

GLOBAL ASSET MANAGEMENT 2023—21ST EDITION

# The Tide Has Turned

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# Introduction

The asset management industry has reached a turning point that will require rethinking the way it operates. For much of the past two decades, accommodative central bank policies drove up equity markets. That rise, in turn, gave asset managers a major boost; in fact, market performance has been responsible for 90% of the revenue growth since 2006. However, we are now facing an era of higher interest rates and market uncertainties. The tide has turned, with major implications for the business model that has served the global asset management industry so well in the past.

In 2022, interest rates rose faster than expected, causing both stock and bond values to plummet. The result was the second-largest single-year decrease in global assets under management (AuM) since 2005. Global AuM fell by \$10 trillion, or 10%, to \$98 trillion—near 2020 levels. The net flow rate also fell below 3% for the first time since 2018, reaching 1.6% of total AuM at the beginning of 2022, or \$1.7 trillion. (See Exhibit 1.)

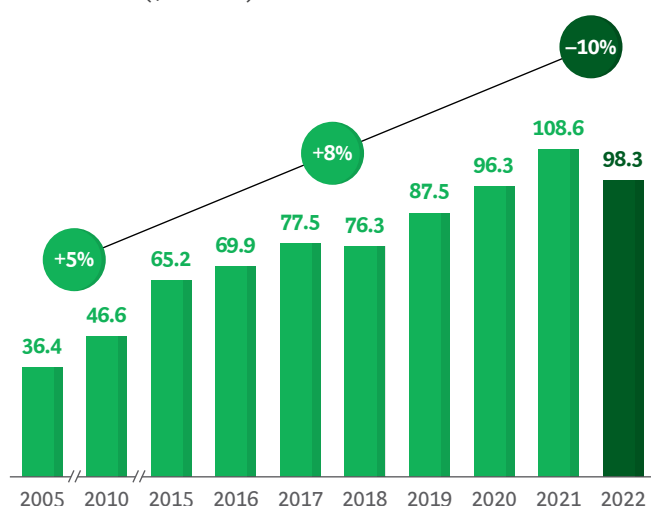
With the collapse of a built-in bull market to support revenue growth, preexisting pressures on the asset management business have been exacerbated and will continue to put a dent in profitability.

But there are new ways to approach profitability. In addition, new technologies are making it possible to expand into high-growth private markets and highly personalized products and services. As we see it, by embracing these three Ps, asset managers can meet investors' demands and have excellent prospects for growth in the chaotic economic climate that lies ahead.

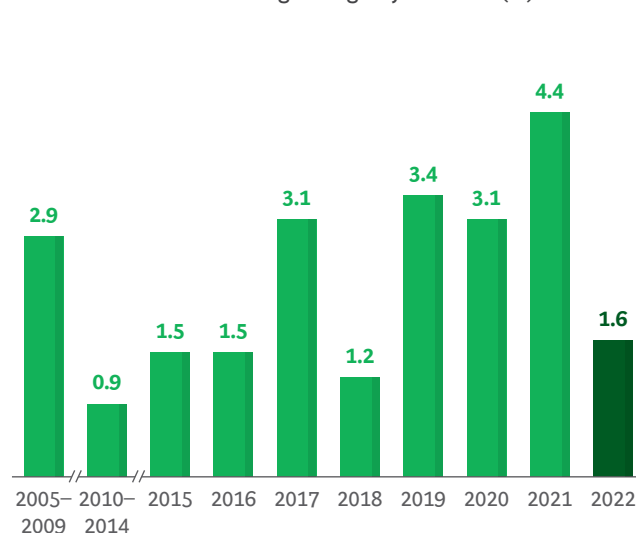
The most forward-thinking industry leaders now recognize that they will have to change course in order to thrive. Make no mistake, the changes will need to be nothing short of transformational if asset managers are to continue enjoying the growth and profitability of years past.

## Exhibit 1 - In 2022, Global AuM Fell to 2020's Level, and the Net Flow Rate Was the Lowest Since 2018

Global AuM (\$trillions)



Net flow as a share of beginning-of-year AuM (%)



**Sources:** BCG's Global Asset Management Market Sizing, 2023; BCG's Global Asset Management Benchmarking Database, 2023.

**Note:** Market sizing was performed on assets sourced from each region and professionally managed in exchange for management fees. (See Appendix 2.) The market sizing included the captive AuM of insurance groups and pension funds that were delegated to asset management entities in exchange for fees paid. Globally, 44 markets were assessed (including offshore AuM, which was not covered in any region). For all countries where the currency is not the US dollar, the end-of-year 2022 exchange rate was applied to all years to synchronize current and historic data. Values differ from those in prior studies because of exchange rate fluctuations, a revised methodology, and changes in source data. Net flow analysis used a benchmarking study of 74 leading asset managers that represented \$62 trillion in AuM, or about 63% of global AuM.



# The Case for Transformation

In looking at the external and internal forces shaping the industry, we find that asset managers face five fundamental pressures that, when taken together, present a clear case for transformation. (See Exhibit 2.) Nearly every part of the value chain is under stress.

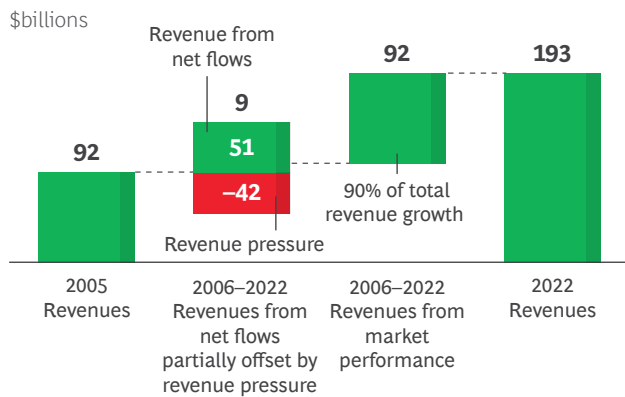
## Pressure One—Growth Is No Longer Guaranteed Since Market Performance Has Been the Main Driver of Revenues

Global equity returns from 2012 through 2021 were in the top decile of most rolling ten-year periods since 1987, according to MSCI World Index data. The net result was a built-in floor for asset managers' revenue growth. In fact, 90% of revenue growth came from market performance since 2006—more than enough to offset higher costs, pressure on fees, and strong capital inflows into low-fee products.

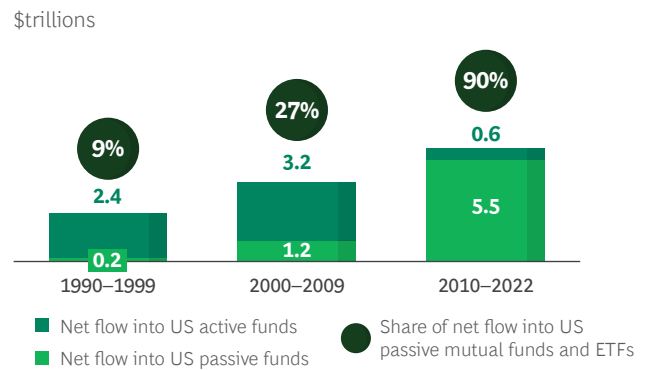
While 2022 was among the worst years for investor returns since 2008, markets are expected to recover. However, central banks are no longer engineering sustained market appreciation. In fact, their goals for the short term are the exact opposite; they are trying to slow growth to combat inflation. Even if central banks succeed in their mandate and interest rates stabilize, it is unlikely that we'll continue to see massive, coordinated stimulation efforts, barring an unforeseen shock. As a result, revenue growth from market appreciation is likely to be significantly less, perhaps as little as half that of the past decade.

## Exhibit 2 - Five Pressures Show the Need for Transformation

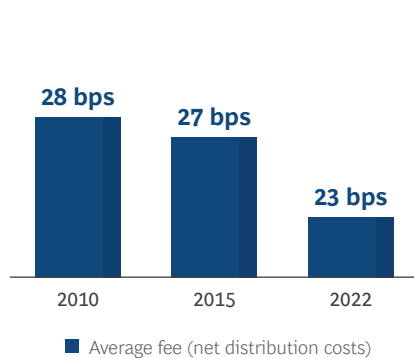
Growth is no longer guaranteed since market performance has been the main driver of revenues



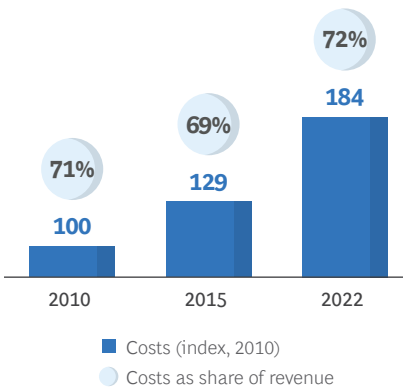
Passive funds are increasingly popular



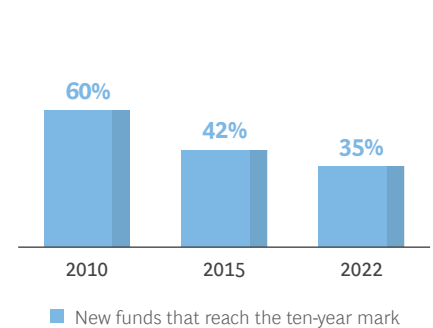
Fee compression is accelerating



Costs are rising



Fewer new products are surviving despite attempts at innovation



**Sources:** BCG's Global Asset Management Market Sizing, 2023; BCG's Global Asset Management Benchmarking Database, 2023; Institutional Shareholder Services Market Intelligence's Simfund; BCG analysis.

**Note:** ETF = exchange-traded fund; bps = basis points.

### Pressure Two—Passive Funds Are Increasingly Popular

In the US, passively managed investment products were the primary beneficiaries of market appreciation from 2010 through 2022. The share of net flows into passive exchange-traded funds (ETFs) and other passive products reached 90%, which was roughly triple the net flows from 2000 through 2009. In 2022, the same dynamic played out. Passive funds continued to be winners, with a net inflow of \$0.5 trillion, while actively managed funds experienced a net outflow of \$1.0 trillion.

We can expect increased market volatility to create more investor demand for expertise in outperforming the benchmarks, yet we do not anticipate a sea change in which significant capital flows back into active funds in the US. The passive value proposition has proven to be compelling, and it is now deeply ingrained in the ecosystem.

Globally, the status of passive versus active investments is very different. In Asia and Europe, passive funds hold only 21% and 20%, respectively, of mutual fund and ETF assets, indicating that active management seems to have a safe haven, at least for the moment. The scenario is driven by multiple factors. In China and other Asian markets, for example, active managers have been able to deliver better-than-average market returns, thereby outpacing any cost advantages to be found in index products.

In Europe, however, there are reasons to believe that the amount of money in passive assets may grow more quickly than it will in Asia. Along with increasing customer demand, regulatory changes could provide a more favorable climate for passive management. The UK already requires fair value assessments of investments. Meanwhile, proposed amendments to the Markets in Financial Instruments Directive (MiFID) II legislative framework could lead to bans in the European Union on inducements for investment products—a move that could give advisors more incentives to steer their clients to lower-priced passive funds.

### Pressure Three—Fee Compression Is Accelerating

As a general rule, asset management fees are headed down, not up. Pricing is increasingly used as a differentiator not only for passive products but also within the overcrowded space of active products that are otherwise similar to one another. The result is persistent downward pressure that is only accelerating.

Since 2010, average fees have declined by more than 15%, a drop that would have generated \$55 billion in revenues given 2022's AuM. In last year's [report](#), we found that some clients of asset managers were still willing to pay for strong performance. That continues to be the case, but only 50% of industry AuM meets that standard.

Over the past 10 to 15 years, extraordinary market performance more than offset the fee pressure on revenue growth and margins, but those days are over.

### Pressure Four—Costs Are Rising

The cost base for asset management was built for better times. Since 2010, costs have generally risen in line with AuM growth, which created the impression that margins were stable despite the pressure on fees. However, from 2015 onward, costs as a share of revenue have increased, alluding to cost structures that are unfit for the new environment. We estimate that about 60% of asset management costs are fixed; certainly, the vast majority of costs are related to personnel.

Looking ahead, we expect that asset managers will need to reduce their cost base by at least 20% to maintain historical levels of profitability. Nothing short of an organization-wide transformation will be required to meet that goal.

### Pressure Five—Fewer New Products Are Surviving Despite Attempts at Innovation

The asset management industry has perfected the art of slicing and dicing products into niche offerings in an effort to stand out in a competitive playing field. Such offerings have led to an abundance of products, but proliferation has not meant meaningful innovation. In fact, investors are increasingly sticking with established products with reliable track records. A whopping 75% of global AuM in mutual funds and ETFs sits in products that are at least ten years old. Meanwhile, less than 40% of all products launched ten years ago are still offered, compared with 60% of all ten-year-old funds in 2010.

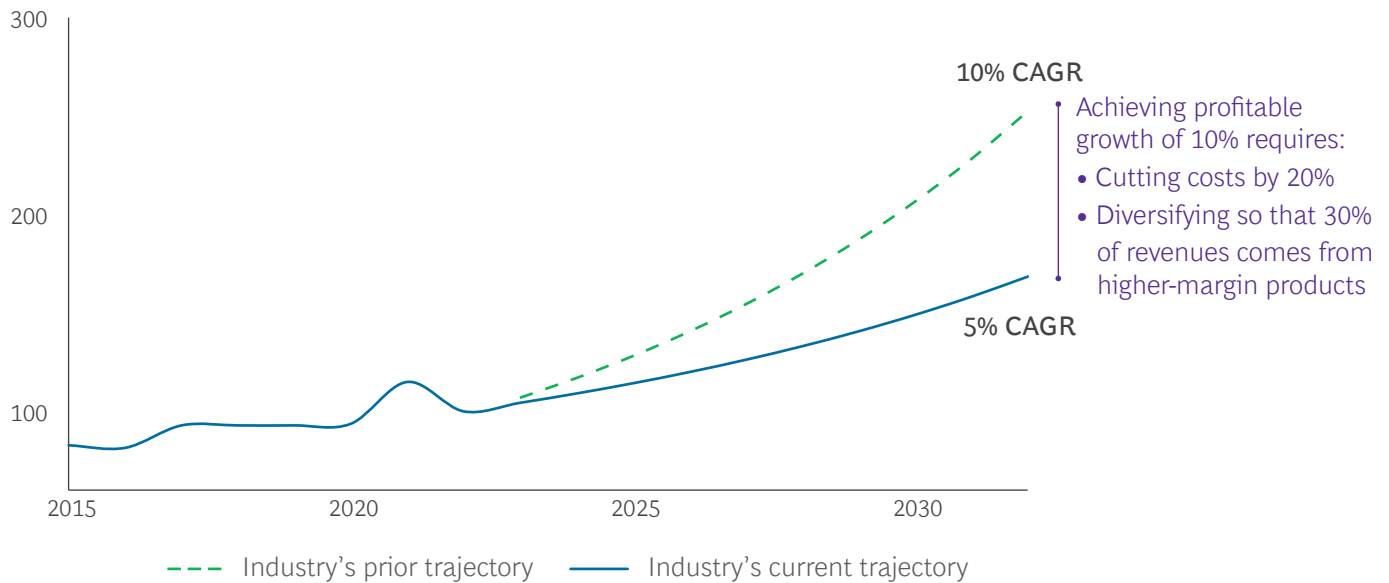
Simply put, the current approach to product innovation is not working. To succeed in the next decade, asset managers will need to reframe their innovation agendas to include new product categories and value-added services.

### The Only Choice Is Change

The pressures facing asset managers now will continue into the future but without the benefit of rapid market appreciation. According to our estimates, the existing pressures and market expectations are such that if asset managers simply stay the course, their profit's compound annual growth rate (CAGR) will be approximately half the industry average of recent years (5% versus 10%). This is a massive gap that would send shockwaves throughout the industry.

## Exhibit 3 - Asset Managers Must Set a Transformative Path to Return to Profitable Growth

Projected profits (index = 100, 2022)



**Sources:** BCG's Global Asset Management Benchmarking Database; BCG analysis.

To get back to historical levels of profitable growth, asset managers will need to address their costs and revenues equally and thoroughly. We estimate that asset managers will need to cut costs by 20% overall. In addition, they will need to shift their revenue mix to generate at least 30% of their revenue from higher-margin products, such as alternative investments. (See Exhibit 3.)

As we scan the industry, few firms have recognized this reality and taken action. Meanwhile, insurance asset managers are finding that transformation measures are needed to meet increasingly complex regulatory standards. (See the sidebar “The New Pressure Gauge for Insurance Portfolios.”)

Asset managers need to change. They need to embark on a transformative journey and assess all aspects of their existing business model. Those that make the journey stand to emerge strong and resilient for years to come.



# The New Pressure Gauge for Insurance Portfolios

Managing assets for insurance clients has just become more complex. On January 1, 2023, amendments to International Financial Reporting Standards (IFRS) 9 and 17 came into effect for the industry, bringing on a new set of accounting practices designed to standardize the way market participants measure an insurer's financial performance. That includes the key factors of investment return and risk exposure.

Not all insurers will be affected by the change: only European and Asian insurers will adopt the new principles in total. However, the amendments require adopting new standards that will be transformational for any global asset manager with insurance clients in Europe or Asia. Asset managers will need to work closely with those clients to achieve optimal performance through a new measurement logic, new criteria for the income statement and balance sheet, and more-detailed reporting requirements. Though the focus is on accounting, the insurer's entire business performance will be examined through a different lens than before. And since IFRS 9 changes the way investment performance is measured as a part of the insurer's profit and loss (P&L) statement, portfolio managers may need to rethink existing asset-allocation strategies.

Under the new measurement logic, assets and liabilities are marked at fair market value instead of at book value or historic value. Marking portfolio holdings this way, on the basis of an estimated market price at the time of the assessment, provides greater transparency around the insurer's financial positions at any given time. However, it is also expected to introduce greater volatility into key performance metrics, because these calculations will be more sensitive to changes in the financial markets.

The new rulings will also require that the fair market value of an insurer's portfolio appears on all quarterly income statements and balance sheets. The valuations must also be defined in a more granular way, through detailed units of account, rather than as past reporting standards required. As a result, insurers can expect more external scrutiny from their investors and other stakeholders when it comes to examining the impact of investment decisions on their KPIs. Insurers will need the support of asset managers in assuring that the new granular units of account are not showing losses, which will have a direct effect on their P&L statement.

Life insurers will have the additional responsibility of reporting their contractual service margin, which details assumptions about future investment income included in current contracts that will materialize over the life of the policy. It will be the asset manager's job to make these assumptions true.

We see four main initiatives that insurance asset managers should put in play to support their clients.

First, asset managers can help by designing portfolios that will stand up to scrutiny and provide hedges against volatility. For example, managers could consistently monitor earnings at risk and define the acceptable volatility bands.

Second, asset managers can enhance the key investment decision-making processes and tools to make sure that the new measurement logic is ingrained. They should, for example, be prepared to clarify all of the tradeoffs that come with an investment decision, offering transparent information to all stakeholders on such factors as the duration, equity-to-debt balance, and risk premium. It will also be essential to provide ongoing analysis of the liability side.

Third, asset managers can define more-granular portfolio construction rules to steer the allocation toward optimal tradeoffs among return, volatility, and risk capital absorption. Stakeholders will expect transparency not only on frequently traded assets (such as equities) but also on less liquid holdings (such as real estate and alternatives), so the asset manager will need to assess those fair market values at regular intervals and ensure that policyholders find the proposed yields competitive.

Fourth, asset managers will need to launch change management actions so that their portfolio teams have the capabilities to look at the business in a new way. Adhering to the new standards may mean, for example, that asset managers who met with insurance clients several times a year in the past now have to schedule monthly or even weekly meetings.

Moreover, measuring fair market value on the basis of past and present performance will not be sufficient in the new environment. A transformation strategy should include developing forecasting capabilities to guide an insurer's portfolio decisions. Asset managers may consider partnering with fintechs for these capabilities. Or, they may invest in transformative technologies such as simulation engines that can build out pricing models that gauge not only the fair market value of the existing assets but also the impact of various future scenarios.

Many large asset managers and captive asset managers of leading insurers have been investing in forecasting models to enhance their capabilities in clarifying tradeoffs. This is a niche that could also create a great deal of value for smaller insurance firms.

Insurers are currently adapting to the new accounting standards and building the capabilities that they'll need. For the asset managers that service their portfolios, this is a one-time opportunity to add value as deeply engaged partners in the effort.



## What Now?

There is a path forward, but it requires a transformative mindset and a leadership agenda focused on three major themes: profitability (achieved by addressing the cost structure and by funding the transformation journey), private markets (a focus for developing high-growth products that will help significantly diversify revenue), and personalization (a cutting-edge way to own the customer relationship).

### Profitability

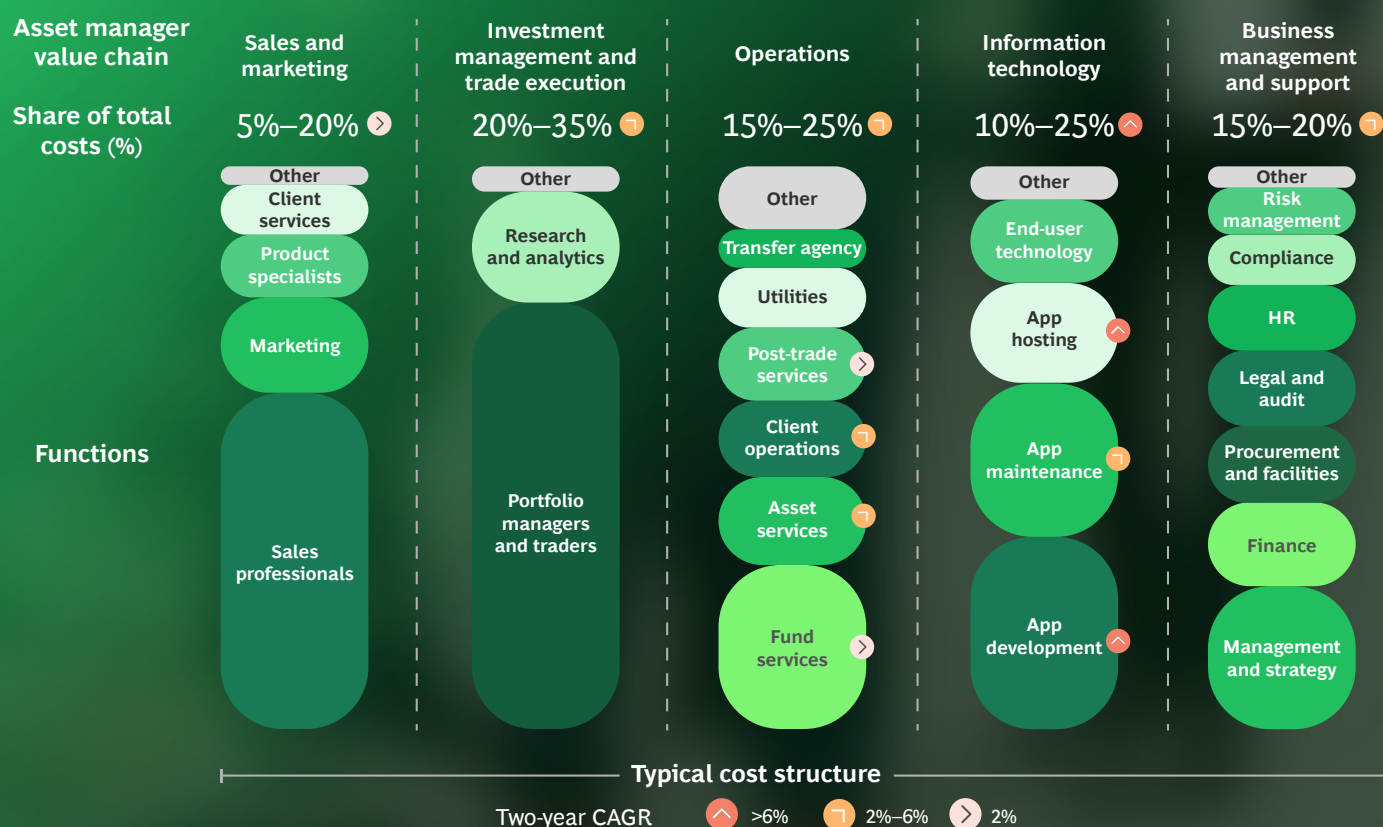
Over the past few years, asset managers' costs have outgrown revenues by about 2%, on average. In a supportive market, this dynamic has been tolerable and didn't call any special attention to cost rationalization. But times have clearly changed.

In 2022, asset managers' net revenues declined by approximately 11%, compared with their 2021 net revenues. At the same time, total costs were stagnant, and total profits declined by 27%. The decline in profits was more pronounced for North American firms—32%—while their European counterparts saw profits slump 13% because of a lower decline in net revenues.

The typical value chain for asset managers includes a wide variety of costs that firms will need to assess in order to drive savings.



# Organizations Should Evaluate and Optimize Costs Along the Value Chain



Sources: Expand; BCG's Global Asset Management Benchmarking Database, 2022.

In order to take action, asset managers need to understand the drivers of key costs, which may come from upstream demand (such as from recent product proliferation and increasing client needs) or from greater organizational requirements. (See Exhibit 4.)

It is important to scrutinize expenses and what drives them in each function. In addition, asset managers should examine the costs of organization-wide functions. We have identified ten key initiatives that asset managers should consider when designing a plan for controlling costs across the organization. (See Exhibit 5.)

Operational and support-function costs can be addressed through many initiatives. For example, asset managers can simplify broadly, across the organization, by optimizing managerial capacity, flattening the organization structure, and increasing their managers' spans of control. Cost efficiency is not the only benefit of this exercise; it also leads to better decision making, enhanced accountability, and faster and more reliable communication throughout the firm. By gaining a deeper understanding of how resources are being allocated across activities and functions, as well as how the allocations compare with those made by industry peers, a firm will also be better equipped to rightsize support functions.

## Exhibit 4 - Asset Managers Should Identify Key Drivers of Cost Growth

### Value chain

### Key drivers



**Sales and marketing**

The increasing number of sales personnel, because clients are requiring a more personalized or specialized sales experience and higher service levels



**Investment management and trade execution**

The increasing product suite and the associated expanded staff, related support, and data and technology in order to expand the implementation of next-generation ways of investing (such as those that use artificial intelligence and machine learning)



**Operations**

The increasing number of client-driven customizations, the firm's expanded footprint, and the higher average cost of investing in private markets all put pressure on operations teams if they have not scaled effectively



**Information technology**

The investment to build more capabilities, especially in data and analytics; the rising costs of maintaining legacy systems due to slow decommissioning; and the ongoing migration to the cloud



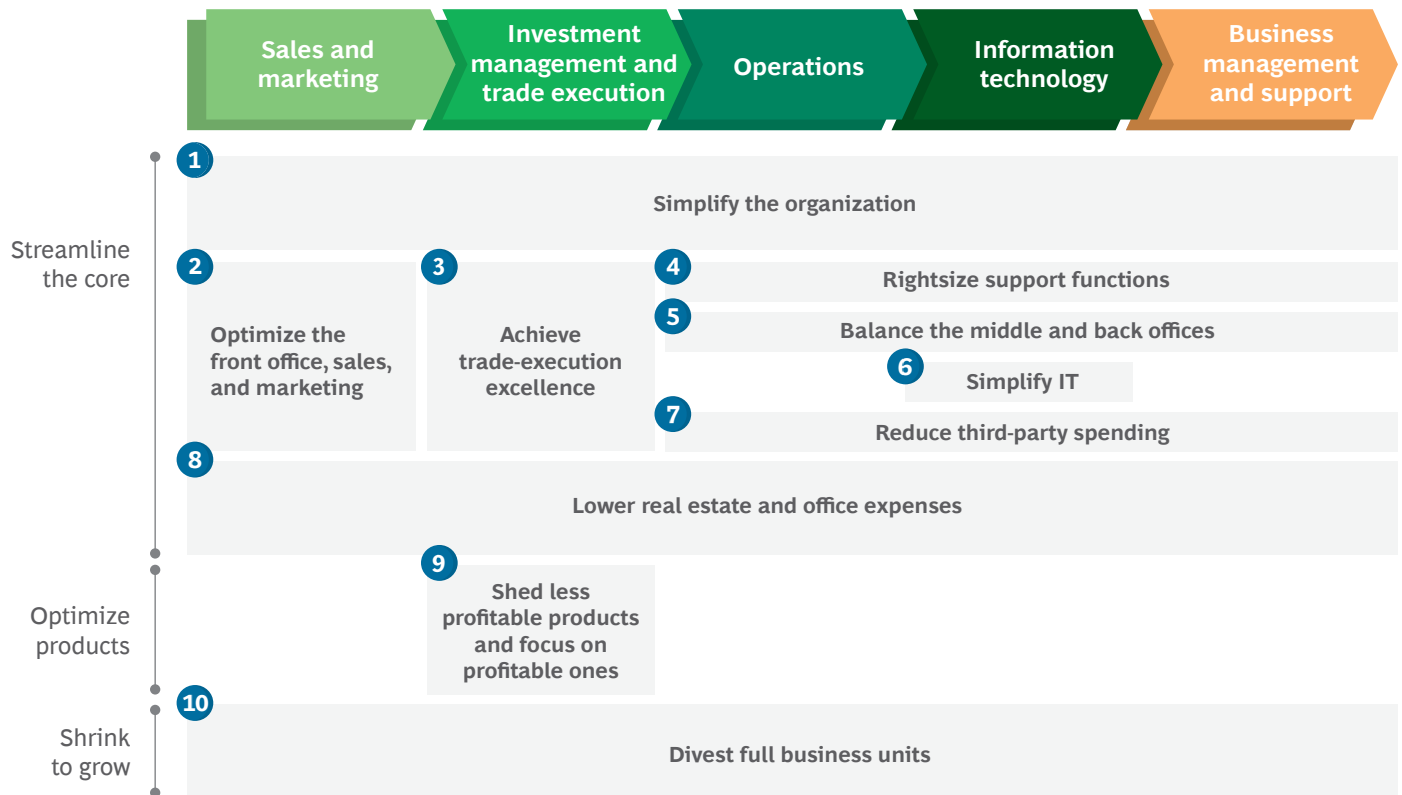
**Business management and support**

The expansion of the HR, legal, and finance functions to support business growth without adopting leaner and agile ways of working

**Sources:** Expand; BCG's Global Asset Management Benchmarking Database, 2022; BCG analysis.



## Exhibit 5 - Ten Proven Initiatives Can Help Address Costs



Source: BCG analysis.

It is also essential to address operational costs by balancing the middle and back offices. A firm should review all processes to determine an optimal operating model. As asset managers expand their front-office capabilities, middle- and back-office functions are sometimes left untouched. At best, the lack of attention to these functions can cause inefficiencies; at worst, it can lead to painful barriers to growth. It is important to uncover the root causes of any issues and address them with surgical precision by assessing the firm's sourcing options, its location strategy, and its governance model.

When it comes to sourcing, many providers that have traditionally specialized in back-office support are now expanding their services further up the value chain. These providers offer asset managers a more seamless support model with improved data capabilities. In considering a location strategy, a firm must consider the best ways to optimize the roles of everyone, including internal employees and external partners, in order to achieve a synchronous operation that balances local customization with global scale. Finally, a healthy operations structure must have a robust governance model that is responsive to the evolution of the business.

Simplifying and rationalizing IT is key to lowering costs as well as to ensuring that the firm is efficiently set up for growth. To be certain that an optimal tech setup is in place, asset managers need to assess the maturity of their IT applications across the value chain. The assessment should identify areas that would benefit from investment in a solution along with legacy systems that should be retired.

To address investment management costs, it is critical to conduct a thorough examination of the business model with an eye toward product optimization. The long bull market from 2012 through 2022 gave asset managers the opportunity to expand their fund portfolios and explore uncharted territories. Trimming away subscale and unprofitable products compels a firm to refocus the business in ways that can yield strong value creation.

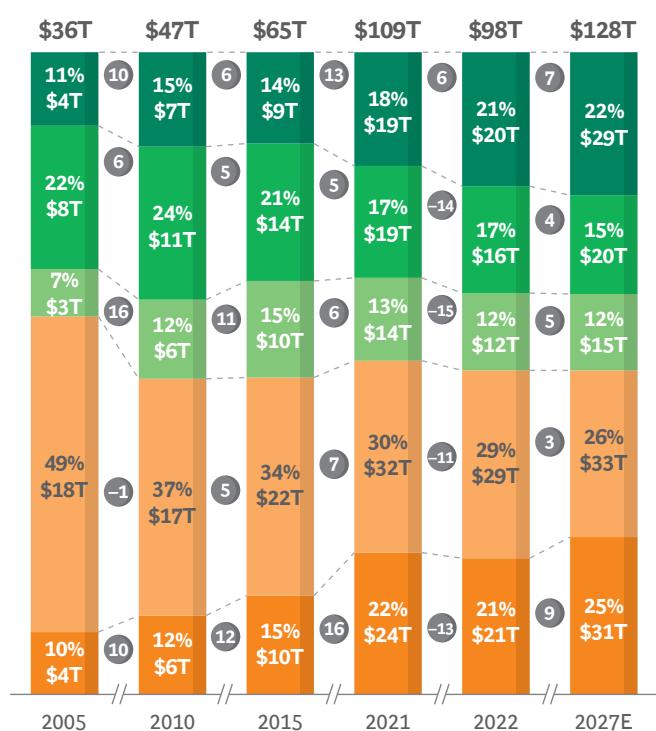
There is nothing new about managing costs to ensure a sustainable and profitable business. However, this time around, the focus should be on optimizing costs in transformative ways instead of simply slashing expenses.

## Private Markets

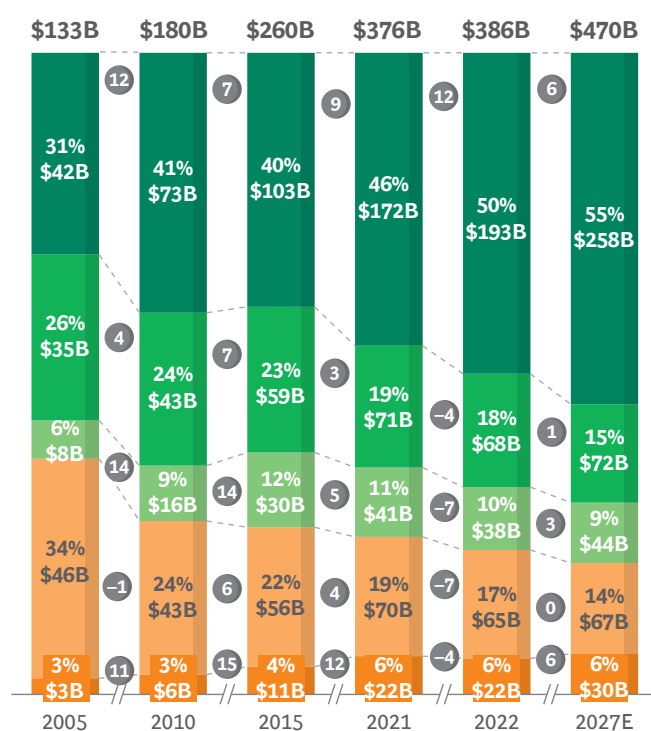
Alternative investments and the private market opportunities therein continue to be a bright spot for the asset management industry. Alternatives represented more than \$20 trillion of global AuM as of year-end 2022. These products accounted for half of the industry's global revenues in 2022—a milestone that was achieved sooner than industry observers had predicted—and generated more than \$190 billion in revenues for the firms that offer alternative investments. (See Exhibit 6.)

## Exhibit 6 - In 2022, Alternative Assets Represented 21% of Global AuM and 50% of Global Revenue

Global AuM by product



Global revenue by product



■ Alternative assets<sup>1</sup>
■ Active specialties<sup>2</sup>
■ Solutions, LDI, and balanced<sup>3</sup>
■ Active core<sup>4</sup>
■ Passive

**Sources:** BCG's Global Asset Management Market Sizing, 2023; BCG's Global Asset Management Benchmarking Database, 2023; Institutional Shareholder Services Market Intelligence's Simfund; Pensions & Investments; Investment Company Institute; Prequin; HFR; INREV; BCG analysis.

**Note:** T = trillion; B = billion. LDI = liability-driven investment. Bar chart values may not add up to 100% or to the specified sum because of rounding.

<sup>1</sup>Includes hedge funds, private equity, real estate, infrastructure, commodities, private debt, and liquid alternative mutual funds (such as absolute return, long and short, market neutral, and trading oriented). Private equity and hedge fund revenues do not include performance fees.

<sup>2</sup>Includes equity specialties (such as global and emerging-market active equity, developed-market small cap and midcap, and themes) and fixed-income specialties (such as emerging markets, high-yield, flexible, and inflation linked).

<sup>3</sup>Includes target date, target maturity, liability driven, outsourced chief investment officer, multiasset balanced, and multiasset allocation.

<sup>4</sup>Includes actively managed developed-market large-cap equity, developed-market government and corporate debt, money market, and structured products.



This strong momentum is expected to prevail, with 7% CAGR in alternative assets over the next five years. This is a growth rate that we expect to see surpassed only by passive investments, which are projected to grow in AuM at approximately 9% annually through 2027. A substantial amount of growth in the alternatives space will be driven by investments in private debt and private equity, both of which are slated to see their global revenues rise by 9% to 10% annually over the next five years. (See Exhibit 7.)

## THE RETAIL OPPORTUNITY

The continued opportunity to reach retail investors is a key contributor to the optimistic future for alternative investments. The asset growth in the retail segment has outpaced that of the institutional segment globally from 2012 through 2022. At the same time, technology, product innovation, and, in select markets, regulatory reforms, have created tailwinds to democratize access to alternative investments.

Globally, retail investors have allocated trillions of dollars to alternative products, with current assets projected to grow by more than 15% annually in the next three to five years. Using private equity funds as a proxy for alternative investments, most of the retail distribution opportunity exists in the North America and Asia-Pacific regions. These two regions account for nearly 60% and 30%, respectively, of global household investment in private equity funds.

Beyond growth, one of the most attractive aspects of retail investment in alternatives is profitability. The fees tend to be higher because retail investors lack the scale that allows institutional investors to pay steeply discounted fees.

The retail market is a diverse demographic, however, and asset managers need a strategic plan to address product packaging and investor access points. (See Exhibit 8.) The wealthiest retail segment, ultra-high-net worth investors, have a broader suite of products that they can access. Their choices include more institutional-like offerings, such as closed-end and direct funds, tender offers, and interval funds. At the other end of the wealth spectrum, mass-market retail investors are limited to more liquid products that have lower minimum investment requirements, primarily alternative mutual funds and ETFs, real estate investment trusts, and business development companies.

Asset managers need a precise understanding of the retail investor segments that they can access through their distribution networks as they define their alternative offerings. For example, in the US market, private and trust banks and registered investment advisors represent promising distribution channels because their wealthier clientele and asset allocation strategies result in a higher demand for alternatives.

This multichannel opportunity also exists in the UK through banks and independent wealth advisors. On the European continent, however, it is imperative that an asset manager have access to the broader universal banking system, as these institutions are the gatekeepers to the majority of retail capital.

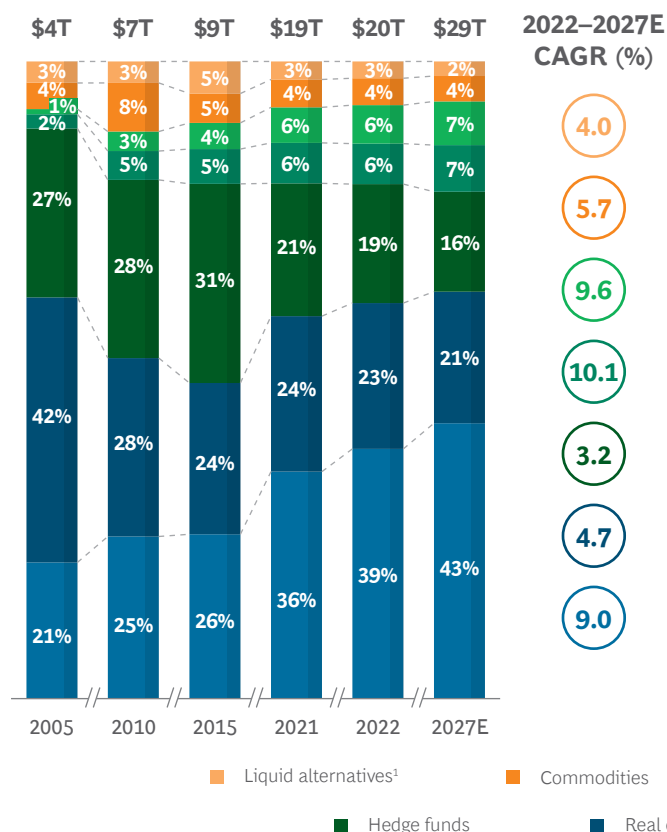
A comprehensive view of the distribution channels needed to access retail investors is critical to identifying the best fit when bringing alternative products to market.

## ENTERING THE ALTERNATIVES MARKET

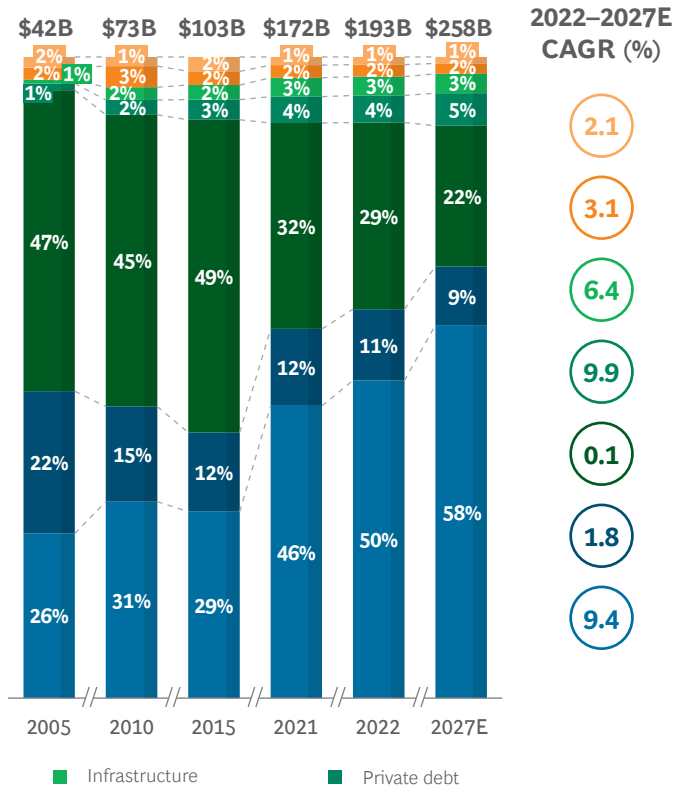
Numerous conventional asset managers have entered the alternatives market. These firms have gathered significant assets, unlocked new offerings to bring to their clients, and catalyzed a high-growth opportunity for their business. (See Exhibit 9.) Among some 30 leading global asset managers that launched an alternatives unit, the AuM for alternative investments and private markets have grown by an estimated 15% to 20% annually over the past five years, amounting to more than \$3 trillion. The firms have made more than 50 acquisitions for an instant step up in alternatives capabilities. Roughly 90% of the firms have focused on offering private equity, private debt, and real estate products, while 30% have established strategic partnerships, often with fintechs, or distribution agreements with third parties. The success of these asset managers paints a compelling picture of the growth opportunity in alternatives and private markets.

# Exhibit 7 - Private Debt and Private Equity Investments Are Expected to Generate More Than 60% of Total Revenue from Alternatives by 2027

Global AuM for alternatives by product



Global revenue from alternatives by product



**Sources:** BCG's Global Asset Management Market Sizing, 2023; BCG's Global Asset Management Benchmarking Database, 2023; Institutional Shareholder Services Market Intelligence's Simfund; Pensions & Investments; Investment Company Institute; Preqin; HFR; INREV; BCG analysis.

**Note:** T = trillion; B = billion. Revenues exclude performance fees.

<sup>1</sup>Liquid alternatives include respective mutual funds and exchange-traded funds (such as absolute return, long and short, market neutral, and trading oriented).

<sup>2</sup>Real estate includes real estate investment trusts.

<sup>3</sup>Private equity includes venture capital.

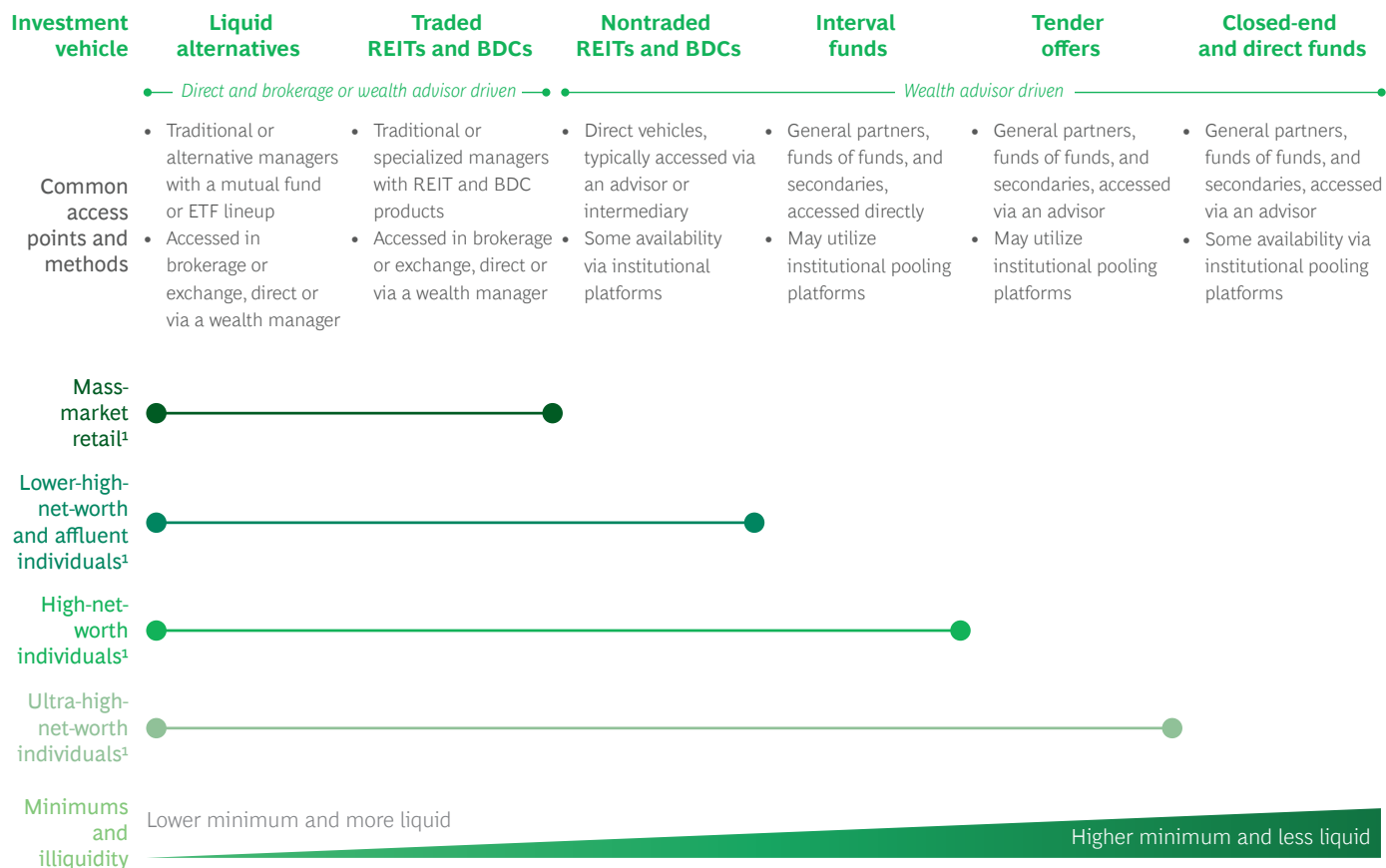
For firms aiming to enter the alternatives market, there are four primary pathways, all of which contain tradeoffs and operating model design choices. Each pathway is briefly detailed below.

- **Build in-house.** Using this approach, a firm builds out its alternatives business in-house, a process that may include acquiring some external teams for instant upskilling but is otherwise an internal effort. This approach yields the highest potential for integration and synergy with the broader asset management unit, and it affords the parent company more control and oversight. Building in-house often requires a longer timeline to prepare a market-ready offering, however. Firms with brand strength and extensive distribution have a higher chance of success.

- **Buy and use an affiliate or boutique structure.** This pathway involves multiple acquisitions and the use of an affiliate or a multiboutique structure, enabling the eventual full-suite build-out of alternatives or private market asset class offerings. The structure includes the possibility of some integration and synergy across the value chain, primarily in noncore functions. Alternatives investment teams remain independent of one another, each maintaining its own distinct brand. The parent company's primary role consists of managerial oversight, select distribution opportunities and introductions, and best-practice sharing.



## Exhibit 8 - Asset Managers Need a Strategy for Packaging Retail Alternatives and Identifying Investor Access Points



**Sources:** Expert interviews; Preqin; BCG analysis.

**Note:** ETF = exchange-traded fund; REIT = real estate investment trust; BDC = business development company.

<sup>1</sup>These are illustrative terms; the exact financial criteria may vary.

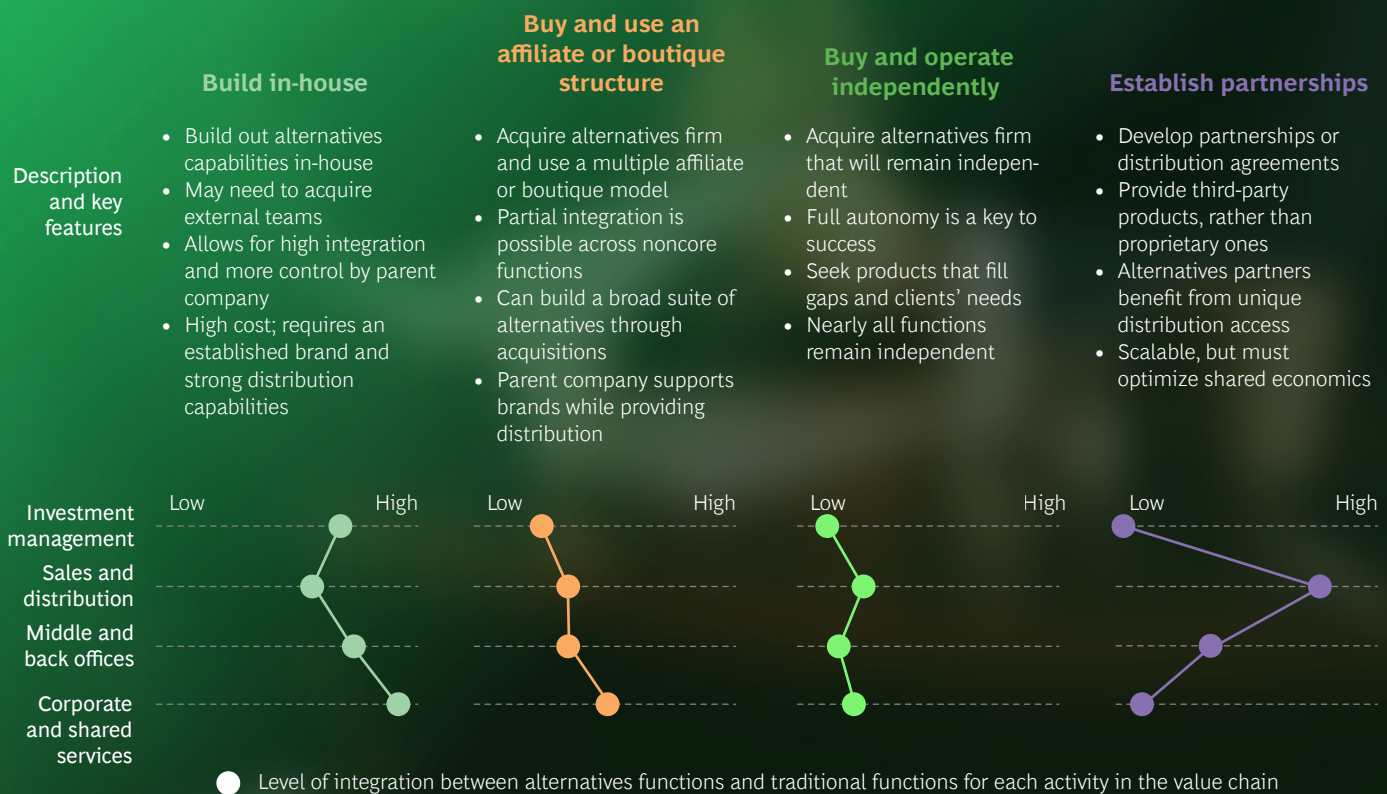
## Exhibit 9 - Alternatives Create Significant Growth Opportunities for Traditional Asset Managers



**Sources:** Company websites; investor presentations; investor transcripts; Preqin; Pensions & Investments; BCG analysis.

**Note:** All figures are based on a benchmarking exercise using a sample set of 30 traditional asset managers that have launched alternatives and private market offerings. Their AuM of more than \$3 trillion includes alternative funds of funds and secondary fund assets.

# Asset Managers Should Consider Four Paths for Launching an Alternatives Business



Sources: Expert interviews; BCG analysis.

- **Buy and operate independently.** A firm following this model must make at least one acquisition to gain an alternatives investment capability. Full autonomy is a key success factor for the operating model, and nearly all functions across the value chain are kept detached from the parent company. Independence and the alignment of incentives are critical to the performance of the investment team and to keeping the sales and distribution staff from the acquired firm in place. Products are highly targeted, determined by the parent company's capability gaps and an analysis of which offerings are most likely to boost the overall financial performance.
- **Establish partnerships.** In this case, an asset management firm develops distribution agreements, joint ventures, or other strategic partnerships to ensure that client demands for alternatives are met. The partnerships are designed to marry the distribution capabilities of the established traditional asset manager with the best-in-class alternatives investment capabilities of a third-party manager. Exclusivity agreements are common. Some co-investment may be required for shared middle- and back-office capabilities, such as onboarding and reporting, since scalability is a key driver for the shared operating model. While such partnerships are cost effective in nature, it is essential that all participants optimize the shared economics in order to have a successful arrangement over the long term.

When we look at these four market-entry pathways, it becomes clear that no one archetype is more successful than another—all methods are viable. The alternatives market has existed for decades, and traditional asset managers have been entering (and exiting) the space for some time—long enough to make it clear that the most important characteristics of a successful alternatives unit revolve less around a firm's method of entry and more around its execution.

In studying initiatives related to alternatives and speaking with executives who have led them, we have identified five core principles of success in establishing an alternatives business.

**Perfect the value proposition.** The strongest alternatives units are built around a harmonized value proposition. A traditional asset manager bringing an alternatives team onto its platform must convey the benefits of doing so and deliver on that promise. Examples of the benefits can come in the form of expanded distribution, such as obtaining access to retail distribution; a path to scalability through such means as shared services or middle- and back-office operations; or even a strategic capital partnership, gained, for example, by recapitalizing the founding team's equity or co-investing in strategic projects.

Simultaneously, the value proposition for the traditional asset manager comes in the form of unlocking new investment capabilities; the addition of a high-margin, accretive business unit; and an elevated ability to meet increasing investor demands for exposure to alternatives. A definitive shared-value proposition between the traditional and alternatives businesses is a key ingredient to success.

**Tailor incentives to drive growth.** Distinct incentive structures are essential to driving the growth, recruitment, and retention of management teams for alternative investments. Traditional asset managers pursuing alternative offerings need to adopt a variety of incentivizing tools to ensure that the alternatives team delivers strong performance. This may come in the form of compensation schemes, such as increasing carried interest or providing stock options of the parent company. Some firms we studied have strategically incorporated longevity into their incentive structures; for example, some use milestone-based bonus pools that are aligned with fundraising goals. An optimal incentive arrangement will produce strong investment performance, retain the current alternatives team, and attract top talent to grow it.

**Preserve the autonomy of the alternatives team.** Irrespective of how a traditional asset manager enters the alternatives market, a consistent determinant of success revolves around autonomy. The highest-performing alternatives teams are kept independent of the traditional asset management business. That means incorporating an operating model that protects the autonomy, culture, and often the brand of the alternatives team.

Seeking out cost-saving and efficiency-producing opportunities across the value chain—for example, through centralizing corporate services or integrating some middle- and back-office functions—is entirely possible, as long as the core alternatives front-office team remains detached. Multiple firms cited this as the biggest driver of success in their alternatives business and often a key criterion for closing an M&A deal.

**Optimize distribution and fundraising.** Assuring the continuity of sales and fundraising while forging new distribution opportunities gives an alternatives business a secure foundation with the prospect of strong growth into the future. Traditional asset managers can provide anchor capital to aid fundraising efforts and form a specialized alternatives sales team to certify that the right expertise is being deployed in distribution activities. In a merger or acquisition, the target should engage their limited partners or existing investors early in the process to address concerns and gather consent.



Managers can identify additional distribution opportunities by leveraging existing institutional relationships and encouraging collaborative efforts between the institutional and alternatives sales teams. Meanwhile, the strategic pursuit of new growth areas, such as retail, can uncover future sources of asset flows.

**Align strategic interests.** The most successful alternatives units have been formed around the alignment of strategic interests. When building, buying, or partnering with an alternatives team, a traditional asset manager must have full conviction in the underlying alternatives business and, therefore, possess a fundamental belief in value creation. Furthermore, the bold decision to expand into alternatives must be a strategic priority among the firm's top leaders, who must then communicate their plans and rationale to all of the organization's stakeholders. It is essential to go in with an underlying hypothesis and commitment to the notion that the future of asset management encompasses alternative investments.

The alternatives arena is one of the most prosperous avenues across the asset management industry. This much-in-demand asset class meets investor goals of increased diversification and return potential while, at the same time, creating an unprecedented profit opportunity for the firms that manage it well. Asset managers that skillfully enter the alternatives market and capture the upside can forge an accelerated path toward success.

## Personalization

Owning the customer experience will be as important as having good products in the years ahead. Advances in data availability, data science, and computing power now make it possible to create true personalization in the asset management industry, much like consumers experience when they use entertainment platforms and service apps. Personalization will span both the client experience and products.

### THE CLIENT EXPERIENCE

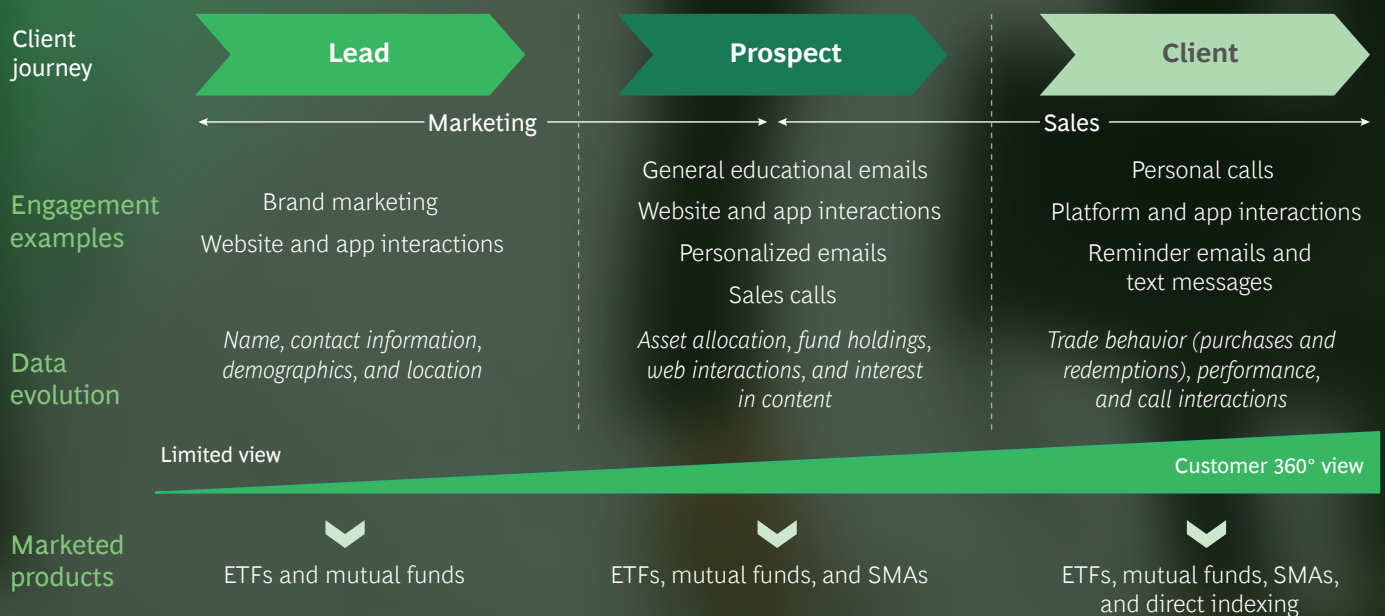
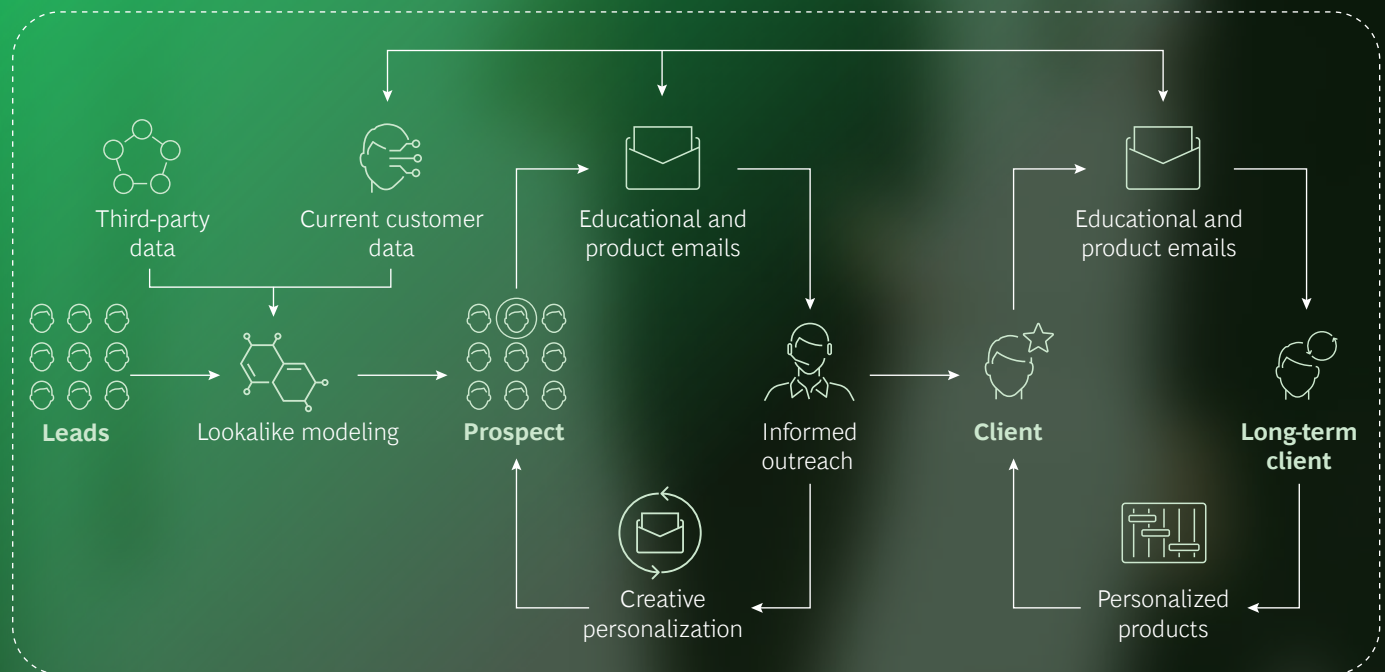
Personalized engagement already exists in asset management. In the US, where asset managers are often independent businesses, employees of the wholesaling function of an asset manager typically call on a financial advisor to discuss the advisor's needs, which is a version of personalization. The problem is that this method doesn't scale efficiently to serving thousands of advisors, so it's an expensive proposition. Nor is it possible for even the most talented wholesaler to keep track of all the relevant information about their client book.

New technologies, however, can provide a huge boost to personalization efficiency and effectiveness. For example, systems that have automated features can help marketers engage prospects in a dialogue. A marketer sends purpose-built multichannel communications (such as targeted educational and product emails and content interactions on web properties) to a prospect, and the system captures and processes every interaction and recommends the next step on the basis of the prospect's responses. The interaction continues largely automatically until the threshold for personal engagement is reached. At that point, the marketing team has a truly warm lead—one with a huge amount of data—that it can hand off to the wholesaling function, dramatically increasing the odds of a successful conversion. By deploying such technologies, we have seen asset managers increase their sales conversion rates by about 20% relative to traditional approaches.

Once a prospect becomes a client, a client data system can guide an asset manager using a new set of data and analytic capabilities. It will be possible to create fully automated lists that synthesize all known opportunities, risks, and relationship metrics in one place, delivered in natural-language sentences that clearly explain why an advisor is on the list.

For example, similar to the way a device for a global positioning system can scope out the best route, a client data system can recommend tailored actions, including marketing packages that launch automatically with a click of a button. Let's say that a smaller account holder is starting to express an interest in a new product; the system knows this because the advisor recently visited the product page. The system also knows that advisors of a similar size have recently increased their purchases of the product. Rather than scheduling a call, which can be time consuming and, therefore, expensive, the system prompts the wholesaler to hit a button on the computer screen labeled "launch cross-sell package A." That one click sends out preprogrammed, multichannel educational content to entice the client to learn more and, ideally, purchase the product.

# Personalization Can Be Applied Throughout the Client Journey in Marketing, Sales, and Products



Asset managers can provide more-personalized products the more they know their clients

Source: BCG analysis.

Note: ETF = exchange-traded fund, SMA = separately managed account.

Such systems can be implemented now, but many asset managers face challenges with data integrity, technology capabilities, data science talent, and buy-in from the sales team. Overcoming such barriers should be a top priority. The power of personalization will lead to a winner-take-most dynamic, in which the firms that truly know their customers stand to earn more than a fair share of capital inflows and lock in longer-term trusted relationships.

## PERSONALIZED PRODUCTS USING DIRECT INDEXING

The vast majority of products sold to retail customers are one size fits all. Customization (through products such as separately managed accounts) is reserved for ultra-high-net-worth individuals or institutional segments. Direct (or custom) indexing (the ability to create highly customized portfolios at scale) has the potential to change the game by unlocking the potential for truly personalized products at scale for affluent individuals. Gaining access to these retail investors requires asset managers to determine how they are going to build this disruptive technology into their transformation plan; if they don't, it could present an existential risk to their business.

So far, the US has been the main adopter of direct indexing. The past several years have seen AuM from portfolios built with direct indexing more than quadruple, rising from roughly \$100 billion to more than \$450 billion since 2015. Technological advances have unlocked the ability to scale in recent years, but direct indexing really caught on in the US after fractional shares and zero-fee trades went mainstream in 2019. These initial developments helped create a perfect storm for the popularity of direct indexing in a market where investors already favored passive products. Customization offers them additional benefits, such as the ability to choose which underlying components to sell during drawdowns, selectively allowing for greater tax alpha realization than an ETF could offer.

There are also clear benefits from an asset manager's perspective, such as higher fees (compared with passive funds) and long-lasting investor relationships. What most asset managers may not have fully realized, however, is that there has been a shift in who creates value.

Direct indexing works in much the same way that some streaming services make it possible for customers to download and mix individual songs, instead of buying albums. Direct indexing enables advisors and their clients to buy securities one at a time and mix them into an individualized portfolio. With that, the power to create value shifts from the asset manager to the end customer. The largest wealth managers have been very transparent about their intention to let advisors create customized portfolios, essentially bypassing the traditional asset management distribution value chain. Many asset managers we've spoken to have not fully processed this implication.

Nevertheless, the technology that makes direct indexing possible is here to stay, presenting risks to asset managers but also multiple opportunities. (See [Exhibit 10](#).)

**Three Strategies.** The successful implementation of direct indexing will require a number of considerations, and a game plan is essential. Asset managers must be able to clearly identify the firm's goals and technological capabilities. They must also weigh one strategy against another:

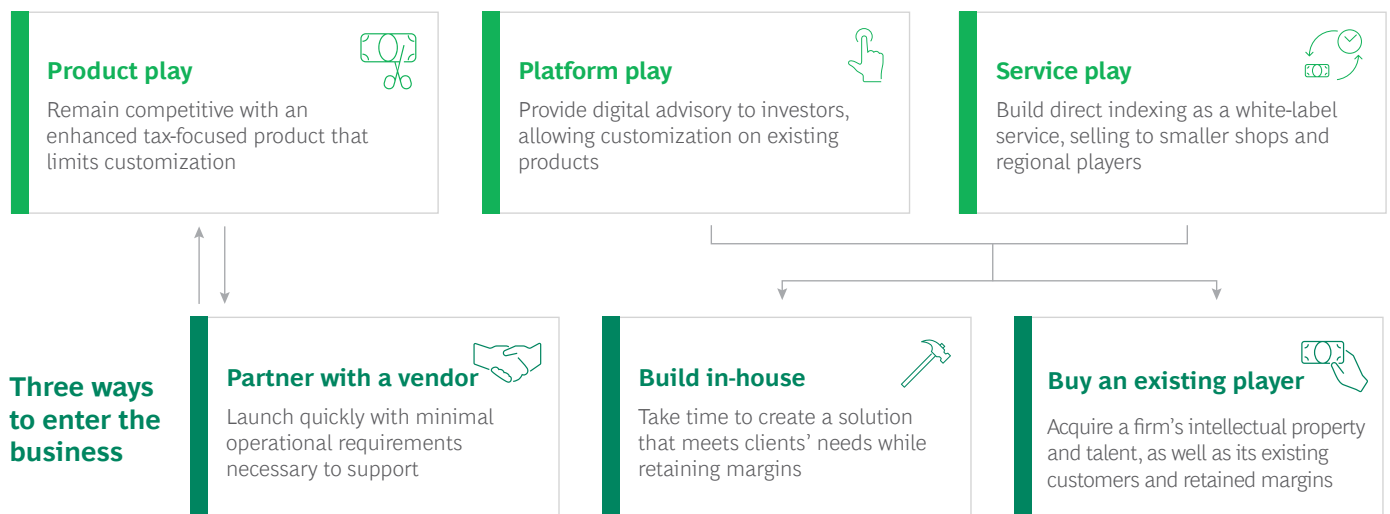
- **Product Play.** The lightest-touch direct indexing offering is a tax-focused product with limited customization. The product makes it possible for asset managers, particularly those that already have existing tax-focused products, to limit the risk of direct indexing disintermediation without having to make significant resource commitments. Current investors can achieve tax alpha benefits, while new investors may have an incentive to leave competitors that lack comparable offerings and come on board. Since the demand for these direct indexing products is driven by investors who prioritize tax efficiency, providing a tax advantage through a product that has a plain-vanilla portfolio with limited customization can be a highly replicable and scalable offering with limited operational impact downstream.
- **Platform Play.** For asset managers that do not have a significant wealth-management client base, direct indexing is an opportunity to provide investors with a quasi-wealth-management experience at scale, without requiring a large staff of advisors. For clients who are comfortable with self-service, the ability to develop total portfolio solutions with customization can be a compelling offering. A likely starting point would be to combine this with an existing or new robo-advice offering to provide wealth services, further differentiating the value proposition. A platform play of this nature can unlock additional revenues beyond the currently captured product fees.
- **Service Play.** Another strategy that can lead to success in the direct indexing space is to develop a white-label service for wealth managers who lack the scale and sophistication to build or buy direct indexing themselves. Taking this approach positions the asset manager as a value-added service provider whose expertise can be monetized through either a fee for service (such as a subscription-based business) or through increased customer share of wallet and loyalty.

Firms that build a direct indexing service can leverage their scale, selling their technology to smaller shops and regional players. While white-label service players risk having to compete with fintechs, a strong service-based offering can increase the stability of earnings that are not reliant on market outperformance.

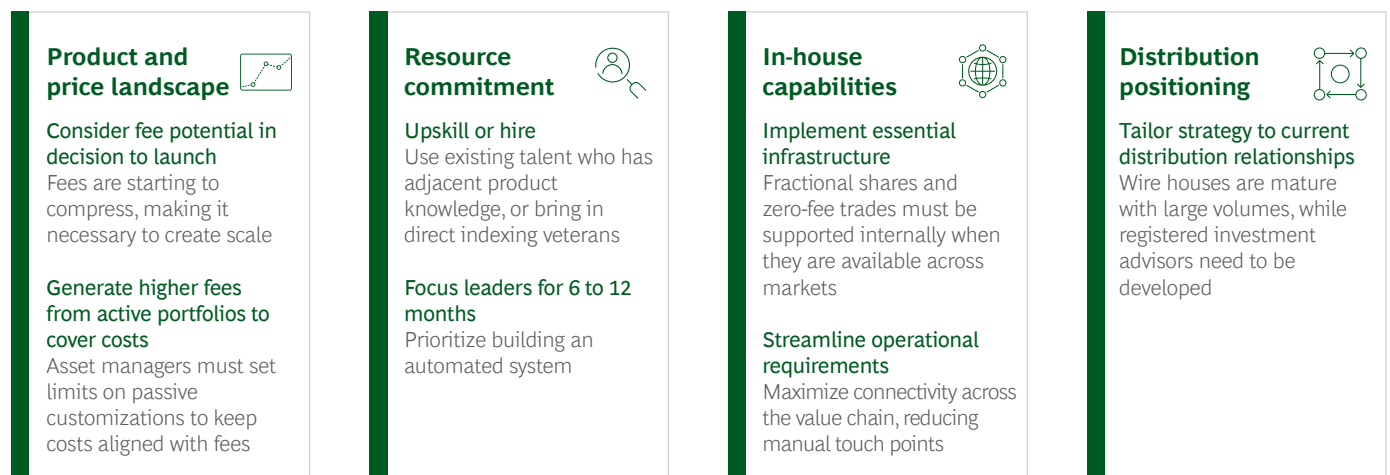


# Exhibit 10 - Winning in Direct Indexing Requires a Game Plan

## Three strategies



## Key considerations



Sources: Expert interviews; BCG analysis.

**Key Considerations.** As asset managers evaluate these different end-states, they will also need to determine how they'll enter the direct indexing business. They may partner with a vendor, build the capability in-house, or acquire an existing player. The key decision drivers will be which end-state they desire, along with their time-to-market goals.

For asset managers that prioritize speed to market and minimizing operational impact, partnering with a vendor will meet their needs, with the tradeoff of giving up some margin to the provider. To build the capability in-house assures that the asset manager can retain the fees charged for direct indexing, but it also requires devoting significant time and capital to the transformation effort. Buying an existing player is a great way to acquire all of the necessary capabilities, gain a customer base, and retain the margins, but the acquiring asset manager must be willing to make a large initial capital outlay and a commitment to managing the integration.

Internally, asset managers that want to get into direct indexing products need to evaluate a number of core factors to ensure success. In particular, they should consider such details as product pricing, resource commitments, existing capabilities, and distribution positioning.

When it comes to the product and price landscape, asset managers must be careful not to treat direct indexing as a silver bullet against margin pressures. Direct indexing has not been immune to the fee compression that has plagued many areas of the industry. As it has received more attention, competition has increased, and average fees have already fallen by roughly a third, with more room to decline given that performance costs are relatively low. Firms must also consider how freely they will allow customization, as straying into too many permissible positions invites operational complexities that could be more akin to an active strategy than a passive one. A viable compromise is to institute customization within a core-satellite model. In this model, large portions of the portfolio are standardized with limited customization, while a smaller part of the portfolio has increased flexibility.

While talent and resourcing have been top concerns for the past couple of years, these factors will be particularly important to succeeding with direct indexing. Building a transformative framework will take an outsized level of effort at the beginning. The firm's leadership should plan to make it their main focus for approximately 6 to 12 months. In addition, given that the pool of people with experience in this area is small, asset managers may want to consider cross-training in-house talent with strong experience in tax-focused or index-based products before looking to hire or acquire talent. It will be important to have this specialization across the value chain, as sales teams, investment management staff, and technology specialists will have a role in making decisions that ultimately impact investment performance.

Having the internal capabilities to scale automation across the value chain is also critical to success. Fractional shares and zero-fee trades are key to enabling direct indexing, so the firm must have these capabilities in systems across the value chain. In addition, the tech stack must be configured to have strong connectivity throughout, enabling automation in the rebalancing engine, trade execution, and client reporting. Even with best-in-class automation, asset managers may experience difficulties quickly processing complex transactions, so they should be prepared to handle constrained positions and large redemptions, both of which will require specialized knowledge to resolve. Asset managers with existing expertise in separately managed accounts will be well positioned to leverage their risk management, compliance, and other enabling functions, given the similarity between these accounts and direct indexing.

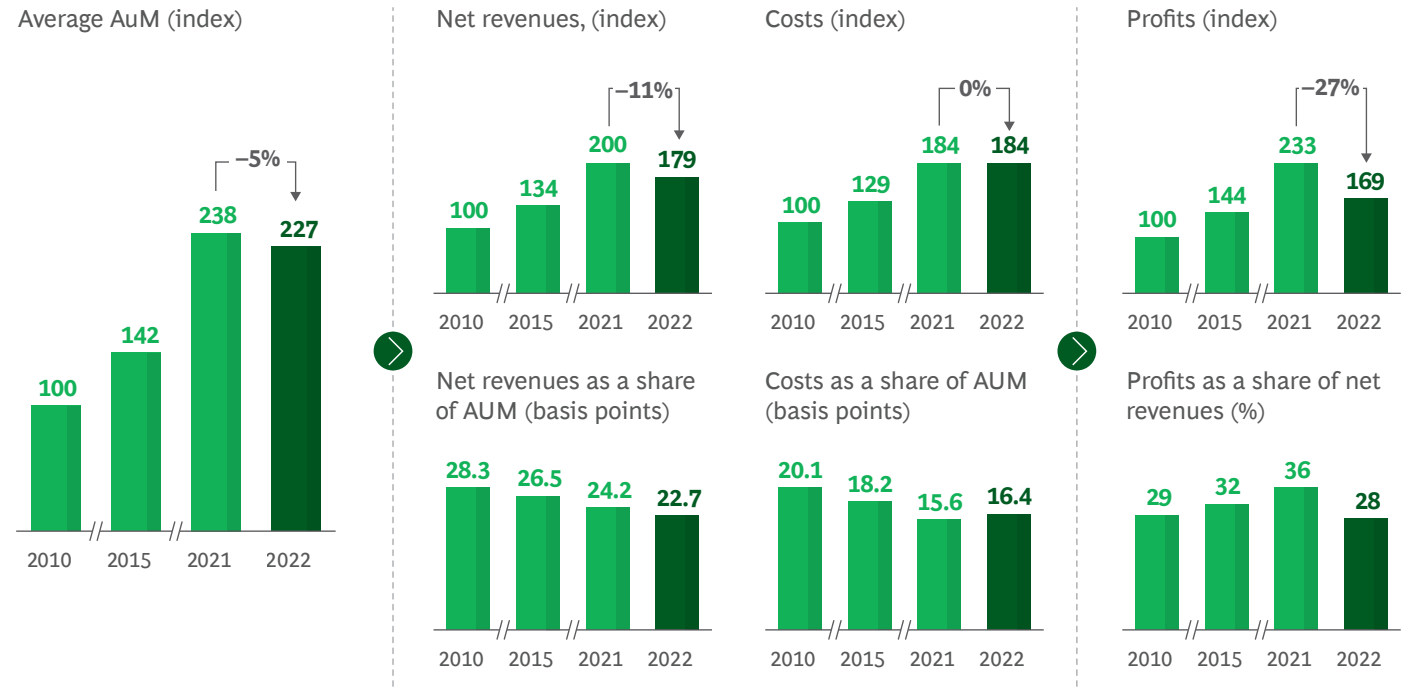
Existing distribution channels will play a significant role in an asset manager's ability to roll out direct indexing. In the US, wire houses have been the quickest to educate themselves—and their clients—on direct indexing. As a result, the partnerships they've forged, especially when combined with their large volumes, have made them the preeminent channel for direct indexing. For asset managers with a larger concentration of registered investment advisors, a well-designed product with streamlined integration will be key to convincing the advisors to grow their direct indexing offerings. Asset managers connected with family offices, which often follow investment strategies that are aligned with a set of principles, will find that strong customization capabilities are key to winning clients over to direct indexing.

After years of organic growth and record profits, asset managers must now test their mettle. The markets are full of uncertainties, and the march of technology is bringing inevitable changes to the way financial services firms serve their clients. It is, therefore, more important than ever for asset managers to transform and build more innovative organizations.

On the bright side, however, the path to transformation is clear and imminently achievable for most. The leaders who take action now are the ones most likely to survive and thrive in the decade ahead.

# Appendix

## Appendix 1 - Asset Managers' Profits Fell Significantly in 2022, While Costs Remained Constant

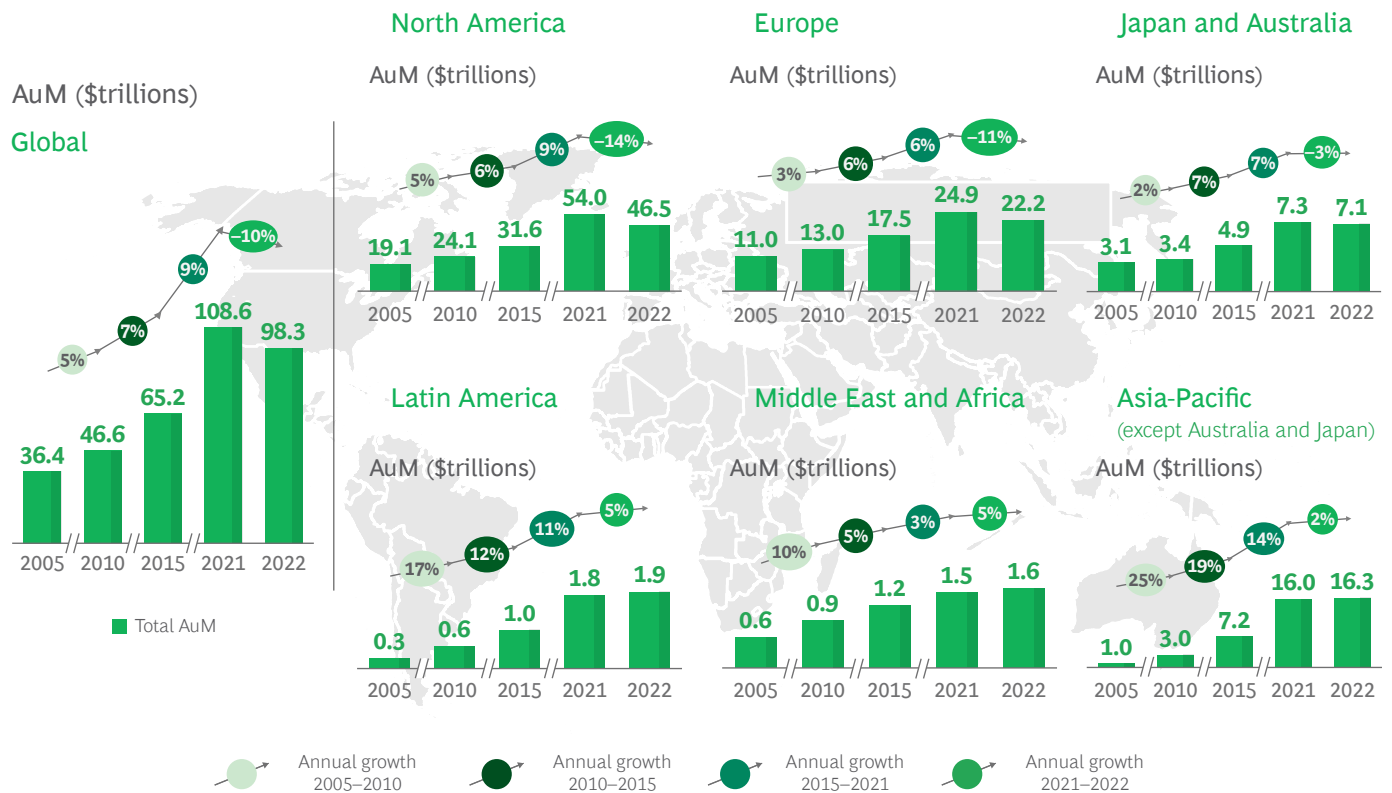


**Source:** BCG's Global Asset Management Benchmarking Database, 2023.

**Note:** Analysis is based on a benchmarking study of 74 leading asset managers that represent \$62 trillion in AuM, or about 63% of global AuM.



## Appendix 2 - Global AuM Fell 10% in 2022, with North America and Europe Being the Main Drivers of the Decline

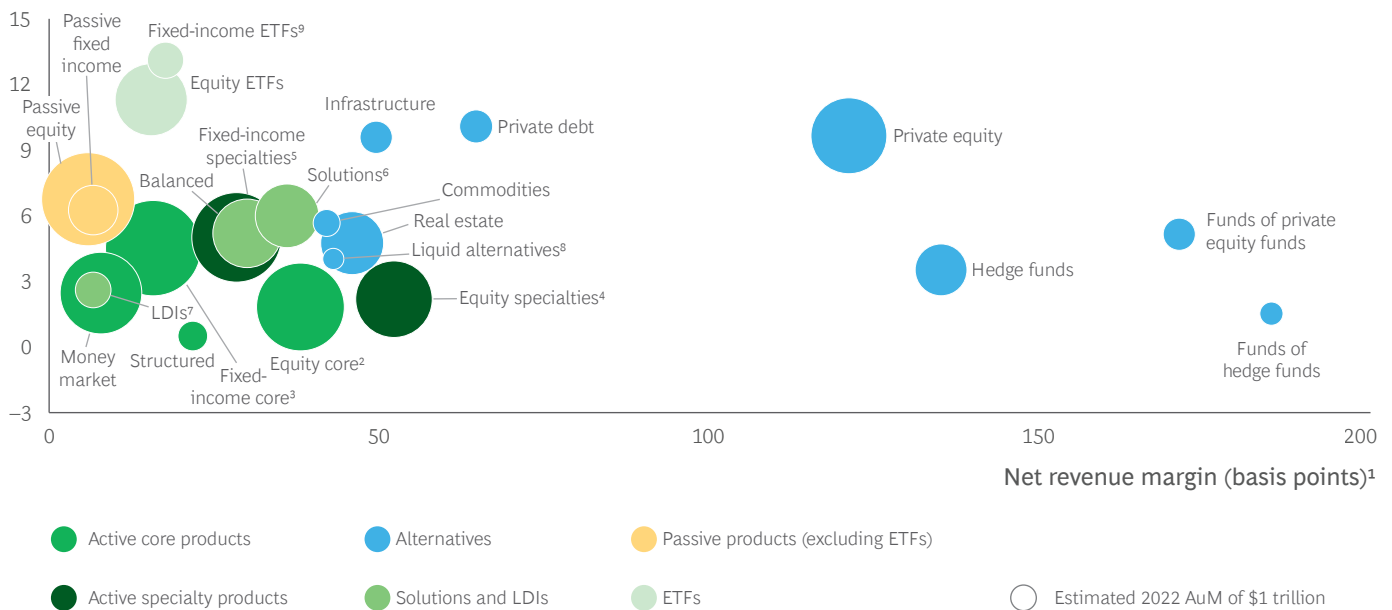


**Sources:** BCG's Global Asset Management Market Sizing, 2023; The Economist Intelligence Unit; Institutional Shareholder Services Market Intelligence's Simfund; WTW; government agencies, including regulators; BCG analysis.

**Note:** Market sizing was performed on assets sourced from each region and professionally managed in exchange for management fees. The market sizing included the captive AuM of insurance groups and pension funds that were delegated to asset management entities in exchange for fees paid. Globally, 44 markets were assessed, including North America (Canada and the US); Europe (Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Russia, Spain, Sweden, Switzerland, Turkey, and the UK); Asia-Pacific (Australia, Hong Kong, India, Indonesia, Japan, Mainland China, Malaysia, Singapore, South Korea, Taiwan, and Thailand); Middle East and Africa (selected sovereign wealth funds of the region and mutual funds, plus Morocco and South Africa); Latin America (Argentina, Brazil, Chile, Colombia, and Mexico); and offshore AuM (which is not included in any region). For all countries where the currency is not the US dollar, the end-of-year 2022 exchange rate was applied to all years to synchronize current and historic data. Values differ from those in prior studies because of exchange rate fluctuations, revised methodology, and changes in source data.

## Appendix 3 - ETFs and Select Alternative Products Are Expected to Lead Growth Through 2027

AuM growth, 2022–2027E (%)



**Sources:** BCG's Global Asset Management Market Sizing Database, 2023; BCG's Global Asset Management Benchmarking Database, 2023; Institutional Shareholder Services Market Intelligence's Simfund; Pensions & Investments; Investment Company Institute; Preqin; HFR; INREV; BCG analysis.

<sup>1</sup>Management fees net of distribution costs.

<sup>2</sup>Includes actively managed developed-market large-cap equity products.

<sup>3</sup>Includes actively managed developed-market government and corporate debt.

<sup>4</sup>Includes global equities, emerging-market equities, developed-market small caps and midcaps, and themes.

<sup>5</sup>Includes emerging markets, high-yield, flexible, and inflation-linked products.

<sup>6</sup>Includes target-date funds, target maturity products, and outsourced chief investment officer.

<sup>7</sup>LDI = liability-driven Investment.

<sup>8</sup>Includes absolute return, long and short, market neutral, and trading-oriented mutual funds.

<sup>9</sup>EFT = exchange-traded fund.

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