



## Recovering From The Storm

The New Economic  
Reality for  
U.S. Asset Managers

## Contents

Introduction	1
Impact of the financial crisis on asset managers	5
Restructuring to recover from the crisis	9
Five structural shifts that will change the U.S. asset management industry	17
Taking charge: The management agenda for 2009 and beyond	27



## Introduction

After a quarter century of largely uninterrupted growth and profitability, the recent economic and financial crisis has challenged asset managers in ways not seen in generations. While markets recovered to year-end 2008 levels during the summer of 2009, it is worth recalling that in 2008 the S&P 500 experienced the second-largest contraction in its history, rivaling the catastrophic losses of the Great Depression. The market downturn caused net flows to long-term mutual funds to turn negative for the first time since the 1970s, raising questions about the lasting impact on the U.S. investing culture.

In spite of this, average pre-tax operating margins for the industry held remarkably steady, falling from 33 percent in 2007 to 30 percent in 2008 (27 percent including one-time and restructuring costs). This result, however, masked the rapid deterioration in assets under management (AUM) that occurred at the end of 2008. Most firms expect that 2009 will be worse, with profitability falling by as much as half from its cyclical peak in 2007, due to sharply lower assets and revenues.

The majority of asset managers also anticipate a slow, four- to seven-year recovery in AUM from the low point of the crisis. While firms recognize the gravity of the situation, most have not acted aggressively enough to restructure their operating model. To sustain average historical margins through an expected prolonged downturn and fund necessary investments for growth, firms need to fundamentally reduce costs by as much as 25 to 40 percent. This is more than twice the 10 to 15 percent cost savings firms have budgeted for in 2009, almost all of which stem from lower variable compensation.

To realize enduring savings of this magnitude, asset management firms must consider restructuring their cost base to become more flexible. On the investment management front, this includes moving away from pure revenue-driven compensation models for portfolio managers toward “partnership” models with longer payout horizons, as well as rationalizing sub-scale products and teams. There is also a series of actions firms can take to restructure their non-investment platform costs, including reducing non-compensation expenses, employing lean techniques to resize support functions and overhead, optimizing distribution and marketing and, finally, creating a more flexible professional services organization through workforce management techniques. Of the four

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distinct segments we see emerging in terms of how firms have responded to the crisis and their future outlook, only the handful of “Decisive Operators” have taken such bold actions to restructure their operating costs with notable success.

In addition to taking immediate restructuring actions to become more resilient, asset management executives also need to prepare now for five structural shifts that will continue to profoundly shape the industry over the next three to five years. First, industry revenue yields are likely to continue to fall, by as much as one-third by 2012, due to declining net revenue yields

(caused by increased pressure from distributors and regulators), a shift in client asset allocation towards lower-margin products (e.g., fixed income and passive) and dramatically reduced revenues from alternatives. Second, shifting client needs are also concentrating growth opportunities for asset managers into a few areas such as retirement and select international markets.

For example, consider that in the last recession more than 80 percent of retail flows went into qualified programs (e.g., defined contribution plans and IRAs) for a period of three to four years.

Third, the long-predicted process of consolidation and decoupling of manufacturing and distribution is gathering steam. Over the past decade, pure-play asset managers have steadily gained share from their bank- or insurance-owned counterparts, and are accelerating that growth through recent M&A (e.g., Blackrock – BGI). Pure-play firms now control the majority (63 percent) of assets under management. Fourth, a new super league of advisory platforms has also emerged following a dramatic flurry of mergers in the past year. The top five distribution platforms now control 61 percent of assets (up from 41 percent five years ago) and they haven't even begun to exert their greater bargaining power over asset managers. Finally, asset managers must adjust to a more capital-intensive industry and develop world-class risk management capabilities in light of recent risk-related losses in the billions of dollars, more demanding institutional investors, and potential new capital requirements for money market funds.

Overall, while the asset management industry has remained attractive even through the crisis, the expected slow recovery and longer-term impact of structural changes pose threats to future profitability. Senior executives need to fundamentally transform their firms' operating models, adapt to the industry shakeout, and simultaneously invest in growth and talent opportunities.

We base these findings on one of the most in-depth studies of the economics of the U.S. asset management business. Each year since 2001, McKinsey & Company, in conjunction with Institutional Investor's U.S. Institute, has benchmarked the financial performance of the industry. In 2008, more than 100 firms collectively managing more than \$9 trillion in assets, or almost half the industry total, participated in the effort. In addition, we conducted research this year on how firms are navigating through the crisis, including a detailed survey of 47 asset managers, interviews with senior managers from a dozen firms, and a thorough review of the industry landscape.

This report elaborates on our conclusions and the underlying analytics, covering four major areas:

- The impact of the crisis on the asset management industry in 2008 and the bleak prospects for 2009
- The expectation for a slow market recovery, yet hesitation by most in the industry to take concrete actions to fundamentally restructure costs to sustain profitability through the downturn and fund investments for growth
- The five structural changes that will continue to profoundly shape the industry over the next three to five years, for which firms now need to prepare
- Key considerations for senior executives charting their strategic direction and management agenda.



## Impact of the financial crisis on asset managers

The recent crisis challenged asset managers in ways not seen in generations. In 2008, the S&P 500 saw the second-worst decline its 180-year history as market capitalization fell by 40 percent, rivaling the Great Depression. Along with plunging stock market values, the asset management industry also experienced negative net flows into long-term mutual funds for the first time since the 1970s, raising questions about the lasting effect on the U.S. investing culture. However, because the crisis broke late in the year, average assets and revenues held up and the impact on industry profits was muted. After rising to a five-year cyclical high of 33 percent in 2007, industry pre-tax operating margins dropped to 30 percent in 2008. Including one-time restructuring costs and write-downs, margins fell to 27 percent (Exhibit 1 on page 6).

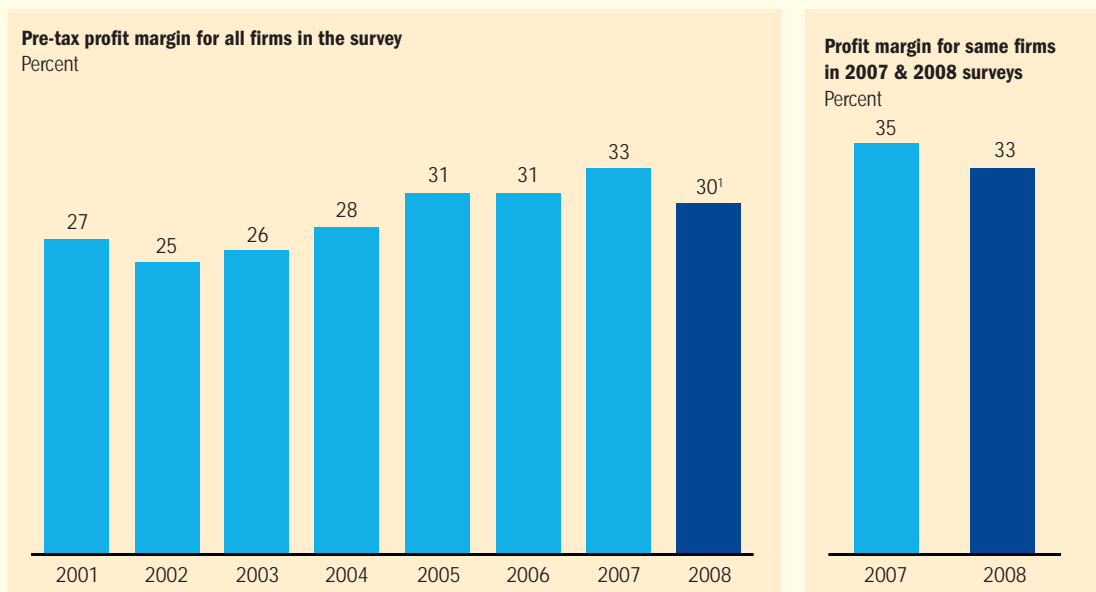
Conditions in the industry have deteriorated rapidly from the early days of the crisis. Third-party AUM began shrinking in the last quarter of 2007 and contracted by near-record amounts at the height of the crisis to end 2008 down 23 percent. All major asset classes, except money market and fixed income, suffered declines in AUM of roughly 30 to 40 percent across both the retail and institutional segments. Markets continued to weaken dramatically early in 2009 and only returned to end-of-year 2008 levels during the summer of 2009.

In addition to the impact of greatly reduced asset values, net revenue yields (revenue per dollar of assets) also declined in 2008. Retail net revenue yields, which have fallen by over 10 basis points (bp) from the start of our survey, dropped from 46 bp in 2007 to 43 bp in 2008 due to an ongoing decline in net revenue yields across most core asset classes. Institutional net revenues also declined, from a peak of 41 bp in 2007 to 39 bp, following similar-sized drops in large cap equity, money market, and pure index funds, along with a greater than 100 bp collapse in revenues from hedge fund performance fees. Adding to these revenue woes was a dramatic shift in asset mix on both the retail and institutional side. The share of assets and revenues from lower-yielding fixed income and money market jumped, largely at the expense of equity and higher alpha products.

Most asset managers expect profitability in 2009 will be much worse than 2008, as firms are struggling to ratchet down their costs in line with sharply

Exhibit 1

### Operating profit margins: The end of a 5-year growth cycle for asset management firms



<sup>1</sup> Profit margin including one time expenses = 27%

Source: 2009 McKinsey/USI AM benchmarking survey

lower AUM and revenues. In 2008, firms reduced costs an average of 4 percent, and expect to cut only another 10 to 15 percent this year (versus analyst expectations of 20 percent or more). Because of the combination of these relatively limited cuts and expected further declines of 15 to 25 percent in average assets and revenues, firms anticipate profits will deteriorate an additional 25 to 45 percent in 2009 (Exhibit 2). In such a revenue environment, firms would need to reduce costs by a total of 25 to 40 percent to maintain margins at their average over the last cycle.

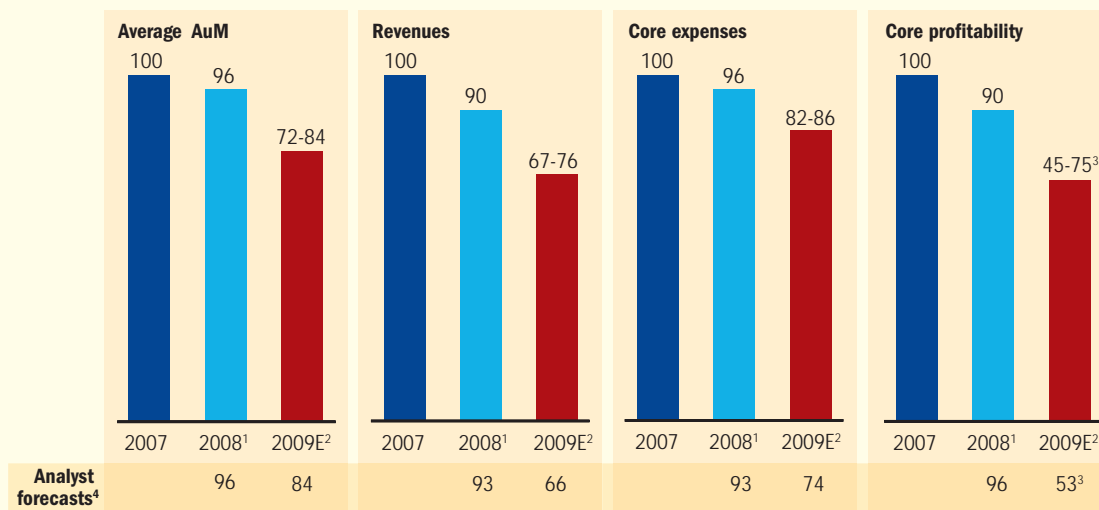
Moreover, all cost savings in 2008 came from lower compensation expense. In fact, while firms reduced bonuses and long-term incentive payments by 10 percent, non-compensation costs actually increased. Headcount remained unchanged after two years of double-digit increases. Similarly, firms seem to be relying primarily on cuts in variable compensation to reduce costs in 2009. Reductions in headcount and non-comp expenses are expected to be only in the 5 percent range.

A major factor in the growth in non-compensation costs is the cost of operations and technology. More than two-thirds of firms saw these costs rise in 2008 often due to infrastructure investments initiated long before the start of the crisis, driving up overall operations and technology costs/AUM for the third year in a row. Not surprisingly, firms have budgeted an average reduction of zero to 5 percent in these costs for 2009.

Exhibit 2

**Most asset managers are struggling to realign their cost base to lower assets and revenues**

100 = 2007 results indexed



<sup>1</sup> Averages of same firms in 2007 and 2008 benchmarking surveys

<sup>2</sup> Averages as reported in the McKinsey "Navigating the storm" survey

<sup>3</sup> Mathematically derived range based on changes in revenues and costs; Average index value from the "Navigating the storm" survey = 68

<sup>4</sup> Analysis includes Legg Mason, Franklin, BlackRock, Janus and T. Rowe; Values weighted by revenue of each player

Source: McKinsey/USI 2009 AM benchmarking survey; McKinsey "Navigating the storm" survey



## Restructuring to recover from the crisis

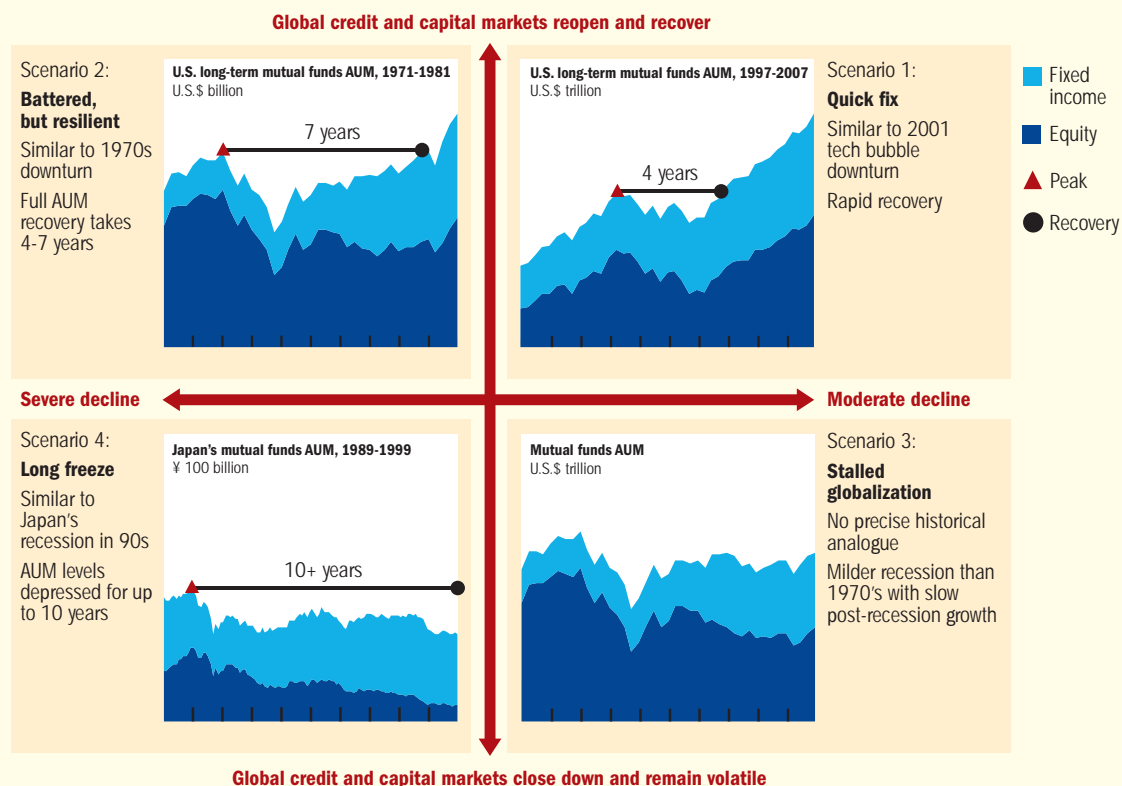
The outlook for global and U.S. markets remains highly uncertain. To better understand the pace of economic and AUM recovery, we modeled four economic scenarios based on the severity of the recession and the extent to which global credit and capital markets recover (Exhibit 3 on page 10). What has distinguished past crises is less their severity and more their duration (in 2001, it took AUM four years to recover; in the 1970s, seven years; and in Japan, 10 years and counting). When we tested these scenarios with firms, nearly two-thirds said they expect there will be a slow “Battered but Resilient,” 1970s-style recovery of AUM in four to seven years. However, another third believe a more negative “Stalled Globalization” or a “Long Freeze” scenario is likely, implying an even slower recovery of AUM. Less than 10 percent of firms predict a quick rebound.

While many asset managers understand the gravity of the situation facing them, few have taken the necessary actions on costs to sustain margins and fund investments in talent and growth. Indeed, the results of our “Navigating the Storm” survey show that four distinct segments of firms are emerging based on their responses to the crisis. Of these, only one segment has acted quickly to reduce and restructure costs by anywhere near enough (Exhibit 4).

- **Decisive Operators:** Firms that have acted aggressively to restructure their operating costs in light of revenue declines. Interestingly, they are also the most optimistic about economic recovery.
- **Trimming the Sails:** Firms with revenue declines similar to those of Decisive Operators, but with middle-of-the-road cost restructuring.
- **Depressed and in Denial:** Firms that are most pessimistic about recovery, yet have barely made a dent in reducing costs.
- **Marginally Impacted:** Firms that are well-positioned due to their business and asset mix and have not needed to take much action on costs.

Exhibit 3

### A full recovery of assets under management is not likely for the next 4 to 7 years



Source: 2009 McKinsey/USI AM benchmarking survey

What differentiates the Decisive Operators from other segments suffering similar declines in assets and revenues is how fast these firms have responded to the crisis and how they have led the way in all of the fundamental types of restructuring actions we tested (Exhibit 5 on page 12). The remainder of this chapter describes the five restructuring actions most firms should consider taking.

### 1. Restructure investment management costs

Not surprisingly, investment management (IM) compensation expense is the largest cost for a typical asset manager, accounting for over 9 bps of costs or more than one-third in total. Although over half of IM compensation in 2008 was theoretically variable (bonus and long-term incentives), firms have discovered that while these costs were highly variable as markets rose during the bull market years, they were far less so as markets declined.

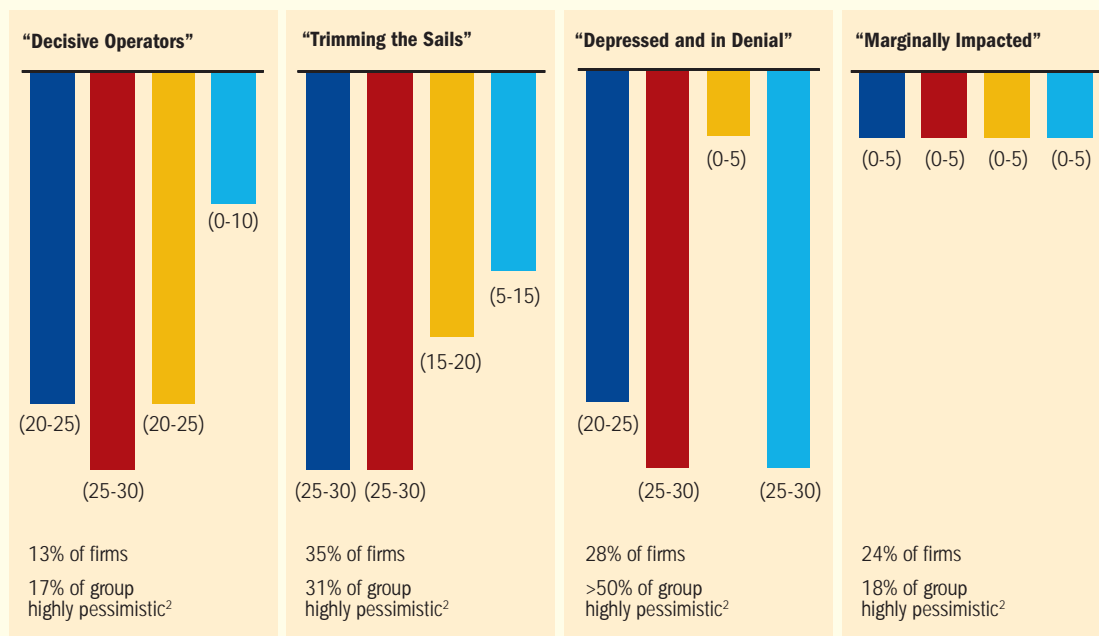
Increasingly, firms are using the best talent market in decades to take a hard look at the structure and level of their investment management costs. We expect that firms will move away from revenue-based compensation

Exhibit 4

### Only a few asset managers have used the crisis to make meaningful changes to their operating model

Expected change, 2009 versus 2008

Percent



<sup>1</sup> Mathematically derived average change in profits: Decisive = 25-52, Trimming = 47-52, Depressed = 68-95, Marginally = 0-5

<sup>2</sup> Percent of firms that believe “stalled globalization” or “long freeze” are the most likely economic scenarios (e.g., longest time-frame for economic and AUM recovery)

Source: 2009 McKinsey/USI AM benchmarking survey; McKinsey Navigating the Storm survey

models for portfolio managers toward “partnership” models with bonuses paid over longer time horizons and based on long-term risk-adjusted performance and overall firm and team economics. There will also be more deferrals of payouts as opposed to traditional end-of-year payments. For example, more than two-thirds of Decisive Operators have recently revised or are considering changing compensation models for their investment professionals to offer more non-cash and longer-term incentives, compared to 56 percent of firms in the Trimming the Sales segment, and only 31 percent of those who are Depressed and in Denial.

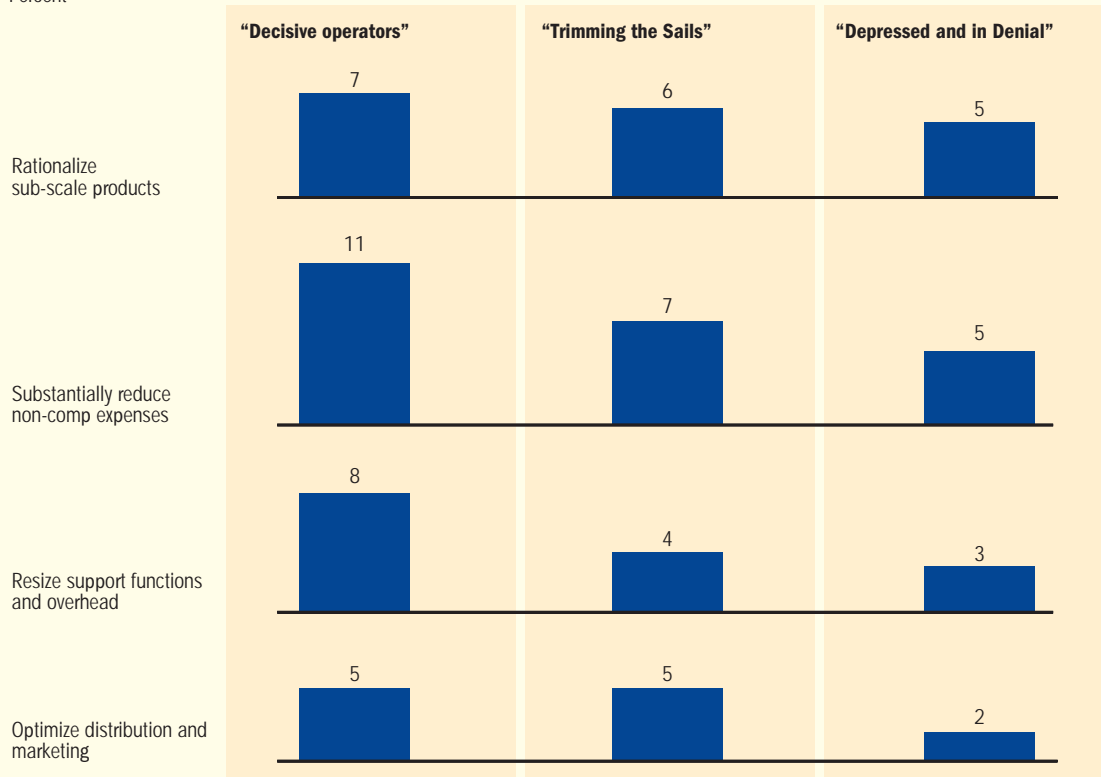
In addition to lower investment management costs, there are often equal or greater reductions possible in middle- and back-office expenses. Our annual benchmarking surveys have consistently found that scale effects are typically realized at the investment strategy and vehicle level rather than the firm level. Firms with the greatest investment strategy scale outperform others by up to 14 margin points. Decisive Operators have already taken the lead in realizing the greatest savings from rationalizing sub-scale products and teams.

Exhibit 5

### Decisive operators have taken the most aggressive restructuring actions

Savings from actions taken, 2008/09E

Percent



Source: 2009 McKinsey/USI AM benchmarking survey; McKinsey Navigating the Storm survey

## 2. Reduce non-compensation expenses

Asset managers have not historically focused on rigorously managing non-compensation expenses, which now account for one-third of total costs – equal to investment management compensation costs. Five actions that Decisive Operators have focused on include: better managing demand or consumption of procured goods and services, such as travel, hardware and software; bringing transparency and consistency to vendor relationships

across the firm, allowing the sharing of best practices; renegotiating vendor spend categories; managing IT infrastructure expenses; and renegotiating fees for funds and products with the largest partners.

The trick is to take these actions in a consistent, strategic and sustainable way. There is, for example, a substantial difference between negotiating vendors down to the last penny versus forming strategic sourcing partnerships.

Decisive Operators have used techniques like these to reduce non-compensation expenses in 2008-09 by more than 10 percent – almost twice as much as other firms. In our experience, asset managers should be able to realize even more – 10 to 15 percent cost savings in non-IT areas and 15 to 25 percent in IT in as little as 6 to 18 months.

### 3. Resize support functions and overhead

Asset managers can also restructure costs by resizing support functions such as finance, human resources, marketing and legal. These functions can be quite large and have grown in

line with increasing AUM over the years. Opportunities exist to apply lean principles to streamline the operating model (e.g., assess what should be dedicated to businesses versus pooled in a shared utility), increase leverage of low-cost high-skill locations (e.g., near-shoring or offshoring, potentially through external providers), eliminate duplicative efforts, and further automate process steps.

As with other restructuring actions, Decisive Operators have been the most aggressive in resizing their support functions, generating average savings in 2008/09 of 8 percent – more than twice that of other firms. Our experience with clients is that firms can shave as much as 15 to 30 percent off these costs, while delivering significant improvements in effectiveness, service and quality.

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#### 4. Optimize distribution and marketing

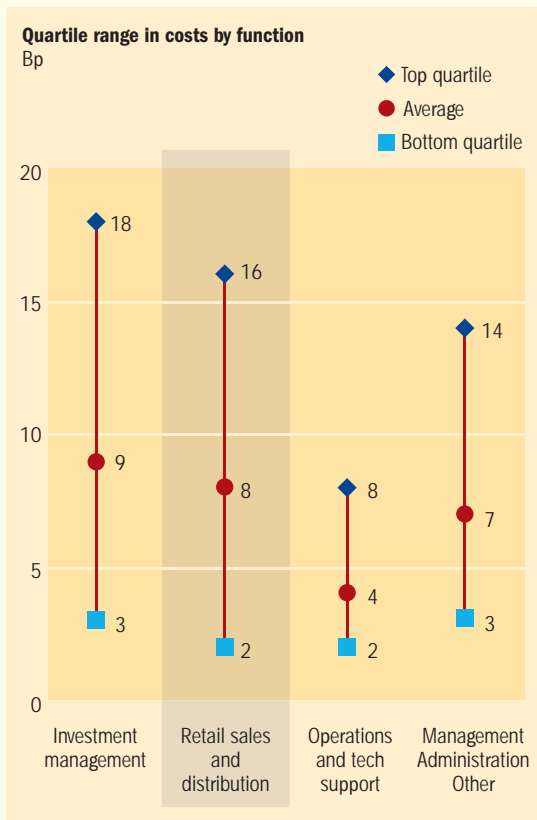
Some asset managers have begun tackling the challenge of improving the link between distribution effectiveness and firm profitability in retail asset management. For example, firms are increasingly questioning the core compensation formula for sales professionals (based on gross sales) and replacing it with more net-flow and profit-based components. Distribution support ratios are also under scrutiny. Given the low correlation between support ratios and productivity (Exhibit 6), firms could benefit greatly from entirely rethinking their distribution models. Similarly, retail marketing spend is transforming from an art to a science, borrowing from techniques pioneered by credit card companies, to pinpoint demand among segments of advisors and orient the sales force around the highest potential opportunities.

Decisive Operators are also leading in both of these areas. These moves can help firms to gain efficiency savings of 15 to 20 percent.

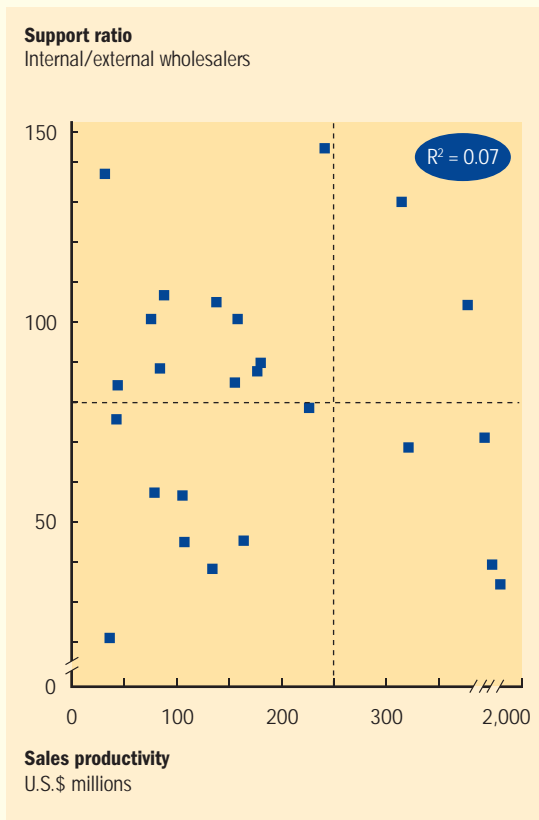
Exhibit 6

### Retail sales and distribution costs vary greatly and there is low correlation between support ratios and productivity

Variations in retail sales and distribution costs...



... Support ratios versus productivity



Source: 2009 McKinsey/USI AM benchmarking survey

**5. Create a more flexible “professional services” organization with fewer layers through workforce management techniques**

Asset managers can use workforce management techniques to fundamentally reduce compensation costs and create a more nimble organization, with clear accountability and decision-making channels and fewer layers. Benchmarking across the company and against similar competitors can help identify areas ripe for change. These typically include groups where there are a significant number of managers with spans of less than four direct reports, or more than eight layers of management (across both businesses and functions) between the CEO and frontline employees. Given that compensation represents as much as two-thirds of an asset manager’s cost base, streamlining the organization – while the most aggressive of the actions – can reduce compensation costs by 10 to 20 percent.



## Five structural shifts that will change the U.S. asset management industry

The lasting impact of the financial crisis will be shaped primarily by five structural shifts, rather than by the pace of the market recovery. In addition to taking immediate actions to strengthen resilience, asset management executives need to prepare their firms for success in an altered market landscape.

### 1. Net revenues are likely to continue to decline by as much as a third by 2012.

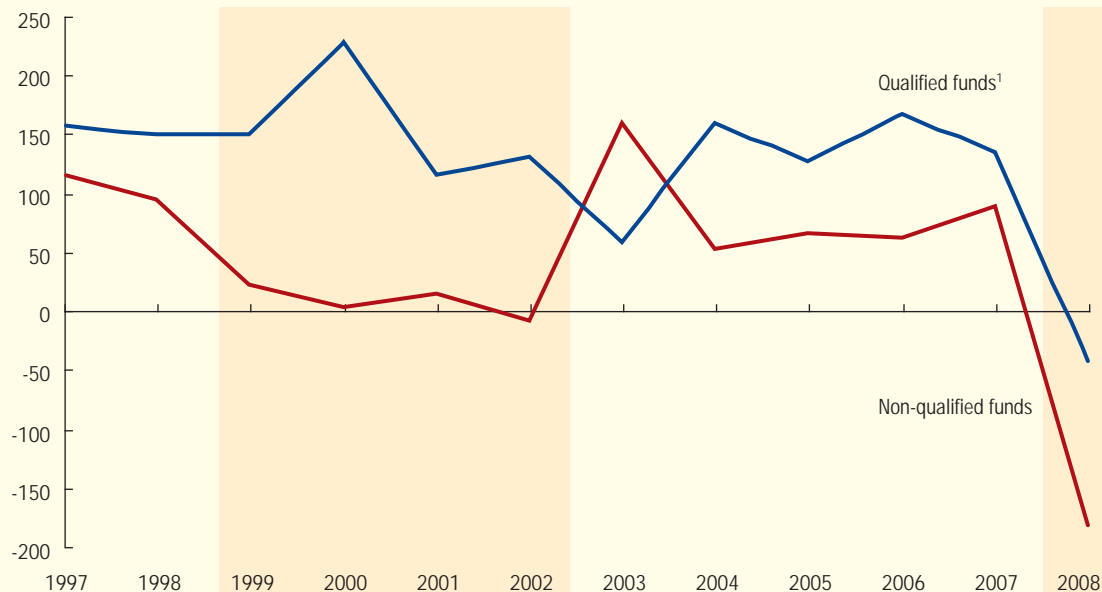
While the crisis has already resulted in significant declines in asset management revenues, structural factors are also driving industry revenue yields (net revenues over AUM) down. As noted previously, retail net revenue yields have experienced downward fee pressure over the past eight years of our benchmarking survey, as have some core asset classes within the institutional sphere. Most players expect this trend will continue. Moreover, while the mix of assets dramatically shifted in 2008 due to the crisis, investors are expected to make longer-term shifts in their asset allocation towards lower-margin products such as fixed income, cash and passive funds. At the same time, revenues from hedge funds, fueled by a “2 and 20” model and easy leverage, dramatically boosted institutional revenue yields, even for traditional asset managers. But, given high-water marks, less leverage and greater transparency, the hedge fund industry will likely have a revenue pool that is half of its 2007 levels.

As a result of all of these trends, we forecast that by 2012 net revenue yields could fall 10 to 30 percent in retail and 10 to 20 percent in institutional. The implication of this “new normal” is clear: firms need to model the potential impact of structural revenue declines on their businesses and adapt accordingly.

Exhibit 7

#### Flows to qualified account funds remained steady at over \$100 billion annually during the last recession, while non-qualified flows fell sharply

Net flow, long-term funds  
U.S.\$ billions



<sup>1</sup> Qualified defined as Defined Contribution, Defined Benefit and IRA accounts  
Source: Investment Company Institute, 2008 data based off ICI/Flow of Funds

**2. Industry growth will be concentrated in a few specific product and client segments.**

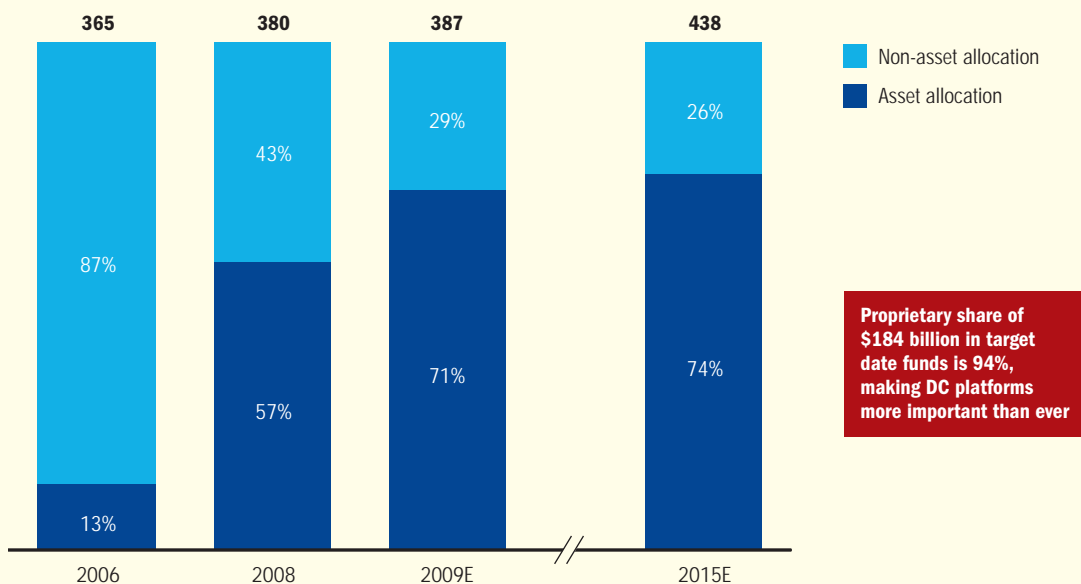
While the near-term outlook for asset managers is challenging, there are clearly opportunities for growth – but these will be in more targeted, concentrated areas than in the past. Firms that selectively invest in new products or specific segments (or improve investment performance in these areas) could tap into significant new engines of growth. Some examples include:

**Qualified assets.** We expect more than 80 percent of net flows in the U.S. retail asset management market in the next three to five years will go into qualified funds (defined contribution and IRAs). For a period of three to four years during the last recession, qualified flows dominated the industry as investors continued to save for retirement within qualified funds, but shied away from investing directly in retail markets (Exhibit 7). However, since the introduction of QDIAs, DC assets have increasingly become proprietary: target date and other asset allocation funds now capture 71 percent of all DC inflows (Exhibit 8) and over 90 percent of target date funds are in proprietary programs. Barring any regulatory change, owning a DC platform will continue to be an increasingly important advantage to capturing consistent flows.

Exhibit 8

**DC platforms are increasingly crucial as asset allocation funds now capture three-quarters of DC flows, and nearly all such funds are proprietary**

**Asset allocation funds as a percent of DC inflows<sup>1</sup>**  
U.S.\$ billion



<sup>1</sup> Excludes managed accounts. Includes asset allocation inflows plus switching  
Source: Pensions & Investments, McKinsey analysis on the future of Defined Contribution

While DC has moved toward “guided” architecture, IRAs, which account for 40 percent of qualified flows, remain relatively open, creating opportunities for retail asset managers to participate. DC platforms still have some natural advantages especially as they improve their IRA rollover capture rates, but retail investment firms can develop innovative solutions – focusing especially on what happens when consumers reach their “target” retirement date.

**Passive products and ETFs.** ETFs have been one of the “must-have” vehicles of the past decade, growing into a \$700 billion market globally. Yet the ETF market has remained remarkably concentrated (as have passive investments overall), with the top five players controlling over 95 percent of assets. Some of this concentration has been compounded by hedge funds, which have become one of the largest buyers of ETFs, seeking funds with the greatest liq-

uidity. While niche ETF offers (with leverage, shorting, and actively managed characteristics) have proliferated, none have gathered meaningful share to date. Going forward, ETFs will continue to be a growth business, but will remain highly linked to the future of passive investments, and in all likelihood the growth will remain concentrated among a handful of players. New entrants will need to consider how to incorporate ETFs into overall portfolio construction or how to innovate for particular segments (e.g., broker-sold UMAs) if they are to participate in this growth.

Pure-play asset managers have made dramatic gains in market share over the past decade.

In 1998, these firms accounted for just over one-third of the market.

By 2007, their share had grown to more than half due to faster organic growth.

**Outcome-oriented products.** The industry is ripe for product innovation, not least because so many products failed to deliver on their promises during the crisis. According to McKinsey’s 2009 Consumer Retirement Survey, investors appear to be looking for more outcome-oriented ap-

proaches and moving away from benchmarks. For example, signaling a shift from the past, 60 percent of surveyed DC participants are interested in having an investment option that provides guaranteed income in retirement, and this interest is even stronger for younger pre-retirees (aged 45 to 55 years). If legislation starts to follow this need (for example, permitting guaranteed-income options as QDIAs), we could see significant demand for income-oriented products and a range of target-driven solutions.

**International flows and sovereign wealth funds.** While 2008 was a tough year for international investing, asset growth in markets outside the U.S. will likely continue to outpace domestic growth. Unlike in the past, however, growth will be concentrated in a few markets, pressuring asset managers to take a hard look at their footprint and concentrate on three to five regions and client seg-

ments where they can cost-effectively achieve double-digit growth. For example, sovereign wealth funds, which have grown over the past decade at 18 percent annually, will likely continue to be a major growth market. In 2007, sovereign funds were roughly one-third of the size of the U.S. mutual fund market; in 2008, while mutual funds dropped, sovereign fund accounts in aggregate held steady and are now roughly half the size of the mutual fund market. Most leading asset managers have “sovereign wealth” efforts underway, but very few have focused on this market anywhere near its true potential.

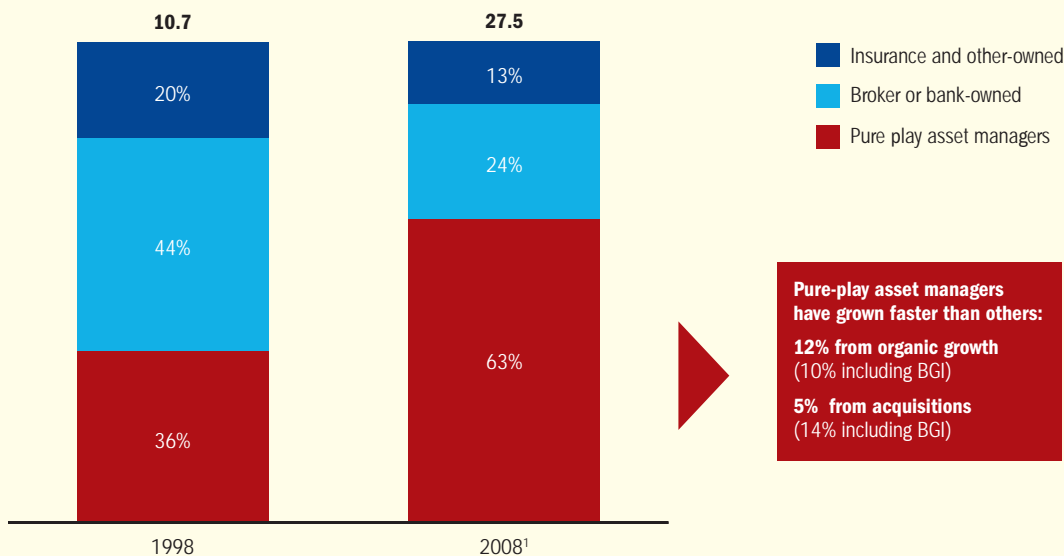
**3. The industry is becoming increasingly concentrated and dominated by “pure-play” asset managers.**

Pure-play asset managers – those not owned by another financial institution such as a bank or insurance company – have made dramatic gains in market share over the past decade. In 1998, these firms accounted for just over one-third of the market. By 2007, their share had grown to more than half due to faster organic growth. The BlackRock/BGI transaction accelerated this trend of course, with nearly two-thirds of assets now controlled by pure-play asset managers (Exhibit 9). This trend will almost certainly continue, as banks, brokerage houses and insurance companies divest their asset management units to generate cash and achieve greater focus. In several cases, private equity firms are becoming enablers of this divestiture.

Exhibit 9

**Pure-play asset managers have gained share and grown faster**

Asset share of top 50 U.S. asset managers  
U.S.\$ trillion



<sup>1</sup> Banks include JP Morgan, PIMCO (Allianz), and Goldman Sachs. All others in the 2008 top 10 are Independents: BlackRock/BGI, State Street, Fidelity, Capital Group, BNY Mellon, Vanguard, and Legg Mason. Note that BNY Mellon and State Street have been classified as pure-play asset managers as they have focused their business models around custody/investor services and asset management. Also, figures include impact of BlackRock-BGI transaction, although announced in 2009

Source: Institutional Investor; SNL Financial; McKinsey analysis

The increased concentration and scale of the leading pure-play asset managers has a number of potential implications for industry structure. First, while successful asset management firms will continue to exist within insurers and universal banks, there will be a greater onus on these firms to realize true synergies with their parent. Second, as pure-play firms have grown from partnerships or family-owned enterprises into significant, complex financial institutions in their own right, there will be a greater need to ensure their culture and organizational processes can scale across thousands of professionals spanning dozens of geographies. Finally, it remains to be seen how larger players will use their scale advantages: so far cost synergies have been muted in asset management, but these mega-scale firms could use pricing power or distribution power to their advantage in new ways.

#### 4. Distributors are also consolidating rapidly, further pressuring asset management economics.

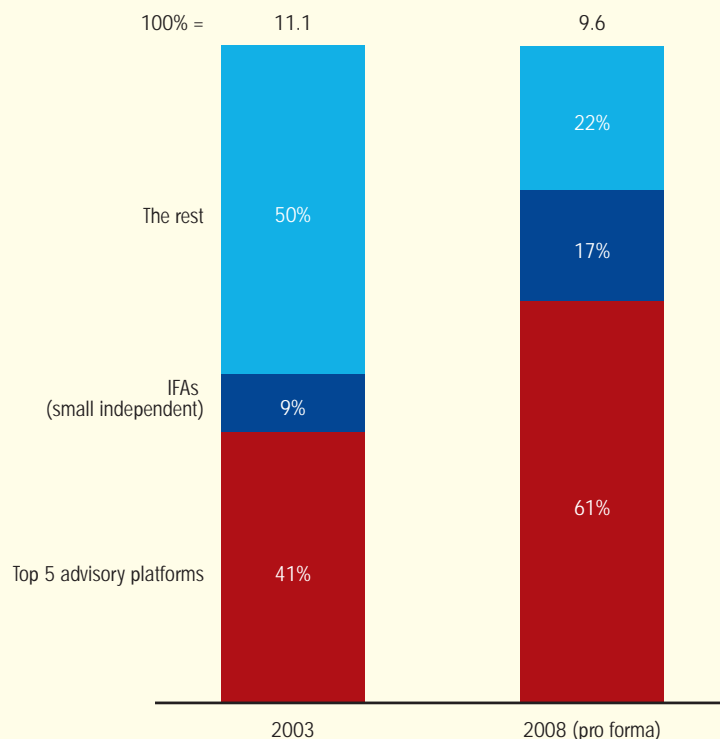
As a result of both consolidation and organic growth, the five leading advisory platforms – Morgan Stanley, Merrill, Schwab, Fidelity and Wells Fargo

Exhibit 10

### Consolidation is creating a league of super distributors

Total client assets as percent of total U.S. household assets in selected products

U.S.\$ trillion



Source: U.S. Federal Reserve Flow of Funds Accounts; Company filings; McKinsey estimates; Cerulli Associates

– now collectively control more than 60 percent of U.S. household assets, up from 40 percent just five years ago (Exhibit 10). This fact has two implications for the asset management industry. First, the top players control a growing share of assets through wrap accounts (more than 20 percent in 2007), for which they pay lower institutional prices to retail asset managers. Second, these players are almost certain to exert their

Despite ever more complicated approaches to risk management in the past decade, asset managers have been hit hard by recent risk-related losses in the billions of dollars. But losses to date are only the tip of the iceberg.

increased bargaining power to renegotiate revenue sharing arrangements, further driving down retail net revenues for asset managers. Given the importance of revenue sharing to an advisory firm's profits and a 10-point margin disparity between leading advisory firms and average asset managers, it is likely that these wealth managers will make renegotiating revenue sharing a high priority.

Left alone, these renegotiations are likely to further increase asset managers' sales and marketing costs. Our annual benchmarking surveys show that retail sales and marketing costs as a percent of revenue have steadily crept up from 14 percent in 2005 to 18 percent in 2009. Marketing and distribution has served firms well in bull markets, but few firms

have stress-tested their distribution model against changing revenue sharing and institutional pricing, concentrated flows and flat market environments. Some firms have discovered a need to overhaul the whole economic model of retail distribution. For example, compensation arrangements will need to gravitate away from gross sales, toward net sales and tighter links to firm profitability and long-term incentives; marketing spend will need to be more carefully targeted toward certain segments of advisors where potential is greatest; and sales models will need to move away from the traditional 1:1 ratio of internal to external wholesalers, toward closer alignment with the underlying profitability of each channel.

##### **5. Innovations in risk management and stronger balance sheets are a new reality.**

In 2008, write-offs and other extraordinary items wiped out three points of margin on average and more than \$1 billion for some firms. Whether it was from money fund losses, principal risks embedded in the business or volatility from performance fees, 2008 challenged the conventional wisdom around asset manager earnings stability. Going forward, firms will not only need to avoid repeating past risk mistakes but also adopt a more activist approach to risk management.

**Risk management.** Despite ever more complicated approaches to risk management in the past decade, asset managers have been hit hard by recent risk-related losses in the billions of dollars. But losses to date are only the tip of the iceberg, as players are exposed to new investment and business model risks following the crisis. For example, reduced investor confidence in asset diversification as their sole risk management technique is creating demand for product innovation and a movement from pure asset management to managing to specific outcomes (e.g., capital preservation, inflation protection). In addition, firms will need to focus on a range of new business risks brought on by greater business and capital markets complexity (e.g., earnings volatility from performance fees, principal risks, liquidity risks, implicit/explicit contingent obligations related to legal or reputational issues).

However, according to a recent McKinsey/U.S. Institute survey on the topic, asset managers do not believe their risk management practices are adequate to manage their exposures. Common problems cited include the risk function's inability to influence key business decisions, such as new products, and a lack of transparency on key risks. The research clearly found that asset managers across the board (i.e., firms of all size, asset class focus, and types of ownership structure) need to modernize their approach to risk manage-

Exhibit 11

### Asset managers need to modernize risk management processes across four fronts



Source: McKinsey/US Institute Risk Management Survey

ment. For example, firms scored an average of 53 out of a total of 100 on our proprietary Risk Management Quality Index, and the scores did not vary much by type of firm. Improvement is not simply a matter of adding to the existing team or enhancing risk analytics. Rather, firms need a holistic approach that upgrades risk capabilities across four fronts: insight and strategy; governance, organization and processes; culture; and finally, measurement and reporting (Exhibit 11).

**Stronger balance sheets.** 2008 also called into question the notion that asset managers did not need a strong balance sheet. Nowhere was this more evident than in the money fund business, where firms backstopped their implicit commitments to avoid “breaking the buck,” often at a cost of several hundred million dollars or more. Those with balance sheet support were able to maintain their commitments from parents, others had to raise capital to do so, and others without support exited the business. While the regulatory outlook on money funds is still uncertain, especially some of the G30 calls to regulate money funds as banks with bank-like capital and guarantee provisions, balance sheet management is likely to be a new reality for most asset managers. Investor demand for guarantees is also driving the need for stronger balance sheets. As mentioned previously, McKinsey’s 2009 Consumer Retirement Research shows that both retail and institutional investors are increasingly seeking guaranteed and outcome-oriented products in the wake of the enormous uncertainties of the past year. Asset managers with balance sheet strength and product innovation skills to meet these demands should do well, particularly in a retirement context.



## Taking charge: The management agenda for 2009 and beyond

The dramatic cyclical and structural changes facing the asset management industry will challenge the ability of all players to adapt. Significant differences have already emerged in the economic performance of winners and losers (e.g., Decisive Operators versus Depressed and in Denial). Senior executives must focus their management agenda on ensuring that their firms survive what most expect will be a slow recovery and make the investments for growth that will allow them to prosper in the new economic reality. Specifically, senior management teams should be asking five critical questions and developing action plans around the answers.

First, what are the market, AUM and revenue scenarios that could occur and how resilient is the firm's business model to a prolonged downturn, continued high market volatility, macro-economic shocks (e.g., inflation), and/or secular changes (e.g., erosion in revenue yields)? Management teams often have a consensus or majority view on the likely scenarios, but can still fail to act on their convictions or to plan for lower-probability, higher-impact events (especially on the downside).

Second, is the firm taking restructuring actions to make its cost structure more resilient and flexible in a range of broader recovery scenarios? Specifically, can firms redesign their operating models to

While firms understand the gravity of the situation, most have not responded sufficiently to fundamentally restructure their operating model. While acting to survive the crisis and slow market recovery, asset managers must adapt now to the structural shifts that will continue to profoundly shape the industry over the next three to five years.

fundamentally transform costs to be more variable, more flexible and more responsive to changing client needs? And is everything being done to address not just compensation, but also non-compensation related expenses?

Third, if firms can no longer rely on market appreciation to fuel growth, what are the pockets of changing client demand that hold the most opportunities? For example, how can we capitalize on a surge in qualified fund flows? Are there innovative outcome-oriented or guarantee products the firm is well-positioned to offer? What are the best selective bets to make internationally? Are we resourced in proportion to the size of the opportunities (for example to serve sovereign wealth funds)?

Fourth, how will M&A, divestures and joint ventures change the game? While the long predicted consolidation boom appears to be gathering steam, firms need to assess the true benefits of merging or divesting. Will there be greater opportunities for

smaller, focused players as retail sales institutionalize? Will balance sheet strength increasingly become important?

Finally, does the organizational model of the asset management firm need to evolve? As firms grow from several hundred professionals to several thousand, can their partnership roots remain intact? Can multi-boutique firms capture growth opportunities across their firms? How

can new talent be drawn into firms and compensation models be made more “partner-like” with greater back-end benefits tied to firm goals?

\* \* \*

In the aftermath of the worst economic and financial crisis since the Great Depression, most asset managers are expecting an extremely challenging year in 2009, followed by a slow and tough recovery. While firms understand the gravity of the situation, most have not responded sufficiently to fundamentally restructure their operating models. While acting to survive the crisis and slow market recovery, asset managers must adapt now to the structural shifts that will continue to profoundly shape the industry over the next three to five years. In short, asset managers should begin to fundamentally transform their operating models, adapt to the industry shakeout, and simultaneously invest in growth and talent opportunities.

Just as Darwin found that survival of the fittest was not necessarily a function of being the strongest or the most intelligent, but rather the most adaptable species, the need for senior executives to adapt quickly to the dramatic changes facing the asset management industry is profound.

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