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Agenda

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An industry in flux: the future of asset management

Where in the value chain of the asset management industry are the leading trends occurring? How and why are the trends taking place in terms of specific drivers, incentives, underlying structural mechanisms, and strategic choices made by different players? A new Oxera report for the European Commission considers these trends, particularly with respect to emerging and existing risks to the asset management industry itself, as well as in relation to competition, integration of financial markets across Europe, and the impact on the end-investor

In a comprehensive new study for the European Commission's Internal Market Directorate, Oxera has reviewed the main developments in the asset management industry over recent years and identified the key structural trends that are likely to shape the industry in the future. The focus of this pan-European investigation is where in the asset management value chain (core asset management, distribution and back office) the current trends are occurring, and how and why the trends are taking place in terms of driving forces, incentives, underlying structural mechanisms, and strategic choices made by different types of player. This article provides an overview of some of the main findings, discussing first the drivers of change, followed by a look at the trends in core asset management.[1]

Drivers of change

The asset management industry in Europe has undergone a fundamental transformation over recent years across all parts of the value chain. In response to turbulent events in financial markets at the turn of the millennium, new competitive pressures, rapid financial innovation, and accompanying changes in investor demand, the industry has adopted new business strategies and adjusted its long-standing business models.

The downturn in the financial markets at the turn of the millennium has been one the key drivers behind the industry transformation. In particular, it had at least two important effects on the core asset management activities, which have had a permanent impact on the industry as a whole:

– it resulted in falling revenues and profits due to poor performance, market downturn, and competitive pressures;
– it stimulated investors' exploration of new markets and products. Additional driving forces have emerged from changes in consumer preferences, regulation and pension reforms.

Investors' demand for asset management products appears to have changed significantly. The complexity of institutional investors' needs as well as their ability to be more actively involved in the design and monitoring of their portfolios have increased. Similarly, private banking clients increasingly exhibit greater sophistication. As a result, incentives to shop around for the best-performing products and funds, and to diversify into alternative investments and other new types of product, have increased substantially following the market downturn.

However, for retail investors, a direct increase in sophistication such as that of institutional or private banking clients is less evident. In most EU Member States, retail clients still appear to be heavily reliant on their local banks for investment decisions. Although there are some signs of change, such as the growth of alternative distribution channels (eg, fund supermarkets), retail clients are still not particularly inclined to shop around for value for money. Nevertheless, developments, such as the growth of open architecture in private banking—ie, banks opening their distribution networks to third parties (other banks)—and the increasing importance of assemblers/intermediaries (firms positioned between asset managers and distributors) in the fund manufacturing function, are having an indirect

This article is based on 'Current Trends in Asset Management', report prepared by Oxera for European Commission DG Internal Market and Services, October 2006, available at www.oxera.com.

effect by producing market outcomes similar to those that would have resulted had retail investors directly become more sophisticated.

Beyond changes in investor demand, the introduction of Management Company and Product Directives, commonly referred to as 'UCITS III' (Undertakings for Collective Investments in Transferable Securities), and reforms of the European pension systems represent further critical drivers of change. UCITS III regulations have allowed funds to invest in a wider range of financial instruments and contributed to the reduction in barriers to cross-border marketing of funds and provision of management services.

The impact of pension reforms is already significant and is likely to increase. The implications for the asset management industry include increasing the amount of funds under management, substitution between traditional asset management products and pension products, and stimulation of product innovation. Going forward, the response to the European pension challenge might become the most important driver shaping the industry value chain. However, a true single market for pensions might not be possible without the creation of pan-European pension products, which is being facilitated by the initiatives such as the European Personal Pension Account (EPPA) and European Pension Plan put forward by the European Fund and Asset Management Association (EFAMA) and the European Financial Roundtable (EFR). Potential success in the development of a pan-European pension market might also have further implications for overall industry efficiency and the level of financial integration.

Trends in core asset management

Among other trends, the key developments to have a significant impact on the shape of the core asset management segment of the value chain include the separation of manufacturing and distribution into discrete businesses; the emergence of intermediaries, assemblers and aggregators[2] providing business-to-business services to both manufacturers and distributors; and fragmentation of the core asset management activity into ‘pure’ manufacturing and sub-advisory (ie, where the asset manager acts in a consultancy capacity). The resulting effects range from shifts in the internal organisation of the fund management process to the development and marketing of new products—some of these considerations are discussed below.

Increasing diversification of the range of products marketed to consumers

As client demand has shifted away from traditional products, large asset managers seeking to remain attractive to investors have sought to diversify their product range. In the retail market, more flexible investment restrictions following UCITS III have allowed firms to expand their regulated product range to meet the change in demand.

One particular form of increasing diversity of investment solutions has been the development of structured[3] and alternative products. In that respect, investor demand has been one of the primary drivers behind the growth, with investors searching for new sources of returns from alternative investments in response to the underperformance of traditional products at the turn of the century.

Evolution of investment strategies

The industry has increasingly been adopting investment strategies based on the overarching ‘core satellite’ approach. In essence, this approach advocates a clear separation of the passively managed core portfolio from one or more actively managed ‘satellites’ focused on the search for ‘alpha’. The evolution of these strategies has had significant implications for the transformation of the asset management value chain, including the emergence of boutiques and outsourcing of the core asset management function.

Driven by both the increase in assets under management from diversifying investors on the demand side, and the prospects of high profit margins on the supply side, the hedge fund industry has experienced significant growth over a relatively short timescale. Traditional asset managers have also increasingly adopted hedge fund-type investment strategies. The emergence of alternative and structured products, the increasing investor exposure to these asset classes, and the changing composition of UCITS towards more sophisticated financial products can be seen as developments parallel to, and closely linked with, the increasing adoption of the hedge fund model in the asset management industry as a whole.

To meet the demand for product diversification and exploration of new investment strategies, asset managers are actively seeking development of new skills in-house as well as purchasing them externally. In particular, outsourcing of the core asset management activity with respect to specific asset classes has become increasingly popular. This is based on a strategy to offer an expanded product range by buying additional products from another provider, which can prove cost-effective if the particular asset management skills are not available in-house, or would be expensive to build up. This process has resulted in the growth of the market for core asset management outsourcing and an increase in the linkages across the industry via assemblers and aggregators working with multiple providers.

An alternative strategy adopted by industry players to address the diversification of demand has been to specialise in a small number of asset classes. This strategy has been largely confined to smaller and medium-sized firms, aiming to achieve scale and expertise in a limited number of asset classes and investment strategies. Such specialisation can be an alternative to larger asset management firms outsourcing their core activity for particular asset classes. It relies on clients meeting their diversified demand by engaging multiple specialised asset managers, rather than hiring a single asset management firm that can offer the entire range of products required.

Geographical location and internal organisation of core asset management

To meet the requirement from clients to reduce the costs and increase the quality of asset management, industry activities are being concentrated in fewer locations to benefit from economies of scope and clustering effects. This is linked to the strategy of meeting pan-European demand from one location (or a small number of locations) to exploit cost efficiencies through scale.

Mainstream asset managers are increasingly adopting the boutique-type business model in response to the emergence of, for example, the core-satellite approach and hedge fund-type investment strategies. To meet the requirement to diversify their product range, some asset management firms have restructured their internal investment activity to enable the manufacture of required products in-house.

Efficient manufacture of new products has often necessitated a change to internal organisational structures in the form of semi-autonomous boutiques. For large asset management firms this response has involved the pursuit of alliances with specialist asset management firms, acquisition and incorporation of boutiques in the company structure, and/or hiring of entire teams of external managers in order to develop the required investment skills and/or manufacturing capabilities in non-traditional asset classes.

Evolution of distribution channels

The distribution of asset management products in the retail sector has recently witnessed the emergence of open and guided architecture models,[4] with industry players opening up their distribution channels.

However, the gradual opening of distribution appears to be neither homogeneous nor universal across Europe's asset management industry. It takes up a variety of forms, with players pursuing different business models, and also varies by degree in local markets.

There are examples of open architecture business models where traditional distributors, such as banks, sell all available funds in the market to their clients; however, other distributors consider the adoption of third-party products as destroying value for the group, and continue to retain the closed business model. Others have decided to enter into strategic alliances with a limited number of external fund manufacturers and have adopted the guided architecture model.

Where present, the gradual opening of traditional retail channels, accompanied by developments in the core asset management segment (such as growth in outsourcing), has affected the strategic and business linkages between the core asset management and distribution segments along the value chain. As a result, fund manufacturing and distribution are gradually becoming functionally separate, although they often remain parts of the same financial group.

At the company level, the degree of such business separation or strategic decoupling appears to be linked to the extent to which distribution is open to third-party products and, correspondingly, to the extent that the in-house core asset management function competes with external providers. At the industry level, such decoupling is sometimes reported to lead to distributors having more bargaining power than the manufacturers in negotiations over commission rates.

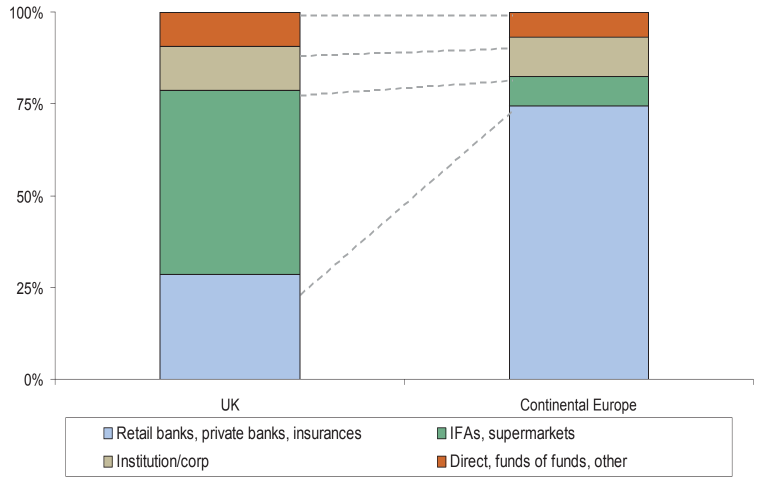
Beyond the transformation of traditional retail networks, decoupling of distribution and manufacturing can take an alternative form, with players pursuing the integrated business model and developing networks of financial advisers. This business model typically operates in accordance with the open architecture principle. The networks are functionally separate from the in-house manufacturer, and are managed independently of the rest of the parent group.

As shown in Figure 1, there is a marked difference in fund distribution between the UK and Continental Europe, with financial advisers being more prominent in the former.

Growth in outsourcing of the core asset management function has also led to greater importance of sub-advisory as a new distribution channel. A separate class of intermediaries—the assemblers or aggregators—is emerging, which combine the asset management expertise of different providers into a single investment product.

The emergence of intermediaries is likely to have significant economic implications for the asset management value chain.

Figure 1 Comparison of market shares of distribution channels in the UK and Continental Europe, 2005



Note: 'Continental Europe' represents data for France, Germany, Italy, Spain and Switzerland. Cross-country averages for Continental Europe are shown.
Source: FERI Fund Market Information Ltd data, as reported by ZEW/OEE (2006), 'Current Trends in the European Asset Management Industry' (Part 1), and Oxera calculations.

Evolution of the marketplace through platforms

Although there has been a degree of stabilisation and maturing in the level of outsourcing of back-office functions, new functional changes have been occurring recently with implications for the back-office segment of the value chain. One of the key developments has been the evolution of market platforms. These platforms are the point at which asset managers and distributors can conduct transactions without having to meet.

Current trends in the industry are making retail distribution networks increasingly multilateral in their demand for core asset management products, thereby creating opportunities for new types of player—business-to-business distribution platforms—which offer distributors a single point of access to a variety of product providers and high-quality infrastructure in order to facilitate trading. As more clients become connected, the platform evolves as an intermediary, integrating fund providers and distributors into a single 'marketplace'.

This is likely to increase market efficiency due to operating efficiencies in the back office and the creation of additional linkages between industry participants, and to facilitate further open architecture and cross-border trade. Industry efforts to increase standardisation of fund distribution and fund processing are critical in this respect. However, depending on the magnitude of the network effect, the emergence of dominant platforms might have regulatory implications.

Concluding remarks

The European asset management industry has been going through a period of transformation, and numerous developments in the core asset management, distribution and back-office segments of the industry value chain will continue to have significant implications for asset managers and their customers. A detailed review of the impact of these developments on competition, value creation for consumers, and risks in the European asset management industry is beyond the scope of this article, but is provided in the full Oxera report published by DG Internal Market and Services.

[1] See the main Oxera report for a discussion of the implications of the trends in asset management for risks and value to consumers.
[2] A class of intermediary that combines the asset management expertise of different providers into a single investment product. The final product can be marketed to the end-investor, another distributor or a master distributor.
[3] Structured products have a specifically designed risk/reward profile (eg, guaranteed/protected capital funds).
[4] In its pure form, an open architecture model means that the distribution channel makes available all products in the market. The model in which only a limited number of non-proprietary funds are marketed to clients is referred to as the guided architecture model.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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