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The state of the European asset management industry 2017

Global Wealth & Asset Management Practice

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Introduction

The European asset management industry added to its string of record achievements in 2017, hitting new highs in assets under management (AUM)—€22.5 trillion at year end—revenues, and profits. As in the past few years, most of the AUM increase has been driven by rising prices in the world's financial markets. New client flows dropped from the record levels of 2014 and 2015 but were still healthy at 3 percent of start-of-year AUM.

Europe's asset managers achieved these records despite significant shifts in the industry's economics. Both institutional and retail clients have increasingly migrated away from traditional actively managed strategies, resulting in a gradual erosion in asset managers' revenue margins. And while managers' costs continue to rise in the aggregate--particularly at the compensation line—considerable expansion in the managed asset base contributed to lower cost margins. Still, the industry remains vulnerable to a significant downturn in markets.

Looking ahead, the industry faces three important long-term dynamics: the continuing shift away from traditional products to lower-cost options (e.g., from active to passive) or into alternative asset classes; changing expectations of retail and institutional clients, calling for a re-engineering of investment distribution and the investing experience; and the impact of data and advanced analytics on the full investment management value chain.

From their current position of strength, forward-thinking asset managers have many tactical options to meet these client and market forces head-on, and add significantly to the bottom line.

- Expand digital modes of delivery, strengthen branding, and broaden product sets via "go-to-market" models that personalize offerings and advice, and create a whole new experience
- Invest in innovative investment processes that take advantage of new data sets and analytical techniques, and broaden investment teams
- Gain a greater understanding of cost drivers, and break the traditional link between growth in AUM and costs
- Implement advanced analytics across the entire value chain (also outside the investment process) to create significant upside through higher revenues and lower costs
- Strengthen "execution muscle" to transform the business model

Three clusters of European asset managers have pulled away from their competitors, and realized significant growth through new business and higher profitability. First are *at-scale firms* with broad product lines, extensive marketing, global client relationships, and very low-cost structures. Between 2015 and 2017 these firms earned profit margins of 55 percent on net revenues. Second are *customer-focused marketers.* Through an intimate knowledge of customers and superior delivery (be it via intermediaries or increasingly digital or even direct delivery), firms in this group earned profit margins of 42 percent against net revenues. Third are the *alpha generators,* who seek to generate superior portfolio returns through innovative investment processes, and earned profit margins of 35 percent on net revenues. The remainder of managers are "stuck in the middle" strategically, and consigned to the bottom ranks of profitability, earning profit margins on net revenues of just 21 basis points on average.

In recent years, the gap in AUM growth and profit margins between top-performing European asset managers and the rest of the industry has been growing. Firms therefore

should tune their strategies towards one of the three winning business models, although large, well-resourced managers can draw on elements of all three.

Moreover, asset managers have a range of options, and astute choices will ensure that leaders maintain their competitive positions, while allowing innovators to move into the upper ranks of growth and profitability.

2017: Another extraordinary year for Europe’s asset managers

The European asset management industry enjoyed a ninth consecutive year of records in 2017, as AUM rose 8 percent to €22.5 trillion—one of the best showings since the financial crisis. The global industry reached new highs as well, powered by strong performance in many of the world’s stock markets (Exhibit 1).

Net new inflows from clients were among the strongest of any major region, at €581 billion, or 3 percent on the prior year, complemented by a 5 percent gain from market performance. Even though the effects of market performance were weaker, Europe’s managers showed overall AUM growth in line with the average 8 percent pace of the last few years (Exhibit 2).

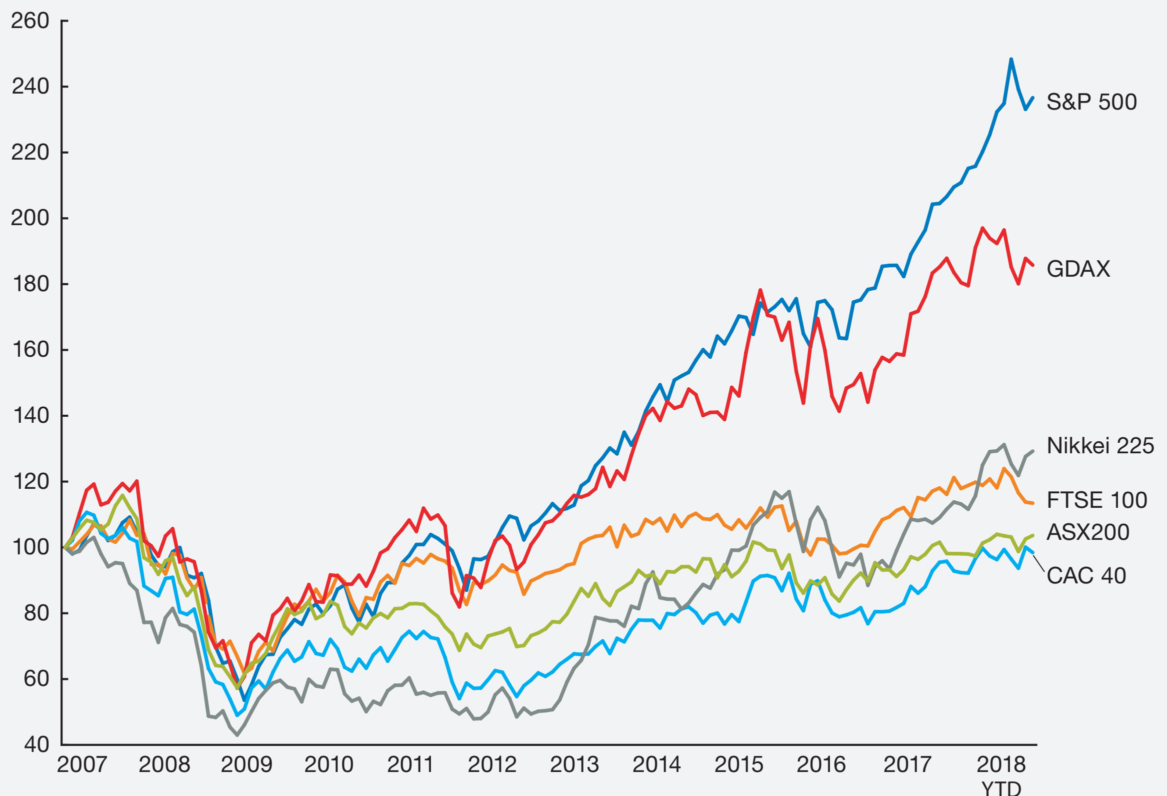
Typically, growth from net flows has been driven by institutional investors (which make up 70 percent of European industry AUM), but 2017 saw inflows from the retail sector of 5 percent, versus just 2 percent from institutional clients. Across Europe, most country markets enjoyed strong new cash flow: large contributions came

Exhibit 1

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

Index price evolution

Index = 100 (01/03/2007), 2007-18 year to date[1]

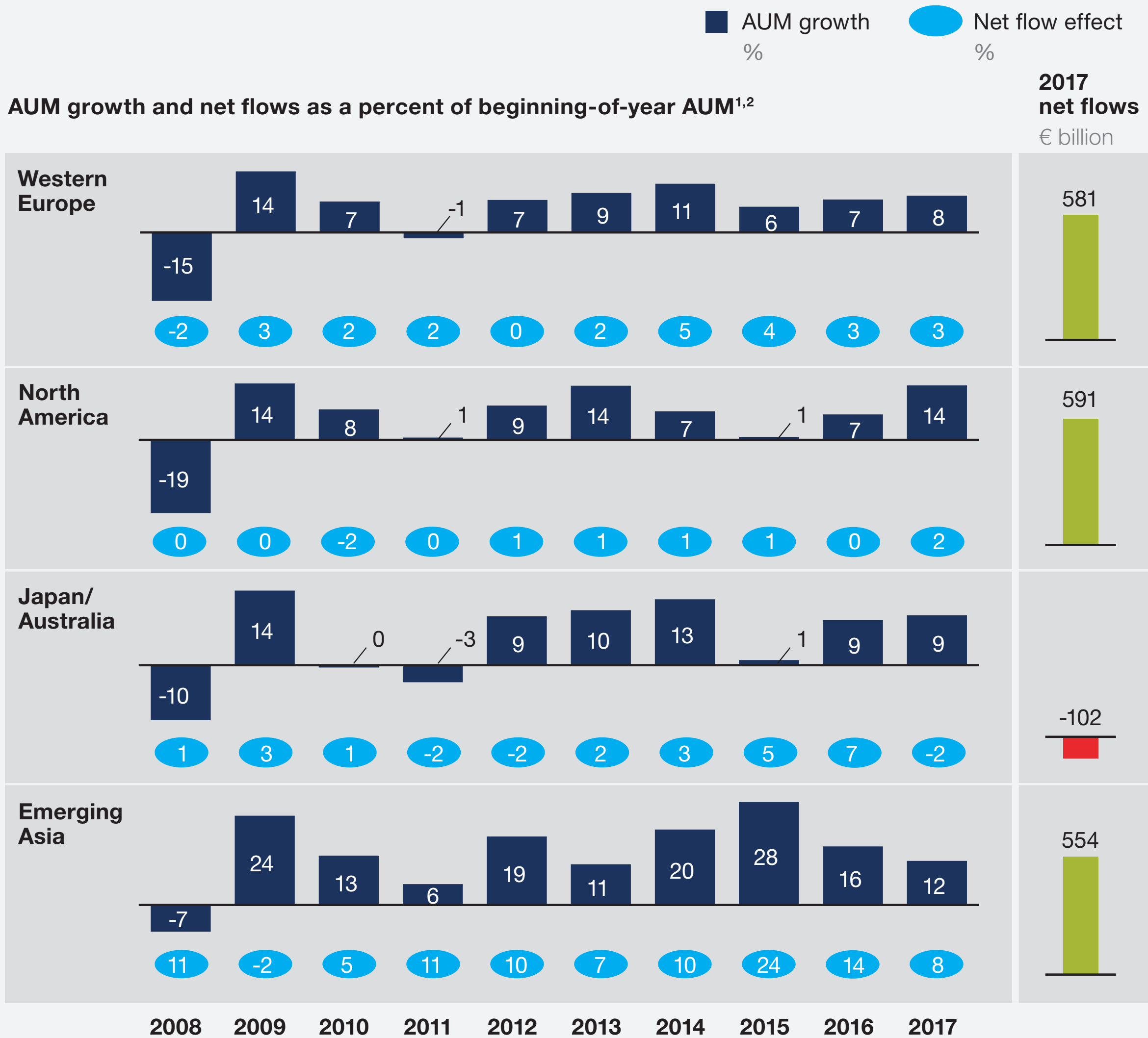


[1] Indices used: US Equity: S&P 500; Germany: GDAX; Japan: Nikkei 225; UK: FTSE 100; Australia: ASX200; France: CAC 40.

Source: ICI; Simfund; Datastream; McKinsey analysis

Exhibit 2

Net new flows for Europe's asset managers were among the highest in the world in 2017.



[1] Includes 29 countries from North America, Western Europe, Developed and Emerging Asia (accounting for 98% of global AUM).

[2] Numbers have been rounded off.

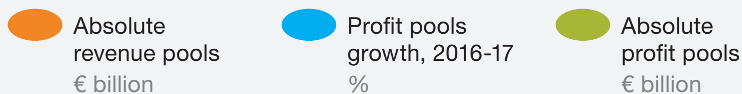
Source: McKinsey Performance Lens Global Growth Cube

from the UK (adding 5 percent from retail and 4 percent from institutions) and Germany (gaining 7 percent from retail and 3 percent from institutions).

Peak levels of AUM carried through into European managers' revenues and earnings, which set records in 2017 (Exhibit 3). From 2007 through 2017, average AUM increased by 62 percent overall, while revenues climbed 56 percent. Profit margins among Western European managers rose to 13.0 basis points of average AUM for the year, up from 12.1 basis points in

Exhibit 3

Western Europe's asset managers set records for revenues and earnings.



Data indexed to 2007, includes only traditional AUM (excludes alternatives)[1]

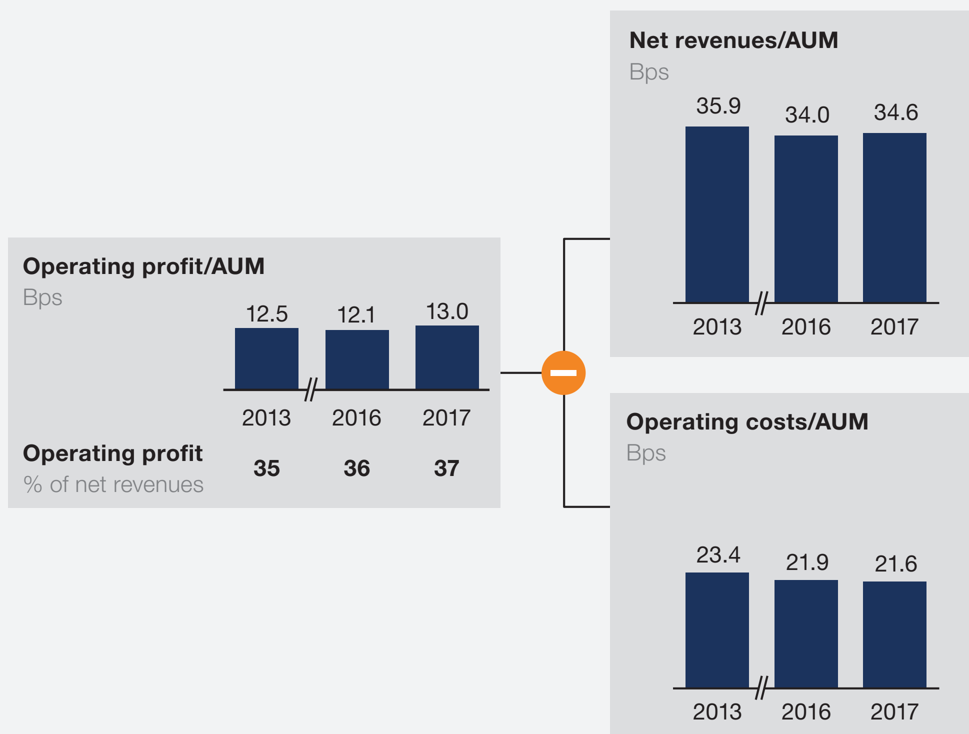
	Region	2007	2013	2014	2015	2016	2017	Profit pools growth, 2016-17, %	Absolute revenue pools / profit pools, € billion
Average AUM	Western Europe	100	119	131	140	150	162		
	North America	100	121	133	138	143	158		
	Asia	100	140	158	181	204	227		
Revenue pools	Western Europe	100	115	125	137	140	156		~69
	North America	100	121	129	131	134	151		
	Asia	100	182	205	235	252	292		
Profit pools	Western Europe	100	98	107	123	123	147	20%	~19
	North America	100	121	127	123	121	151	25%	~39
	Asia	100	141	170	208	204	244	20%	~25

[1] Includes 29 countries from North America, Western Europe, Developed and Emerging Asia (accounting for 98% of global AUM).

Source: McKinsey Performance Lens Global Growth Cube

Exhibit 4

Western European managers’ net revenue margins have edged lower since a recent high in 2013.



Note: All metrics are for Western European asset managers.
Source: McKinsey Performance Lens Global Asset Management Survey

2016. Measured against net revenues, profit margins reached 37 percent (Exhibit 4). Profitability in most country markets was higher as well, and some surpassed their pre-crisis high-water marks: In Germany, for example, profit margins hit 18.3 basis points of AUM, versus 16.9 basis points in 2007.

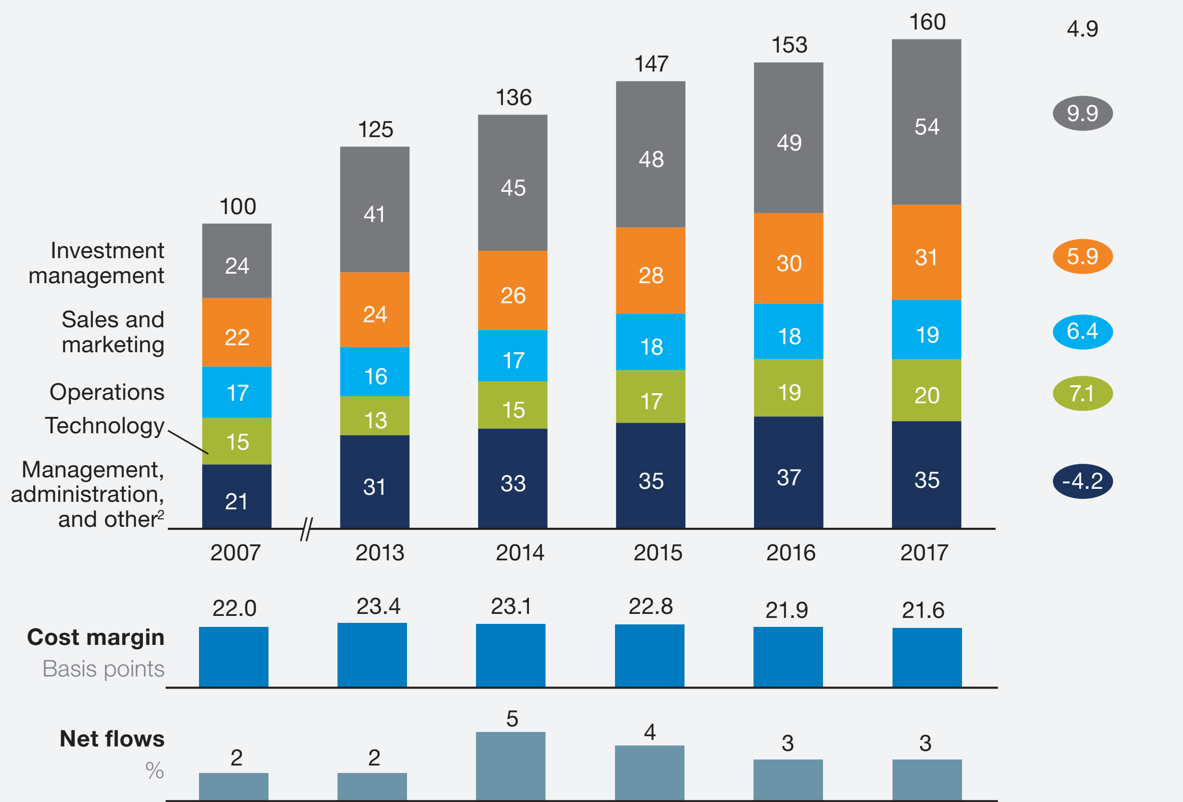
Profit margin trends are favorable, but are they durable?

Although profit margins rose in 2017, the year was not an unqualified success, and the results point to several challenges that will put pressure on performance going forward. Western European managers' net revenue margins have edged lower since a recent high in 2013 through 2015, and stand well below pre-crisis levels. Still, they remain well ahead of 2008 and the few years following.

While AUM have grown rapidly thanks to strong financial markets, increases in total costs are clearly outpacing the industry's organic growth from net inflows. Expenses were up close to 5 percent year over year in both 2017 and 2016, a pace well ahead of those years' net flow additions of 3 percent (Exhibit 5). However, due to the recent strength in asset growth, operating cost margins, measured as a percentage of AUM, have declined. Longer term, managers'

Exhibit 5

Western Europe cost pools grew by 5% in 2017, outpacing the rate of organic AUM growth.



[1] Includes third-party business only.
[2] Includes management, administration, support, and other cost categories.
Source: McKinsey Performance Lens Global Asset Management Survey

total costs were up 60 percent from 2007 to 2017. The corresponding total gains in AUM and revenues came to 62 percent and 56 percent respectively, but direct growth in terms of net new assets from clients accounted for just 24 percentage points.

Costs have risen in all categories for managers in Western Europe, but the strongest increases have come in investment management, rising 10 percent in 2017. Here, most investment management costs come in the form of compensation, which increased by 7 percent from 2016 to 2017.

Higher compensation is the result of managers' expansion of their investment teams in both traditional asset classes and alternative assets. The war for talent has forced salaries higher in the aggregate, and per employee as well: Per capita investment management compensation rose approximately 40 percent from 2013 to 2017.

Meanwhile, Western European managers' revenue margins have slipped over time, notwithstanding the sharp increases in AUM and rise of equity markets. Although revenue margins improved in 2017, they dropped to 34.6 basis points of AUM from 35.9 basis points in 2013, and 37.6 basis points in 2007. The forces behind this revenue erosion are well-established: Institutional clients have demanded fee concessions on active strategies, and in both the institutional as well as wholesale markets, customers are steadily migrating to low-fee passive strategies.

To sum up, the aggregate costs of European asset managers have grown in line with the combined gains in AUM. However, due to the exceptional market performance of the last ten years, gains in net new assets accounted for a smaller share of the increase in total AUM. Given that much of the increase in costs has become crystallized into fixed outlays—especially the fixed component of compensation or the investments into IT and infrastructure—firms may have less control over profitability. Moreover, net revenue margins have become thinner. Therefore, firms should be particularly concerned about threats to profits from increased capital markets volatility, as well as a sustained market correction that could be triggered by increased geopolitical and macroeconomic uncertainty.

Three dynamics will reshape asset management

Based on recent success, managers may be lulled into thinking that their current operating models will support future growth. However, to sustain and build profitability, the industry will have to address three interlinked forces:

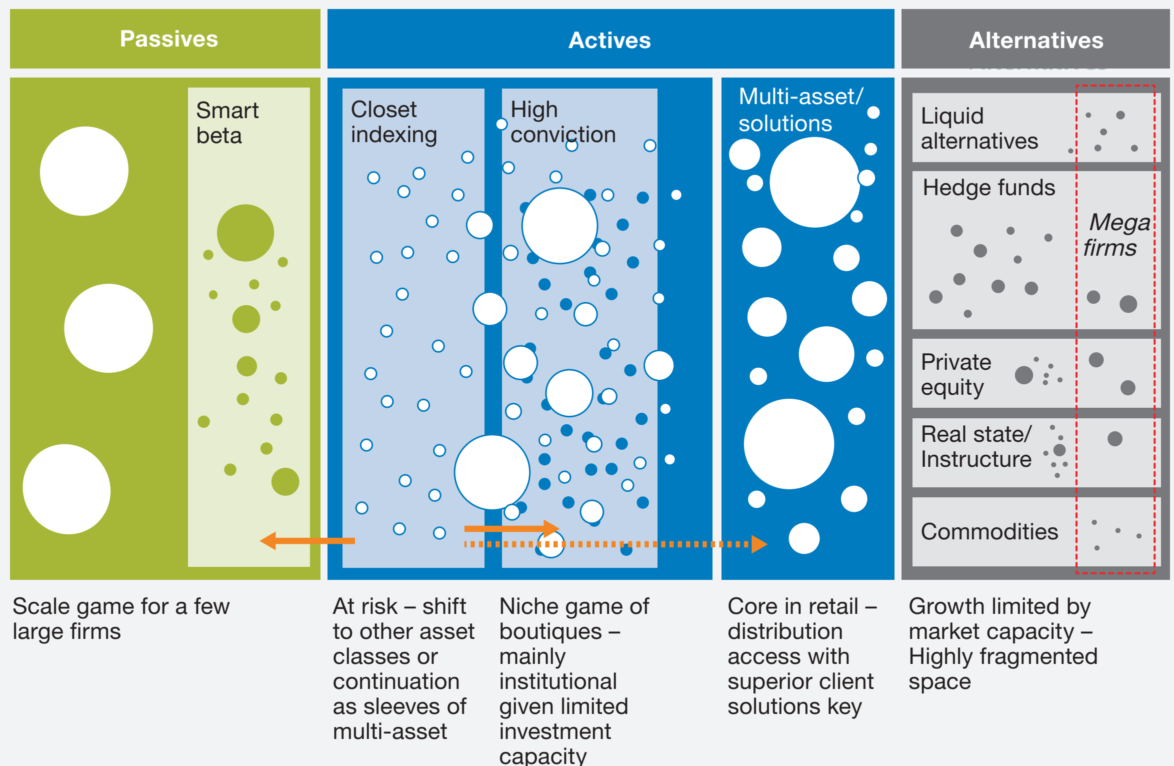
- The continuing shift in the asset mix away from traditional active strategies to lower-cost/passive offerings or alternative asset classes
- Changing expectations of retail and institutional clients, calling for a reengineering of investment distribution and the investing experience
- The rise in data and advanced analytics, redefining the entire investment management value chain

Shift within asset mix

The movement away from traditional active strategies (Exhibit 6) has already lowered average fee rates, consolidated market shares, and shifted the balance of power and profitability among asset managers.

Exhibit 6

Change is on the horizon: Sustained shift towards passives, multi-assets, and alternatives.



Source: McKinsey analysis

This shift has been underway for more than ten years in both the institutional and retail sectors, and since 2013 passive strategies have taken a greater share of European managers' flows. Over the coming five years, we expect that passive will gain a further significant share across retail and institutional markets, providing net flows of up to 6 percent annually. Such a market move would naturally benefit the few large firms who can thrive on very low fee rates.

This reallocation will not bring about the end of active management, however. In the retail segment, investors will be increasingly drawn to multi-asset strategies that combine equities, fixed income, and other asset classes, providing solutions designed to meet investors' risk and return goals across a range of market environments. Given the strong retail emphasis on these product offerings, managers' success depends on building up an attractive multi-asset offering quickly and moving beyond the traditional balanced products.

Active management will also see growth in the institutional sector, through the separation of returns into alpha and beta components. Investors will continue to build passive core portfolios for capturing beta exposures. These are supplemented with satellite strategies for generating and isolating alpha, by combining active management with risk overlays that remove beta exposures. Alpha-beta separation offers managers two sources of growth: first, greater AUM in high-conviction strategies seeking alpha in liquid traditional markets, and second, in illiquid alternative asset classes, as sponsors of pension plans and sovereign wealth funds seek to meet their obligations through the potential of these classes' higher expected returns.

Changing client expectations and investing experience

Digital delivery is about to change investors' everyday lives. Already today, 30 percent of customers are using digital devices or channels at some point in their investment product buying journey. Over 50 percent of investors indicate willingness to invest through digital channels. Therefore, a compelling digital presence will be mandatory, not only for serving younger retail customers, but also affluent and high-net-worth individuals.

Moreover, digital attackers and robo advisers are aggressively marketing to individual clients. Not far behind are additional new competitors: Regulatory changes, such as PSD2, are eroding the industry's traditional barriers to entry, enabling skilled digital incumbents to capture market share without needing special licenses.

Firms need to innovate beyond distribution, however, and redesign the entire customer journey. These innovations start with streamlining digital onboarding, accelerating processes, eliminating paper and manual work, and reducing waste by "getting it right the first time." Ongoing service will be improved by digital solutions for recurring advisory, performance reporting, and client coverage. Managers can also make their operations more effective through digitally-driven RFP response management and sales support.

A stronger value chain through data and advanced analytics

A few leaders have realized the value of data and analytics and promoted them to the top of their strategic agendas, but many firms have so far implemented only isolated pilot use cases. In our view, data and advanced analytics will be essential for managers seeking to protect and expand their customer relationships, but these tools will also add significant benefits across the entire value chain.

In customer acquisition, we envision three primary use cases: improved sales coverage through more granular segmentation; algorithms that predict client preferences (such as "next product to buy"); and more precise management of marketing efforts.

Taken together, these marketing enhancements through data and advanced analytics can deliver revenue gains of 5 to 20 percent.

Portfolio management will also see multiple benefits. Alternative information sources, such as satellite data and social media trends, can be developed into novel leading indicators. Moreover, advanced analytics will monitor portfolio managers' decision-making for behavioral biases, and reduce transaction costs through improved trading algorithms. Through such innovative portfolio management and risk controls, managers can generate an estimated additional 50 to 100 basis points in investment returns.

Managers will also realize savings in operations and overhead costs, through increased process automation (such as matching and reconciliation of trades) and lower costs of data management (from reliance on a single source of clean data). In some situations, overhead efficiencies from adopting data and advanced analytics can save asset managers 10 to 30 percent in operating costs.

To realize the full potential of advanced analytics, managers must come to understand their challenges and goals from a new angle, develop a clear roadmap that ties data and analytics to firm strategy, and then integrate them into their business processes. Also essential is a concentrated recruiting effort for advanced analytics specialists, particularly "translators" who are fluent in both business and analytics and can integrate analytics into workflows.

A shifting landscape creates opportunity

A select group of firms has recognized these emerging trends, and adapted their operating models to find new opportunities, grow their businesses, and sustain or expand profit margins. In addition to these offensive measures, these firms are also defending their profitability by rationalizing their cost structures in anticipation of market downturns.

Given the industry headwinds, their performance is remarkable: European asset managers in the top profit-margin quartile earned 54 percent on net revenues, versus 21 percent for the bottom quartile. This top-to-bottom profit differential has expanded considerably in recent years, and we expect the gap to widen further.

Among the top quartile managers, which enjoy not only higher profits but stronger net inflows, three successful operating models emerge:

- At-scale firms: These firms manufacture and distribute a wide range of investment products, and have been able to translate size into scale. From 2015 to 2017, these broad-product firms gathered net flows of 5 percent annually, and realized an operating margin on net revenues of 55 percent while keeping cost margins down.
- Customer-focused marketers: The strength of these firms lies in their insights on customers. They study their clients and target markets carefully. They have built well-tuned distribution engines, empowering and enabling distributing intermediaries and serving institutional clients effectively. These firms generated annual client flows of 10 percent between 2015 and 2017, and earned margins averaging 42 percent of net revenues.
- Innovative alpha generators: These firms seek to deliver superior returns for their clients through novel investment processes. Between 2015 and 2017, innovative alpha generators captured annual net client flows of 4 percent, and earned an average profit margin of 35 on net revenues.

The remainder of the Western European market appears to be “stuck in the middle” strategically, and lacking a clear and differentiating business proposition. These firms gathered just 1 percent in client flows in 2015 through 2017, and earned average profit margins of just 21 percent on net revenues.

Tactical choices offer significant value

For many asset managers, a strategic and tactical realignment to a digital consumer and financial environment is essential for realizing greater value. Fortunately, given the rising revenues and profits of the past few years firms are in a position of financial strength, and have many tactical options for expanding their net new business, improving portfolio performance, and enhancing profitability. Time is of the essence, however, as any sustained weakness in global financial markets will drive cost margins significantly higher, deny managers the chance to protect their market positions and profitability, and make large-scale investments much more difficult.

In light of the dynamics shaping the European asset management industry—the shift in asset mix, new client demands for digital delivery, the reshaping of the value chain through data and analytics—we believe firms will need to focus on one of the three archetypes that have enabled selected firms to outperform. Larger firms with more diverse operations and greater resources will be able to adapt all three across their different sub-businesses.

A choice of business model is not enough to succeed, however. Asset management firms should also consider the following tactical actions to benefit from industry dynamics:

- Expand digital modes of delivery, strengthen branding, and broaden product sets with "go-to-market" models that personalize offerings and advice, and create a whole new experience
- Invest in innovative investment processes that take advantage of new data sets and analytical techniques, and broaden investment teams
- Gain a greater understanding of cost drivers and break the traditional link between growth in AUM and costs
- Implement advanced analytics across the entire value chain (also outside the investment process) to create significant upside through higher revenues and lower costs.
- Strengthen "execution muscle" to transform business models.

Adding to a string of successes since the financial crisis, Europe's asset managers enjoyed an exceptional year in 2017, achieving records in AUM, revenues, and profits. To support this growth, however, the industry's cost base has expanded accordingly, and those higher costs will challenge profitability in the event of a sustained drop in markets and revenues.

In addition to contending with cost structure, managers must confront three dynamics that are shaping the future of the industry. Each offers opportunities to adapt to new business model archetypes. In addition, leaders need to assess their unique strengths and resources to take advantage of the changing face of asset management and apply a combination of tactical measures.

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The authors would like to acknowledge the significant contributions of the following colleagues to this report: Pooneh Baghai, Pierre-Ignace Bernard, Kevin Cho, Stefan Engelhorn, Nils Janssen, Niklas Nolzen, and Verena Thaler. They would also like to acknowledge the leadership of Martin Huber and Philipp Koch in developing the report.

About the Research for this report

This report is based in part on insights gleaned from McKinsey's Performance Lens data and analytics solution for wealth and asset management. Performance Lens provides fact-based, actionable insights to improve business performance by providing industry-leading benchmark data, analytics, and tools with McKinsey's deep industry expertise.

Global Growth Cube

The Global Growth Cube is grounded in the understanding that asset growth, flows, and revenue trends vary greatly across the major regions of the world, reflecting fundamental differences in market maturity, industry structure, and regulatory frameworks.

To provide deep insights on where to compete and to help asset managers make effective strategic growth, resource allocation, and product decisions, the Global Growth Cube dissects growth and revenue trends in over 4,000 micro segments across 41 regions and countries, 9 client segments, 15 asset classes, and 5 product vehicles.

Global Asset Management Survey

The Global Asset Management Survey is the leading survey of its kind, with unrivaled coverage (over 300 participants representing $40 trillion or 60 percent of AUM globally), data quality and depth (8,000 business performance benchmarks), and the longest track record in the industry.

Now in its 17th year, the survey helps asset managers assess their operational effectiveness versus relevant peers and indicates actions to improve growth and profitability.

Sales Alpha

McKinsey's Sales Alpha methodology measures the value add of sales and marketing (adjusting for investment performance), utilizing a factor analysis of over 10,000 retail and institutional products.

This tool conducts detailed fund-level analyses of gross sales, redemptions, and net flow metrics that are aggregated at the channel and company level to help asset managers identify opportunities to improve distribution effectiveness and stimulate faster growth.

Wealth Management Survey

The Wealth Management Survey is one of the most widely published and respected surveys in the industry. With more than 190 participants, it represents a significant share of the wealth business in Western Europe and globally. It provides detailed overview on industry economics such as AUM volumes, revenue and cost levels, as well as operational details on product and client splits.

Additional information regarding McKinsey's proprietary knowledge on the asset management industry is available at www.mckinseyperformancelens.com, or by email at performancelens@mckinsey.com.

Global Banking Practice
November 2018
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