McKinsey & Company

Global Banking Practice

Asian asset management: Protecting and creating value in disruptive times

September 2019

Authors

Jacob Dahl

Senior Partner
Hong Kong

Fumiaki Katsuki

Partner
Tokyo

Vishal Kaushik

Senior Knowledge Expert
Singapore

Philipp Koch

Senior Partner
Munich

Gunashrit Nag

Solution Delivery Specialist
Gurgaon

Anu Sahai

Senior Knowledge Expert
Singapore

The authors would like to acknowledge the contributions of Vidushi Sathoo and Cheryl Grover to this report.

Asian asset management: Protecting and creating value in disruptive times

On at least one critical measure—growth—Asia dominates the global asset management industry. The region attracted 56 percent of global flows between 2013 and 2018. Yet, Asia is not immune to the recent macro-economic uncertainties that have affected the global industry. After six years of robust growth of 15 percent CAGR, Asian assets under management (AuM) gained just 5 percent in 2018. In addition, five disruptions—rising cost pressures, pressure on margins for traditional products, the ascendance of pension and insurance segments, increased demand for cross-border products, and the progress of digitization—are likely to affect future growth of Asian markets.

How can asset management companies survive these disruptions and continue to create sustainable value? The answer lies in identifying the right avenues to create value and adopting the most relevant capabilities. Gaining scale, finding new sources of fee revenue, and adopting digital and analytics are important priorities on the path ahead.

This article reviews the year just past, the five key trends shaping the Asian asset management industry, their impact on the industry's economics, and the three elements companies must revisit to build sustainable value. Our findings are drawn from our two long-running research programs, the McKinsey Performance Lens Global Growth Cube and the 2019 edition of the McKinsey Asia Asset Management Survey.

Despite a slow 2018, Asia still propels global growth

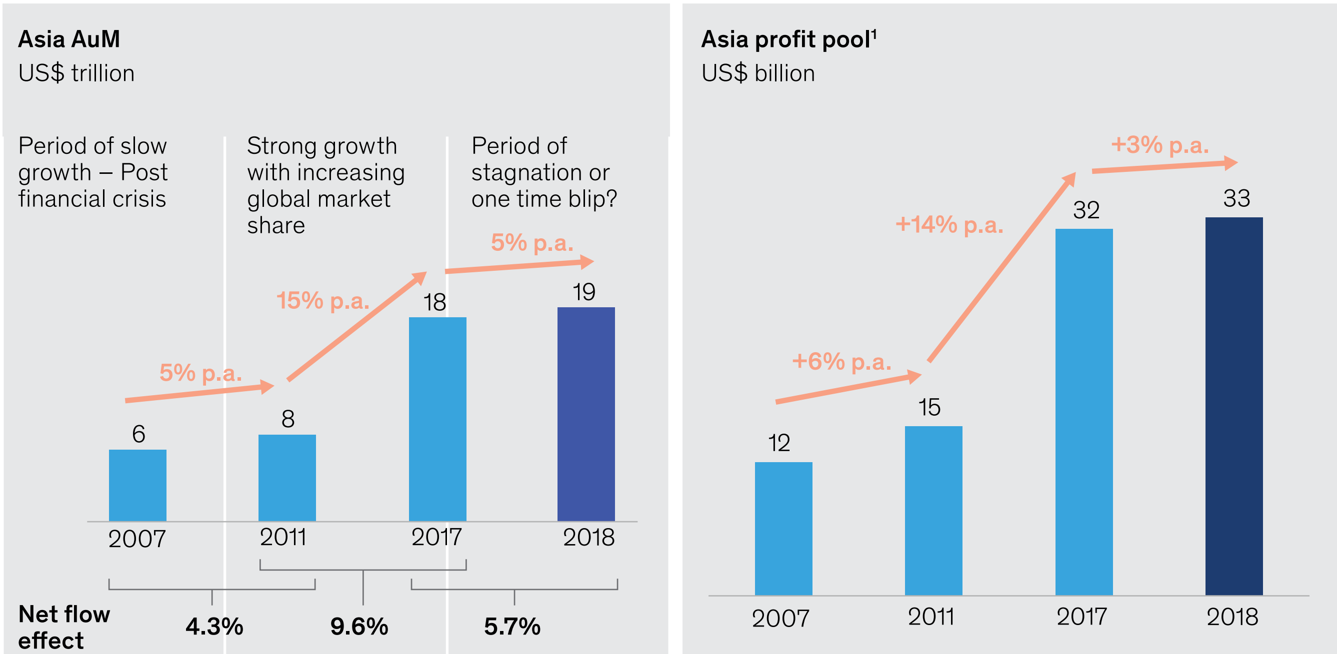
In 2018, macro events and geopolitical turmoil caused a reverse in growth (-1 percent year-on-year) in the global asset management industry for the first time since the financial crisis. Asia slowed dramatically; AuM growth was the slowest in seven years (Exhibit 1). A primary cause was the decline in market performance of 3.2 percent on average in 2018, driven by weakening Asian equity markets, which were highly volatile. Profit pools were accordingly affected, growing at 3 percent for the year, down from an average of about 14 percent over the previous six years .

While the slowdown is disturbing, Asia still dominates global growth: more than half of all growth between 2013 and 2018 took place in the region (with about 77 percent of global flows, or about $1.5 trillion, in 2018). Asia has long had stronger profit margins than other asset management markets, and that continued in 2018. Revenue and cost margins rose in tandem, and Asian profit margins remain healthy at 22.5 bps (of average AuM), around double those of North America (11.1 bps) and Western Europe (12.3 bps) (Exhibit 2).

Of course, Asia is a composite of many national markets, all with their own nuances and regulatory

Exhibit 1

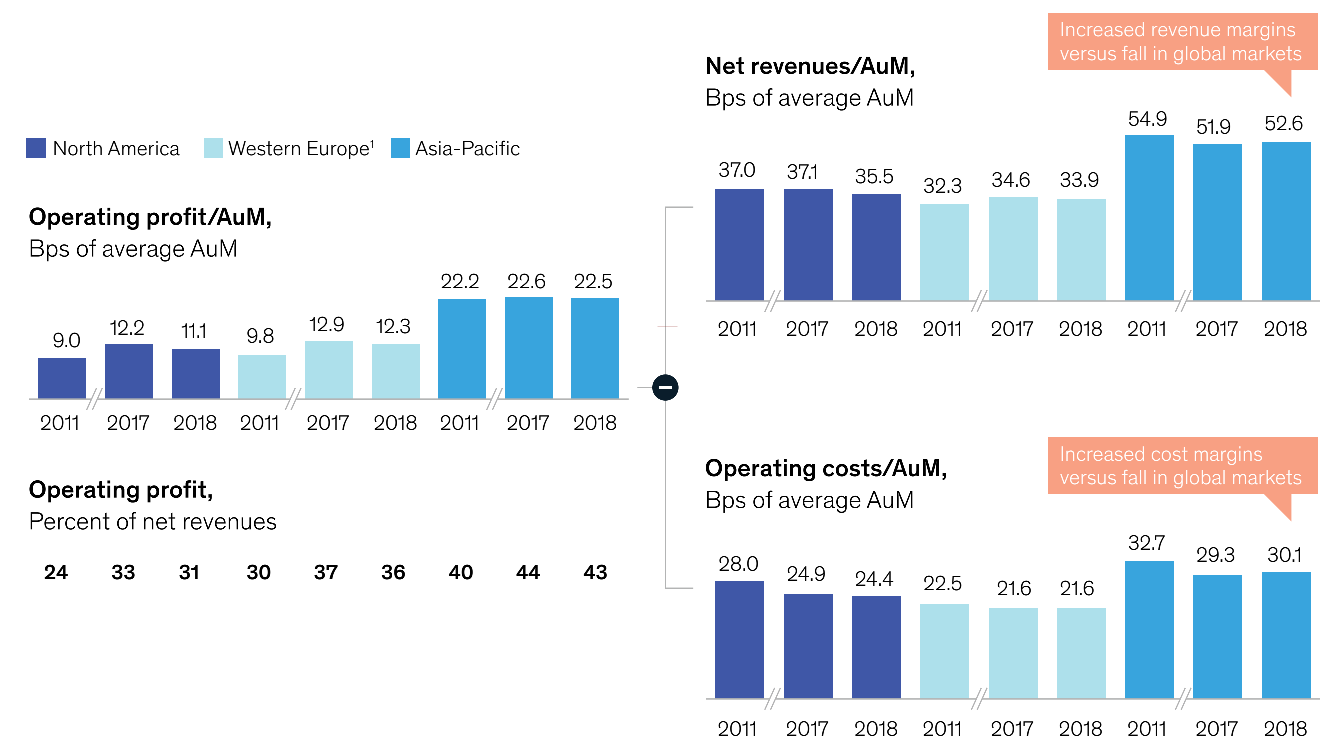
In 2018, Asia registered its slowest AuM growth in seven years.



[1] Profit pools based on traditional AUM (excluding alternatives)
Source: McKinsey Asia Asset Management Survey; McKinsey Performance Lens Global Growth Cube

Exhibit 2

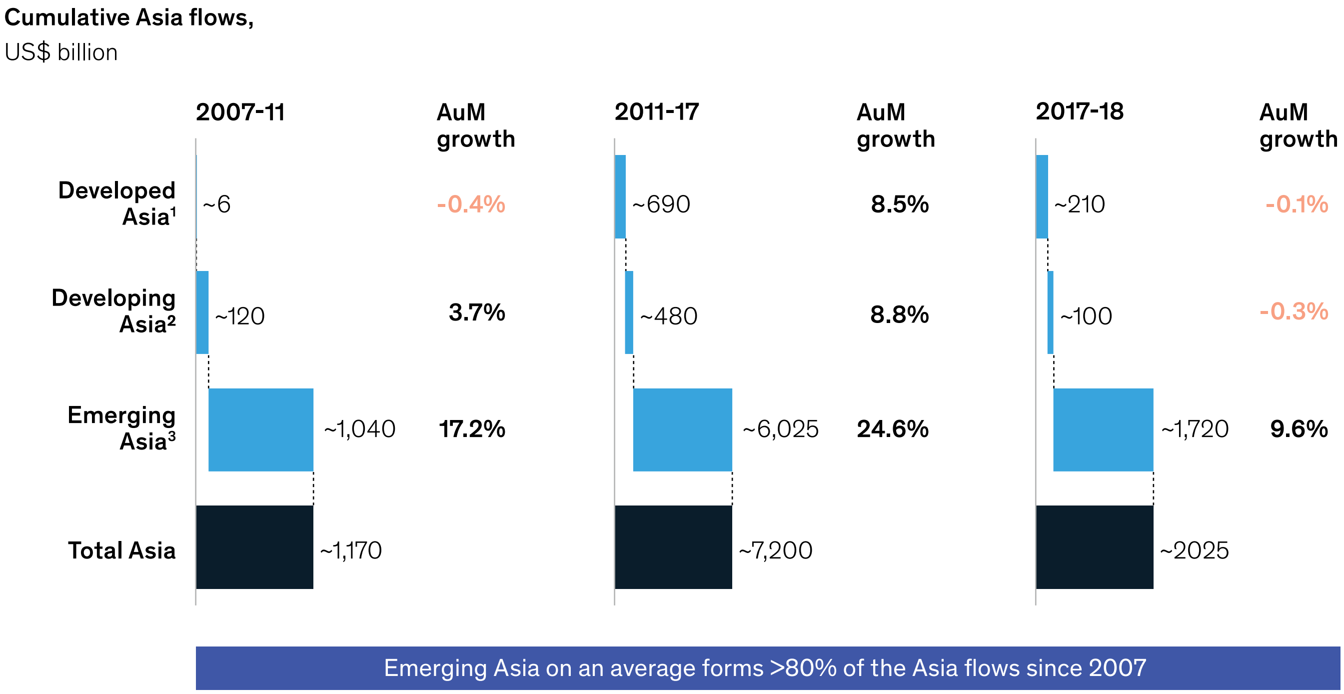
Asia's profit margins remain strong, ~2x global markets.



[1] Western Europe Operations includes ~1bps of expense from associated TA costs
Source: McKinsey Performance Lens Global Asset Management Survey

Exhibit 3

Emerging Asia leads the region, with strong flows and increasing share of AuM.



[1] Includes Australia and Japan
[2] Includes S Korea, Singapore and Hong Kong SAR China
[3] Rest of Asian markets
Source: McKinsey Performance Lens Global Growth Cube

regimes. While Emerging Asia[1] registered rapid (about 10 percent) growth in AuM from 2017 to 2018, and accounted for 85 percent of all Asian flows, Developed Asia[2] stayed nearly flat, losing 0.1 percent AuM 2017–18. The difference is also stark if we compare the two markets over a decade: Emerging Asia garnered more than 80 percent of all Asian flows in the period 2008-18 and registered 22 percent annual growth in AuM, while growth in Developed Asia was 6.0 percent annually (Exhibit 3).

About 93 percent of Emerging Asia flows (including money-market funds) come from Mainland China. Fuelled by strong retail demand and a newly conducive regulatory environment, the growth story in Mainland China is the envy of developed markets. Mainland China's market boom has contributed heavily to strong net flows over the past decade, with an average flow effect of around 20 percent annually. In addition, recent regulatory changes have given impetus to foreign firms to explore opportunities to set up shop in the private fund market to serve institutional and accredited investors. This has been coupled with the proposal to allow global firms to enter Mainland China's public fund market either through majority ownership of domestic firms, or through conversion of the private funds license (proposed for next year). These moves suggest growth will stay strong.

Close behind are Indonesia and India, with an impressive asset growth trajectory of 17.7 percent and 17.5 percent respectively over the last decade due to strong capital markets and a significant regulatory push to develop the asset management industry. South-east Asian markets on average have been increasingly contributing to growth, driven by growing affluence, the shift of financial savings into investment products, regulatory impetus to grow the industry, and improving investor confidence and awareness.

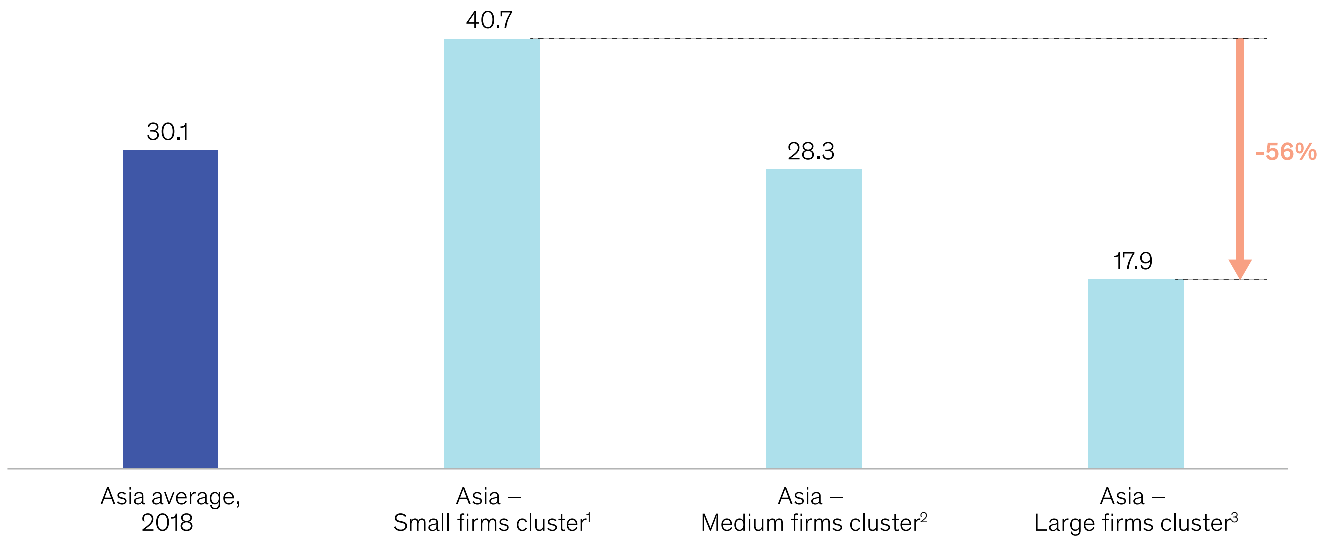
[1] Emerging Asia includes Mainland China, India, Indonesia, Malaysia, Thailand and Taiwan China.
[2] Developed Asia include Australia and Japan.

Exhibit 4

Large firms reap efficiencies of scale.

Asia Operating cost

Bps of average AuM, 2018



[1] Firms with AuM less than US$ 40 billion
[2] Firms with AuM in between US$ 40 -100 billion
[3] Firms with AuM greater than US$ 100 billion
Note: Sum of figures may not add up due to rounding differences
Source: 2019 McKinsey Asia asset management survey

Five fundamental shifts

Global market uncertainties and geopolitical volatility (such as the US–China trade war) might dampen future growth. However, there are five disruptions specific to Asia that can potentially have much bigger impact on growth and the industry's economics.

Increasing cost pressure makes scale critical

With rising costs and required investments for the future, Asian asset managers are seeing scale as a vital value-creation lever. Absolute costs have risen swiftly, about 25 percent over the past two years, partly due to investments into growth markets. Firms' economics vary widely, with smaller asset management companies (AMCs) at cost margins of about 41 bps (costs/average AuM) versus larger AMCs at about 18 bps (Exhibit 4).[3]

Margin pressure leads to more non-traditional offerings

Margin pressure and client demands are leading to the rise of non-traditional offerings, and a solutions orientation for managers. Products have shifted gradually in recent years from traditional offerings to solutions that address a client need. Multi-asset and passives represented about 90 percent of total flows in 2018; active equity funds registered outflows. Within passives, ETFs have been the key offering, driving about 70 to 80 percent of the region's flows, with particular strength in Japan, Taiwan China, and South Korea. In multi-asset solutions the demand has been for absolute return strategies and, increasingly, target-date and target-risk funds. In many cases, new solution-oriented offerings are a bundle of traditional and non-traditional products.

The trend toward solutions has supported the industry's economics. Managers can potentially charge higher fees for multi-asset and alternatives, in line with the sophistication and precision of the solution offered. While retail active equity and active fixed-income fees dropped in 2018 (on average by 4 percent and 8 percent, respectively), the multi-asset category registered a 12 percent increase.

[3] Smaller AMCs are those with AuM under USD 40 bn, while "larger AMCs" are those with AuM over USD 100 bn

From a thematic standpoint, environmental, social, and governance (ESG)-oriented investing is gaining strong momentum due to growing client demand and greater regulatory focus on fiduciary responsibility. Asian firms are likely to invest further in developing competencies in manufacturing and distributing ESG products. The 2019 edition of McKinsey's Asia Asset Management survey confirms the trend: by 2022, every AMC we surveyed expects to offer ESG as a key strategy.

Pension and insurance waves redefine the institutional landscape
In institutional, pension is the dominant client segment with a 40 percent share of AuM. The industry has seen a continued shift from defined benefit (DB) to defined contribution (DC) over the past few years, with strong flows into DC. Additionally, regulators across Asia are pushing for more mandatory and voluntary pension savings programs, to ensure broad-based retirement coverage. The National Pension Fund in Thailand, currently in discussion, is one example; China's third pillar of retirement savings, a market-oriented personal pension scheme, is another.

A second client segment, insurance, has steadily gained share in the institutional mix. It represented the majority of institutional flows in 2018, boosting its share of institutional AuM from 7 to 10 percent. Difficulty in finding fixed-income yield is prompting insurance firms to seek alternative sources of return, and to outsource more mandates to third-party asset managers. Insurance firms are also re-orienting to solutions; they are offering their customers more fund-linked products to grow their share of wallet and boost their own revenue margins. Sales of two such products, unit-linked insurance plans (ULIPs) and annuities, are also up; in South-East Asia, that's been driven primarily by accentuated volatility in capital markets.

Cross-border integration is key for future growth
As customers increasingly demand both broader regional and global access, domestically oriented AMCs are contemplating the right cross-border vehicles to meet their needs. The choice between greenfield expansion or partnerships with larger global and regional AMCs—or a combination of the two—remains the big question, with material and direct impact on economics and the distribution model. Cross-border schemes developed in Asia have still not gained significant traction because of varying taxation and regulatory regimes. UCITs[4] and feeder funds (28 percent and 21 percent of cross-border assets, respectively) remain the key cross-border vehicles for AMCs, with European locations dominating in UCITs and SE Asian markets (especially Thailand and Malaysia) leading in feeder funds.

Managers digitize more of the value chain
Our 2019 Asia Asset Management Benchmarking Survey singled out digitization as the priority theme. Strategies to digitize various elements of industry's value chain are critically important to customer acquisition, investment performance, and reduction of operational costs. However, adoption has been slow; only 30 percent of firms surveyed say they now use or are installing tools such as digital marketing, big data to de-bias investment decisions, machine learning in risk management, and many others.

These five disruptions will affect industry economics (Exhibit 5). A failure to adapt to these five disruptions might reduce profits from the current 22.5 bps by 10 percent or so over the next five years. Profit growth might also slow down, to about 3 percent annually, in line with 2018 growth. The pressure on profit margins will be driven by shifts in both revenue margins and costs. Pressure on fees on traditional products (which still dominate the product mix) will reduce average revenue margins. At the same time, costs are expected to continue rising, partly because of investments in future business growth and partly because of challenges in achieving economies of scale in a heterogenous market.

How AMCs can navigate these disruptions and create value

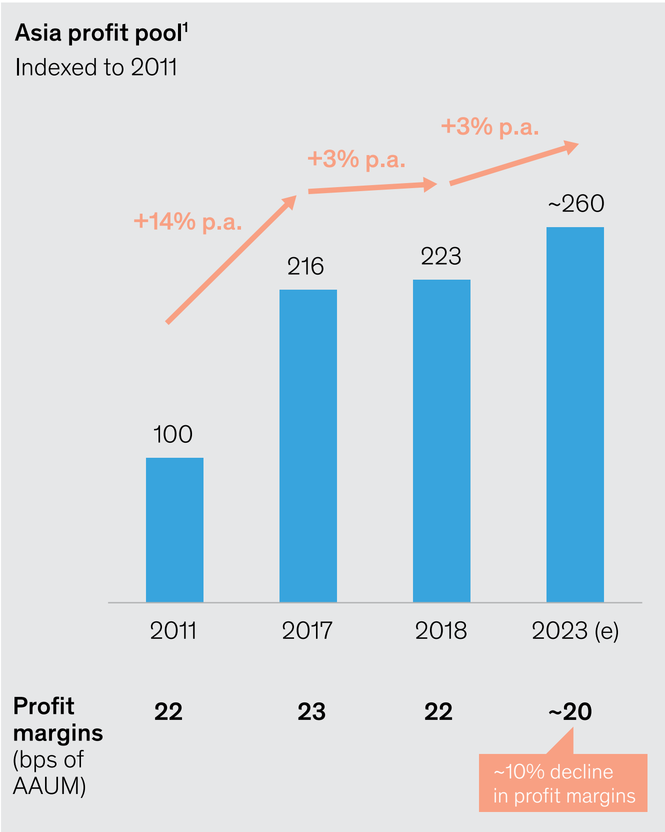
To make the most of the potential in these disruptions, and minimize their risks, asset managers must develop the right set of capabilities. We list three prominent priorities:

— **Gain scale:** Asset managers will need to find opportunities for partnerships and consolidation. As operating costs rise (and rise further with future investments) sub-scale firms with high cost margins may be challenged. Medium-sized and large firms will be better placed for partnership or acquisition opportunities. Critically, they must analyze these opportunities

[4] Undertakings for collective investment in transferable securities, a European Union directive that provides a regulatory framework for funds managed and domiciled in the EU and intended for sale to retail clients within and outside the EU.

Exhibit 5

Five disruptions will likely slow growth in profit pools; profit margins might decline by ~10% over next 5 years.



Key forecasting assumptions

AuM growth	Slower net flow trajectory vis-à-vis historical years of high organic growth Continued market volatility leading to conservative market appreciation going forward
Asset class mix	Traditional products dominating product mix; challenging transitioning from traditional to non-traditional assets given capability mismatch at fund houses
Revenues	Continued margin pressure on traditional products, with an increasing push towards solution orientation
Costs	Sustained increase in costs, driven by future spending towards digital adoption, regulatory compliance etc.

[1] Profit pools based on traditional AUM (excluding alternatives)
Source: McKinsey Asia Asset Management Survey; McKinsey Performance Lens Global Growth Cube

to ensure synergies across product capabilities, geographic access, client segment focus, talent, and technology. And they must bear in mind that those synergies can only be captured in a broader framework of cultural integration and revised governance model.

— **Attain fee flexibility through solution orientation:** In both institutional and retail, AMCs will need to shift the focus of their business model from products to solutions. AMCs will need to establish the right solution infrastructure, such as ESG offerings for high-net-worth individuals (HNWIs) and institutional clients, liability-driven investments and outsourced Chief Investment Officer (CIO) for insurance and pension clients, and mass-commoditized solutions like retirement funds for digital aggregators. Given fee pressure on traditional offerings, a solutions orientation will provide AMCs the flexibility to maintain or even grow fee margins.

They must of course explore whether they have the right skills and support infrastructure to develop such solutions internally; if not, they may need to acquire niche product teams or enter into partnerships to create and distribute white-labelled products with shared economics.

— **Digitize operations to enhance productivity and optimize cost:** Digitization is broadly associated with front-end customer engagement. However, many other applications have emerged, highlighting the importance of digital and analytics across the full asset management value chain. In distribution, for example, digitization can enhance RM productivity, and in some cases double it. In the back office, digitized processes can reduce costs and expand capacity. Robotic process automation and chatbots have helped some managers cut operational costs by 30 percent. In risk management, natural language processing can analyze alternative data such as social media to improve and debias investment decisions.

AMCs must ask if their current technology infrastructure is the right platform to digitize at scale and reduce investment cost. Often it is not. They then must decide whether these capabilities can be built internally, or whether partnering with fintechs and gaining access to their unique technologies will be faster and more effective.

Growth is suddenly in question, and other trends are gathering force. To stay relevant and competitive, AMCs will need to adapt. For many, the right levers are likely to be the pursuit of scale, the shift to solutions, and digitization across the business.

www.mckinsey.com/industries/
financial-services/our-insights

@McKBanking