Thriving in the New Abnormal

Idea In Short

Reset your return expectations downward. McKinsey identifies five megatrends reshaping asset management: lower returns, active fund shake-up, alternatives growth, digital revolution and rising regulation.

The Global Asset Management Business Is Huge

There are many billionaires and many ordinary people who have their wealth in pensions, 401k plans and stock or bond mutual funds. With incredibly loose monetary policy, it is no surprise that global Assets Under Management [AUM] performed well. In fact, they had their best year ever at the time of this report. McKinsey noted that global AUM reached 68.6 trillion dollars in 2015, up more than 40 percent from the end of 2007. To put that number in perspective, the US economy was approximately 18 trillion dollars. 1 documented the scale and the structural pressures facing the industry.

Troubling Signs in the Second Half

While things looked healthy on the surface, McKinsey noted several unsettling developments in 2015. Major volatility hit crude oil prices, the S&P index and Treasury prices. Average corporate operating profit fell for the first time in seven years. The industry recorded the first net outflows from mutual funds and Exchange-Traded Funds [ETFs] since 2011. These signals suggested the tailwinds driving growth were weakening.

The second half of 2015 served as a harbinger. McKinsey expected it to mark the beginning of a general lowering of the baseline for investment returns and potential flows over the next two decades. The firm identified five megatrends that would transform the asset management industry, and each one pressured the traditional business model.

Passive Equity Is Growing

John Bogle, the founder of Vanguard, envisioned a low-cost way to invest in equities, and that vision continued to become reality. Although passively managed AUM represented only one-third of the total, it was gaining momentum quickly. Passive equity on the retail side accounted for half of total net flows of money. 2 traces how his advocacy for low-cost, passive investing reshaped the industry. The shift from active to passive management put pressure on fees and forced active managers to justify their costs.

Tons of Competition

Oddly, the supply of investment products was not slowing down. More than 800 new products launched annually, with only 500 getting retired. This led to a universe of 11,000 mutual funds and exchange-traded products, up 17 percent since 2009. The proliferation created a crowded marketplace where differentiation became harder and fee compression intensified.

While choices multiplied, only a few captured the lion's share of investor funds and attention. Of the 3,000 newly launched mutual funds since 2009, only 8 percent, or 239 funds, captured 70 percent of net inflows. The Pareto principle was alive and well. The industry needed to cut costs, but that was easier said than done.

Cost Structure Pressures

McKinsey broke down the cost drivers of traditional asset managers and found costs rising fastest in sales and marketing, operations and IT, and legal and compliance. As the industry grew more crowded and complex, the costs it incurred multiplied. These structural cost pressures squeezed margins at precisely the moment when fee compression from passive investing intensified.

Five Megatrends Reshaping the Industry

McKinsey forecast five megatrends affecting asset management. The first was the end of 30 years of exceptional investment returns. The firm expected equities to deliver 150 to 400 basis points lower returns and fixed income 300 to 500 basis points lower. The next 20 years of returns were forecast to be lower, a lot lower. Ruchir Sharma of Morgan Stanley echoed this view.

The second trend was a shake-up of actively managed funds. Tony Robbins pointed out in his book that 96 percent of actively managed funds failed to beat the stock market average over any 15-year period. Investors were paying a premium to underperform the index. McKinsey saw a large pool of benchmark-hugging active assets, up to 8 trillion dollars, at risk of moving to passively managed funds or alternative investments. This shift threatened the traditional fee model that asset managers had relied on for decades.

The third trend was lower returns driving money toward alternative investments. McKinsey expected a significant shift toward illiquid investments as investors sought above-average returns, or alpha. Hedge funds had disappointed, which would push even more capital toward alternatives. The search for yield in a low-return environment pushed investors into private equity, infrastructure and real assets, where the complexity and illiquidity premium offered a chance to outperform public markets.

The fourth trend was a digital revolution to improve efficiency and customer engagement. This transformation was happening across all industries, and asset management was no exception. The shift went well beyond robo-advisors to encompass data and analytics across portfolio management, capital markets activities and back-office operations. Firms that invested in digital capabilities gained a structural advantage over those that clung to legacy systems and manual processes. The fifth trend was increased regulation. 3 required investment advisers to act as fiduciaries when advising on retirement accounts. McKinsey called it one of the largest shocks to the wealth management industry in over 40 years.

Trouble Ahead

For investors, this means resetting expectations. The days of 10 percent average US stock market returns were ending. People needed to save more, build a diversified portfolio and stay smart about their money. Social security, government worker pensions and other public financing mechanisms relying on high returns faced significant risk. The gap between expected returns and actual returns would create funding shortfalls that strained public budgets and retirement systems for years to come.

McKinsey argued persuasively that the industry would have to change to meet increased volatility, lower expected returns, rising customer expectations and continued competition. The report outlined multiple strategies and paths forward, calling for new capabilities, new products and new operating models. None were easy or quick fixes, but Wall Street had a

strong track record of surviving and profiting from volatility. The firms that adapted would capture share from those that clung to the old model. Consolidation through mergers and acquisitions would likely follow, as smaller firms lacking scale and digital infrastructure struggled to compete on cost and capability.

- 1McKinsey's Thriving In The New Abnormal Report On North American Asset Management
- 2John Bogle's Pioneering Work On Index Fund Investing At Vanguard
- 3The US Department Of Labor Fiduciary Rule And Its Impact On Investment Advice

Summary

The era of 10 percent average stock market returns is fading. Save more, diversify and stay informed. Asset managers face structural change requiring new capabilities, products and operating models. Consolidation will likely follow.