The Boston Consulting Group

A Restless Recovery

GLOBAL ASSET MANAGEMENT 2004
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GLOBAL ASSET MANAGEMENT 2004

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Note to the Reader

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Following the publication of *Navigating the Maze: Global Asset Management 2003*, the asset management practice at The Boston Consulting Group decided to undertake a second, similar study to follow the evolution of the industry, examine how various trends had played out, and explore how leading players had achieved their success.

This decision led to a broad research endeavor that featured a benchmarking exercise involving roughly 50 of the world’s largest asset-management institutions with a collective total of more than $9 trillion in assets under management (AuM). We asked benchmarking participants to complete a quantitative questionnaire that addressed both the institutional and the retail sides of their business during 2003. We requested information about fund inflows and outflows, revenues, and profits, as well as data on client mix, fees, distribution channels, products, and costs. This gathering of data concerned professionally managed assets only—that is, those for which a management fee is paid. As in our previous study, the focus of the exercise was to achieve a better understanding of sales and channel issues, operational cost drivers, and overall industry profitability. In addition to the quantitative survey, we conducted in-person interviews with senior managers of many participating institutions to elicit their thoughts on the current state of the industry. We also drew on publicly available data.¹

The result is this report, *A Restless Recovery: Global Asset Management 2004*. Its goal is to offer a comprehensive look at the asset management industry, with a primary focus on continental Europe, the United Kingdom, and North America—markets that together account for more than 90 percent of global AuM. We hope this report—and its sister publication, *The Rich Return to Richer Returns: Global Wealth 2004*—will both engage readers and foster a climate in which asset managers can constructively reflect on their businesses in these daunting times for the industry.

¹. See the Methodology, page 30.
BCG’s Benchmarking Study Focused on Leading Asset Managers Throughout the World

Source: BCG asset-management database.
The value of professionally managed assets—those for which a management fee is paid—grew by 14 percent globally to $37 trillion in 2003.

- Although capital inflows increased appreciably in many regions, the expansion was attributable mostly to the better-than-expected performance of global equity markets, particularly those in the United States. This growth, which represented a clear recovery from 2002 when global assets fell by 8 percent, has not generally continued in 2004, owing mainly to weaker equity markets.

- The value of global assets under management (AuM) continued to be almost evenly split between retail business (45 percent) and institutional business (55 percent), with substantial variation by country.

The United States and the United Kingdom are relatively open markets with a significant number of independent players and limited captive distribution. In continental Europe, by contrast, banking and insurance groups own the majority of asset managers and control distribution.

- Despite some signs of increasing openness in Europe, these structural differences are likely to remain largely unchanged in the near and mid term.

- The open distribution systems in the United States and the United Kingdom, combined with the higher proportion of experienced retail investors in these markets, has contributed to the availability of a broader spectrum of products than is found in most continental European markets.

There is a wide range in profitability among asset managers globally. Ten percent of the institutions in our benchmarking sample had pretax margins above 50 percent, whereas 7 percent of the institutions had margins of 10 percent or below. Overall, the weighted average profit margin was 31 percent.

- The leading mixed players (those pursuing both retail and institutional business) had average costs but above-average revenues.

- The leading institutional players did not necessarily have relatively higher revenues but displayed excellent cost management.

The value of AuM worldwide is likely to expand at a compound annual growth rate (CAGR) in the mid to high single digits over the next five years, with market impact and capital inflows accounting for 60 percent and 40 percent, respectively, of the growth. If AuM growth matches our best-case scenario—a CAGR of about 9 percent through 2010—average industry profit margins could rise from their 2003 level of 31 percent to nearly 40 percent, provided that asset managers exercise rigorous cost management.

- Among our benchmarking participants, average costs across the value chain were about 21 basis points compared with 18.5 in last year’s study (a jump of more than 13 percent).

- Retail players’ costs were typically higher than those of institutional players.

- Over the next few years, the drivers of rising costs will include consumer demand for a broader range of investments, the evolution of new platforms for third-party distribution and for customers’ online access, compensation for top-performing portfolio managers, and expenses related to back-office efficiency initiatives.

The percentage of management fees that manufacturers pay back to distributors ranges from roughly 10 percent to 80 percent. This enormous gap indicates that many players can improve their management of transfer pricing and distribution costs.

- In institutional asset management, the influence of investment consultants continues to grow—particularly in the United Kingdom, Australia, and North America.

- Given the weight of consultants’ recommendations, an increasing number of asset managers are...
viewing consultants as a client segment in their own right that must be served in much the same fashion as the institutional plan sponsor itself.

Previous allocation trends in which assets were directed away from equities toward fixed-income instruments and cash have largely reversed themselves in some countries, particularly in the United States. By contrast, continental Europe still shows a more cautious allocation trend toward equities.

- Traditional core products—such as actively managed equities, bonds, and money market vehicles—continue to be squeezed by revenue and margin pressure.

- Commodities—which consist mainly of index funds, enhanced index funds, and exchange-traded funds—are drawing increasing attention from investors, as are alternative investments such as hedge funds. As minimum investment requirements decline for some hedge funds, such funds are becoming somewhat more available to retail investors.

There are critical initiatives that are relevant to improving the profitability of the vast majority of asset managers: sharpening brand identity, managing distribution tightly, streamlining the product portfolio, developing clear cost and scale strategies, and deepening trust and relationships with clients. How institutions go about these initiatives will shape the industry in the near and mid term.

- Having a sophisticated distribution strategy clearly leads to better performance. Best-practice players are developing and using metrics to track asset inflows, revenues, costs, and profits on a comprehensive basis—by product, channel, salesperson, and geography. They are also stepping up efforts to improve cross-selling.

- Trust and ethics have become a competitive issue, and many asset managers are turning to outsourcing not only to battle rising costs but also to address ethics concerns. Regardless of how markets perform, asset managers can control their own destinies by “out-managing” competitors on many fronts.
A Snapshot of the Industry

Today’s global asset-management landscape is more diverse and challenging than ever before. Products and investment styles continue to proliferate. Markets, although not unusually volatile, are nonetheless unpredictable amid a tense economic and geopolitical climate. The regulatory environment is constantly evolving. And the somewhat bewildering range of choices available to both institutional and retail investors—along with their shifting preferences and growing sophistication—is ratcheting up the industry’s already intense level of competitiveness to new heights.

If there is one unifying aspect of the industry, it is that all players have common goals: to attract asset inflows, outperform stock markets, maximize revenues, minimize costs, and raise profitability. These goals may sound simple in the abstract, but asset managers know that in practice they are becoming increasingly difficult to achieve. In order to move forward successfully, all players need a strategy that fits their size, growth aspirations, target market, investment style, and human and technical resources and capabilities.

A Potentially Encouraging Year

Following two years of substantial decline, the global asset-management market rebounded in 2003. The value of professionally managed assets—those for which a management fee is paid—rose by roughly 14 percent to $37 trillion. (See Exhibit 1.) The overall expansion provided a stark contrast with 2002, when the value of global assets under management (AuM) shrank by 8 percent, and with 2001, when global AuM slid by 2.5 percent. Reaping the benefits of the equity-market updrafts of 2003, global AuM has now surpassed its end-of-2001 level, with the majority (more than 60 percent) continu-

EXHIBIT 1

AT THE END OF 2003, PROFESSIONALLY MANAGED ASSETS WERE VALUED AT APPROXIMATELY $37 TRILLION GLOBALLY

North America: ~$23 trillion
Europe: ~$11 trillion
Other: ~$3 trillion

Sources: Central banks; national insurance and asset management associations; BCG analysis.

Note: The overall increase in the U.S. dollar value of global AuM in 2003 was 20 percent, with 6 percent of the increase owing to exchange-rate appreciation against the U.S. dollar.

2. We included only professionally managed assets. If we had included the investable financial assets of insurance companies, pension funds, corporations, governments, charities, and banks, the $37 trillion figure would have risen to about $58 trillion.
ing to originate in North America. The value of assets managed by our benchmarking participants, excluding the impact of exchange rates, also rose on average by 14 percent, reaching $8.2 trillion in 2003. Sixty-four percent of the increase was attributable to the rise in equity markets that weakened substantially in 2004.

Just as fluctuations in AuM varied widely by institution and by country in 2002, there were considerable variations in 2003 as well. These differences were evident among our benchmarking participants, with the value of AuM ranging from growth of more than 40 percent at some institutions to net losses in the low single digits at others. Similarly, net inflows as a percentage of AuM ranged from gains of more than 20 percent to losses (net outflows) of around 10 percent. (See Exhibit 2.)

The return to higher equity allocations in the United States, the world’s largest asset-management market, coupled with the relatively stellar performance of major U.S. indices in 2003, meant that market impact accounted for more than 90 percent of AuM growth in U.S. mutual funds compared with less than 60 percent in European funds. In the high-growth years between 1995 and 2000, market impact accounted for 68 percent of AuM growth in the United States compared with 57 percent globally.

Indeed, the performance of major U.S. equity indices in 2003 surpassed most expectations. The Dow Jones Industrial Average gained 25 percent, the Standard & Poor’s 500 rose 26 percent, and the technology-heavy NASDAQ 100 index gained 49 percent. Moreover, although overall allocation

3. This amount is based on benchmarking participants that provided data on both change in AuM and net inflows. The total AuM of all participants was more than $9 trillion.
patterns in retail mutual funds varied widely by
country during the year, it was clear that capital
inflows into equity funds were strongest in the
United States, with the United Kingdom and contin-
ental Europe maintaining a more cautious alloca-
tion approach. (See Exhibit 3.) All told, the value
of assets in U.S. equity funds rose 38 percent to
$3.7 trillion in 2003, while equity-fund assets rose
globally by about 40 percent to $5.8 trillion.

In segmentation terms, the asset management mar-
ket remained relatively evenly split between retail
business and institutional business, at 45 percent
and 55 percent of global AuM, respectively.¹ Wide
variations by country persisted here as well. France
and the Netherlands, for example, with their large
share of professionally managed insurance assets,
were significantly skewed toward institutional busi-
ness, as was Japan with its undeveloped private-
banking and mutual-fund markets. But Italy, with its
strong retail-fund market, and Switzerland, with its
large offshore private-banking business, were both
tilted toward retail business.

In revenue terms, as in previous years, retail asset
management brought in a disproportionately high
share of asset management revenue—a dynamic
that was clearly evident in our benchmarking study.
Excluding low-cost, low-revenue index players, insti-
tutional business accounted for 62 percent of assets
managed by this year’s benchmarking participants
but just 40 percent of revenues. Retail business
accounted for 38 percent of AuM but 60 percent
of revenues. Weighted-average net revenues for
our benchmarking participants were roughly 19
basis points in institutional business and 46 basis
points in retail. Globally, retail business accounts
for around 60 percent of asset management
revenues.

Wide Diversity

Today’s institutional and retail investors have a
broader-than-ever variety of institutions to turn to
for asset management services, ranging from pure
asset-management firms and insurance companies
to global banking and insurance groups, investment

¹Retail AuM includes mutual funds, insurance unit-linked products
(such as variable annuities), and assets managed for high-net-worth indi-
viduals. Institutional AuM includes the professionally managed assets of
banks, insurance companies, pension funds, corporations, and charities.
See the Methodology on page 30 for a more detailed description.

Source: Morgan Stanley industry report, The Asset Management Barbell:
banks, and commercial banks. Moreover, the lines of regional market landscapes are being more sharply drawn, with the major fault line continuing to divide the North American and U.K. markets from those in continental Europe.

The most basic difference involves ownership structure. Whereas the North American and the U.K. markets have a relatively high proportion of independent players—50 percent (in the United States) and 25 percent in the United Kingdom—nearly all asset managers in continental Europe are owned by banking or insurance groups. Accordingly, in these two factions, the respective amounts of AuM consisting of captive assets—those owned or held by an asset manager’s parent or by a group-affiliated company—are widely disparate. Captive assets comprised, on average, less than half of total AuM for North American and U.K. players that participated in our survey but nearly 80 percent for continental European asset managers. Revenues were between 30 and 50 percent higher for noncaptive institutional assets than for captive institutional assets, depending on the specific geography.

The Dynamics of Distribution

A further and significant ripple effect of regional variances in ownership structure concerns the dynamics of distribution for asset management products. Generally speaking, distribution continues to be far more open and fragmented in the United States and the United Kingdom—and manufacturing less concentrated—than they are in continental Europe. Given ownership patterns on the continent, an average of 90 percent of retail mutual fund inflows in France, Germany, Italy, and Spain are sold through asset managers’ affiliated banks or insurance companies. (See Exhibit 4.) In the United Kingdom, the corresponding figure is only 17 percent; and in the United States, the amount is negligible. Independent financial advisers (IFAs) still distribute most retail funds in the United Kingdom, whereas broker-dealers, financial planners, fund supermarkets, and insurers account for the bulk of distribution in the United States.

Another consequence of the open distribution system in the United States and the United

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**EXHIBIT 4**
IN CONTINENTAL EUROPE, RETAIL DISTRIBUTION IS DOMINATED BY BANKS AND INSURANCE COMPANIES

<table>
<thead>
<tr>
<th>Channel</th>
<th>France</th>
<th>Germany</th>
<th>Italy</th>
<th>Spain</th>
<th>Sweden</th>
<th>Switzerland</th>
<th>United Kingdom</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>92</td>
<td>82</td>
<td>90</td>
<td>96</td>
<td>85</td>
<td>50</td>
<td>17</td>
</tr>
<tr>
<td>IFAs</td>
<td>17</td>
<td>20</td>
<td>17</td>
<td>20</td>
<td>15</td>
<td>20</td>
<td>17</td>
</tr>
<tr>
<td>Other</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

**Source:** FERI 2003 European Fund Market Yearbook.
Kingdom—in conjunction with the relatively high percentage of experienced investors found in these markets—is that the asset-management product range is more heterogeneous in these countries than it is in continental Europe. Vehicles such as exchange-traded funds (ETFs), hedge funds, and funds of funds have typically been introduced into the market earlier and matured more rapidly; and there is greater use of passive management, enhanced indexing, and quantitative styles. It is also easier in these markets for innovative products to obtain visibility and for small asset management firms—or specialists within large firms—to carve out a viable niche and maintain it.

A Thriving or a Struggling Industry?

As might be expected, the participants in our benchmarking survey displayed wide variations in profitability in 2003. (See Exhibit 5.) Ten percent of the institutions reported pretax margins above 50 percent, and 57 percent of players had margins above 30 percent (compared with 42 percent of institutions in our last survey). At the other end of the spectrum, 7 percent of institutions reported margins of 10 percent or less (compared with 24 percent of institutions in our previous report). Overall, the weighted average profit margin for participating companies was 31 percent.

On a country-by-country basis, the Canadian players in our survey had the highest average margin (52 percent), followed by Italy (46 percent), Germany (40 percent), Australia (37 percent), and France (36 percent). The average margin in the United States was about 25 percent, and in the United Kingdom 14 percent. Perhaps most encouragingly, fully 73 percent of our benchmarking respondents either maintained or increased their margins compared with the prior year, versus 62 percent in our previous study. (See Exhibit 6.) We found no correlation between size of the institution and overall profitability.

Still, on a broader level including players much smaller than those in our survey, a fair number of global asset-management institutions are losing money, and even more are hovering just above negative territory. Management fees continue to vary widely, as do the portion of those fees that manu-

![Exhibit 5](image-url)

**Exhibit 5**

**Profitability Varied Widely Among Asset Managers**

- Pretax margin, 2003 (% of net revenues)
  - Eight of the top ten derive more than 70 percent of their revenue from retail business
  - Benchmarking participants, 2003
  - Benchmarking average: 31%

Sources: BCG asset-management database; BCG analysis.

Note: Based on benchmarking participants that provided data on profitability. Averages are weighted.
facturers must pay back to distributors. These distribution fees—including 12B-1 fees, retrocessions, rebates, and shelf-space payments—are higher on average in continental Europe than they are in the United Kingdom and North America. Among our benchmarking participants, the average level was 53 percent in continental Europe compared with 43 percent in North America and 21 percent in the United Kingdom. (See Exhibit 7, page 16.) Across the board, distribution fees ranged from as low as about 10 percent for some players to as high as 80 percent for others. This is an extraordinary gap, one that clearly reveals the ongoing differences among asset managers in transfer pricing and management of distribution costs. The costs of entry into the industry also remain variable, with access to the U.K. and U.S. markets far less daunting than entry into continental Europe.

Ultimately, weighing recent positive developments in the asset management sector against areas that still prove challenging for many competitors, the question is whether we are left with an industry that may return to the halcyon days of double-digit growth in AuM value every year or whether the gains of 2003, few of which have expanded further amid a generally unexciting 2004, should be taken with skepticism and more than a few grains of salt. Our view would tend toward the latter perspective.

The friendly equity markets of 2003 did give the industry a bit of much-needed breathing room. And despite weaker equity performances in 2004, global business confidence is arguably higher than it has been for several years. Still, the asset management industry is not—and may never be again—the automatic moneymaker that it seemed to be at times during the 1980s and the late 1990s. Investors are increasingly knowledgeable and discerning, downward pressure on margins will continue, and the Basle II accord, when it takes effect in 2006, will heighten scrutiny on operational risk. Moreover, the tense global geopolitical climate adds a potent wildcard to the mix that could profoundly affect equity markets and therefore the health of the entire sector.

In our previous report on the asset management industry, our findings suggested that many institutions were not managing their businesses with the same processes, metrics, and rigor that are commonplace in other areas of financial services and in
other industries such as pharmaceuticals, retailing, and industrial manufacturing. This year, although our survey indicates that a number of asset managers have made significant strides in such initiatives as motivating sales forces, developing timely products, and controlling costs, many still have more progress to make. On an industrywide basis, we also find that there remains ample room for improvement in tracking basic information on revenues, costs, profitability, products, channels, clients, and personnel.

All things considered, however, it is clear that the asset management business will remain highly profitable for those institutions that execute best.

Indeed, on the positive side of higher investor sophistication and the demands that come with it is a growing population of investors in many global markets, particularly for retail products. Yet most asset managers, perhaps more than ever, will have to fight fiercely to attract asset inflows, optimize distribution networks, maintain or gain market share, and reduce costs. Perhaps above all, asset managers must strive to earn and sustain the trust of their clients, for whom switching costs are constantly decreasing. Over the next few years, management skills—particularly the capacity to react quickly to changing market dynamics and client preferences—will be as great a key to profitability as how markets perform themselves.

EXHIBIT 7
THERE IS A WIDE GAP IN DISTRIBUTION FEES

<table>
<thead>
<tr>
<th>Distribution fees</th>
<th>Net revenues</th>
</tr>
</thead>
</table>

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**Sources:** BCG asset-management database; BCG analysis.

**Note:** Based on benchmarking participants that provided data on distribution fees. Companies that derived more than two-thirds of their retail revenues from continental Europe were classified as continental European.

1Distribution fees represent the percentage of gross revenues paid back to distributors.
In order to achieve optimal performance, it is critical for asset managers to have a firm grasp on industry trends as they unfold. At BCG, we categorize asset management trends into four groups: those concerning market size, the present and potential client base, the product spectrum, and the competitive landscape.

The Market

In our last report on the industry, we stated that the value of global AuM was likely to rebound from the market contractions that occurred in 2001 and 2002 but that the strong expansion achieved between 1995 and 2000—an average compound annual growth rate (CAGR) of 14 percent across all regions—would likely drop by more than half, to between 0.7 percent and 6 percent through 2006. The higher-than-expected global AuM jump of 14 percent in 2003, coupled with the lower-than-expected trend of 2004, has resulted in net growth near the high end of our estimate.

Moreover, previous allocation patterns that saw assets pour out of equities into less-volatile vehicles, such as fixed-income instruments and cash, have largely reversed themselves in some countries—particularly in the United States—although the trend has been far less pronounced in continental Europe. Equities have remained the dominant element of U.K. retail-fund portfolios. Meanwhile, hedge funds and other alternative investments continue to draw increasing interest from investors seeking greater diversification and positions that are not correlated with mainstream markets.

Looking ahead, the principal question is whether AuM growth in 2005 and beyond will pick up again at the brisk pace of 2003 or level off to a less robust but still appreciable rate of between 5 and 10 percent per year. Like all observers of the asset management industry, we wish we had a crystal ball that could accurately foretell the future. Lacking that, however, there are some relevant bases from which to make an educated projection. For one, there are few reasons to suspect that overall inflows will decline; historically, they have risen even during bear markets. And while equity markets are certainly unpredictable, current economic fundamentals—as well as our research and interviews with leading asset managers—tend to point toward measured AuM growth between 2005 and 2010. In our view, the value of AuM worldwide will likely grow at a CAGR in the mid to high single digits over the next five years, with market impact and capital inflows factoring in on roughly a 60–40 level.

If AuM expansion matches our best-case scenario—a CAGR of about 9 percent through 2010—average industry profit margins could rise from their 2003 level of 31 percent to nearly 40 percent. However, this increase will occur only if many companies are able to contain costs, realize economies of scale as they grow, and resist continued margin pressure. Players that are unable to succeed at these initiatives may see their profits fall even if their AuM expands. Past experience and current evidence suggest that asset managers are likely to have mixed results in these endeavors, and there is little to imply that the wide divergence in profitability we have witnessed in 2003 will narrow.

Retail distributors are maintaining power. One of the most important market trends from both a structural and a revenue point of view is an ongoing, not a new, one: the increasing shift in power away from manufacturers toward third-party distributors that control the customer relationship and influence product choices. Revenues from direct channels continue to diminish in the largest two markets, the United States and the United Kingdom. And while the demand for top-performing funds and leading brand names will nurture this trend in continental Europe, it will happen at a far slower pace than we have witnessed elsewhere. In 2003, third-party distribution accounted for less than 10 percent of AuM across Europe, as it did in the previous year.

For retail manufacturers, particularly in open markets such as the United States and the United Kingdom, there is also the continuing challenge of gaining shelf space for products through broker-dealers, banks, insurers, fund supermarkets, IFAs, and financial planners. Obtaining visibility is becoming increasingly difficult because distributors...
can pick and choose among products based on performance rankings, transparency, risk profile, fund-manager track records, and other characteristics. Indeed, the number of investment products available to the retail fund investor—worldwide mutual funds alone were estimated at more than 54,000 at the end of 2003—has become truly dizzying, spawning thriving cottage industries, such as investment newsletters and Web sites that aim to help consumers narrow the field. Just as the term *fund supermarket* implies, there are multiple choices of all varieties, shapes, and sizes in every asset-management category.

Such a buyers’ market gives considerable leverage to distributors regarding how many basis points of revenue ultimately reach their coffers as opposed to those of manufacturers, and this dynamic has helped drive the continuing shift in margin mix away from fund companies toward distributors. Among our benchmarking participants, the average margin share kept by manufacturers as opposed to distributors (or the flip side of distribution fees) in 2003 was 79 percent in the United Kingdom, 57 percent in North America, and 47 percent in continental Europe. Although the ratio between manufacturer and distributor margins varies widely from product to product, such offerings as so-called wrap and separately managed accounts—bundles of managed investments and services for a flat fee—continue to favor the distributor heavily.

In our previous report on the asset management industry, we stated that a major question hanging over the retail segment was whether the balance of power between manufacturers and distributors would gradually even out or perhaps shift back toward manufacturers. Our research currently indicates that the shift in favor of distributors is continuing and that the tug of war over basis points is becoming ever more intense. Given the fact that the retail industry is so highly fragmented, it will be very difficult for manufacturers to reverse this trend in their favor.

**More institutional mandates are coming through consultants.** In institutional asset management, the use of consultants continues to rise as pension plan sponsors are increasingly reluctant to choose an asset manager without professional guidance, given the high stakes and their fiduciary responsibilities—especially in the wake of a few high-profile scandals. Many plan sponsors simply do not have the in-house expertise to make an educated choice on an asset manager, and those that do sometimes prefer to share or outsource the responsibility in the event that performance turns out to be below expectations. Other drivers of higher consultant usage are M&A activity, frequent pension-plan reorganizations, and institutions that find their pension plans underfunded. The percentage of pension funds using consultants for some or all of their mandates in 2003 was highest in the United Kingdom, Australia, and North America. (See Exhibit 8.) Although the influence of consultants is growing in continental Europe, it is doing so slowly and is not likely to reach the levels of other major markets any time soon.

As with retail distributors’ allocation of shelf space based on products’ perceived quality, institutional consultants seek to identify asset management styles and strategies that are aligned with plan sponsors’ needs, good organizational characteristics, impressive key people, and a track record of creditable performance. Given the weight of consultants’ opinions and recommendations, more asset managers are treating them as a client segment in their own right that must be catered to as much as the institutional plan sponsor itself. Of course, a solid wall of trust

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**EXHIBIT 8**

**Institutional Consultants Wield Considerable Power**

<table>
<thead>
<tr>
<th>Percentage of pension funds using consultants for some or all of their mandates</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>%</strong></td>
</tr>
<tr>
<td>United Kingdom/Australia</td>
</tr>
<tr>
<td>Canada</td>
</tr>
<tr>
<td>United States</td>
</tr>
<tr>
<td>Netherlands</td>
</tr>
<tr>
<td>Germany/Switzerland</td>
</tr>
<tr>
<td>France</td>
</tr>
<tr>
<td>Italy</td>
</tr>
</tbody>
</table>

**Sources:** Watson Wyatt; Reserve Bank of Australia; Rainmaker Information.
built up between an asset manager and a highly respected consultant can result in a significant amount of new business for the asset manager.

The Clients

Asset management clients, both on the institutional and the retail sides, demand largely the same things: solid and consistent investment performance, a reasonable array of products to choose from, a thoughtful and responsive relationship manager, and overall competence and professionalism from both front and back offices. Institutional investors in particular expect those looking after their money to end each year in positive territory, even if markets are down, and to outperform when markets are up. Accordingly, the trend toward using absolute returns—not relative returns against benchmarks—as a basis for judging performance is gaining more widespread acceptance. Moreover, a number of large pension funds, particularly in the United Kingdom, are shifting away from balanced funds toward more specialized mandates. The sponsors of such funds seem to be willing to pay higher fees for specialized expertise, but they expect higher performance in return.

To be sure, as we suggested in our last report on the industry, ongoing research indicates that highly demanding institutional investors are more and more willing to switch asset managers if they feel the investment needs of their companies and pension funds are not being addressed sufficiently. According to one industry analysis, more than 40 percent of European institutional investors ended an asset management relationship in 2003, with unsatisfactory investment performance cited most often as the primary reason for the termination. (See Exhibit 9.) This is a striking figure, one that drives home the fact that switching costs are ever decreasing. Other factors for changing asset managers included unclear investment strategies, failing to control risk, deviating from the mandate, and high turnover in portfolio managers and contact personnel. In our view, the increasing demands of institutional investors and competitiveness of the industry will lead to continued margin pressure for institutional asset managers.

What is more, the same forces are likely to prevail on the retail side as the expectations of retail investors continue to rise toward institutional levels. Particularly in the United States and the United Kingdom, we are witnessing a steady increase in the

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**EXHIBIT 9**

**CLIENT SWITCHING COSTS ARE DECREASING**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td>26</td>
<td>35</td>
<td>39</td>
<td>34</td>
<td>42.5</td>
</tr>
</tbody>
</table>

Reasons for ending a relationship

- Unsatisfactory performance
- Change of investment strategy
- Failure to control risk
- Lack of clarity in fund management policy
- Deviation from mandate
- Internal reorganization of your group
- Reorganization of asset manager’s group
- Inability to advise on investment strategy
- Inadequate reporting/contact
- Excessive turnover of portfolio managers
- Excessive turnover of contact personnel

percentage of the general population that holds equity shares, bonds, and money-market vehicles. The degree to which these clients are well informed is bolstered by the tidal wave of market information available through the mass media, newsletters, and investment Web sites, as well as through IFAs and broker-dealers. The growing sophistication of the investing public is reflected in its willingness to move out of basic vehicles such as domestic equity, bond, and money market funds into balanced funds, emerging-markets funds, and even hedge funds when the minimum investment required is not too exorbitant.

The investing public is growing in continental Europe as well and will likely increase further as European asset-management markets gradually become more open—a process that is taking place, albeit slowly. The degree to which European retail investors actively follow markets is rising, too. Still, the U.S. climate, characterized by round-the-clock market analysis and the ubiquity of fund ratings by companies such as Morningstar and Lipper, is highly unlikely to develop any time soon in countries where distribution is still carried out largely by banks or by other means of captive distribution.

The Products

From index funds to actively managed equity and bond funds to the arcane world of hedge funds, the range of asset management products continues to multiply. In our view, the overall product range can be broken down into three basic categories: commodities, core products, and alternative investments. Each group will pose its own set of hurdles for asset managers over the next few years.

Commodities. As equity markets turned upward in 2003, commodities—which consist mainly of index funds, enhanced index funds, and ETFs—drew more interest from investors. Index funds, because they are passively managed, command lower fees than actively managed vehicles and provide clients with a way to isolate market risk. Also, experienced investors know that relatively few active managers consistently outperform the market. Index funds currently comprise roughly 14 percent of total retail AuM in the United States compared with about 10 percent in the United Kingdom and around 2 percent in continental Europe.

ETFs, which track an index and can be traded like a stock (offering greater flexibility and liquidity), also witnessed appreciable growth in 2003. In the United States, the value of AuM invested in ETFs jumped 45 percent to $156 billion, with 66 percent of the rise attributable to market impact. (See Exhibit 10.) The growth rate of new ETF launches slowed somewhat, however. This trend was similar in some European countries, notably Germany, where the value of ETF-invested assets roughly doubled and the German bourse’s share of all European ETF assets rose from 45 percent to 57 percent (despite a decline in the actual number of German ETFs). ETFs appear well positioned for further growth in AuM, with the following caveats: the existing range of ETF types is fairly mature; copycat products are not likely to attract high inflows; and barriers to entry in the ETF segment are high, with the global market dominated by just a few players. Moreover, unless sufficient scale is reached, ETFs have limited attractiveness to manufacturers and distributors.

Enhanced index funds, which also track an index but can stray to take advantage of special market opportunities, also showed substantial growth in 2003—particularly in the United States. For example, the value of AuM in enhanced index funds run by two leading players, Barclays Global Investors and State Street, rose by 36 percent and 50 percent, respectively. Enhanced indexing should enjoy continued growth, particularly if stock markets perform creditably. Also, fees for these types of funds are lower than those for actively managed funds (although generally higher than those for pure index funds).

Success for asset managers in traditional, pure index funds will continue to depend on substantial size and a tight cost structure. Pure and enhanced index funds combined currently account for more than 25 percent of the U.K. pension-fund market and about 20 percent of the overall U.S. institutional market.

Core Products. Actively managed equities, bonds, and money market vehicles continue to be pressured by sliding revenues and thinning margins. (See Exhibit 11.) This trend reflects clients’ ongoing demands for greater value, as well as intensifying competition, higher transparency, and the increasing power and influence of distributors. Core products have also been hit by a search for
**EXHIBIT 10**

ETF ASSETS CONTINUE TO GROW

U.S. ETF AuM grew by 45 percent in 2003

![Graph showing U.S. ETF AuM growth from December 2001 to December 2003.](image)

German ETF AuM roughly doubled in 2003

![Graph showing German ETF AuM growth from December 2001 to December 2003.](image)

Sources: Lipper, Global Themes in the Mutual Fund Industry—2003; Deutsche Burs.

**EXHIBIT 11**

TRADITIONAL CORE PRODUCTS ARE BEING TIGHTLY SQUEEZED

![Diagram showing projected market growth for different types of products.](image)

Source: BCG analysis.

1 2004–2006 projections, assuming 7 percent CAGR.
lower costs through commodities and by a drive for
greater performance through alternative products,
such as hedge funds and private equity.

To cope with these dynamics, many traditional play-
ers have tried a variety of solutions such as mergers
with other asset managers (to gain scope, size, and
pricing power); product differentiation (to set
themselves apart on such points as investment style
and type of target equity holdings); and, occasionally,
acquisitions of distributors (to widen margins
and gain more direct access to target customer seg-
ments). Some asset managers have broadened their
horizons through strategic partnerships. Others,
however, have avoided the potential risks of acquisi-
tions and partnerships, and tried to fight shrinking
margins by using pure performance as their only
weapon. As we suggested in last year’s report, it is
likely that only the crème de la crème, those asset man-
gagers with a stellar track record over many years,
will be able to succeed on this basis.

Alternative Investments. Strategic allocation to
nonmainstream investments such as hedge funds,
private equity, and real-estate-investment trusts con-
tinues to grow. This expansion is being driven pri-
marily by hedge funds, which are permitted to uti-
lize aggressive tactics that are not accessible to most
mutual funds (such as short selling, arbitrage, and
derivatives trading).

Over the past ten years, global hedge-fund assets
have grown by roughly 700 percent (more than
twice the growth rate of mutual funds) to more
than $830 billion. Investor inflows exceeded
$70 billion in 2003 and have continued at a brisk
pace in 2004. Although the clear majority of hedge
fund AuM—more than 75 percent worldwide—con-
tinues to be managed in the United States (with pri-
ivate equity showing a similar dynamic), hedge fund
growth has been more rapid of late in Europe,
which now accounts for more than 20 percent of
global hedge-fund AuM.

Moreover, the estimated number of hedge funds
worldwide has grown by roughly 100 percent to
more than 7,000 over the past decade, with the aver-
age fund size more than quadrupling to over
$90 million. Yet there are wide differences by region
in the percentage of alternative-investment AuM
allocated to hedge funds, with Japan leading the
pack at more than 80 percent. Meanwhile, the fund-
of-funds structure, which accounts for a hefty chunk
of hedge fund AuM, is also showing strong growth.

We expect moderate expansion in the alternative-
investment sector over the next few years, driven by
an attraction to vehicles that are not correlated with
equity markets but tempered by forces such as the
perception of higher risk, the size of the initial
investment required, and insufficient liquidity. An
ongoing problem is the difficulty of rating hedge-
fund portfolio managers on the basis of past per-
formance because of the volatile nature of the
hedge fund beast. In addition, the attrition rate of
hedge funds is typically high. Although many traditio-
nal mutual funds also close every year, hedge
funds are particularly vulnerable because of their
volatility and because quite a few have trouble
reaching scale—placed by some industry pundits at
as high as $200 million, more than double their esti-
mated average size. Numerous hedge funds close
down not because of poor investments but because
of business failure for not being able to attract AuM
sufficient enough to gain shelf space alongside big-
ger hedge funds. Heavy attrition in the hedge fund
sector is likely to continue.

In our view, the key to success in alternative prod-
ucts will remain the ability to react quickly and cre-
avitely to rapidly changing market conditions.
Practical steps that asset managers can take to foster
this capacity include stepping up training dedicated
to alternative products, developing specialized sales
forces, and making use of external growth tools.

Meanwhile, the role of the wrap account—not an
alternative investment but an innovative product—
continues to expand. Mutual-fund wraps and sepa-
rately managed accounts collectively grew by about
12 percent to reach $840 billion in AuM in the
United States in 2003, and they are expected to
grow at a similar rate over the next few years. (See
Exhibit 12.) Wraps, which represent possibly the
best way for individual retail investors to create and
manage an optimal level of asset allocation, are also
extremely popular in the Australian market.

The Competitors

The asset management industry continued its con-
solidation trend in 2003, as some firms turned
toward mergers and acquisitions to improve effi-
cency and to strengthen specific product and dis-
tribution positions. But the moves were relatively small scale and tactical. This pattern was largely unchanged from that of 2002 (despite the fact that equity markets were substantially less friendly during that year), and it represented an ongoing shift from the type of M&A activity witnessed in the mid- to late-1990s, when large firms were routinely devoured and huge acquisition premiums were commonplace.

The difference between those days and the present time is that the risks of major acquisitions in the geopolitically volatile, post-9/11 environment seem somewhat greater. Also, high amounts of goodwill are difficult to carry on balance sheets for long periods, and smooth integration processes are the exception rather than the rule. Acquiring firms must demonstrate to employees, the market, and clients that any proposed acquisition will be worth its myriad costs and that business continuity issues have been addressed.

In 2003, most deals were focused on local rather than transcontinental acquisitions, with 10 of the top 15 transactions taking place within European, Canadian, or U.S. borders. All 9 deals involving Canadian buyers were domestic, and European asset managers, by and large, did not take advantage of the strong euro to buy outside of the euro zone. Moreover, M&A activity in the United States may have been held back in the fourth quarter by inquiries into trading improprieties that involved some well-known fund brands. It is a testament to the underlying strength of the asset management industry that highly publicized scandals appear not to have fundamentally damaged the investing public’s confidence in its integrity. But trust issues have risen to the fore.

EXHIBIT 12
ASSETS IN U.S. WRAP PROGRAMS ARE GROWING SHARPLY

<table>
<thead>
<tr>
<th>Year</th>
<th>Mutual Fund Wraps</th>
<th>Separately Managed Accounts</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>208</td>
<td>32</td>
<td>240</td>
</tr>
<tr>
<td>1997</td>
<td>291</td>
<td>49</td>
<td>340</td>
</tr>
<tr>
<td>1998</td>
<td>396</td>
<td>73</td>
<td>469</td>
</tr>
<tr>
<td>1999</td>
<td>462</td>
<td>104</td>
<td>566</td>
</tr>
<tr>
<td>2000</td>
<td>536</td>
<td>144</td>
<td>680</td>
</tr>
<tr>
<td>2001</td>
<td>600</td>
<td>190</td>
<td>790</td>
</tr>
<tr>
<td>2002</td>
<td>640</td>
<td>285</td>
<td>925</td>
</tr>
<tr>
<td>2003</td>
<td>491</td>
<td>349</td>
<td>840</td>
</tr>
<tr>
<td>2004</td>
<td>550</td>
<td>385</td>
<td>935</td>
</tr>
<tr>
<td>2005</td>
<td>630</td>
<td>411</td>
<td>1,041</td>
</tr>
</tbody>
</table>

CAGR (%)

Sources: The Money Management Institute; Investment Company Institute; Cerulli Associates; BCG analysis.
Any asset management organization’s primary challenge is elegant in its simplicity: achieve a consistent (and steadily growing) degree of profitability. This, of course, boils down to maximizing revenues and minimizing costs on an ongoing basis. Given that many factors determine how revenues and costs evolve for each player, this is no small task indeed.

Yet despite the uniqueness of every institution, there are core initiatives that are relevant for improving the profitability of the vast majority of players. The extent to which asset managers succeed at carrying out these endeavors will shape the industry’s landscape for years to come. In our view, these initiatives are sharpening your identity, managing distribution tightly and comprehensively, streamlining your product portfolio, developing clear scale and cost strategies, and deepening trust and relationships with your clients.

**Sharpening Your Identity**

Existential philosophy is not a typical agenda item at most asset-management executive-board meetings. Yet in an increasingly complex industry characterized by vastly diverse types of players and products, it can be highly valuable to revisit such questions as, Who are we? and Why are we here?

Our benchmarking and case work suggest that a fair number of institutions struggle with their identity regarding whether they aim to focus primarily on retail or institutional business (or equally on both), where their sweet spots are in investment style, and what they wish their brand name to evoke. It is also our experience that those players that know most clearly who they are and that succeed in communicating their identity to clients (many of whom start out thinking that all asset managers are pretty much the same) tend to fare better in many ways. A clearer focus on both target market segment and investment style enables any asset manager to concentrate its resources where they are needed most and helps institutions avoid trying to be everything to everyone—a common trap in a hypercompetitive industry.

It is clear that retail business, from an absolute perspective, is more profitable than institutional business. Among our benchmarking participants, the top-third retail players had an average cost-to-income ratio of 51 percent, whereas the top-third institutional players had an average ratio of 71 percent (or pretax profit margins of 49 percent and 29 percent, respectively). Yet it is also clear that, regardless of segment focus, those institutions that drive inflows and manage costs the best are the most profitable. A pure institutional player that executes well will likely have higher profits than a pure retail player that does not. Accordingly, we urge asset managers to review their identities regarding target segments and investment style, and to concentrate their resources (and branding efforts) on what they do best.

In addition, our research indicates considerable room for improvement in managing a particular market segment: small clients. We urge asset managers to follow the lead of best-practice players, which are establishing clearer minimum-size thresholds (generally based on minimum fees), redefining what constitutes an acceptable level of profitability to justify pursuing small clients, and using a range of techniques to reduce the cost of serving them.

**Managing Distribution Tightly and Comprehensively**

The relationships between asset management companies and the various types of entities that distribute their products are increasingly similar to those between manufacturers of mass-retail consumer goods and the outlets that sell them. There is an ongoing battle over prices (distribution fees), and the manufacturer must vie with a wide array of competing products for the distributor’s limited shelf space. These battles can turn contentious at times. Yet like Wal-Mart and Procter & Gamble, both camps ultimately need each other and stand to benefit greatly from stable and cooperative interaction. Asset managers, for their part, need to choose their distributors carefully and work at developing positive, long-term relationships.

From a profitability standpoint, the challenge for asset managers is complicated by the fact that direct channels (such as proprietary bank and insurance outlets, and captive agents) and indirect channels (such as broker-dealers, third-party fund supermar-
kets, nonproprietary bank and insurance outlets, and IFAs) each have their own set of economics. Our benchmarking study indicates an ongoing difficulty for many players in understanding channel profitability to an optimal extent. For example, management information systems that track revenues and costs by channel are still largely underdeveloped, making channel-specific data hard to obtain. Moreover, the expenses of acquiring and maintaining various channels vary widely.

Our benchmarking studies both this year and last suggest that having a sophisticated distribution strategy leads to better performance. Indeed, leading players are developing and using metrics to track asset inflows, revenues, costs, and profits on a comprehensive basis—by product, channel, salesperson, and geography. Many have had an activity-based costing model in place for several years. Top-tier players are also stepping up efforts to improve cross-selling and typically have a team in place whose central task is to manage relationships with investment consultants. Moreover, from an organizational standpoint, many successful companies are allowing salespeople a high degree of independence and some limited price discretion in pursuing new capital inflows. In our view, pricing continues to be an underutilized tool in asset management.

To improve overall distribution performance, we thus urge asset managers to pursue best practices and to analyze channel-related investment and potential new-business initiatives in strict net-present-value terms. Such actions will lead to better-informed choices regarding which channels and distributors are most beneficial, and can help build stronger negotiating positions for determining how many basis points of revenue actually reach the bottom line. Regarding pricing, we recommend trying to identify areas where the market might accept increases in loads and management fees; some form of bundling or unbundling of products or services might better extract the full value that investors are willing to pay; excessive discounting to bring in new business (price leakage) can be sealed up; and the price-volume tradeoff can be more optimally set.

Streamlining Your Product Portfolio

Leading institutions tend to have product portfolios that are directly aligned with both brand identity and distribution strategy. Yet a sizable number of asset managers have product development processes that might be described as inefficient at best and haphazard at worst. The lack of an efficient method to evaluate potential new offerings increases the likelihood that product launches will fail and can furthermore breed a culture in which mature products that are not contributing measurable value are never weeded out. For example, our case experience suggests that by migrating less than 5 percent of underperforming clients and products out of the picture, asset managers can save more than 15 percent of marginal costs.

Of course, on the one hand, a balanced portfolio can help institutions that are established in all or most product categories maintain revenues and leverage existing scale in their cost structure. Cross-selling can widen margins, and risk can be diversified. On the other hand, players that attempt to be everything to everybody often struggle to achieve sufficient visibility and scale in all product areas. Indeed, offering an unusually wide breadth of products—oftentimes the result of trying to keep pace with competitors that may have wholly different resources—only adds cost and complexity if you cannot sell the products efficiently and achieve decent performance levels. Specialists, of course, must also clearly demonstrate that their narrow frame of concentration adds tangible value.

We urge all asset managers to allocate the time and resources necessary to formulate a strategically sound product portfolio—one that is streamlined and concentrated, but flexible enough to adjust rapidly to changing market conditions and client preferences. This process should include the development of a rigorous analytical framework for evaluating both existing products and potential new offerings from the viewpoint of market demand, achievable economics, and available resources (both financial and human). The profitability and viability of all products should be reviewed on an annual or semi-annual basis. From an organizational standpoint—although the prevailing view is that each salesperson should “sell the firm” with no general bias toward a particular subsidiary, geography, or product group—our survey indicated that many players are attracted to the multiple boutique model. When well executed, the multiple boutique approach benefits from tightly focused teeming and from shared infrastructure and functional support.
Developing Clear Scale and Cost Strategies

How big is big enough? What will happen to market share if competitors start to pair off? How can the rising tide of costs be stemmed? Such questions are constantly on the minds of asset management CEOs.

Clearly, every player needs a nonorganic growth strategy, even if that strategy is to stand pat for the near future. And there are many good reasons why any potential merger should be approached with a healthy dose of skepticism. The hurdles of integrating widely disparate management teams and corporate cultures are always difficult to clear. Star fund managers fearing discontinuity have been known to abscond from merger situations, taking highly valued clients and a chunk of AuM along with them. There is also the plain truth that being bigger and more diversified does not necessarily make you better or more profitable.

It is also true, of course, that well-executed mergers can add real and long-term value. In our experience, successfully merged asset-management organizations have several attributes in common: they tend to retain a high degree of premerger assets, rationalize cost overlaps quickly, have a clear view of each other’s investment philosophies and processes, retain their most valuable human assets, and set strict dates for the completion of each stage of integration. Few sets of merger partners do all of these things well, however.

The ongoing question concerns the extent to which consolidation has played itself out. In our view, consolidation will continue as firms seek to improve product portfolios, investment skills, geographical reach, distribution capacity, and overall efficiency. Pervasive margin pressure on both the retail and institutional sides has made many smaller players vulnerable and, in some cases, ready to leave the business altogether. But large-scale, blockbuster mergers will be increasingly rare, and “lift-outs”—of a division, team, or product group, for example—will be more the norm. In the coming years, survival of (only) the fittest will become the industry’s byword.

On the cost side, perhaps the only certainty is that costs will rise. And indeed they have, although there is wide variation among regions and specific players. Among our benchmarking participants, average costs across the value chain were about 21 basis points compared with 18.5 in our previous study (a jump of more than 13 percent). Retail players’ costs were typically higher than those of institutional players. (See Exhibit 13.)

Moreover, it was clear that the most profitable retail players in our survey, while having higher costs,

| EXHIBIT 13 |

| PURE RETAIL PLAYERS HAD THE HIGHEST OVERALL COSTS |

<table>
<thead>
<tr>
<th>Focus</th>
<th>Business management and support</th>
<th>IT</th>
<th>Operations</th>
<th>Investment management and trade execution</th>
<th>Sales and marketing</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail</td>
<td>3.1</td>
<td>3.7</td>
<td>5.7</td>
<td>6.5</td>
<td>8</td>
<td>27 bps</td>
</tr>
<tr>
<td>Mixed</td>
<td>4.2</td>
<td>2.9</td>
<td>3.4</td>
<td>7</td>
<td>5.8</td>
<td>23.3 bps</td>
</tr>
<tr>
<td>Institutional</td>
<td>2.6</td>
<td>1.6</td>
<td>2</td>
<td>6</td>
<td>3.1</td>
<td>15.3 bps</td>
</tr>
</tbody>
</table>

Sources: BCG asset-management database; BCG analysis.
Note: Averages are weighted. Institutional averages exclude index players.
were able to offset them with the highest revenues. The top mixed players had costs in line with the average but were able to generate above-average revenues from their cost bases. And the leading institutional players did not necessarily have outstanding revenues but excelled at cost management. Also, the costs of the most profitable players overall tended to be weighted more toward sales and marketing than those of middle- and bottom-tier players. (See Exhibit 14.) Generally speaking, firms continue to put more resources toward enhancing revenues than toward cutting costs.

Going forward, rising costs will be driven by demand for a wider range of investment vehicles, compensation for top-performing portfolio managers, further development of platforms for third-party distribution and customers’ online access, and investment to support real-time settlement, straight-through processing, and other back-office efficiency initiatives. In marketing and sales, compliance costs to get products to market will increase because of tighter regulation.

These developments, of course, leave asset managers in the never-ending position of looking for “fat” in their organizations. To find and trim it, each player will need to carefully analyze its products, systems, and human resources from a cost standpoint. In our view, asset managers can potentially save more than 25 percent of support costs by challenging the added value of each function. We also urge asset managers to explore outsourcing for functions such as accounting, data management, business support, execution and post-trade services, and overall fund administration. (See the insert “Middle-Office Outsourcing Is Reaching Continental Europe,” page 29.) Outsourcing is also playing a growing role in the industry’s ethics concerns.

**Deepening Trust and Relationships with Your Clients**

Despite all the analytics, numbers crunching, and quantitative endeavors that characterize the industry, asset management is still, at heart, a “people” business. The most reliable and profitable clients are often those with whom deep relationships have been forged over a number of years. Yet recent, headline-grabbing scandals have put the entire industry under increasing scrutiny. In the United States, for example, a new Securities and Exchange Commission regulation will require all asset-management firms to have a chief compliance officer in order to ensure ethical practices and full disclosure of market-timing and late-trading policies. The fact is that ethics have become a competitive issue.

Accordingly, many asset managers are turning to outsourcing not only to battle rising costs but also to address ethics concerns. If in-house resources are insufficient to monitor trading practices or if possible conflicts of interest present themselves, an outsourcing solution can provide an objective, third-party overseer to verify that all compliance issues are dealt with properly. In our view, asset managers that make the effort to communicate their ethics policies to clients—and that demonstrate their willingness to operate with full transparency—stand potentially to benefit from greater client confidence and better overall relationships.

* * *

To conclude, we would like to stress that if there is one key insight to emerge from our benchmarking study and interviews this year, it is that sound management clearly outweighs difficult macroeconomic or investment-market conditions in determining
profitability and the overall strength of asset management institutions. Obviously, all players need to drive revenues to the utmost and strive to be lean and mean on the cost side—particularly in an environment as uncertain as the present. They must battle complexity not just on the product and distribution fronts but on the information technology front as well. And they must adapt to a landscape in which, quite simply, it is not as easy to make money as it was not so long ago. Yet despite the fact that the asset management industry is perhaps not as universally attractive as it once was, there remains a world of opportunity—and high profits—for those players that know who they are and that execute the fundamentals best. Ultimately, in our view, roughly one-third of major global players have developed and embraced most of the industry’s best practices. But it will be just as big a struggle for them to stay on top as it will for middle- and bottom-tier players to close the performance gap.

At BCG, we will always welcome the opportunity to sit down with asset managers and discuss their successes, their challenges, and the ways in which they might build a brighter future for their organizations and their employees.

And of course, we would like once again to thank all asset managers, as well as other interested parties, for taking the time to read this report.
The trend of asset managers outsourcing middle-office activities—previously limited to the United States and the United Kingdom—has recently entered the traditionally more conservative continental European market. Major players such as AXA Investment Managers in France and ABN AMRO in the Netherlands have recently announced decisions to outsource all of their middle-office activities to third-party securities-services providers. In a similar vein, BNP Paribas Asset Management has transferred its middle-office function to its internal custody division.

For asset managers, middle-office outsourcing is a major step toward being able to concentrate on their core businesses of asset gathering and investment management. Indeed, infrastructure, including both middle- and back-office operations, is an area where fewer and fewer asset managers are willing and able to dedicate time and resources. Moreover, initiatives such as process automation and specialization, the enablement of straight-through processing, and scale enhancement require resources that are different from those critical to actual investment management.

Custodians are the natural insourcers. After ten years of consolidation, the U.S. custody industry is now mature and searching for its next growth frontier. Players such as State Street, with $9.4 trillion in assets under custody (AuC), The Bank of New York ($8 trillion in AuC), and Mellon ($3.2 trillion in AuC) have saturated their domestic markets. Their core activity, custody and clearing, is under constant price pressure. Over the past five years, they have steadily added new activities—such as securities lending, cash management, and foreign-exchange trading—to their portfolios in order to enhance their margins. Middle-office insourcing in the United States and Europe may be the last piece of their puzzles.

Both middle-office and custody operations are driven by the same forces. In most cases, in fact, the required resources are similar for all asset-servicing activities. Data management must be consistent, enabling full integration of data flows from investment-management decisions to clearing/settlement and fund administration activities. From the custodian’s point of view, middle-office insourcing is a compelling move upstream and a way to secure higher margins while building on infrastructure that already exists.

Thus far, continental European asset managers have not pursued outsourcing solutions widely. Dominated by an integrated model, the large players have been major banks that already have a securities-services division in-house. Therefore, the rationale for outsourcing has not been strong. But the recent entry of U.S. custody players—along with increasing pressure on asset managers to focus on performance in order to enhance returns from their core businesses—has changed the rules of the game. The sheer size of recent transactions—such as AXA Investment Managers’ outsourcing of middle-office activities associated with €132 billion in AuM and ABN AMRO’s outsourcing of middle-office activities on €75 billion in AuM—suggests that middle-office outsourcing has become an option for virtually every asset-management institution in continental Europe, be it large or small, niche player or global power.
Methodology

BCG’s 2004 asset-management benchmarking survey covered roughly 50 institutions with a collective $9 trillion in assets under management (AuM). Roughly 60 percent of these institutions managed the majority of their assets in Europe, whereas about 40 percent managed most of their assets in North America. There were also four Australian participants.

Most survey respondents managed both institutional and retail assets, although a number focused predominantly on just one of these segments. For comparative purposes, we therefore classified participants in one of three peer groups: retail, institutional, or mixed. Participants classified as retail players managed more than 80 percent of their AuM for retail investors, whereas those classified as institutional players managed more than 80 percent of their AuM for institutional investors. Mixed players were those that fell somewhere in between. We also split each of these peer groups into three profitability tiers on the basis of companies’ operating profits as a percentage of their AuM. We then analyzed the drivers of relative profitability in each peer group.

Regarding market sizing, we included only professionally managed assets—those for which a management fee is paid. On the retail side, these assets included mutual funds, unit-linked life and pension products (also called variable annuities in North America), and assets managed for wealthy clients in the private-banking sector; but they excluded directly held securities for which no management fee is charged. On the institutional side, these assets included professionally managed assets for insurance firms (excluding unit-linked products already counted in retail), pension funds, corporations (nonpension), charities, governments, and banks.

The companies in our survey, whose combined total of $9 trillion in AuM represent roughly 25 percent of global AuM, were a major source of data on AuM growth and on the relative contributions of market performance and net inflows in driving that growth. Other key sources in estimating market sizes included statistics from national governments, stock markets, central banks, and asset-management and insurance associations. In preparing the overall report, we also drew on publicly available information from a variety of sources.5

5. These sources included Barclays Global Investors; Bernstein; Cerulli Associates; Datamonitor; Deutsche Borse; FERI Fund Management Information; Goldman Sachs; Greenwich Associates; Hedge Fund Research; INVESCO; Investment Company Institute; Lipper; JPMorgan Chase & Co.; JPMorgan Fleming; The Money Management Institute; Morgan Stanley; Nelson Information’s Directory of Pension Fund Consultants, 2002; Oliver Wyman; Pensions & Investments; press searches; Putnam Lovell NPF Securities; Rainmaker Information; Reserve Bank of Australia; Russell Investment Group; TASS Research; TowerGroup; and UBS.
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