When the ground beneath your feet is shifting, do you stand still or leap forward?

A view on the new asset management global operating model
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When Heraclitus philosophized that change is the only constant, he certainly never envisioned the disruption overtaking today’s global asset management industry.

Since rebounding from the events of 2008, the pace of change has accelerated across the industry, driven by a confluence of market forces and megatrends, including:

- A new wave of investor demands
- Technology innovations
- A sustained flow of assets under management (AUM) from active to passive funds
- Increasing fee pressures from stakeholders across the ecosystem

For wealth and asset managers, these forces have necessitated bold action, which many firms are taking now. Those firms able to define the optimal product, pricing, distribution and service strategy and move quickly to transform their operating model will remain competitive: speed and agility are key, both during transformation and as attributes of new and sustainable operating models. To thrive in this global $70 trillion industry, firms must have an infrastructure designed for ongoing change; simply being responsive to change will not be enough to succeed in the future.

The change now taking place is a complete shift from past eras of cyclical change. It is happening at a faster pace and is more profound and structural than before. Looking to 2020 and beyond, the wave of change will be sustained over the long term and permanently reshape the wealth and asset management landscape.

As we look forward across the next five years, operating margins across all firms will continue to face pressure. To remain competitive, address the powerful forces described below and harness the power of change, asset managers need to embark on unprecedented strategic transformation programs, addressing multiple dimensions of the business:

- Technology platforms
- Intermediary relationships
- Business alliances
- Product innovation
- Sources of talent
- Client engagement
- Brand management

The remainder of this article will outline the actions leading firms are currently undertaking, or assessing, to redesign their operating models for the future.

To thrive in this global $70 trillion industry, firms must have an infrastructure designed for ongoing change; simply being responsive to change will not be enough to succeed in the future.
Megatrends and tectonic shifts make change imperative

The combination of the following drivers and the growing momentum of change will transform the industry over the next five to seven years.

1. **Increasing fee compression**

   Increased sophistication on behalf of both institutional and retail investors, as well as regulatory, political and public awareness over value for money, will continue to drive fees lower while increasing risk transparency. Consider the following global declines in 2016:

   - Passive fees: 16%
   - Hedge fund fees: 6%
   - Active fees: 2%

   The democratization of sophisticated technology analytics has enabled the transfer of performance attribution reporting, smart beta portfolio management and Monte Carlo simulation from the institutional asset managers’ purview to the retail investor’s desktop. That shift compounds fee pressures and intensifies the need for product innovation. Further, “value” is no longer viewed purely in terms of risk-adjusted net returns, but now incorporates a broader set of criteria, including whether investment products deliver on initial objectives.

2. **Rising value of brand and trust**

   Global brand recognition of pure-play asset managers will dominate both retail and institutional channels to drive flows, similar to the way global banks leverage their global brands do today. Younger generations appear to trust nonfinancial services brands more so than traditional firms, which creates an opportunity for new entrants into the industry ecosystem, if they are willing to take on the regulatory and risk management requirements.

3. **Macroeconomic factors drive product development**

   Product innovation over the next decade will be driven by the confluence of:
   - Lingering low interest rates in countries with major capital markets
   - Aging populations in developed countries
   - The need for asset protection
   - The continued shift of retirement from employer or the state to the employee

   Further, the rise of the middle class in countries outside the US, and the unprecedented generational transfer of wealth in the US, will significantly impact both products and distribution. Specifically, it confirms the need for firms to build effective global product and distribution networks through alliances, acquisitions and selective organic growth.

FinTech firms, unshackled by the legacy organization and technology infrastructure, are reshaping the distribution landscape with relatively small technology investments.
“Winner-takes-all” phenomenon and acceleration of the barbell effect

In 2016, net new assets flowing to the top 10 represented 69% of all (NNA). This winner-take-all phenomenon is accelerating the barbell, with managers concentrating on passive products, including exchange-traded funds (ETFs) and smart beta at one end, and a new breed of alternatives at the other end, including private debt and infrastructure. Those managers who remain focused on traditional alpha will face pressure to deliver cheaper and better returns, resulting in more unconstrained and concentrated portfolios.

Asset owners as competitors

Asset owners will increasingly move away from using professional sub-advisors to manage non-complex asset classes themselves; indeed, from 2015 to 2016, sovereign wealth funds withdrew at least $85 billion from asset managers globally. Their increased market sophistication will put additional pressure on fees of alternative asset class managers, particularly the need for detailed and timely reporting to assess the plan's cost of alpha.

Blurring of the distribution value chain

The asset and wealth management value chain will converge as manufacturers with primarily intermediated distribution models develop direct channel capabilities and large-scale wealth firms launch their own registered products to more effectively control product costs. FinTech firms, unshackled by the legacy organization and technology infrastructure, are reshaping the distribution landscape with relatively small technology investments. They are also raising the expectations of investors and intermediaries. Looking forward to the opportunities still ahead for innovative firms, we see the transformation of the distribution model as much closer to being at the end of the beginning phases, rather than at the beginning of the ending phase.

Talent

Automation in all post-execution and some pre-execution processes will eliminate human intervention in operations. It will also dramatically shift the need for scarce, skilled resources in risk, compliance and governance from pure subject matter expertise to statistical, data and analytics skills. Firms will continue to invest in talent and higher-level capabilities to enable a model where:

- Technology addresses repetitive operational activities.
- Highly skilled individuals focus on tasks that deliver competitive advantages (e.g., product innovation or service quality standards).

Outsourcing

Outsourcing the middle and back office to one or more global custodians and nontraditional, specialty managed service providers is gaining traction as the de-facto operating model for both commoditized accounting functions, as well as increasingly more complex capabilities such as regulatory reporting and specialist asset classes.

Technology

FinTechs and other nontraditional technology providers selectively identify opportunities in high-value functions. Thus, they are viewed by wealth and asset managers as a source for technology infrastructure and solutions via acquisition. In addition, the evolution of top asset managers as leading technology providers — with both the understanding of regulatory considerations and distribution capabilities — suggests that the major technology disruptors will be traditional firms that acquire or improve on ideas from nontraditional FinTech or consumer product firms.
Asset managers must address every core function of the enterprise if they are to successfully transform:

- Distribution, sales and marketing
- Front office
- Back office
- Middle office
Distribution, sales and marketing: data, brands and new players deliver disruption

Distribution operating models have not been immune to technology-driven disruption. Leading firms are redesigning their distribution organizations and adopting technology to address the rapid shifts in product demand and service levels across institutional, retail direct and intermediary channels.

From a product perspective, firms are adopting life cycle views and engaging resources from investments, operations, finance, risk, compliance and distribution to thoughtfully assess the end-to-end impact and cost of new product or mandates.

New KPIs and more data

The distribution model of the future will be based on an enhanced set of meaningful key performance indicators (KPIs). As firms learn the power of scalable data architectures, visualization and predictive analytics, they clearly see the need for fewer yet more meaningful KPIs. Firms are working in parallel with sales and marketing, product management, risk, compliance and finance to replace legacy reporting packages with more descriptive metrics based on enhanced internal and external data sets.

A number of models are emerging, offering a range of service levels, from self-provisioning by operations, to customized, timely and streamlined executive reports. All of these feature new data models incorporating voice, unstructured and user experience data from all channels, in addition to enhanced traditional data sets on products, channels and pricing.

Technology and digital channels

The rapidly evolving digital advisor paradigm is providing asset managers with new ways to differentiate service to intermediaries and enter or expand their direct-to-investor channel. Top tier asset managers with strong technology development teams, as well as the largest clearing firms, are developing digital tools to facilitate sales of their products via financial advisors in intermediary channels, as well as directly to investors.

While many asset managers have historically provided tools as part of their value proposition, the level of sophistication and breadth of functionality have significantly advanced from prior generations. As intermediaries trim product lines available on their platforms and investors research suitable products, the ability of asset managers to develop enabling technology for investors and advisors, in particular the independent registered investment advisor channel, will increase.

Successful managers will focus not only on product attributes and required disclosures, but also on further educating investors and advisors. In addition, the evolution of the hybrid digital-human advice model will further tip the scales to asset managers that can both deliver low-cost beta or differentiated alpha products and provide technology that meets the expectations of investors and advisors for a quality digital experience.

Big brands and industry concentration

Brands will become increasingly important across all regions. Globally integrated managers, which currently account for 65% of industry AUM, have generally adopted a product strategy based on low-cost beta, enabling them to maintain weighted average operating margins of 30%-38% during the past five years. Their scale, product capabilities and global distribution also provide for strong institutional asset flows, along with total average annual asset growth rate of 3.46% over the past five years.

The 6.26% five-year annual compound growth rate for the top 25 globally integrated managers serves as further evidence of industry concentration in the largest firms. Beyond the impact of market concentration, the ability of the largest firms to provide multi asset class strategies and non-registered product structures, such as separately managed accounts (SMAs) and comingled trusts (CITs), has mitigated the declining flows from sovereign wealth funds and pension plans. We expect to see the majority of institutional assets flow to the very largest firms, thanks to their ability to deliver low-cost products and as a result of their investments in increasingly sophisticated risk and performance reporting to this channel.
The value of simplicity and flexibility: by simplifying the client experience overall, advisors can effectively extend their reach to the next generation of investors. The key to flexibility is a multichannel model that allows clients to access their financial data from any device at any time – even without human interaction.

A hybrid model – where investors expect to have access to their accounts full time and yet elect for human interaction when desired – is critical for achieving success.

The role of advisors: the best technology solutions are built on full digital straight-through-process, but at any time allow the client to be connected to a human advisor – a demand we see growing in the industry. One-dimensional technology is a thing of the past.

Planning vs. products: the value proposition of advisors has become their ability to develop clients’ financial plans and guide them through the challenges of accomplishing the plan – a contrast from product selection.

Emerging technologies: a current challenge for the industry is how to evolve interfaces with voice to interact with technology or advisors and their clients – like asking Amazon’s Alexa about progress in a college saving fund and Alexa responding precisely and perhaps with advice. We are also big proponents of artificial intelligence (AI) as it will allow the industry to scale advice and financial plans for the mass affluent channel.

The way forward: the objective is to constantly innovate, and operate under the assumption that others are constantly trying to make planning more flexible, simpler and scalable. Non-traditional players may cherry launch solutions based around narrow capabilities or niches.

Multi-boutique managers

The future of distribution for multi-boutique managers is similar. Many of these companies have been able to delay the impact of declining fees as a result of smart beta products. Leading firms are looking to aggregate product, channel and intermediary revenue data across boutiques to inform decisions on M&A, product and channel strategies. While multi-boutique managers have maintained revenue margins in the low 40% range since 2011, they recognize the prevailing downward pressure on fees and are looking for cost efficiencies across the affiliate networks. We anticipate continued M&A activity, as well as innovative cost savings strategies, for multi-boutique structures as they adopt more sophisticated product profitability reporting, client profitability reporting, data analytics capabilities and more selective channel strategies.

For both globally integrated firms and multi-boutique managers, risk management due diligence and ongoing oversight of intermediaries are of paramount concern. The current model requires risk, compliance, operations, distribution, finance and fund administration to coordinate oversight of hundreds – and in some cases thousands – of third-party intermediaries.

Firms have been slow to make improvements, given other areas that represent higher potential cost savings. However, it is likely that they will adopt an intermediary oversight model based on risk profiles, integrated data architectures, and workflow capabilities to replace the current email-based model. The eventual model will enable a risk-based, global monitoring framework and a holistic channel management strategy by integrating revenue, AUM and product data.
Front office: data and technology investments for decision support and differentiation

Nowhere has the need for differentiated talent been more evident than in the front office. Historically, product-led growth through innovation has been sufficient to drive net AUM growth. Whether a firm relied mainly on index, active or smart beta products, the infrastructure for product innovation and investment management has typically included:

- Specialty research
- Asset-class-based portfolio and order management systems
- Many different Excel-based analytics and models
- A proliferation of market data
- Investment risk and compliance monitoring contemporaneous with the investment decision or trade order

This front office operating model has gradually evolved, with infrastructure and personnel costs rarely challenged.

Upgrading technology

EY’s estimate for global average AUM growth over the next five years is 4% to 5%, slightly exceeding the global inflation rate of 2%, exclusive of market appreciation. As a result of this low level of real AUM growth globally, we anticipate asset managers will begin to invest heavily in the next generation of technology infrastructure to support their strategies of either global low-cost scale index and smart beta products or niche alpha-generating products.

The extensions of product lineups will include ETFs, environmental, social and governance funds, CITS, Undertakings for Collective Investment in Transferable Securities, US ‘40 Act and SMAs to address the need for different product cost structures across both retail and institutional channels. These additions will further complicate the operating model. In all cases, speed to market is crucial to attracting flows and quickly passing breakeven.

In Europe, the Middle East, and Africa, the Markets in Financial Instruments Directive (MiFID) II requirements are impacting asset managers’ approach to product design, distribution, front-office and trading and profitability strategy. Increased pressure to sell lower-cost products and provide clients with complete fee transparency has influenced asset managers to be much more cost-conscious in product design. This focus on cost is likely to continue, given the overarching fee pressures and low AUM growth.

As a result, the front office of the future will be driven by data flows and technology environments that are highly integrated from end to end and front to back. To realize that model, wealth and asset managers will take a number of actions, including:

- Replacing in-house custom applications with standard vendor solutions for scale or efficiency
- Partnering with specialty FinTech firms that can attract innovative technology talent to develop specialized analytics capabilities and applications
- Enhancing the controls around user-developed analytics and models
- Replacing the disparate Excel models with a consolidated, scalable data architecture with high-end visualization and data analytics capability

These steps will transform not only the portfolio manager’s desktop, but also enable risk and compliance resources to more proactively assess risk.

Data – the new battleground for differentiation

Streamlining the number of duplicate applications, reducing the number of market data vendors and assessing renegotiation strategies will be high on the data agenda. The most forward-thinking asset managers are using alternative data (e.g., web, app, social media and satellite data) as an early indicator of market sentiment.

The rise of alternative data

The use of alternative data does not come without challenges; asset managers need to seek consistency and predictability in alternative data and understand which sources are most useful to their investment process. Machine learning and artificial intelligence (AI) aim to reduce this challenge through data interpretation solutions that automatically improve with experience.

4%-5%

AUM growth over the next five years (EY estimate)
Asset managers have clearly embraced data as a highly valued asset and embraced the steward of data, once it has been received from back-office platforms, for reporting to portfolio managers, finance, risk, compliance, clients and regulators. As such, the middle office has traditionally been a high-cost function spanning manual processes and disparate applications for trade operations, post-trade compliance, performance reporting, position and cash reconciliation and reporting, corporate action verification, broker reconciliation and master data management.

**New roles for talent and service providers**

The middle office is being transformed as managers increasingly demand outsourcing providers – both traditional custodian asset servicers and nontraditional managed service providers – address the need for data management and oversight solutions. There are a number of challenges in designing the future middle-office operating model, including:

- Complexity of sources and uses of data
- Time-sensitivity of data
- Highly manual asset classes such as bank loans
- Interactions with the front office

In light of these constraints, firms will increasingly reallocate scarce talent to interface with the front office, analyze rather than manipulate data, and oversee third-party middle-office providers.

**Focused technology investments**

Firms are deploying technology to drive value on three dimensions:

1. Operational efficiency
2. Data quality management
3. “Big data” analytics

Highly scalable data and analytics architectures, built on foundational technologies, enable asset managers to aggregate and manage large volumes of external and internal data, including both historical and real-time data. Further, such environments provide capabilities in visualization, drill-down analysis, and time-series analysis. At the same time, voice recognition and natural language processing enable analysis of richer data that previously could not be analyzed.

Leading firms are setting up centers of excellence (COEs) for tools, such as Tableau, that look for events and signals and generate predictive insights not only for operational activities but also for alpha-generating market opportunities that benefit investment teams. Once established, these data models are constantly learning, tuning and generating predictive data for risk management, regulatory compliance monitoring, operational efficiency opportunities and workflow imbalances, all of which were previously hidden in unstructured data.
New operating models and capabilities

In parallel with new technology, firms are advancing the role of the middle office as a bridge between:

- Back-office books and records accounting
- Front-office investment management needs with next-generation investment book of record (IBOR)

While industry adoption of a basic IBOR is still maturing, next-generation tools and capabilities – such as “what-if” IBOR scenario modeling on the portfolio manager’s desktop – are already gaining traction.

Similarly, firms are assessing next-generation models for performance measurement and attribution reporting, as well as reporting to institutional clients retail clients and regulators. Significant changes are underway to enhance the employee experience, client experience, production cycle times and both direct and indirect cost savings. Middle-office operating models are being designed that will enable smarter segmentation of content, enhanced digital experiences and more responsive service levels based on channel, product or mandate profitability and regional requirements.

The digital revolution and trust: trust is built primarily on having client relationships underpinned by delivering performance with a track record and a face-to-face relationship with the investment or client-facing teams. We believe that digitization and technology can potentially help foster trust with clients, but will not replace face-to-face interactions in the institutional space.

Innovation in pricing: more innovative pricing structures will become more prevalent. For example, taking fee structures from the alternatives world and combining them with more index-like management fees. Therefore, if investors are not getting anything better than index fund performance, they are paying something close to index.

On nontraditional competitors: we don’t see these companies becoming large players in the institutional space given client demands for active management, customization and client service. There are also large regulatory burdens and investor requirements for consistent, long-term track records of benchmark outperformance and careful navigation of multiple market cycles.

The need for scale: the costs of compliance and doing business are rising, and only managers with scale to invest in a world-class infrastructure to manage those costs will survive. Some small niche players will always exist, but those stuck in the middle will experience difficulties. Increasingly, the opportunities for managers will be in sovereign wealth, central banks and the newly rich middle class on the retail side, and emerging markets and Asia. That requires a global distribution footprint.

What’s ahead: the asset management world will be much more outcome-oriented. Institutional investors will look to asset managers to provide holistic solutions and care less about performance versus benchmark for specific asset classes. On the retail side, we will continue to see significant net flow into target-date funds and more managed accounts. I think the industry is in the early days in the evolution towards outcome orientation.
Scale and complexity issues dominate the back office. The technology investment required to support top-tier firms as they approach or breach the trillion-dollar AUM mark — with hundreds of net asset values (NAVs) to strike and often thousands of separate accounts to support — forces a strategic decision on sourcing.

The evolution of sourcing and location strategies

Firms have, over the past decade, optimized the 24-hour clock with smart location strategies while also enhancing functionality surrounding the core accounting platforms. In terms of optimal low-cost infrastructure and sufficient resource support, the preferred geographic location is constantly shifting. In the US, tax concessions will continue to drive onshore location options, while China and Malaysia are increasingly an option for global managers.

The number of new countries offshore locations will likely slow as automation continues to expand and dominates the search for efficiency over the next three to five years. We also expect that operational footprint changes to these locations will save up to 20% in the cost base. Sourcing is the area where the confluence of industry changes is more apparent and the opportunity to determine strategic priorities in driving scale and cost efficiencies more impactful.

A new wave of automation

The latest wave of automation and digitization is different from past cycles of innovation. First and foremost, today’s influence of nonfinancial technology firms defines the optimal digital experience for both clients and employees, which necessitates a quick response from operations and legacy technology to new products and asset classes.

Other critical factors reshaping the view of the back office include:
- management’s desire to understand and make decisions based on product-level profitability
- increased scrutiny by risk and compliance
- a shortage of talent across skill sets and locations

As a result, more firms now view back-office management in terms greater than just marginal cost; they are factoring in risk and quality standards and looking to transform the organization.

Outsourcing — from “whether” to “why not”

Large global custodians with asset servicing offerings are key to the next generation of investment firms’ back offices. The question is no longer whether to outsource, but rather “why not” outsource. Those firms already outsourcing are assessing how many more functions can be outsourced and seeking to define the optimal global outsourcing model.

Regional requirements differ and lead to some providers being stronger than others depending on a product’s country of domicile. However, the level of investment in technology and the drive to eliminate human interaction in the recordkeeping process are common across all providers.

As a result, the top asset servicers are in a competitive race to drive technology and automation across their organizations and become the most cost-effective and the “back office of choice” for asset managers of all AUM, product types and geographic footprints.

Meanwhile, asset managers approaching the $1 trillion AUM mark are looking to diversify risk and gain negotiation leverage by dividing their business among two or even three servicing firms. For smaller managers using more than one servicer due to geographic or product differences, consolidating business on one global provider can reduce governance and oversight complexity and offer the advantages in scale pricing.

Potential cost savings from changes to the operational footprint (EY estimate)
RPA, AI and FTEs

A look into the future suggests that striking NAVs and valuing portfolios will be highly automated. Robotic process automation (RPA) offers the opportunity to translate high-value, critical processes into repeatable and logical set of instructions across multiple applications.

Changes in organizational structure from cross-functional process teams to function-specific shared services have provided incremental gains in scalability, as well as a hedge against talent shortages. However, the back office of the future will be highly automated. Today, RPA addresses very tactical needs in day-to-day operations (such as reconciliation processes) in a cost efficient way; a single robot costs about $8,000, approximately one-third of the cost of an offshore full-time employee (FTE), according to the Institute for Robotic Process Automation.

Strategic assessments are underway to design organizations based on machine learning and AI for such roles as valuation and fund accounting. Current fund accountants will be replaced not based on labor arbitrage at a low-cost location, but with machine learning and CPUs. Logical, repetitive and analytical steps executed based on well-defined processes and procedures are rapidly becoming the primary use case for AI and machine learning. With the core accounting process made more efficient, firms will then need to address underlying technology platforms and their ability to scale and flex to meet new product, security and regulatory reporting requirements.

The Investment Company Institute estimates that, in 2015, there were 174,000 fund company employees in the US, of which 10% served in fund administration and fund accounting roles. We estimate that this equates to one basis point in industry headcount expenses just to strike NAVs. Thus, there are clear incentives for both fund companies and asset servicers to adopt automation in the back office and redeploy these skilled resources to other internal oversight and client-facing roles.

Further, RPA, machine learning and AI are all gaining traction within firms. The collaborative requirements and significant dependencies of distributed ledger technology (DLT) and blockchain have slowed industry adoption. However, DLT’s potential to transform the industry cannot be discounted. Specifically, the capability to reshape custody and clearing and further drive cost bases lower is very real and highly compelling. We anticipate the large firms will continue to invest in technology to reshape the industry trade matching and settlement model.

Fund companies and asset servicers have clear incentives to adopt automation in the back office and redeploy skilled resources to higher-value roles.
The bottom line: moving forward with purposeful change

Change presents challenges, as well as opportunities. The winning asset management firms of the future will be those with:

- Focused operating model strategies
- Well-designed infrastructure investment plans
- An understanding of how to harness data and enable analytics to inform decisions across the enterprise
- Forward-looking views of new individual and institutional expectations and how they shape investor experiences

Collectively, these attributes will result in organizational and operating models that are designed to proactively change on a continuous basis and in line with market opportunities, rather than just reacting to change periodically and defensively.

For individual firms, the best path forward will vary, based on strategic priorities, current process and technology maturation, product portfolios, AUM, geographical footprint and other factors. However, it’s clear that all core operations and functions must be assessed and that a holistic transformation involves more advanced use of technology and data, increased automation and new approaches to talent and sourcing. In other words, the changes now taking place are multidimensional, high-velocity and more significant than previous market cycles.

Works cited

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