Global wealth and asset management industry outlook
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I. Executive summary

Survive, sustain, grow. That, in a nutshell, describes the global wealth and asset management industry from the inception of the global financial crisis (GFC) through today.
Mutual fund assets worldwide reached an all-time high at the end of 2013, due primarily to strong capital appreciation in equity and balanced/mixed fund categories.

North America and Europe were the largest contributors to the growth in mutual fund assets in 2013.

**AUM size and growth**

Source: Investment Company Institute, Washington, DC. 2012. For the most up-to-date figures about the fund industry, please visit www.ici.org/research/stats.

Growth = increase in AUMs from Q4 2012 to Q4 2013

Based on data for 46 countries; Asia figures exclude Hong Kong and Singapore.
Through a macroeconomic lens, many global equity indices in 2014 have hovered around all-time highs, suggesting that investors are strongly bullish about future corporate profits. Fixed income spreads have come off just marginally from their all-time lows, which typically implies that investors perceive substantially reduced levels of systemic risk and have little concern for inflation.

### Real GDP growth rates (in %)

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<th>2013</th>
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Source: Business Monitor International
*Estimated or forecasted values

Yet these market indicators and many others like them may be highly misleading. Traditional benchmarks of risk and investor sentiment, such as spreads to treasuries and Libor or equity indices, have lost a great deal of credibility. Despite bullish capital markets and record flows into the industry, there remains deep uncertainty about global systemic risk and continued shaky confidence in investment managers. The promise of performance has not been kept, and investors, both institutional and retail, are demanding more for less.
While the largest bulge-bracket asset managers have resumed impressive top-line growth in assets under management (AUM), margins have shrunk. With substantial flows going to less profitable passive products and exchange-traded funds (ETFs), increased global competition for new AUM and ongoing tumultuous changes affecting the entire industry – notably, the implementation of a vastly complex new regulatory environment – continue to put significant pressure on margins and the ability to reinvest for growth in the foreseeable future.

**Corporate valuations in US asset management sector have underperformed broader market since GFC**

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Some of our key observations for the near future include the following.

1. Permanent paradigm shift. Many basic axioms that governed investor behavior and the operation of the industry have long since been discredited. Capital preservation has become the new mantra, particularly for the huge market of baby boomers entering retirement, as well as for institutions and government agencies managing their pensions. The bubble markets of the last decade are in the past and will not likely recur to the same extent in the near future. This means that double-digit investment returns will be exceedingly rare, and the traditional core markets of the US and EU may be approaching terminal mediocrity. Those firms that fail to adjust will face severe challenges to continued profitability and growth. Under the new paradigm, success will be determined by how managers can solve several key challenges:
   - Enhancing operational efficiency
   - Complying with the complex regulatory environment
   - Changing customer expectations
   - Evolving distribution relationships
   - Establishing clear brand identity and unique differentiation

2. Intense competition will result in more focus on transparency, convergence and costs. Information about markets and fund managers is now more transparent, resulting in investors who are far more interested in what they are charged for the risks taken and returns received. Convergence, or at least stronger interest, between traditional and alternative managers in the others’ products continues to gain momentum as manufacturers seek to leverage their brand identity and distribution channels in a cost-efficient drive to enhance revenues and grow AUM. And, closet beta products (active funds that do little more than deliver beta) will become increasingly difficult to sell – when beta can be purchased nearly for free from passive funds and ETFs.

3. The years of regulatory compliance. Similar to the regulatory revolution that reshaped the airline and telecommunication industries in the 1980s and 1990s and rewrote the list of winners, new compliance requirements will likely be a game-changer for asset managers. The reporting infrastructure that many firms – even mid-sized players – had in place before the financial crisis is insufficient to effectively handle the complexity of reporting and data analysis required in the new regulatory environment. Traditionally viewed in the pre-crisis era as back-office non-core functionality, compliance has now taken center stage in the C-suite as a core priority. This time around, the key to winning in the new regulatory environment will be integrated operational control and cost management gained by meeting the challenge of big data: successful implementation of a highly cost-effective, flexible data platform making the entire reporting process automated, efficient and scalable. Particularly in wealth management, client data will soon emerge as a core firm asset, rather than a merely marginalized back-office functionality.

4. Concentrate on core competencies. Core functionalities of most asset management firms encompass business development, portfolio management, client service and, more recently, compliance. Outside of these key areas, most non-core functionalities will come under review for outsourcing, offshoring, shared service solutions or, at the very least, cost cutting and downsizing, in favor of the implementation of technology-supported process improvement. Aggressive cost management – no different from standard management practices in the airline, fast food or hardline retail industry – is the new norm.

5. Investor relationships and reliance on distribution partners. Manufacturers of investment products are unique in two regards. First, they generally don’t control their own direct client relationships but, instead, work substantially through distributors (e.g., registered investment advisors (RIAs), platforms, consultants, wire houses, private bankers). Second, while online and major big box retailing giants continue to break the rules of retailing and practically reinvent their business models every few years, most asset managers have been resistant to change. They have manufactured more or less the same types of products and distributed them in more or less the same way for decades. Success in the post-crisis era will depend on offering new, more customized products to meet the needs of investors increasingly focused on capital preservation. Further, both asset managers and distributors will need to re-evaluate the number and types of their commercial relationships due to changing distribution arrangements and escalating costs. Distribution channels must be more aggressively leveraged to specifically target a whole new class of tech-savvy investors, many of whom command unlimited access to more financial information and advice from their mobile devices than they could ever obtain from most financial advisors.
II. Client view: once bitten, twice shy

Increasing sophistication and decreasing confidence

Global economic risk factors, such as continued uncertainty over growth in emerging markets and the health of the Eurozone, have consistently proven to be key drivers to top-line revenue growth. The asset management industry is essentially a game of confidence—albeit one that is legitimate, highly regulated and, in theory at least, presents far more upside than downside. The basic proposition of the industry to the client is: give us your confidence by letting us manage your funds and, on a risk-adjusted basis, you will do better with us than with an insured bank deposit or cash stuffed under a mattress.

During the past bubble era, systemic risk was substantially viewed as a non-issue. Correspondingly, investors were almost exclusively focused on the expected performance of their asset managers and only marginally concerned about non-performance-related issues, such as operational risk, regulatory risk, liquidity risk, fund governance and transparency.

But that was then and this is now.

Today, issues related to systemic risk are in the headlines almost daily and at the forefront of the entire asset management industry. The ongoing need to reconfigure the financial system and the sputtering economic recovery in many global markets have now made investors as a group vastly more risk averse. When global investor confidence is shaken, growing top-line revenues becomes more challenging.

In short, the new risk aversion among investors has raised the bar for the entire industry in terms of the challenges it faces in winning investor confidence and sourcing new AUM.

As the market as a whole becomes more transparent and as investors have lived through and learned from several boom-and-bust cycles, investors have become savvier and far more technically knowledgeable about risk management. A closer look by investors at governance, fund expense allocation and performance reporting is part of the greater focus on risk management. For example, hedge fund investors in general are moving away from the once almost unconditional trust and ready acceptance of high degrees of leverage that were the bedrock of the client-firm dynamics during the last decade.

Investors are now keenly focused on performance and how it relates to risk. For example, there has been a shift from absolute returns to more granular “real returns,” which are calculated after all fees, expenses and taxes. Customers also want much more transparency in their investment portfolios and greater convenience. There will be an increasing need to understand the new demographic of investor-savvy clientele, their unique behaviors and heterogeneous needs, instead of assuming that “one size fits all.”

In short, following the “lost decade” in equities, as well as the GFC, most investors, particularly at the retail level, have been left somewhat skeptical about the services they received from the wealth and asset management industry.
**Investment accounts score low marks on service delivery and client satisfaction**

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<th>Financial Product</th>
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<td>Savings accounts</td>
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<td>Online banking</td>
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<tr>
<td>Investment account</td>
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Source: EY Global Consumer Banking Survey 2014

**Capital preservation is king: retirees and disgruntled equity investors drive assets to fixed income**

Despite equity indices hitting record highs in 2014, looking at the client side of the asset management industry, we find a large-scale global demographic movement from equities into fixed income and a corresponding increase in concerns about the potential for an overall rising interest rate environment. The trend toward fixed income will be driven in large part by the baby boomer generation and the institutions that manage their savings stepping up allocation into capital preservation strategies. The continued weak performance of the active equity business is no surprise following a lost decade for most equity investors. Within the equity universe, the fastest-growing product segment is low-cost passive indexing, a business in which margin growth is exceedingly challenging to obtain for all but a handful of bulge-bracket global product providers.

More importantly, the global asset management marketplace — even beyond the retirement planning space — has slowly adapted an entirely new perspective on risk aversion. Pre-crisis, the search for absolute returns was the key driver for top-line AUM growth with only marginal concern for a variety of secondary factors, such as liquidity risk, operational risk, due diligence and transparency.

**But that was then and this is now.**

Capital preservation, risk management and corporate governance have now taken center-stage prominence well above and beyond the past focus on merely chasing after the hot stellar fund from the last quarter. For example, during the bubble era, investors exhibited a nearly insatiable appetite for “black box” and algorithmic trading strategies. Rarely did investors, even sophisticated institutions, fully understand exactly how these strategies worked. Managers were often less than forthcoming in disclosing the precise details of their black box operations, citing concerns about safeguarding proprietary secrets. Nonetheless, the allure of chasing near double-digit returns was more than enough to attract substantial inflows. The mystery of the investment processes was, oddly enough, something of a selling point.

Today, black box investing and mysterious investment processes would prove very challenging to sell to a much more skeptical market.

Due to the adoption of this entirely new outlook on risk management and the disillusionment with regard to equities and wide-scale global demographic shifts, investors have likely just begun a long-term strategic shift away from asset classes, such as active equity, and into product classes in which capital preservation is paramount. As such, the fixed income asset class, despite coming off a record 30-year bull run and widespread concerns about the US Federal Reserve shifting toward tighter monetary policy, will continue to enjoy a golden era for the next several years. Asset management firms have been quick to respond to demand and roll out new products for yield-focused and risk-averse investors, particularly targeted at the retirement market. Longer term, given the asymmetric estimated returns of fixed income investment, risk management and investor...
Post-crisis, funds had been flooding into fixed income, while 2013 witnessed a shift out of fixed income and into equity due to apprehensions regarding rate outlook and bond buyback.

Communication will prove crucial.

Transparency and corporate governance
Pre-GFC, most product manufacturers, particularly in the alternative space, grew AUM and operated on a business model based on their ability to generate alpha or, at the very least, their ability to generate expected returns that were not only generous but also wholly uncorrelated to traditional beta.

Investors who focused exclusively on these goals of absolute return and the lack of correlation to beta have been left severely disappointed.

Post-GFC, the pursuit of alpha, absolute returns and correlation relative to traditional markets are no longer the primary drivers behind manager selection. Instead, risk management, due diligence and transparency have clearly become the buzzwords. In fact, many consultants engaged in due diligence on behalf of large institutional investors first inquire about whether an asset manager has implemented a Global Investment Performance Standards (GIPS)-compliant performance reporting system before they inquire about last year’s performance return. Asset managers will increasingly look at outsourcing key functionalities not only to control costs but also to implement the type of institutional quality reporting standards and valuation methodologies required by today’s far more demanding manager selection and due diligence process. The outsourcing trend will become particularly relevant for smaller firms that likely do not have the in-house IT infrastructure, expertise or scale to efficiently cope with the complexity of new, onerous regulatory requirements nor the internal processes and controls that meet the heightened standards of investors.

Investors and regulators will increasingly examine the corporate governance standards of hedge funds or, more specifically, the lack thereof. While a fund director is, in theory at least, intended to protect investors’ interests and provide oversight, there will be growing concern about “professional” directors and their ability and capacity to effectively oversee dozens of funds.
III. Manufacturer view: differentiate and customize to survive

Shifting from products to customized solutions

Pre-GFC, the bedrock proposition made by the asset management industry to investors was simple: buy our products and we will target (and hopefully achieve) the maximum return. While a product-push approach may have succeeded during a bubble era, investors overall have now begun to slowly realize that we may only be at the beginning of a long-term cycle of low-to-zero real returns. Further, looking back over the past financial crisis, this product-push-centric proposition has clearly failed investors.

Many investors have now come to realize that a large proportion of alpha strategies are arguably effectively closet beta – that is, an expensive and disguised beta product. It is not surprising that many long-only active funds have seen quarter after quarter of net outflows. The growth of AUM and profitability of many strategies based purely on absolute return, particularly in the equity space, will likely be under severe pressure for the indefinite future.

In a nutshell, investors will increasingly seek customized solutions from manufacturers and not simply the same type of absolute-return products that failed to deliver over the past decade. Successful distribution solutions will depend heavily on establishing better client relationships and defining a firm’s unique brand identity in the marketplace. This is a complex undertaking and will entail enhanced and more focused relationship management throughout the entire value chain: better retail client relationships on the part of distributors, better distributor relationships on the part of asset managers and, possibly, even a renewed drive by asset managers to sell through direct client channels.

Investors have started a gradual long-term shift away from simply buying products based on the expectation of alpha generation and have adopted an entirely new view of risk management. Prevalent among most investors is a new skepticism about the industry as a whole. As a result, a major underlying market trend will be the move away from chasing returns. Instead, the marketplace will increasingly buy into customized solutions among which investors can selectively choose from an array of services designed around meeting their personalized goals.

Solution-based services will incentivize the industry to renew its focus on investor education and enhanced product training for distributors. New products will be specifically personalized toward particular client needs. Accordingly, successful firms will likely need to spend more effort on establishing their brand and educating investors. This will entail stepping up their client communications and focusing more on relationship management with distributors so that investors fully understand the concepts and potential consequences of risk, underfunded liabilities and volatility.

In the wealth management space, private banks are looking to adopt a “whole bank” approach to investment advisory in order to differentiate themselves from the competition. Many large universal banks have merged their wealth and asset management arms in pursuit of better synergies between “in-house manufacturer-distributor” relationships.

A core competency for wealth management players is personalized advice and the investment advisory process. This is precisely how wealth managers differentiate themselves from competitors. Traditional asset managers who have focused on “retail” products will now focus on synergies they have with their HNW-targeted distributors, such as private banks. That is, asset managers will offer more customized products that are
tailored to high net worth clients’ specific requirements. This sort of entrepreneurship in private banking is becoming increasingly important.

As a prime example of the trend away from simply pushing products, investors are demanding tailored solutions based on different underlying strategies and not just the same old generic absolute return products. Traditional strategies are primarily absolute return: swing for the fences and attempt to achieve the highest return. Customized solutions focus on goals – for example, mirroring benchmarks, asset-liability matching, managing assets around a target date or targeting a goal, such as purchasing a house, funding an education or making a charitable donation.

**Pursuing operational efficiencies: rationalization of product suites**

A classic sign of a bubble industry is a steady stream of ostensibly new products that are manufactured and put out for sale well before market demand fully develops. The driver behind the “more products = more sales” mantra is based upon classic supply-side economics: where supply is created, demand will ultimately follow. This trend may have worked for the industry during the past three decades, particularly since the creation of the equity culture in the late 1980s, as the market for investors steadily grew in size and complexity.

However, projecting forward, manufacturers and distributors alike will need to focus their product-suite planning on operational efficiency and to exercise far more prudence in deciding on the array of products to work with. According to A Snapshot of European Platforms, published by Cerulli Associates, between 2008 and 2011, an average of 1,743 mutual funds closed each year in Europe, and the universe of Europe-based hedge fund products is expected to continue this downward trend. Much like mushrooms sprouting in the forest after the rain, there will always be new hedge funds popping up in the markets every week of the year, given the huge talent and entrepreneurialism in the industry. Yet, at the same time, many of those new funds will eventually close after failing to gain critical momentum.

On the manufacturing side, the trend toward rationalization will result in managers being asked to intensify the support given around a target date or targeting a goal, such as purchasing a house, funding an education or making a charitable donation.

This is the aggregate market return for any given asset class (e.g., large cap US equities, investment-grade US fixed income, global emerging markets (EM) equities). The major index ETF manufacturers have all but locked up the market for investors seeking nothing more (or less) than exposure to purely traditional beta. While there may be other, smaller markets where a traditional beta product has yet to be offered and a smaller manufacturer can adroitly step in to fill the demand, those niches will be few and far between.

**Beta**

Beta has generally been measured by indices produced by a handful of commercial index providers, such as Dow Jones, FTSE and MSCI. Academics and many practitioners have argued that the traditional indices, which usually aggregate a collection of equally weighted security prices on a real-time basis and are used by investors to measure and replicate beta, are inefficient. They do not efficiently represent the aggregate market return. Other, more efficient measurement methodologies that govern a passive beta investment strategy, it is argued, can provide a greater return for the same or even less volatility. Investors who focus on passive investment and exposure to pure beta may demand strategies based on these smart beta indices. A small handful of boutique index providers have developed customized proprietary methodologies to measure and gain exposure to the market. Efficient indices can be used as a basis for a smart beta passive indexing strategy.

**Smart beta**

This is the return above and beyond the market return (or beta). In the simplest definition, an investor’s total return is composed of beta and alpha. Generation of alpha is typically associated with the unique skill, ability and decision-making prowess of the investment manager. In the pre-GFC era, pure alpha was the “raison d’être” of the hedge fund industry. However, post-GFC, whether most hedge funds can consistently and reliably generate alpha is a hotly debated topic.

**Traditional alpha**

This is a non-capitalization-weighted strategy, either rules-based or optimized, with evolving rules, dynamic rebalancing and enhanced risk management.

**Systematic alpha**

In a definition slightly modified from traditional alpha, a manager tasked with generating pure alpha will look across the entire universe of investable instruments, from equities and fixed income, to commodities, nonperforming emerging market debt, bankruptcy claims and aircraft leases. Unlike traditional alpha – where managers are typically restricted to long-only exposure limited to one clearly defined asset class, such as listed equities or US dollar-denominated fixed income – managers focused on pure alpha can invest in any asset with virtually no restrictions. As there is no specific market that a pure alpha manager generates, there is thin to zero correlation to beta.
to distributors for their products. At the same time, those asset managers will also evaluate the profitability of their distribution relationships more closely. The average national accounts team for an asset manager will likely focus more efforts on fewer products targeted at fewer distributors. With more time, energy and investment allocated to distributors, asset managers will likely make decisions about reducing the number of distributor relationships they have based on a careful profitability analysis.

For most managers, the composition of their product suites will also likely be closely scrutinized for profitability. For global fund families, some market niches may have several dedicated and overlapping products. If a global equity manager offers 12 products covering Africa, for example, the revenues for each product will be carefully examined to see if they adequately exceed the typical administrative and regulatory filing costs required for running each fund. For the largest bulge-bracket asset...
management firms, which manufacture several hundred products, there are cases in which fewer than 5% of their funds account for more than 50% of revenues. In wealth management product pricing, the entire revenue model is being restructured, and the ability to price modularly, as well as at the client level, will become a must-have for product managers.

A bloated product suite and supply pipeline may have been common in the past and the logical outcome of a long-term bubble market where new products are continually manufactured, yet hardly any are consolidated or eliminated.

Today, by contrast, the growing trend toward rationalization and keen prioritization of operational efficiency will result in fewer products with a greater concentration of resources on each. For all but the smallest boutiques, consolidation and rationalization of product suites is an inevitable process that will be implemented to safeguard margins.

Reviewing product suites in order to understand the granular profit and loss statement (P&L) is all part of the trend toward firms seeking a greater understanding of market segmentation. In wealth management especially, firms are increasingly focused not only on a product-by-product analysis of profitability but also on a market segment analysis whereby the entire market is viewed as a collection of broader segments based on individual characteristics, such as risk tolerance, wealth and life stage. More and more, wealth management firms will build out product suites and focus their P&L planning and analysis on selling to the unique characteristics and demands of broad market segments rather than on pushing individual products. Thus, there will be fewer questions on the profitability of a product and the firm resources needed to enhance that product and more interest in the profitability of a particular market segment and the business case for increasing firm investment in that segment.

The 800-pound gorilla: ETFs and low-cost beta

During past capital market bubbles, investors were not as concerned about performance benchmarking or indexing.

By contrast, in the “trust but verify” post-Madoff, post-GFC era, it will become increasingly difficult to sell beta when beta can be purchased for nearly nothing from one of the major index ETF providers. Keenly cost-sensitive investors allocating toward passive strategies has resulted in the ETF product class continuing to demonstrate stellar growth. This growth will come at the direct expense of competing product classes, such as actively managed large cap equities whose growth rates will likely stagnate.

The fastest growth for the ETF asset class will likely come from the Gen Y segment. This youthful “echo boomer generation,” while seen as a significant element in the future of the industry and aggressively sought after and courted by financial services firms, is cynical about investing and traditional financial advisors. The segment also tends to be considerably more financially literate than older investors and can readily access real-time news and information online. They were children when the NASDAQ bubble burst in the late 1990s, and most were still in college, sitting on the sidelines, when the next bubble burst in 2008. Thus, not only did they miss out on the entire equity culture of the 1990s and the get-rich-quick spirit of the bubble, but also they have never seen an equity bull market short of the recent post-GFC recovery either. Instead, many have witnessed the retirement savings of older relatives nearly evaporate. For most of this group, the old
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Market share of funds by product theme

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Source: Lipper FundFile
paradigm that equities outperform fixed income and increase over the long term has been thoroughly discredited.

The stellar growth of ETFs and their widespread acceptance by the crucial Gen X and Gen Y market segment have emerged as a considerable force that all active fund managers must face; like it or not, their product line will be comparison-shopped against index ETFs. The ETF threat will force asset managers offering active products to respond on several fronts:

- For active investment strategies, managers must educate, explain and prove alpha more than ever to increasingly skeptical clients.
- Managers offering primarily closet-beta products will find growth more difficult to obtain as investors simply become averse to paying a substantial markup for beta performance that they can purchase elsewhere nearly for free.
- Differentiation both at the product-suite level and the firm level is now essential. This means firms must invest in innovation, such as customized solutions, investor education and building brand identity.

Manufacturers’ product mix: convergence between traditional and alternative product suites

Demand for diversification into non-correlated products and risk mitigation is likely to drive managers to implement functionalities that were in the past typically offered separately – but not simultaneously – by traditional or alternative managers. This demand has given rise to an ongoing trend of convergence between alternative and traditional products.

Some traditional, as well as alternative, asset managers are already well down the road toward convergence, and the trend is expected to gain further momentum over the next few years. Even private equity firms that were once highly specialized are expanding and moving into a wider range of asset classes.

Convergence in the asset management industry is a classic case of the way manufacturers can grow and gain market share even in a tight market through horizontal integration. By leveraging existing resources, such as technical expertise, infrastructure, business operating model and office space, and existing commercial relationships, such as distribution channels, client wallet share and brand identity, firms can grow the top line by utilizing scale to source new revenues, thereby safeguarding and enhancing margins. By comparison, for many decades, fast food restaurants never offered breakfast, concentrating entirely on lunch and dinner instead. Then, in 1971, in the midst of a US recession and falling consumer spending and with negligible investment in building out infrastructure, McDonald’s introduced the Egg McMuffin. Since then, all fast food restaurants have followed suit and now offer breakfast.

Convergence in 2013 and beyond: uninterrupted area of overlap in offerings from traditional asset managers, hedge fund managers and private equity firms

IV. Distributor view: the changing distribution equation

Managing the value chain

Pre-GFC, distribution strategy was based primarily on a numbers game: more products pushed through the pipeline generally resulted in more AUM generated at the other end of the pipeline. The underlying paradigm was that if the products existed, one way or another, the products would be sold in the market, AUM and revenues would grow, and earnings would follow. Meaningful profitability analysis on a product-by-product basis has historically been a challenge, with little true precision due to the impact of corporate allocations. Therefore, consistent rationalization of unprofitable products was not rigorous, and orphaned products remained, “just in case.” The prevailing conviction was that if a large enough product suite was put into distribution, sooner or later some products, at least, would produce revenues.

Post-GFC, in the new regulatory environment, an increased focus on costs and far more risk aversion among investors have led to a rapidly changing distribution landscape. Manufacturers are attempting to get closer to the client, develop direct distribution channels and potentially minimize traditional costs in the value chain. FA and RIA client-facing advisors, for their part, are attempting to capture a greater wallet share by acting as their own manufacturers (i.e., advising on customized portfolios of ETFs) and serving as both the advisor and manufacturer of product. Everyone is seeking to do more for the client and to control more of the value chain as a means of revenue enhancement; the process of disintermediation is underway. The symbiotic relationship between manufacturer and distributor may come under strain.

In an effort to increase profitability, asset managers will prune the number of distributors they partner with, much in the same way as those managers will start rationalizing and downsizing the number of products they offer.

On the other side of the equation, gatekeepers at distributors are demanding more services and more sales support from manufacturers as funds become more complex. Asset managers will no longer simply be able to offer products, as they will increasingly be expected to back up their offerings with communication and education initiatives that explain with clarity what the products do and how, if at all, they are different from simple closet-beta products. Distributors, who usually own the client relationship, want to boost their profitability, rationalize the number of asset managers they support, and seek ever greater competitive advantages in terms of differentiated product suites, preferred pricing and investor education initiatives. While large universal private banks will continue to focus on sourcing products and investment advisory in house, they will need to exercise caution and flexibility so as not to fall victim to internal organizational barriers and become nearsighted to market trends and evolving client sentiment. Many distributors will enhance their client-targeted financial planning services as a way to add value, enhance customer experience and establish differentiation. Distributors feel they control the pivotal link in the manufacturer-to-consumer supply chain. As a result, they will likely demand a greater cut of the pie for funds sold through their platforms.

All segments of the market will realize that traditional fund management is a highly commoditized business. With limited room for differentiation on product design and performance, asset managers who have not focused on building brand identity in past years will be forced to increase spending on investment sales and marketing efforts – yet another factor continuing to compress margins. In fact, given that a growing proportion of the manufacturer-client interface will be technology based, there is an ongoing move toward more personalized marketing content from asset management and insurance companies targeting end investors.

Client-firm dynamics in wealth management: two relationships in one

Distributors in the wealth management space also will focus more closely on the granularity and bifurcation of their client-firm relationships; while clients may have a legal relationship with a distribution firm, say a global wire house, the relationship that delivers true value is the one between the client and the individual advisor. Thus, there are two separate relationship-management functions in play. One is the employment relationship between a firm and its network of advisors. The other, more important, relationship is between the advisors and their actual clients. Thus, when posing the question of precisely who owns the client within wealth management, the answer may be the employee advisor of the distribution firm rather than the firm itself. The key differentiators within the distribution part of the value chain will increasingly be the advisor-client relationship and the personalized advisory process itself, probably more than the actions and performance of the global wire house that employs the advisor. Interestingly, this is in stark contrast to the manufacturing side of the equation, where large asset management firms have mitigated “key-man” risk by generally moving away from promoting a specific star fund manager, their personality and their individual track record.

Yet again, distribution firms – like asset managers – will recognize the threat of disintermediation and will continually have to focus on how to make themselves relevant and add value to the production chain well above and beyond simply providing office space and trade execution services to their employees.

The potential for value creation in the client-advisor relationship can be clearly seen by looking at recent trends in profitability margins. Costs are rising and margins are shrinking throughout most of the global financial services industry, particularly within asset management manufacturing. However, when drilling down
Global online population: 41% of the total online population comes from Asia-Pacific

Gen Y (25-34 age group) is the major contributor to the online population in all regions except North America

Source: “The Digital World in Focus,” comScore, July 2013
to the product-specific level, margins have actually grown in wealth management, specifically in the client-facing advisory segment. Advisors can and will be able to sustain pricing power due to their tight ownership of the client relationship and the client perception that they are actually getting value for money. In fact, the industry is so optimistic about the outlook for margin protection and enhancement within wealth management that there will continue to be a feeding frenzy to buy up and pay top dollar for successful wealth management businesses that can deliver a proven book of business, recurring revenues and a well-established network of client relationships.

Part of the increasing focus on enhancing client relations is the trend toward personalization, particularly in wealth management. For smaller clients, while wealth managers may not necessarily provide personalization for every individual client, they will provide personalization for each individual market segment based on characteristics such as wealth, risk tolerance and life stage.

Private banks have recognized the importance of building client relationships within the shift to the Gen Y high net worth segment, particularly the children of the high net worth baby boomer generation. Reaching this younger segment will require investment in starting and building relationships by offering more enhanced e-banking and e-investment solutions — a shift toward “complete information, now.” Indeed, this is already a clear trend for many Asian private banks, which are revamping their advisory processes and platforms and specifically targeting relationship-building within the Gen Y segment.

Creating differentiation within a crowded industry and finding new ways to add value — the core functionality of wealth management advisors — is becoming essential for survival. This is especially true within wealth management, given the mediocre longer-term outlook for the fixed income asset class. In wealth management, capital preservation usually implied a predominant allocation toward vanilla investment-grade fixed income. But in view of the flat longer-term outlook for fixed income, wealth managers will become increasingly active buyers of alternative products and any way they can add value by offering a unique combination of “safety,” as well as some upside potential.

Fixed income in general is a prime example of where the tight market in rates and nearly homogenous investor demands will add to the commoditization of many areas of the asset management industry. Distributors may soon find that they are competing for new investors on the basis of factors that are only marginally related to the product itself, factors such as investor education, interactive tools, client communication and client service. Not surprisingly, this is similar to how a global big box retailer competes for client revenues: almost all products sold by the global retailer are identical to and readily available at countless smaller retailers, yet the global retailer consistently outperforms on the basis of lower cost and better service.

Distribution and fee sharing: regulatory overhaul in sight
In the UK, the entire system of distribution fee sharing has come under radical regulatory overhaul with the implementation of the Retail Distribution Review (RDR), which went into effect at the end of 2012. RDR requires advisory firms to explicitly disclose and separately charge clients for services. The biggest change for client-facing distributors is that they can no longer accept commission payments from asset managers for selling products. Instead, they must be paid directly by the clients they advise and only the clients they advise.

Although the jury is still out on the exact effects RDR will have on profit margins, small and mid-sized manufacturers could see new business volumes in the UK decline by some 15%-20% as a direct result of evaporating consumer demand and shrinking availability of advisors. With full transparency of pricing, consumers are likely to spend less, particularly for high-margin niche products. Reduced spending for advisory services will inevitably lead to a shakeout and decline in the number of client-facing advisors and lower demand for many types of fund products that often relied heavily on generous commissions and aggressive sales and marketing.

The US market has so far escaped any significant regulatory overhaul of distribution fees. However, regulators around the globe have closely followed the near decade-long struggle to put RDR into legislation and, in many cases, have begun similar initiatives. In the EU, negotiations are underway between the European Parliament, European Council and European Commission to amend the Markets in Financial Instruments Directive (MiFID II) in order to ban inducements paid by asset managers to independent advisors, sometimes referred to as “revenue sharing” or “placement fees.” In the US, conflicts
of interest within the entire asset management industry have become a growing priority for the Securities and Exchange Commission (SEC). The complex system of expense allocation among distributors, manufacturers and clients is just one of many areas where potential conflicts of interest have been reported. Already, the SEC has issued several official statements about its intention to focus on specific conflicts within the asset management firms it inspects.

In such jurisdictions as the Netherlands, Korea and Australia, regulators have already enacted into law changes in distribution fee sharing. In short, while the exact framework may still be under debate from jurisdiction to jurisdiction, some form of regulatory overhaul or at least investigation into the complex and opaque system of distribution fees is likely for most of the global asset management industry.

In the US, regulators are starting to draft a “uniform fiduciary standard” to cover the entire scope of the retail distribution process. The Dodd-Frank rule-making process now underway by the SEC and the US Department of Labor will eventually implement new rules on fee disclosure and legal responsibility for advisors that will affect the entire wealth and asset management industry.

The crucial regulatory area now under review is the intricate and overlapping responsibilities of broker-dealers in comparison with investment advisors. Presently, there are two complicated and confusing federal statutes that underpin the selling of investment products to investors.

In countless federal court decisions over several decades, investment advisors have been deemed to be fiduciaries to their clients. This is due to the recognition by the courts that clients entrust investment advisors with assets and investment authority. By contrast, since the creation of the first round of federal security regulations in the 1930s, broker-dealers were generally viewed not as fiduciaries, but rather as salesmen whose primary function was distributing and selling securities and executing securities transactions.

However, given the rapidly increasing overlap between the two functions, in the public marketplace, there is now virtually no differentiation between brokers-dealers and investment advisors as they are both actively pursuing and servicing wealth management clients.

For the brokerage industry, which operates primarily in the wealth management space, adoption of a far more rigorous fiduciary standard in day-to-day sales operations will require a re-evaluation of the product line offered to clients, far greater compliance costs and, most likely, a significant hit to the bottom line. For asset managers, while it is far from clear precisely how the industry will change and conform to tighter regulations, increased costs and decreased profitability for brokers, an increase in the cost of distribution or reduction in the number or type of relationships in this channel is likely.

Regulatory tinkering with remuneration models that have underpinned the industry and stood unchanged for decades is a highly daunting prospect for all players in the distribution chain. In drafting any possible new restrictions, some key points that regulators may ask, and firms must be prepared to address, include:

• Services – Exactly what services are distributors charging investors for? After the GFC, many investors themselves are asking this very question. It may prove essential for advisers not only to enhance the added value of services offered to the investor at the end of the distribution chain but also to provide clarity in explaining precisely what services the industry is providing.

• Transparency and disclosure – Given the highly complex, convoluted and opaque system by which the industry generates fees throughout the entire distribution chain, few investors fully understand the total all-in price for asset management services. In fact, the asset management industry is highly unique in price discovery; end consumers rarely know for certain how much they are paying and what exactly they are paying for, and there is hardly any monitoring system in place. Similarly, in health care, another huge sector based on a highly complex and convoluted pricing system, the end-consumer may not know exactly how much they are paying. However, the huge difference is that the end payor in the health care industry, either an insurance company or government agency, oversees an aggressive pricing control and verification process for cost and payment mechanisms.

• How much is too much? In a free market without price controls, private sector firms are free to charge whatever they want for the services they offer. Yet, given that most investors are only vaguely aware of how much they are paying for asset management services, many regulators not only are starting to closely scrutinize how fees are effectively hidden in the distribution system but are asking if those fees are too high. The excessive all-in fees that UK retail investors were paying, usually without even understanding those fees, was one of the driving factors behind RDR and fee restructuring. At the very least, far more transparency of pricing, including disclosure of all fees, expenses and associated costs, will be demanded by investors and will likely be implemented to some extent by regulators.
V. Regulatory compliance: the era of big data and complex chaos

Following the financial crisis and widespread political support on both sides of the Atlantic for tighter oversight of financial services, new regulations have been created at a fast and furious pace. Over the last two years – from Dodd-Frank and FACTA, to the Basel Accords and AIFMD – there has been a very evident trend toward the globalization of financial regulatory policy that is only just beginning. Regulatory change will continue to reshape internal policies and procedures, particularly with the implementation of FACTA and increased scrutiny by regulators on offshore banking and mis-selling by advisors.

North America
Dodd-Frank Act, Basel III, AIFMD, FTT and IFRS Convergence are likely to dominate the regulatory agenda.

Latin America
Improved regulatory regimes with the intention to come into line with the G20 recommendations. For example, a higher percentage of adherence to Basel core principles than the developing markets of Asia (Source: IMF).

Europe (and Eastern Europe emerging markets)
UCITS, AIFMD, EMIR, extraterritorial Dodd-Frank, FATCA, Basel III, plus MiFID II, PRIIPs, MAD II, AMLD and especially FTT all contribute to a complex and concentrated period of regulatory reform in the region over the next 3-5 years and beyond.

Asia-Pacific
A number of initiatives are being undertaken by regulators to reduce bureaucracy, speed up the process of bringing new products to market and stimulate market activity within their jurisdiction by attracting more participants. Investor protection, through stricter codes of conduct for intermediaries, is also a high priority. The first steps toward an integrated marketplace will be implementation of the proposed Asia passporting scheme.

Rest of the world
Many of the emerging markets such as Africa and the Middle East currently under extreme civil unrest, making the application of national and regional regulation extremely challenging.

Source: EY
The new regulatory environment will have a profound impact on the entire industry's business development and strategic planning. Some key points for survival will include:

- **Data, data, data** — Asset management firms have entered a new era of big data, again following the footsteps of large retailers and airlines that command a global IT infrastructure that is often more sophisticated than the data systems of many sovereign governments. Firms will eventually be compelled through regulation to store, manage and disclose more client-specific data related to portfolio holdings. Most regulatory requirements focus on sources and retrieval of data held by the enterprise, as well as data held by external service providers on behalf of that enterprise. Procedures and systems that many firms – even mid-sized players – had in place before the financial crisis are insufficient to effectively handle the complexity of data analysis now required in the new regulatory environment. Increased demands for data gathering will further incentivize firms to revisit outsourcing.

- **Disclosure and transparency** — An unprecedented level of disclosure to regulators and investors has become the norm. For new regulatory filings, firms must often disclose data that once was considered confidential or proprietary. AIFMD-regulated funds will need to disclose remuneration levels of key staff, which is perhaps not surprising, given open debate in the EU about mandatory capping of executive compensation packages in financial services.

- **Redesign operating model** — Many entrepreneurial and proactive firms will look upon the new regulatory environment, understand the secular trend impacting margin compression and demands for big data, and seize the opportunity to implement a new operating model from the ground up. The complex chaos of the rapidly changing regulatory environment affecting the entire industry will prove to be an opportunity for highly adroit firms. They will come out of the restructuring process with an enhanced competitive advantage in terms of higher levels of productivity, efficiency, flexibility and, ultimately, lower operating costs.

- **Prepare bucket number two** — One key challenge will be to implement systems that not only comply with current regulations but also are readily scalable for unknown future demands. While designing a new operating model should focus on current regulations and near-term filing deadlines, there should be plans for a “bucket number two”: data gathering required for regulations that are not finalized or that firms have not yet assessed.
VI. Outlook: expectations for the global wealth and asset management industry

Given the mediocre record of industry pundits during the financial crisis, making predictions about the direction of the global wealth and asset management industry comes with a considerable degree of risk. Nonetheless, we can arrive at several broad conclusions about how recent trends will play out.

1. Adapt or face irrelevance … or extinction. Many paradigms that governed investor behavior have long since been discredited. Firms that fail to adjust will face severe challenges for continued profitability and growth. Whether relying upon 2007-era data infrastructure or keeping in-house functionalities that can be efficiently outsourced, firms that continue to operate under pre-crisis business models may risk disappearing. Change is a necessity, not an option.

2. Competition will force innovation. Investors have become extremely price sensitive and far more sophisticated about costs, benchmarking, alpha versus beta and risk management. Firms will realize they can no longer successfully compete by charging excessive fees for a beta-like product. To compete successfully and grow within this heightened level of competition, firms must invest in innovation, deal effectively with a fiat to rising interest rate environment, tactically re-evaluate investment in their distribution channels, create product differentiation and build brand awareness. Projecting forward, firms will undoubtedly compete in pricing for new AUM, but winning in the market also will be heavily influenced by a host of other factors, such as product differentiation, successful partnership and relationship management with key distributors, building brand identity among investors and innovation. Certainly, the biggest firms will get bigger as they command the economies of scale to win the battle for the lowest price. But, at the same time, small boutiques can and will effectively compete and win against the bulge-bracket firms, based on many different factors above and beyond pricing.

3. Firms will focus on core strengths. Most non-core functionalities will continue to come under periodic review for outsourcing or, at the very least, major downsizing of headcount in favor of technology-based streamlining and process improvement. Processes will be restructured and streamlined: many middle- to back-office activities will be consolidated or moved into Business Process Outsourcing (BPO) models as core-system platform changes become a priority for firms seeking improved operational efficiency and cost management. For those middle- and back-office functionalities that are not outsourced completely, firms will certainly expand the use of vendor-provided services, tools and platforms, thereby retaining full ownership of the functions but also controlling costs, de-prioritizing those
functions and enabling management to focus even more time, energy and resources on core strengths. The restructuring process also includes evaluating existing portfolio management skills. There will be a clear need to evaluate product line, rationalize products where there is no in-house expertise and explore opportunities for sub-advisory and white labeling with asset managers that have the skills necessary to deliver to investor expectations.

4. Unique brand identity will be essential. Some of the largest names in the global asset management industry are, relatively speaking, unknown names in the broader consumer market. Perhaps, for the first time, many firms must carefully review their brand identity in the market and begin the long-term process of investing in and building their own direct-to-consumer brand identity. This may imply further marginalization of many aspects of the value chain, such as client-facing FAs and RIAs, as well as far more investment by asset managers in B2C sales and marketing and cost-efficient, technology-driven distribution platforms. In wealth management in particular, firms will win or lose based on their ability to clearly define in the client’s mind a “unique value proposition” that differentiates their brand identity from that of other players in a very crowded market.

5. Compliance is “core.” The new era of compliance will force firms to focus on an enterprise-wide integration of business strategy and not simply short-term tactical solutions. Success in the new environment will require establishing new operational processes with ownership from the business and compliance alike, as well as a substantial investment in data architecture and review of the business operating model. The investment in data architecture will not merely be a short-term exercise in meeting filing deadlines, but rather a smart long-term strategy to enhance growth opportunities and find new markets. For firms that effectively meet the challenge of the changing regulatory environment, investments in infrastructure and implementation of an enhanced operating model will provide opportunities to enhance profitability and ensure growth.

6. The role of data architecture and IT infrastructure will change. Data architecture and IT infrastructure will increasingly become a “business problem,” taking a prominent seat squarely in the front office and the C-suite. Particularly in wealth management – given the trend toward greater personalization of service offerings and the prioritization of enhancing client relationships, as well as regulatory requirements – client-specific data will become a valuable core asset.

7. The shift from product push to customized solutions will continue. Restructuring the product mix to focus more on solutions, most notably liability management-type investing, will entail considerable enhancements in client communication and distributor relationships. A prime example of this is the effort to change focus from simple absolute return toward a specific goal, such as retirement, a charitable donation, purchase of a vacation house or funding a university education. Developing solutions to meet a client’s personalized goals rather than selling absolute return products will slowly become the norm. Firms will virtually abandon their old sales and marketing strategy of selling specific transaction-based services – many of which can now be executed online for a few dollars per click – and instead emphasize their ability to customize and deliver a variety of bespoke solutions built around targeting personalized goals. For the most adroit and visionary firms, the shift toward providing customized solutions will prove to be an outstanding opportunity to benefit from innovation and excellence at understanding and serving the client’s needs.

8. The fastest growth will come in retirement, ETFs and EM. Due to demographic shifts in developed markets, the retirement planning and pension space will draw more and more attention from major industry players. Although emerging markets will remain marginal in size compared to developed markets, most firms will still look to this space as one of the last great frontiers for the industry – with the largest prize by far being China. ETFs will remain the fastest-growing asset class, continuing their trend of double-digit annual growth. Given the oligopolistic structure of the indexing space and potential growth in niche products, the ETF industry is already demonstrating bifurcation. AUM in passively managed indexed ETFs will continue to rise but will mostly flow to the three or four largest index ETF providers. The second-tier, more boutique-like industry will emerge in active and specialty niche ETFs; this second tier, however, will be a very tough market indeed in which to control costs, gain critical mass and flourish. Like it or not, most active funds will eventually be benchmarked and comparison-shopped against the ETF index universe.

9. Embracing change will win the distribution game. Given changing demographics across global markets, evolving technology and client disappointment with old-paradigm investment management, the most upside potential for top-line revenue growth will be in building a truly trend-setting distribution infrastructure. At the end of the day, substantial growth will only be delivered through understanding and
embracing the rapidly changing distribution game. This will require a complex combination of building brand identity, moving closer to the client, mastering social media and skillfully leveraging market intelligence to accurately gauge and quickly respond to investor sentiment. Change is a constant: if you’re not moving forward, you’re going backwards.

10. The middle will erode. Large firms command the budgetary resources and economies of scale to compete on price, develop innovative product suites, build brand identity and aggressively chase new AUM. Smaller, entrepreneurial firms can identify and efficiently exploit niches and, if skillful enough, will grow and protect margins through specialization and unique differentiation. For firms in the middle, the path to survivability and growth is less apparent. In wealth management, personalization of services for a specific client – or, at least, personalization around a specific market segment encompassing client groups with similar characteristics – will become essential. Unique product differentiation, highly innovative steps toward successfully building distinct brand identity and world-class client service through investor/distributor education and communication will become critical for mid-sized firms to avoid irrelevance.

11. The industry will grow ... and shrink. In terms of AUM, the industry will continue to grow steadily and keep pace with global economic growth. However, in terms of the number of firms in business and total employees, the structure of the industry will alter ... and shrink. The historically distinctive segments of the industry will blur. The “middle” will need to choose a direction or bear the challenge of staying relevant. Manufacturer/distributor relationships will diminish but deepen. In short, the global AUM pie will grow, and the biggest firms will get bigger. But headcount and profitability margins for most firms, particularly for all but the most innovative players, will narrow.
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