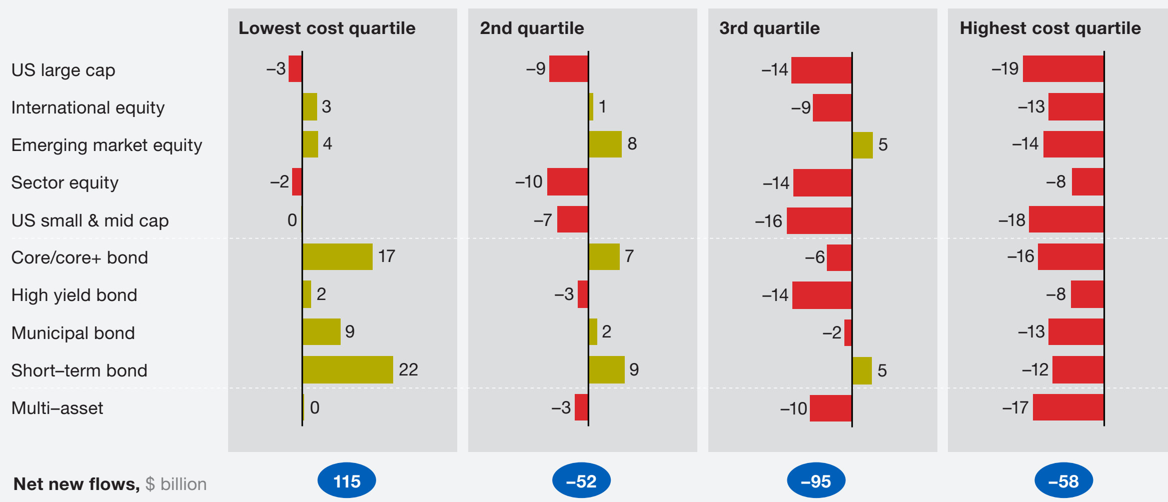


Source: Strategic Insight Simfund Mutual Fund; Cerulli Associates; eVestment

Exhibit 10

When fees decline, flows shift to funds at the bottom of their price categories—but the magnitude of the effect varies by asset class.

Net new flows to US domiciled '40 Act funds by fee quartile (active)
Percent of beginning–of–year AUM, 2017



Source: Strategic Insight Simfund Mutual Fund; Cerulli Associates; Envestnet

industry is the emergence of pricing as a major competitive lever. A number of firms are aggressively using price cuts to plant a flag and gain share in fast-growing markets, to promote low-cost "entry level" products, and to deploy "loss leaders" for client acquisition in hopes of later broadening the relationship into higher yielding products. These firms are employing this lever in a highly judicious way, with a clear view of economic payoffs expected in price adjustments and with tiered strategies to protect premium products from cannibalization.

Strategic pricing—the ability to set price in a way that reflects value creation based on an understanding of what really matters to different client segments—is emerging as one of the major strategic levers in the New Great Game of North American asset management. Price cuts in and of themselves do not guarantee massive new flows or a significant gain in market share, nor does offering the consistently lowest price necessarily spell a strategy for growth and success. And clearly some firms have perfected the art of strategic pricing while others have not. When we compared outcomes for ETF sponsors that made fee reductions over a five-year period ending in 2017, we found little correlation between the magnitude of the adjustments and the average annual flow into or out of those funds. One firm lowered fees 98 times by an average of just 2 basis points during that period—and took in $1.23 billion of assets with this re-priced portfolio. Another firm reduced fees 56 times by a much less generous 8 basis points on average—and gained only $376 million (Exhibit 11, next page).

Pricing is both an art and a science—and either way, an increasingly sophisticated one. Asset managers are following a vast array of pricing practices, and some are using price as a lever of growth much more effectively than others.

Cost: Doing more with the same (if not less)

Costs tend to move in one direction, and 2017 saw an additional $5 billion of new spend being layered on to the North American asset management industry, for an aggregate cost base of $89 billion (Exhibit 12, next page). The biggest causes of cost growth in absolute terms were investment management, operations and technology, and legal and compliance costs, the latter two being essentially fixed costs.

Even as investment management costs have increased over the past decade, they have actually declined slowly but steadily as a percentage of the industry's cost base over the same period, from 44 percent in 2007 to 39 percent in 2017. Operations and technology costs, on the other hand, have increased by a considerable 8 percent CAGR over the same period (compared with just 3 percent for investment management) and have increased from just 8 percent of the industry's cost base in 2007 to 17 percent today.

Some of this recent cost growth represents investments that asset managers have been making to take advantage of technological and analytical advances that can bolster their core investment and distribution activities. But a more important driver is the increasing level of complexity in underlying operating models, a mosaic of legacy systems that have been heavily customized over the years to meet the needs of individual teams and clients. The fixed nature of operations and technology costs and the fact that they have been among the fastest-growing cost segments may be a point of concern for asset managers in the coming years.

The good news in the near term is that, thanks to a rising market, the North American asset management industry increased its operating leverage

Exhibit 11

Price cuts do not guarantee new flows; some have perfected the art of strategic pricing better than others.

Fee reductions by ETF sponsors
2012-17

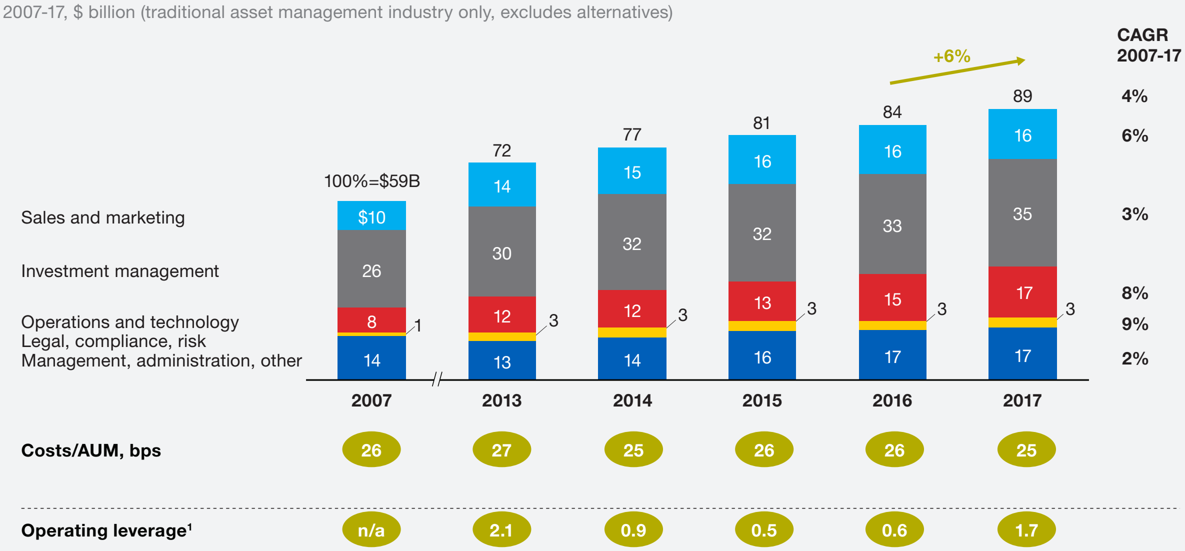
[1] Excludes flows for fund cuts made in 2017.
Source: Morningstar; Lipper; ETF.com; McKinsey analysis

Exhibit 12

Costs grew 6% in 2017, but faster revenue growth helped the industry achieve positive operating leverage.

Estimated total North America industry costs by function

2007-17, $ billion (traditional asset management industry only, excludes alternatives)



[1] Operating leverage is defined as the ratio of the change in $ net revenues over the change in $ costs.

Source: McKinsey Performance Lens Global Asset Management Survey

in 2017. Overall cost of managing a dollar of assets fell by 1 basis point to 25 basis points and revenues grew a full 70 percent faster than costs over the course of the year. The industry's jump in operating profit margin, to 33 percent from 30 percent in 2016, was impressive, especially since it incorporated a moderate cost increase of 6 percent, year-on-year.

Yet, the industry's dependence on market appreciation invites caution. Given how important market performance, as opposed to organic growth, has become as a driver of revenues, the question facing the industry is how much stickier costs could be in a downturn—that is, will additional costs be fixed rather than variable, and how rapidly will firms be able to mobilize to bring costs in line with lower revenues? A few of the most forward-thinking firms are taking advantage of these times of plenty, making moves now to redesign their operating model for leaner years.

■ ■ ■

In summary, 2017 was a superb year to be an asset manager, very clearly demonstrating the underlying attractiveness of the industry's ability to grow with markets and achieve operating leverage. But it also brought into sharper relief a set of structural changes that are reshaping the market. What will separate the winners and losers in such an environment is the agility with which individual managers reposition their business and operating models to respond to these changes. As we discuss in the next chapter, the degree to which they possess that agility is mixed.

A new logic of scale

At first glance, North American asset management is in a state of rude health. Industry profit margins have reached pre-crisis highs of 33 percent, bouncing back from their dip in 2016: a year when markets were up but profitability went down. And while buoyant markets were a big part of the story, they were not the only critical element. Organic growth returned to the industry, with net flows registering a healthy 2 percent growth rate, although its impact was small compared with the huge gains in the market.

The casual observer could not be blamed for assuming that a rising tide lifted all asset managers. The reality is more complicated. In what should have been an exceptional year for nearly every firm, the gap between over- and underperformers widened in significant ways. In particular, scale emerged as a far more important gauge of growth and profitability than in any year prior.

What lies beneath …

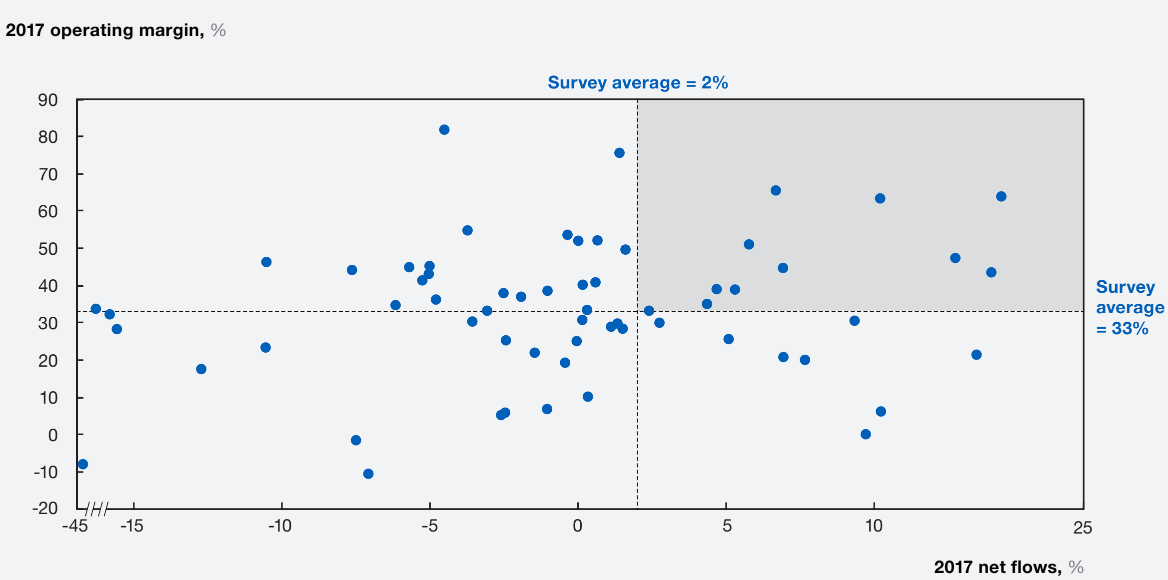
Averages can often mislead. This is certainly the case in the talent-centric and performance-driven world of asset management.

According to McKinsey's proprietary benchmarking data covering more than 100 managers in North America and 80 percent of industry AUM, the spread of individual manager performance, as measured by growth and profitability, remained wide in 2017. Even in a year of plenty, a large gap separated the best- and worst-performing firms. Eliminating the outliers at both the upper and lower ends, the large group of firms clustered in the middle still posted margins ranging from about -6 percent to about 8 percent. There was no such thing as an "average" firm (Exhibit 13).

The exuberance of capital markets provided a boost to profitability across a broad-based set of firms. More than four out of five improved their

Exhibit 13

Significant dispersion in performance of individual managers.



Source: McKinsey Performance Lens Global Asset Management Survey profit margin relative to 2016. But while profitability was easy, growth was more elusive. Almost half of managers (45 percent) were unable to achieve organic growth in 2017 despite robust net flows into the North American market.

A widening "organic growth gap"

Granular analysis reveals an accelerating rift between the industry's haves and have nots. This can be seen in two of the most important measures of corporate economics: revenues and net flows. Even as the (already substantial) profitability gap between top and bottom performers remained constant in 2017 at 41 percentage points, the revenue growth gap widened by 5 points and the "organic growth gap" (the ability to capture new money) separating the best- and worst-performing quartiles expanded by a full 7 points (Exhibit 14).

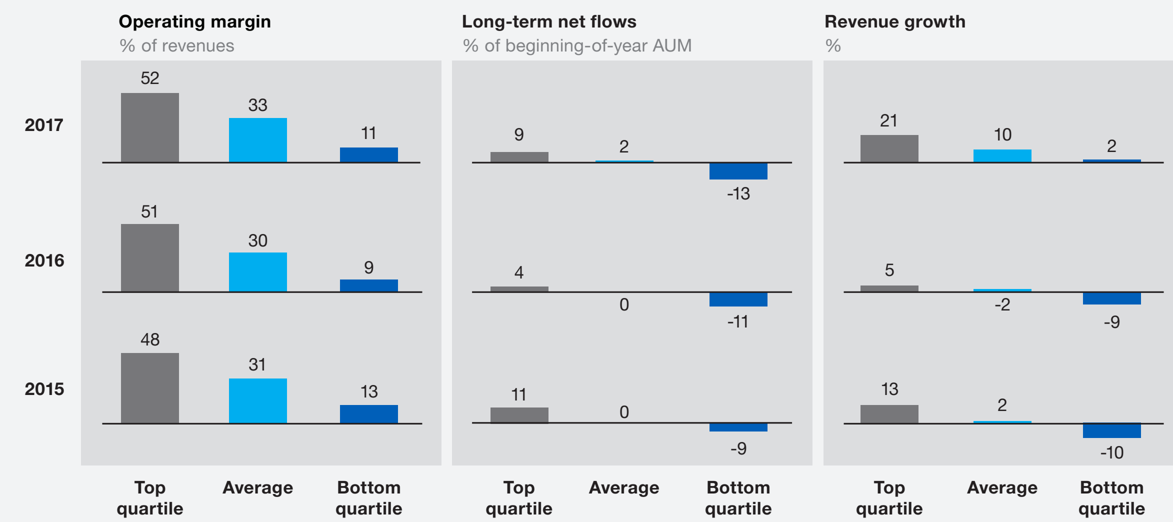
The differences between haves and have nots is even more stark when the previous three years are added in. Since 2014, top-quartile firms have increased their operating margins to 52 percent from 48 percent while bottom-quartile firms have seen margins deteriorate from 13 percent to 11 percent. Revenue growth for top performers took a healthy jump in 2017 after lackluster performance the previous year, but firms at the bottom barely scratched their way back into positive territory. Long-term net flows for top-quartile firms were not quite as high in 2017 as in 2015, at 9 percent, but for bottom-quartile firms, they slid further, to -13 percent last year from -9 percent in 2015. The organic growth gap, then, is not a temporary phenomenon.

An emerging-growth barbell

The growth gap not only widened in 2017; it also shifted in favor of certain types of firms: the very large and the very small. The very largest firms in the industry, those with $1 trillion or more in AUM, were overrepresented among those capturing organic growth (Exhibit 15,next page).

Exhibit 14

The "organic growth gap" between top and bottom performers widened.



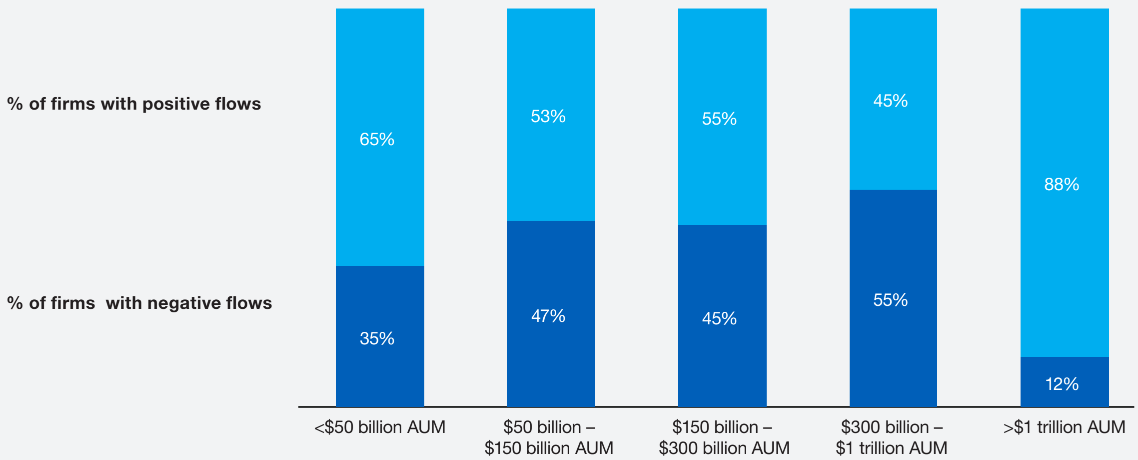
Source: McKinsey Performance Lens Global Asset Management Survey

Exhibit 15

Organic growth was particularly scarce for all but the largest firms.

Share of firms with positive vs. negative net flows in 2017 by size of firm

%



Source: McKinsey Performance Lens Global Asset Management Survey

Nearly 90 percent of these “trillionaire” firms posted positive flows in 2017, and this group was overrepresented in the top quartile of the industry by organic growth as well. At the other end of the scale, firms with less than $50 billion in assets posted respectable growth. Two thirds achieved positive flows, although it should be noted that they were also overrepresented in the industry’s bottom quartile.

The firms that fared poorly in 2017’s benign environment were clustered in the middle. These managers, typically with a broad range of products and capabilities spread over several hundred billion dollars of AUM, were overrepresented in the category of firms with negative flows. In particular, a greater proportion of firms in the $300 billion-to-$1 trillion range struggled, with 55 percent losing net assets over the course of the year. In our previous research we’ve sounded a cautionary note about a set of firms that we see as being “stuck in the middle.” The performance of these firms in 2017 clearly illustrated the challenges facing this group.

Some of the most striking findings of 2017 highlighted the importance of scale. Net new flows gravitated to a smaller number of managers—often, the largest ones. While newer, smaller firms typically post the best flows, this dynamic flipped last year, with the largest firms enjoying the fastest increases. It was the year of the “trillionaires,” with the top ten firms capturing some 90 percent of positive flows (Exhibit 16, next page). Starkly, no firm that posted more than $30 billion in net flows last year had less than $1 trillion in AUM.

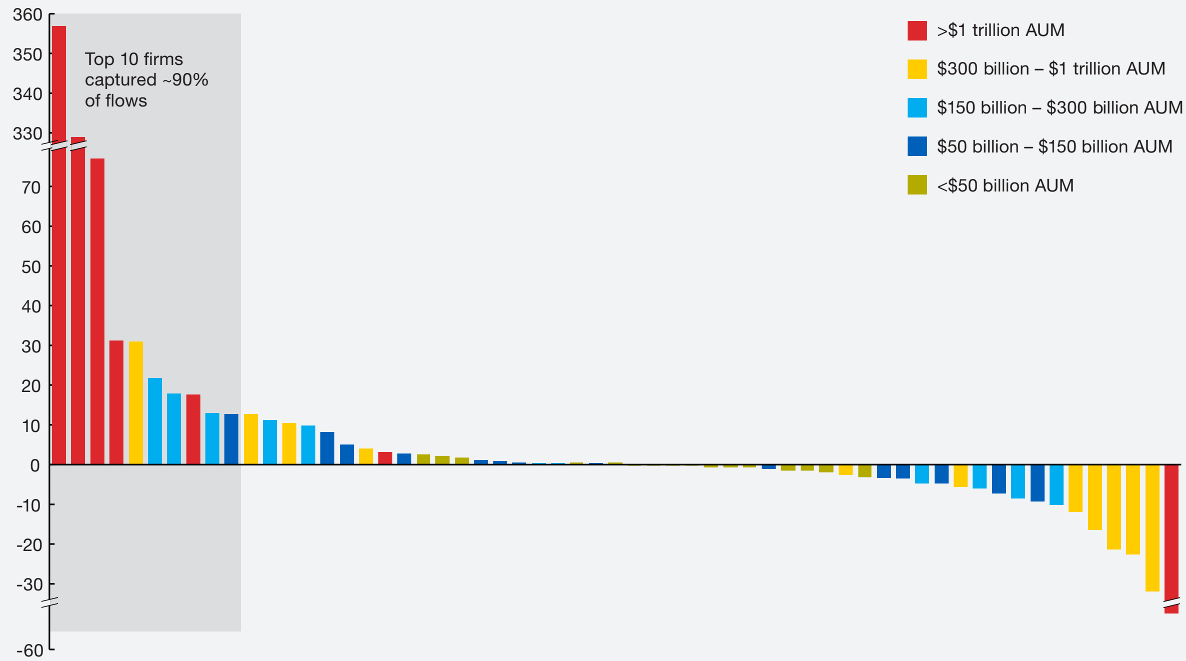
A new logic of scale

Yet even as the largest firms captured a disproportionate share of growth, we maintain—as we have for many years—that size is not destiny. Some “trillionaires” stumbled and a fair number of mid-sized firms thrived in 2017. Size is a highly imperfect proxy for scale.

Exhibit 16

The best-performing firms captured 90% of absolute flows.

2017 net flows
$ billion



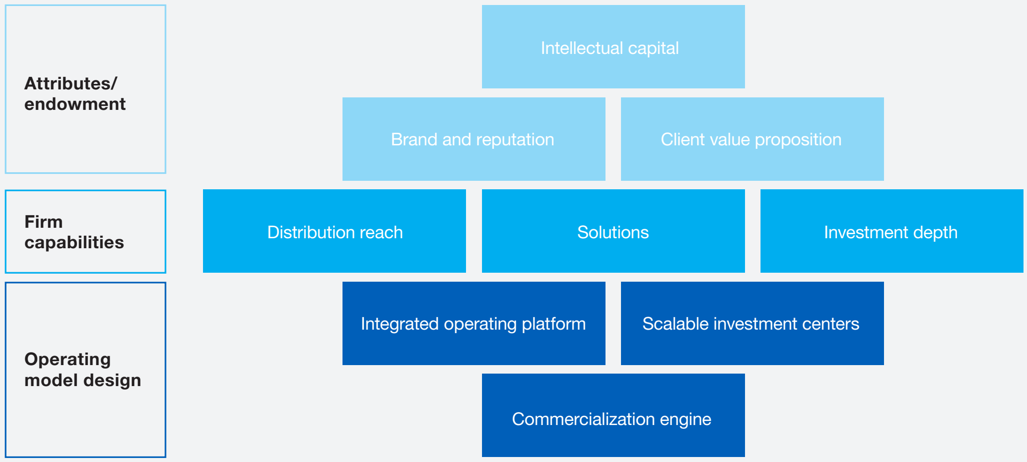
Source: McKinsey Performance Lens Global Growth Cube

When we look behind the curtain at the managers that truly achieved organic growth, a pattern emerges. Each of these firms possessed outsized strengths. In some cases, these strengths were intrinsic to the firm, like intellectual capital, brand, and reputation; in others, such as distribution and unique client solutions, the firm invested to build them. In still other cases, the firm's strengths were rooted in a superior blueprint that delivers efficiency, like an integrated operating platform or scalable investment centers. Each winner found a way to focus on a few of these strengths and leverage them across the breadth of its business, allowing it to punch above its weight in the categories where it chose to compete (Exhibit 17, next page). This new logic of scale mapped only imperfectly to assets under management and it was in this sense that scale made the difference.

Firms that struggled in 2017—particularly those "stuck in the middle"—failed to achieve scale. In many cases, where distinctive strengths existed, they were trapped within silos rather than being used at scale across the franchise. Where new capabilities were required, they were seeded in small and incremental ways rather than receiving the attention and resources needed to exploit them fully. The most common pitfall for firms in this category was that they tried to imitate the mega-firms by being all things to all clients. The net result was a fragmented, sub-scale set of capabilities that did not deliver a clear advantage

Exhibit 17

Scale matters . . . in the right places.



Source: McKinsey Asset Management Practice

and instead suggest a "big firm acting like a small firm"—or simply an uncoordinated collection of small firms under a single name.

■ ■ ■

The new logic of scale is about the ability to marshal a set of distinctive capabilities and leverage them across the entire enterprise for competitive advantage. The New Great Game of asset management will be contested by firms that understand this logic and deploy scale for competitive advantage. The importance of scale will only grow in coming years as the broader system in which asset managers exist and compete undergoes a broader evolution in response to macroeconomic, regulatory, and competitive pressures.

The new industry landscape in five transformations

A rising market covers many sins; it also distracts from structural transformations taking place across the current broader asset management industry (Exhibit 18). These transformations are reshaping the environment within which firms operate, creating new sets of client needs, new breeds of competitors, and new sources of competitive advantage.

Put slightly differently, the New Great Game of asset management is being played out on a different chessboard and under a different set of rules. These new rules will reinforce the advantages of scale we discussed in the previous chapter. Regardless of size and attributes, every asset manager will need to rethink its business model to thrive in this new environment.

The dynamics of the new landscape can be understood through the lens of five major transformations playing out in the industry (Exhibit 19, next page).

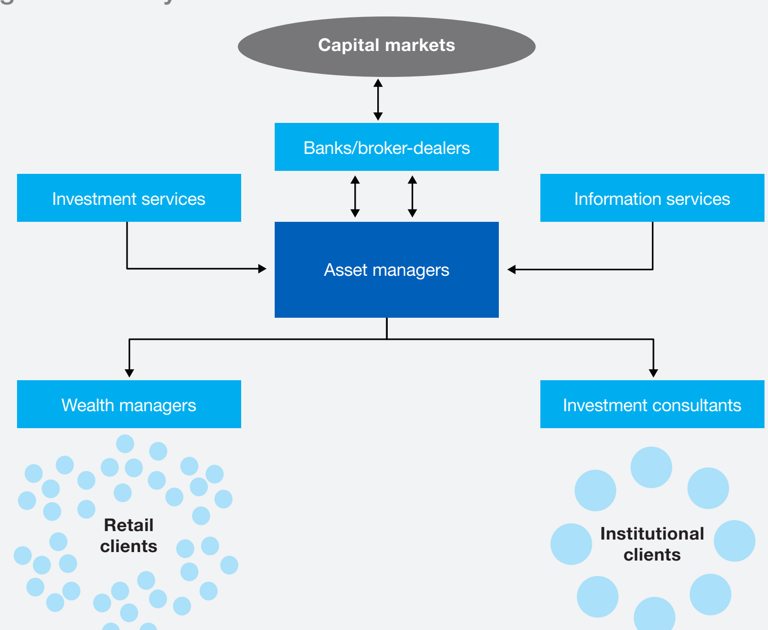
1. The institutionalization of retail

On the surface, retail asset management remains a highly fragmented market of 200,000 financial advisors and millions of individual investors. What has changed most markedly over the past few years, however, are the means by which asset managers connect with this highly fragmented client base. Gatekeepers increasingly resemble institutions in their buying behavior, and they have increased in prominence.

The dominant model of wealth management in North America is changing rapidly. Over the past five years, regulatory trends in favor of more stringent fiduciary standards and a set of commercial decisions by large retail intermediaries have led to a definitive shift from a brokerage- and

Exhibit 18

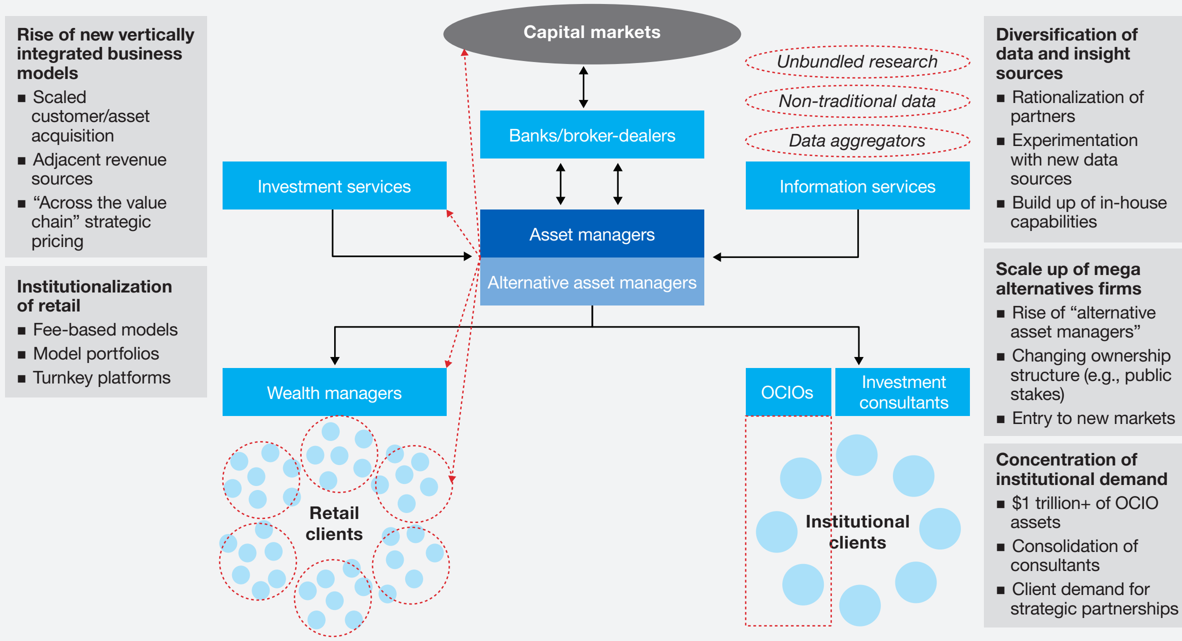
The asset management ecosystem 1.0.



Source: McKinsey Asset Management Practice

Exhibit 19

The asset management ecosystem 2.0.



Source: McKinsey Asset Management Practice

commission-based model for selling products to a fee-based model characterized by the provision of holistic advisory services and powered by the model portfolio. Due to clients' desire to improve their investment outcomes and lower costs, fee-based advisory assets reached $15.2 trillion in 2017, more than double their total in 2010 (Exhibit 20, next page).

The shift toward an advisory model has increased the prominence of the wealth management home office, particularly in its role of determining asset allocation and selecting managers. Having a place on the home office "approved list" is increasingly a prerequisite for generating meaningful scale, and the rise of home office-influenced model portfolios has moved buying criteria away from individual wholesaling relationships in favor of a more centralized, data-driven, institutional approach. The institutionalization of retail has been further cemented by several large wealth managers' decision to retain the services of institutional investment consultants to enhance the rigor of manager screening and selection.

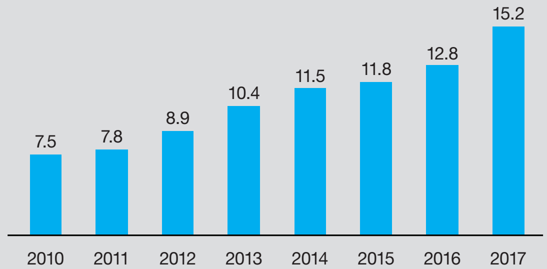
The transition to a more institutional approach to buying places a premium on performance and value delivered for fees. Asset managers now face a far higher bar for gaining access to distributor platforms. Over the past 18 months, major wealth management firms have narrowed their product shelves, cutting the number of funds on offer by 30 to 40 percent. Wealth managers are increasingly eager to work more closely with a narrower set of asset managers that can meet the full breadth of their product needs with a high level of quality and consistency. At the same time, they are crafting new revenue-sharing arrangements as a condition for access. The wealth management business itself is structured

Exhibit 20

The institutionalization of retail.

Fee-based advisory assets

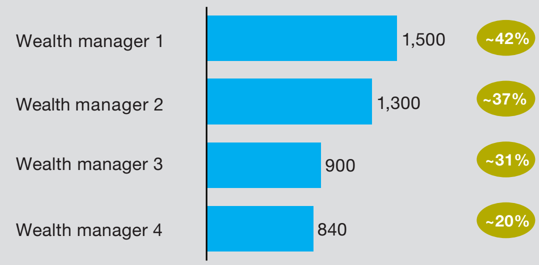
$ trillion; percent



- Critical role of model portfolios in “powering” the shift
- Home offices increasingly focus on compliance
- Technology-enabled tools enable greater centralization

Product shelf rationalization

Number of product cuts announced, % of total shelf



- Enhancement of gatekeeper resources (including third-party consultant support)
- Focus on performance and value delivered for fees
- Increasing role of “core” asset management partners

Source: Cerulli Associates; press search; McKinsey Asset Management Practice

less around the individual “producer” than it once was, as firms shift from products with embedded distribution fees that reward financial advisors to business-to-business distribution arrangements and partnerships negotiated at the enterprise level.

The move to a more institutional standard is not limited to large distributors. Many registered investment advisors—one of the fastest growing segments of the industry—have long viewed themselves first and foremost as investors. The growth of turnkey asset management platforms, model portfolio manufacturers, and third-party investment strategists has enabled this segment to achieve a level of institutionalization equal to their larger wealth management counterparts.

The institutionalization of retail has three implications for asset managers. First, the bar for performance and value for fees has ratcheted up significantly with the rise of data-driven buying criteria. Second, the center of gravity in distribution has shifted. Coverage of the home office by institutional-quality national accounts teams assumes critical strategic importance as firms struggle to secure a place on the all-important recommended lists. Third, the ability to build and manage an enterprise-level strategic relationship that goes beyond a set of products (through, for example, portfolio/solutions offerings, marketing partnerships, and creative white-label offerings) takes on new importance.

The world of retail is transitioning to one in which a narrower set of institutional relationships takes on disproportionate importance, a world that favors the relevance that comes with scale.

2. The concentration of institutional demand

This new concentration of asset management relationships is not limited to retail. The “small is beautiful” philosophy of manager selection that was in vogue in the early 2000s has receded as large investors wrestle with asset pools weighed down by the organizational complexity—not to mention mean reverting performance—of hundreds of managers in each sleeve of the portfolio.

"Fewer but more strategic relationships" is the new mantra. Large, sophisticated institutions are gravitating toward a core set of investment managers that can help them deploy capital at significant scale and with consistent performance. These investors are entering into formal strategic partnerships with their preferred managers, embracing multibillion-dollar separate account mandates, often across multiple product types. They are looking to these managers to fulfill a broad range of needs: advice across their entire portfolios, co-investments in unique opportunities, and research into new markets and emerging asset classes.

The aggregation of institutional demand is not limited to the largest investors. The rise of the outsourced CIO (OCIO) market—a set of services in which management of an entire portfolio is outsourced to a third-party provider—has created a new channel through which asset managers can access the "long tail" of thousands of smaller institutions. Growing at a 13 percent-per-annum clip over the past seven years, the OCIO market has amassed some $1.74 trillion (Exhibit 21). Sparking its rise are a diverse range of providers including multiproduct asset managers, investment consultants, and stand-alone fund-of-funds. OCIOs provide access to a previously fragmented market, but to win this business, firms must bow to the fee pressures attendant on selling to a larger platform.

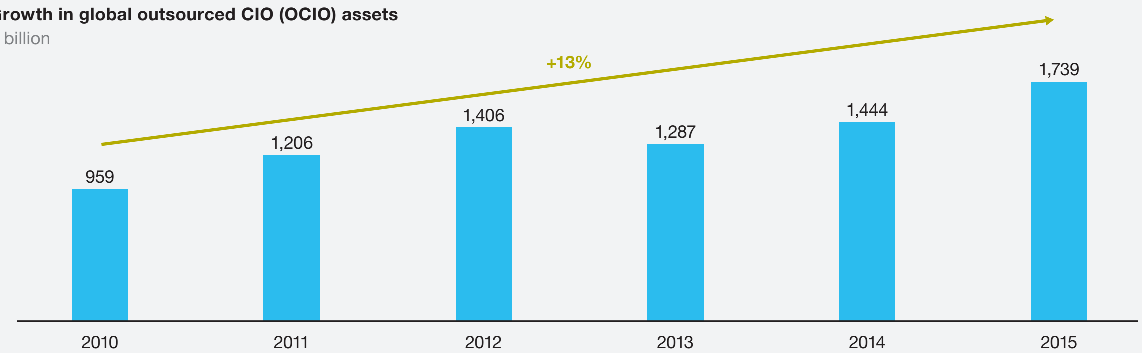
The concentration of institutional demand has three major implications for asset managers. First, success requires a new set of skills in solutions-based selling: the ability to identify underlying needs in a client portfolio and to construct customized outcomes leveraging the full capabilities of the firm. Asset managers adept at delivering value at the portfolio level stand to gain meaningful share. Second, asset managers focused on the institutional segment will need to develop a strategic partnership "playbook" along with a proactive orientation that enables them to

Exhibit 21

The concentration of institutional demand.

Growth in global outsourced CIO (OCIO) assets

$ billion



- Aggregation of small institutional investors
- Increased bar on performance and value for money
- Pricing pressure on small mandates

Source: *Pensions & Investments*

identify their most important “anchor” clients and deepen their relevance to these clients beyond being point providers of individual products (the success of which can wax and wane based on performance). Third, the new institutional environment places demands on the consultant relations function and creates new protocols for dealing with intermediaries that are now simultaneously sales channels, clients, and competitors.

3. Diversification of data and insight sources

A third set of changes relates to the sources of data and insights that asset managers—particularly active managers—use to inform their investment processes and, hopefully, drive outperformance. In the traditional asset management model, these sources of insight occupied a relatively concentrated set of nodes. A handful of information services providers served as aggregators for a panoply of market and pricing data and an array of large broker-dealers provided asset managers with access to their specialized research teams, along with “soft dollar” research funded by trade execution through the broker-dealer’s trading desk.

Tight informational ecosystems are being forced apart by a set of forces from across the Atlantic. The second Markets in Financial Instruments Directive (MiFID II) lays out a sweeping set of changes affecting financial institutions operating in Europe. Among these is a requirement for greater transparency to end investors. In a move away from the old soft dollar arrangements, asset managers must unbundle the cost of investment research and either pass it through separately to their end investors or take it on as a cost to their P&Ls. The majority of large asset managers have made the pragmatic decision to go down the latter route and are either considering or have already adopted a unified set of practices for their investment teams in Europe.

Unbundling of research costs has catalyzed a re-think by leading asset managers concerning how they get their insights now that broker-provided research and corporate access is no longer “free.” This is precipitating three major shifts: first, a reshuffling of research relationships, in some cases in favor of smaller, specialized research providers; second, more centralized management of hard-dollar research budgets; and third, a move on the part of the very largest managers to consider bringing additional elements of investment research in-house, where they could share advantages of scale.

Reevaluation of the investment research model has coincided with an explosion of alternative data sources including satellite imagery, geospatial data, social media feeds, and other “open source” big data, as well as the growth of technology firms seeking to aggregate data and translate it into insights that can feed their investment process. Asset managers are working to develop their internal investment models, in some cases building more centralized internal research and analytics capabilities to take advantage of these new opportunities.

This diversification of data and insight sources is leading to a re-prioritization of research relationships based on “research ROI” at the firm level, rather than preferences at the individual team level, as was traditionally the case. It’s prompting a re-mapping of “sources of insight” through an expansion of the set of external parties (including fintech and non-traditional data firms) with which asset managers need to establish and maintain relationships.

4. Scale up of mega alternatives firms

It has been a decade since the first wave of IPOs by alternative investment managers introduced a new group of competitors into the world of asset management—many of which came with formidable expertise in some of the fastest-growing segments of the market (e.g., private markets). The past ten years marked a takeoff for the most successful of these firms as they collectively rebranded themselves from "private equity firms" to "alternative asset managers," signaling their intention to grow as multi-product platforms that provide investors with more than just a jolt of alpha. A shift in ownership model from private partnerships to publicly-owned and C-corporation structures has provided a strong impetus for these players to seek not just growth but scale and institutionalization. Today, the three largest mega alternatives managers manage collective assets of close to $1 trillion. While this places them on the level of mid-sized asset managers by AUM, the premium fee levels their products command generate revenues and profits that rival those of some of the largest asset managers by AUM.

Hungry for growth and rapidly building their distribution capabilities, the mega alternatives firms have been eyeing adjacent market segments that traditionally were the preserve of their larger, better established rivals, including retail investment, insurance, and defined contribution plans. Their mode of entry is fundamentally disruptive for traditional asset managers—less about competing with like-for-like products and more about expanding the reach of alternative asset classes, such as illiquid investments for insurers and infrastructure for fixed-income investors. The scale and profitability of these firms enables them to make at-scale investments in a number of strategic areas, including retail distribution and products with a lower risk-return profile and longer duration. What they offer prospective clients, distinctively, is once-exclusive alternative "solution" structures and strategic partnerships.

These segment-specific value propositions will create a more competitive environment for every other firm in the North American asset management landscape. Managers with a traditional product focus will need to defend their franchise against a new set of competitors touting higher-octane investment products that offer the prospect of a return on both skill and illiquidity. Traditional asset managers that already have sizeable alternatives franchises will need to renew their commitment to the business and sharpen their value proposition relative to the mega alternatives firms.

At the same time, the redrawn landscape poses intriguing opportunities for traditional asset managers. Beyond the mega alternatives firms that have pulled away from the pack there is a long tail of smaller firms, many with market-leading brands and robust investment performance, that lack the scale to penetrate new markets. In an environment where scale is becoming critical, these firms will increasingly seek to collaborate with (and in some cases be acquired by) traditional managers that can give them the distribution and product development capabilities they need to project themselves into growth markets.

5. Rise of new vertically integrated business models

New breeds of competitors are emerging not just from outside the traditional boundaries of the asset management industry, but from within. A new generation of vertically integrated business models is emerging. Several large firms have been expanding their presence beyond the core asset management activities of manufacturing and distribution, extending into the domains of investment advice, capital markets, and technology-based services. A classic example of such business expansion is "robo advice"; several large asset managers have built formidable direct-to-consumer offerings that serve as flow engines for low-cost proprietary products. Another new category of firm deploys digital advice on a white-label basis as an extension of its service offering to intermediary clients, deeply embedding itself within clients' internal operations.

Firms whose businesses span the investment value chain have been in existence for many years. But these were often loosely connected and independently managed entities where synergies were at best occasional. The new generation of vertically integrated business models differs in two ways. First, their pervasive embrace of technology gives them access to new client segments, lowers the cost of client acquisition, and enables precise, data-driven decision-making.

Second, the new wave of vertical integration is being deployed with strategic intent (Exhibit 22). Firms are purposefully leveraging synergies across different lines of business to increase growth and profitability; for example, applying a strategic pricing lens to their range of products to identify areas where low-cost offerings can lead to outsized share gains, launching low-cost products to extend their reach into new client segments, and creating new sources of fee-based revenues (e.g., digital advice or portfolio analytics) that can help deepen and further monetize client relationships. The move toward low-cost or no-cost funds, for example, needs to be understood less as a race to the bottom on price, and more as part of a new set of tactics that large asset managers are deploying as they seek to acquire new, often smaller customers; harness technology innovation to better serve these clients profitably; and provide access to more complex, high-margin products over time.

Many industry observers have focused on a "race to bottom" on fees as this new breed of vertically integrated business models seek to weaponize the ecosystem. This view is only partially correct. What is playing out behind the scenes is a "race to the customer"—whether individual investors, financial advisors, home offices, or institutional investors—that signals a new dimension of competition. These new business models offer

Exhibit 22

Vertical integration is being deployed with strategic intent.

	Competitive advantages created
Client acquisition platforms	■ Aggregation of small institutional investors ■ Increased bar on performance and value for money ■ Pricing pressure on small mandates
Digital portfolio construction	■ Increased client share of wallet ■ Ancillary revenue sources (e.g., wrap fees and cash management spreads) to cross-subsidize loss-leader products
Technology as a service	■ Default product positioning ■ Client stickiness ■ Behavioral data
Insurance balance sheets	■ Source of seed capital ■ Credibility with new segments ■ Ability to pursue unique long-dated opportunities
Capital markets access	■ "Trading alpha" through preferred access to liquidity and new issues ■ Ancillary revenues (securities lending) enable price competitiveness

Source: McKinsey Asset Management Practice multiple channels for monetizing relationships, enabling firms to lower pricing to zero in one set of products as a way to acquire customers who can generate revenues in another.

New, vertically integrated business models take many forms and offer a way into a variety of client segments. But the end result is an upending of the traditional asset management business model, with its focus on collecting fees on individual products.

■ ■ ■

The five transformations described above—the institutionalization of retail, the concentration of institutional demand, diversification of data and insight sources, scaling up of mega alternatives firms, and the rise of new, vertically integrated business models—are changing the competitive dynamic of the North American asset management industry. The rules of the game are being rewritten, and this will force traditional asset managers to reevaluate their strategies. These changes demand a new focus on differentiation and scalability. In the next chapter, we examine the new pressures on the traditional asset management operating model and how leading asset managers need to respond.

A new business model for a new world

Behind the headline of a record year, the North American asset management industry is being reshaped by an interplay of long-term secular trends. The results are increasingly plain to see: heightened pressure on margins caused by a mix of fee compression and rising costs which in turn are borne of operational complexity, lower organic growth in core market segments, and changes across the client base that are concentrating relationships and making the buying process more institutional. At the same time, new sources of competitive advantage have emerged with the democratization of data, analytics, and technology, and the opportunities they create to achieve step changes in both growth and efficiency.

In this rapidly evolving landscape, the gap between haves and have nots is increasing. Even with the powerful tailwinds of strong markets, the gap in performance between the best- and worst-performing asset managers is widening. In this environment, scale matters more than ever and a smaller number of managers are capturing a larger share of growth. Many of the "trillionaires" are marking out an advantaged position, while others are finding ways to leverage their innate strengths to punch above their weight class.

The advantages of scale will become even more important in coming years as the industry continues to evolve and clients become more sophisticated in their buying behavior. The advantages of scale will be further entrenched with the rise of formidable new competitors from the periphery of the traditional asset management industry.

Imperatives for North American asset managers

We see three core imperatives for all asset managers in this changing environment:

- **Client-centricity** that enables firms to provide a frictionless, end-to-end client experience, and to deliver the value required to seed, grow, and retain a set of anchor clients that want long-term strategic partners, not just product providers

- **Commercial excellence** that ensures that revenues are maximized, that customers are won with a low cost of acquisition and retention, and that a well-curated product portfolio is maintained with disciplined rationalization of underperformers and a strategic approach to pricing that creates growth and wins share

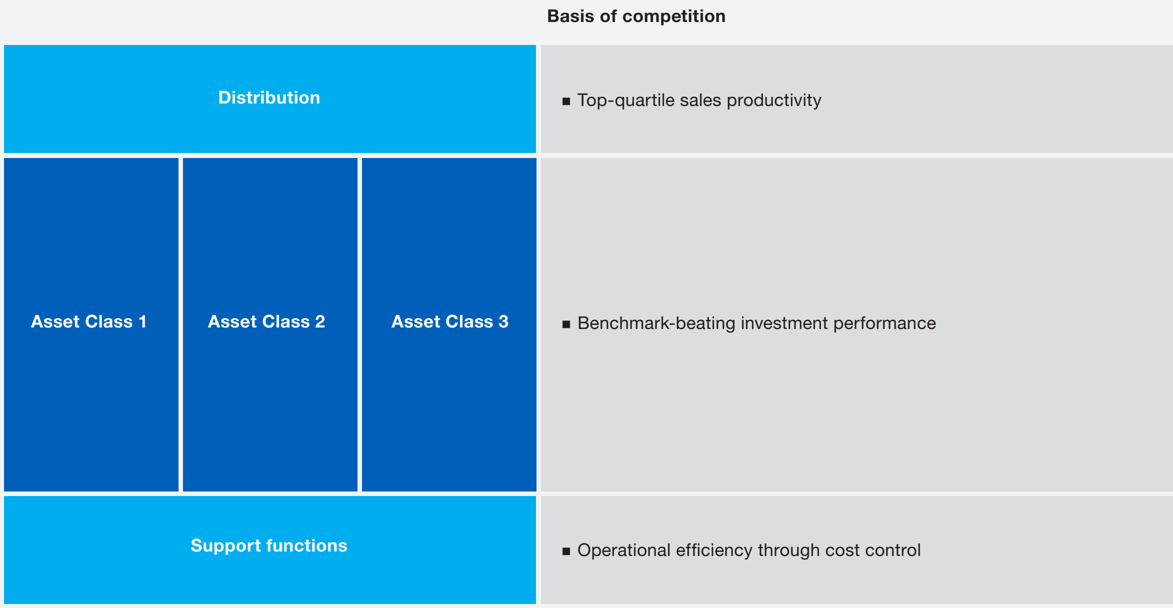
- **Scale and operating leverage** which are essential for combating margin compression and freeing up the resources and talent required to develop next-generation capabilities

Straightforward as these imperatives may seem, the traditional asset management firm's operating model is poorly suited to act on them. The traditional model is built on functional excellence across three "vertical" capabilities: portfolio management, distribution, and operations (along with many sub-verticals, such as asset classes) (Exhibit 23, next page). Excellence within each of these verticals, defined by benchmark-beating investment performance, a high level of sales productivity, and a low cost and efficient operating platform, has been the traditional route to success.

Excellence within verticals is still important, but it is far from sufficient in the new world of asset management, with its more demanding clients, disruptive competitors, and disruptive technologies. Meeting these challenges means developing (or acquiring) new cross-cutting capabilities that span all verticals.

Exhibit 23

Firms will need to add new capabilities to the traditional asset management operating model.



Source: McKinsey Asset Management Practice

The next-generation operating model: From vertical to horizontal

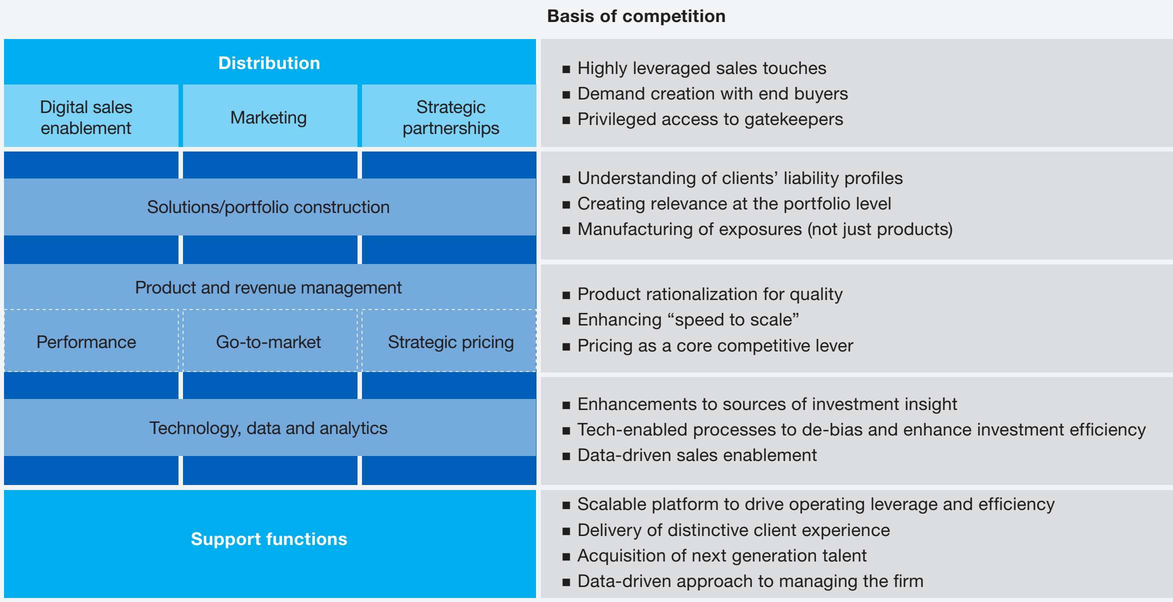
The next-generation asset management operating model requires a new set of "horizontal" capabilities (Exhibit 24). While excellence in each of the three traditional verticals remains important, they are now table stakes. Success in the emerging market environment will require the ability to work across verticals using new, horizontal capabilities like advanced data analytics and digital distribution to build scale and deliver to clients in a precise way that maps to the their needs. It requires tools that create operational leverage through dramatic mass customization (e.g., digital distribution) along with new data sources and advanced analytics that facilitate the drive for alpha by generating alternative insights.

Asset managers will need to develop and incorporate the following new "horizontal" elements into their operating model:

- *Distribution with a big "D"* (that is, without a bright line between sales and marketing), underpinned by new digital sales channels that enable massive reach and leverage marketing as a cross-channel sales multiplier, but which follow a playbook for deepening partnerships with core clients.
- *Portfolio/solutions capabilities* that bring together the full investment skillset to meet client needs at the portfolio level, rather than through individual product sleeves only, and that deliver customized solutions for the most important clients.

Exhibit 24

Success in a new environment will require horizontal capabilities that create “virtual” scale.



Source: McKinsey Asset Management Practice

- *Product and revenue management capabilities* that ensure a well-curated set of products, launched into the market at pace and priced strategically to maximize the firm’s competitive position. These also include the ability to design effective, performance-based revenue sharing and performance management arrangements that align incentives with critical distributors and investors.

- *Technology, data, and analytics* that deliver new insights and advantage to traditional verticals. Once regarded as the preserve of the back office, technology and data analysis are being catapulted into the front office as critical force multipliers in distribution and investment. To build critical mass and scale, these need to be delivered across the entire firm.

- *Highly scalable support functions* that enable all of these attributes to mesh through a platform that supports operating leverage and efficiency, supplies data-driven insights to manage the firm, and ensures acquisition of next-generation talent and delivery of a consistent client experience.

Winning in the New Great Game

The Great Game of the 19th century changed the political geography of a continent. It set in motion a complex set of forces that precipitated the decline of great empires and the emergence of powerful new nation states. The New Great Game of asset management will have a comparably sweeping effect on the firms that make up the North American industry. Large firms—some household names—that fail to adapt will shrink or even vanish; smaller firms that choose the right path will scale up successfully or, perhaps, combine to create more viable competitors. Partnerships, in some cases with the large competitors that are increasingly disrupting the business, will develop even more innovative and dynamic ways to meet changing client demands.

The next few years will be critical as North American asset management firms recalibrate their strategies and redesign their operating models for the new landscape. Despite ongoing pressures on fees and margins, the outlook for the industry remains robust; it will continue to offer great success to firms with the talent, expertise, and creativity to keep delivering great ideas and consistent value for their clients. Last year's buoyant markets provided critical breathing room for asset managers to adapt their models for a new age. But if the first three quarters of 2018 are any indication, the markets' linear ascent cannot be taken for granted.

The New Great Game is creating a very different landscape for asset management firms: more intensely competitive and with a distinct winner-takes-all dynamic. The transformations we laid out in section 3 are changing the rules of competition and require a considered strategic response. The approach each firm opts for will determine whether it survives and thrives in the face of the new imperatives of the industry—particularly the search for new sources of organic growth, the new logic of scale, and the need for smart, scalable investments that enable firms to take advantage of data and technology.

We conclude with seven questions that management teams of every firm should be asking as they contemplate the path forward:

- **What is our true source of competitive advantage?** How can advances in technology, data, and analytics help us deliver in ways that are sustainable and scalable?

- **What is the right model for delivering value for our clients across internal silos?** What is the integrated end-to-end client experience that should define us?

- **Who are our most important anchor clients?** What do we need to do to ensure they continue to see us as long-term strategic partners?

- **How should we think about our commercial model in a world where pricing goes to zero in some segments?** Where can we find defensible sources of revenue?

- **Can we deliver greater scale through greater focus?** Do we have opportunities to aggressively reallocate resources away from marginal capabilities towards areas where we enjoy natural competitive strengths?

- **What is the blueprint for our next-generation operating model?** What elements of our operating model will benefit from greater "horizontal" focus and how can we deliver a step change in operating leverage?

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