The Science of Competing at Scale

Growth Readiness for Asset Managers

STATE STREET.

225 YEARS

A DISCIPLINED APPROACH

The act of pruning can powerfully stimulate growth in living organisms. When winemakers strategically trim their grapevines to remove unwanted branches, they channel the plant's energy into fruit production, minimizing the risk of poor yields.

The human brain undergoes its own extensive pruning in the first two decades of life. As young brains develop, billions of neurons in each cortex are selectively pruned to remove unnecessary structures and connection points. This process is associated with more mature learning and higher-order thinking, as the flow of information improves and more sophisticated signal processing is allowed to take place.

This pruning principle is highly pertinent to today's asset managers. They must learn to compete at scale while also becoming hyper-efficient and effective in their operations.

Managers should concentrate their resources into smart growth strategies that can differentiate their value proposition in an increasingly crowded marketplace.

New research from State Street shows that nearly two-thirds (64 percent) of asset managers believe it's becoming harder to find avenues for growth in the current environment.[1] As the pressure on existing business models intensifies, managers able to apply a more scientific approach to growth will be positioned to thrive.

Keys to Growth for Asset Managers

Strategize on scale

The future will present the greatest opportunities to global, multi-functional organizations or niche specialists that perfect the art of big and small; midsize players should move fast.

Fight inefficiency

New digital technologies such as robotics, artificial intelligence and blockchain will revolutionize investment and operating models, providing the foundation for managers to improve client outcomes.

Engage differently

Investors are demanding change across investment strategy, distribution and fees, risk management and access to information. It's time for managers to redraw their engagement models.

[1] State Street 2017 Growth Readiness Study. State Street commissioned Longitude Research to conduct a global survey of more than 500 senior investment industry executives, including 202 respondents from the asset management sector, during March and April of 2017. Study participants spanned investment, operations, sales and distribution roles. For more details, see page 20. All figures in this report originate from this research unless otherwise noted.

AN END TO EASY GROWTH

The asset management industry is being tested like never before. After years of high profit margins and revenues rising in line with assets under management, radical changes are sweeping the industry.

Confidence belies uncertainty

The asset managers in our study are more optimistic than the asset owners or insurers surveyed about hitting their growth targets over the next five years, with 78 percent reporting confidence, compared to 72 percent and 76 percent, respectively.

A major driver of this confidence is the expectation of strong economic growth: 56 percent say the economic outlook will provide one of the greatest opportunities for their business growth over the next five years and 40 percent cite the equity outlook in their key markets. However, managers should be prepared for more constrained conditions. Sustainable economic growth is a corollary of political stability, and there are good reasons to expect a volatile geopolitical environment in the next few years.

The International Monetary Fund (IMF) reduced its 2017 growth expectations for the US from 2.3 percent to 2.1 percent, based on the government's failure to pass immigration and healthcare legislation, raising doubts about the likelihood of its enacting a business-friendly legislative program.[2] The IMF also lowered its forecast for the UK (from 2 percent to 1.7 percent) as the country's recent general election left its parliament without a single majority party. Heightened unpredictability of Brexit negotiations creates risk of political and economic disruption in the UK and EU, which could act as a drag on growth. Asian economies are also at the mercy of escalating geopolitical tensions, which can make a bet on benign economic conditions over the next five years a risky one.

Managers should be cautious of overreliance on external growth factors. Industry leaders will develop a smarter, more focused notion of growth based on differentiation from peers through better systems and services, allowing more effective targeting of clients across markets.

The growth shortfall

A diverse mix of competencies is needed to support asset managers' growth ambitions — and that mix is evolving. Our Growth Gap Matrix (Figure 1) identifies the areas that asset managers must prioritize to strengthen their growth strategies by analyzing the competencies they rate as most important for long-term growth, versus their relative strengths and weaknesses today.

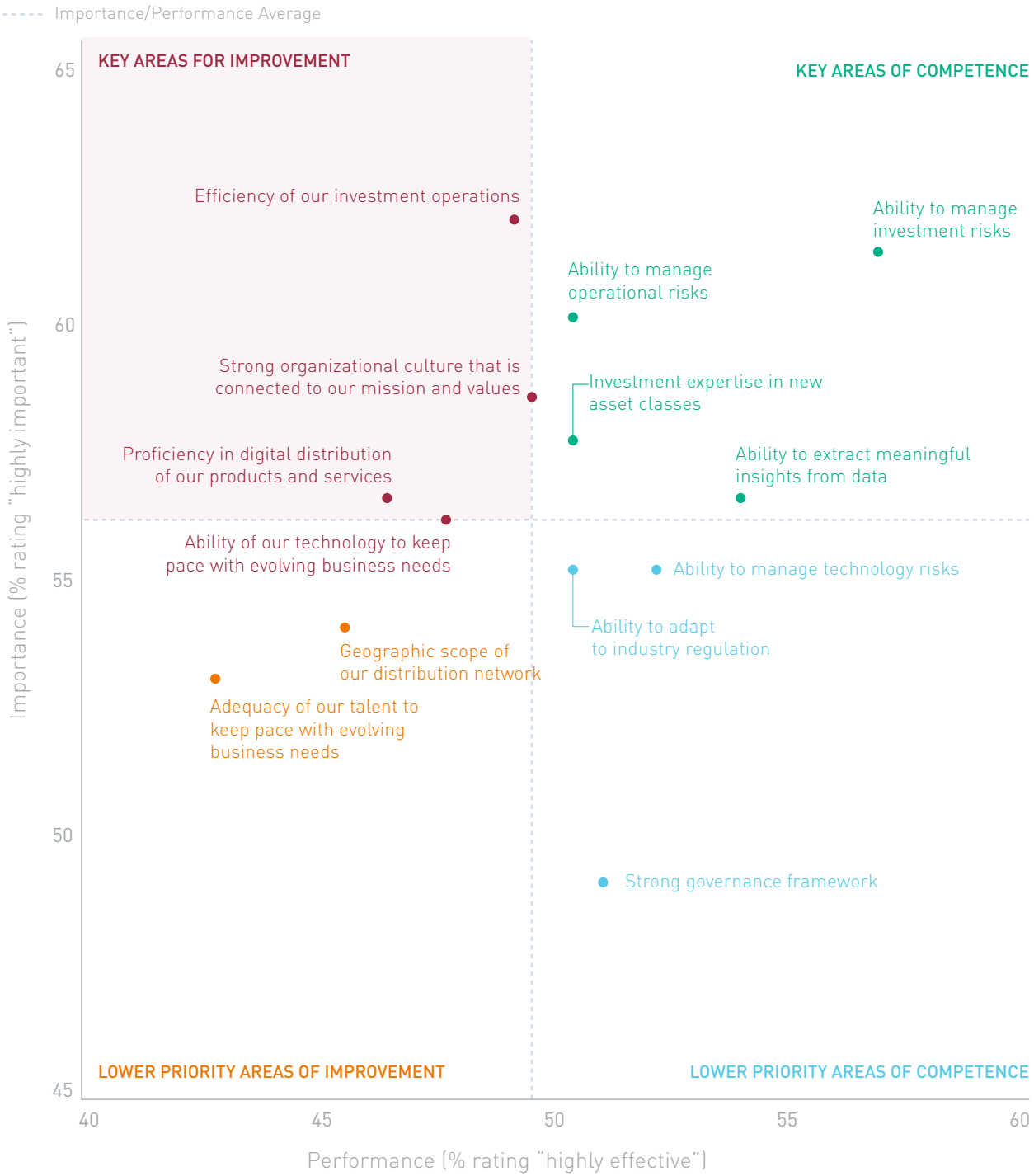
Across the industry, there are four areas that respondents deem critically important for their growth, but also recognize are relative weaknesses today:

- Proficiency in digital distribution
- Strong organizational culture that is connected to mission and values
- Ability of technology to keep pace with business needs
- Efficiency of investment operations

[2] IMF, World Economic Outlook Update, July 2017

Figure 1: Identifying growth gaps

How important do you think these internal capabilities will be in enabling your organization to meet its growth targets over the next five years? And how would you rate your organization's capabilities today?



Source: State Street 2017 Growth Readiness Study

Figure 2: Mismatched expectations

What are the most important changes that asset managers will need to make over the next year to attract investors?

Source: State Street 2017 Growth Readiness Study
Note: Respondents could select up to three options.

Shifting investor demands

Industry competition will intensify as institutional investors rationalize their use of external managers over the next five years and develop more sophisticated investment capabilities of their own. According to our research, 44 percent of asset owners and insurers say they will place larger mandates with fewer investment providers over the next five years, while 38 percent will place smaller mandates with more investment providers.

Investors continue to rebalance their portfolios in the push for returns. Investments in traditional fixed income asset classes are expected to combine with riskier, more complex strategies such as derivatives and alternatives over the next five years.

To compete for investor mandates, managers should either expand their investment capabilities and offerings or assert a reputation as an industry leader in highly specialized or complex investment strategies.

Our research shows misalignment between asset managers' plans and the evolving needs of institutional investors in a number of areas (Figure 2). Investors are more likely than asset managers to cite enhanced transparency and more bespoke solutions over products as the key changes that will enable asset managers to remain attractive to their clients and prospects in the future.

Innovation explosion

New digital technologies will likely deliver a competitive edge to first movers — and leave others at a significant disadvantage. Asset managers in our study believe that machine learning technology to enhance both investment and risk analysis will have a significant impact on their business over the next five years (Figure 3).

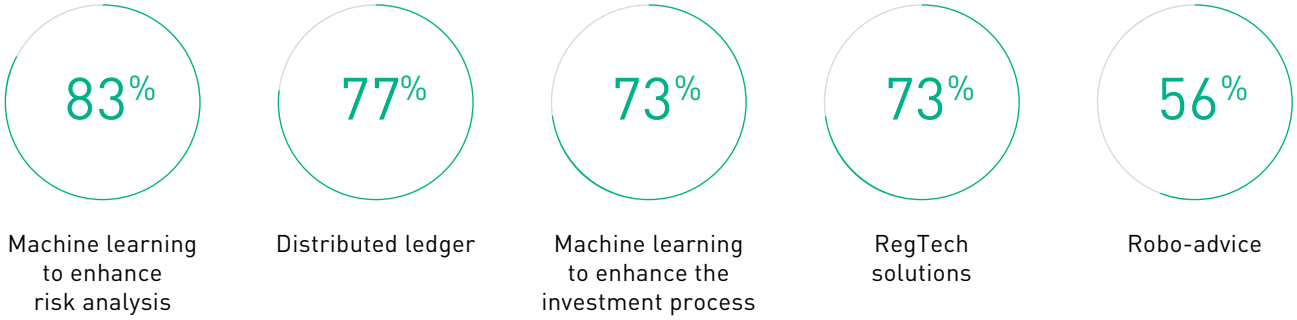
Outdated distribution models

As competition for institutional flows intensifies, attracting new retail customers will be an increasingly important strategy for growth in many markets, particularly as digital efficiencies create opportunities to serve this client base at lower cost.

However, winning retail business will not be possible without rethinking distribution models. Managers will need to embrace digital and mobile, both to engage retail customers on their preferred channels, and to lower the costs of distribution.

Figure 3: Disruptive technologies

Please rate the following emerging technologies in terms of how much you think they will impact your business over the next five years. (Percentage citing highly significant or significant impact)



Source: State Street 2017 Growth Readiness Study

Unfortunately, digital distribution expertise currently ranks lowest in asset managers' sales skills, according to our research, with just half rating their organization effective in this area.

Growing compliance costs

Three-quarters of the asset managers we surveyed agree that new regulatory developments will make it harder for smaller asset managers to survive on their own, while 37 percent say that regulation governing investment behavior is one of the biggest threats to their growth over the next five years.

New regulations such as MiFID II in Europe — set for implementation in January 2018 — are cause for concern. Affected managers face the prospects of higher costs for investment research, increased obligations to monitor execution quality, and more onerous transaction reporting requirements.

Managers therefore need to look at embedding highly efficient and automated operations solutions and forging strategic partnerships with outsourcing providers that can support the scale-up process.

STRATEGIZE ON SCALE

Based on our study, 85 percent of asset managers say they will increasingly need wide-ranging investment and distribution capabilities to meet investor demands.

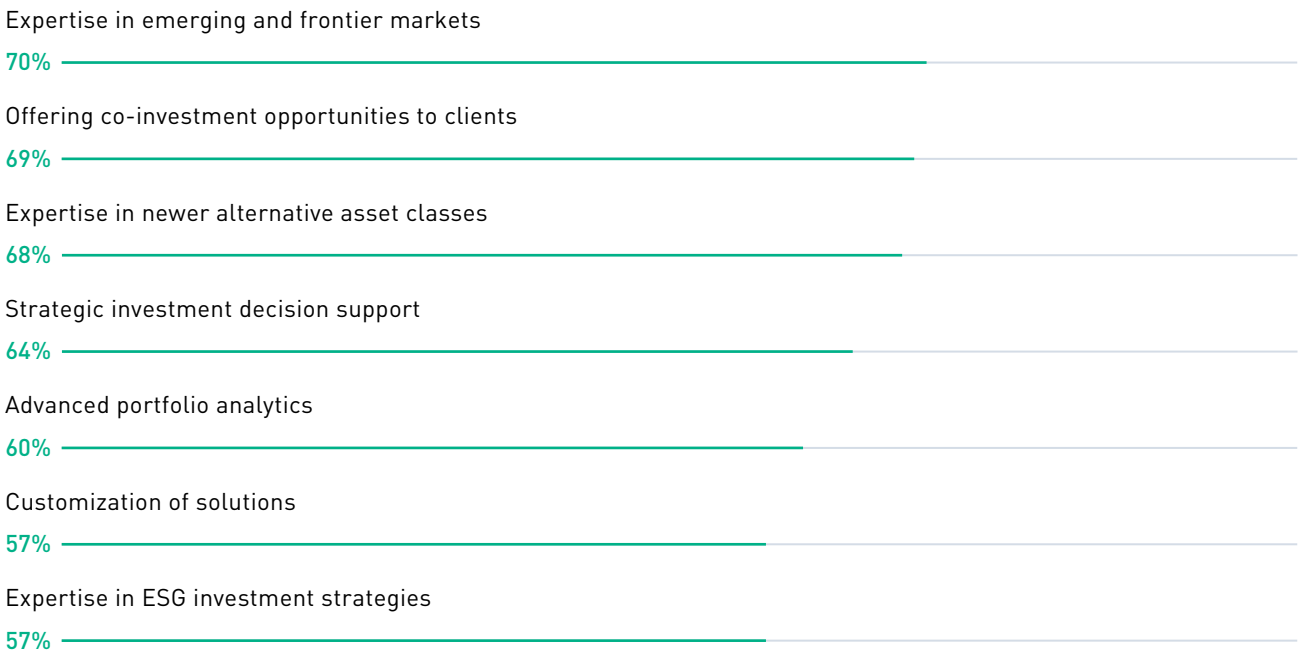
Our research also indicates that institutional investors are seeking more diversification in their investment grade bond allocations. Domestic government and investment grade bonds, and developed market government bonds, were jointly the biggest planned asset allocation increases for asset owners and insurers over the next five years. At the same time, emerging market and alternative asset expertise are among the top investment capabilities that asset owners want managers to improve (Figure 4). This reflects both the broad spectrum of opportunities for managers serving today's institutional investors and the changing nature of some of those opportunities.

For the majority of asset managers we surveyed, the strategy will be to broaden capabilities (Figure 5). One way that asset managers plan to onboard new expertise is through acquisition: 83 percent believe there will be an increase in merger and acquisition (M&A) deals in the industry over the next five years.

For other managers, the most efficient way to expand their investment offering and access new opportunities within different geographies and customer segments will be to create new partnerships. This may include appointing third-party managers with specific expertise or creating white-labeled solutions for key market distribution partners such as banks and wealth managers.

Figure 4: Investors' wish list

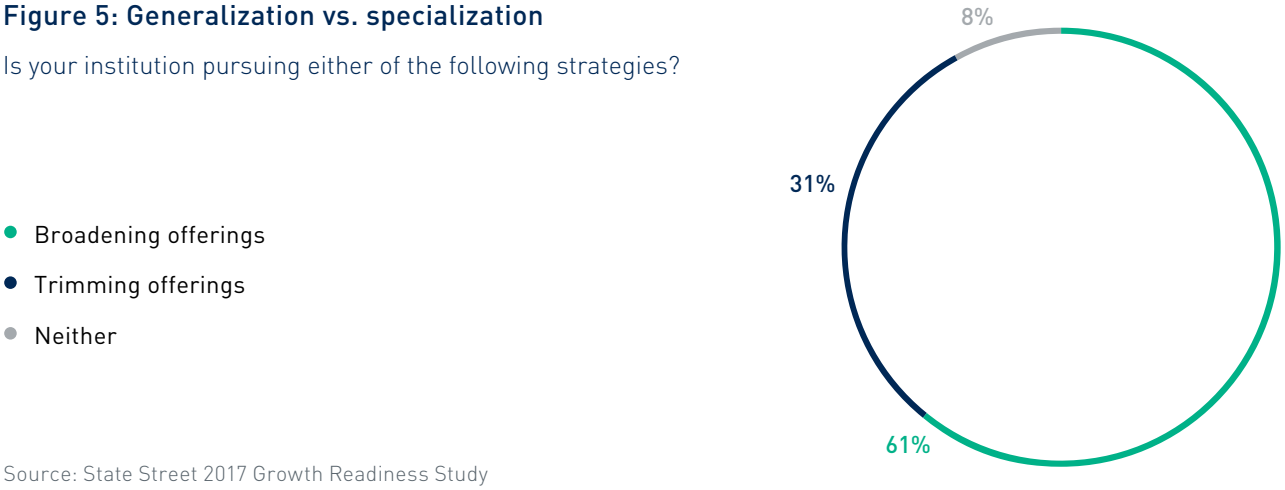
To what extent do you think that asset managers need to improve the following investment-related capabilities to better serve institutional investors' needs? (Percentage of asset owners citing significant improvement needed)



Source: State Street 2017 Growth Readiness Study

Figure 5: Generalization vs. specialization

Is your institution pursuing either of the following strategies?



Source: State Street 2017 Growth Readiness Study

FIGHT INEFFICIENCY

Fierce pressure on margins will intensify over the next decade. International regulatory bodies continue to broaden the scope of their supervision, as we see with European initiatives such as AIFMD and MiFID II.

As regulation deepens, compliance and reporting costs will increase for both large and small managers. The rise of passive strategies will also drive greater fee pressure for active managers over the next few years.

The upshot for active managers is that they must become hyper-efficient to succeed in the future. According to our research, more than half (55 percent) of asset managers say they have significant operational inefficiencies to address to support their firm's growth ambitions. And when asked about the key enablers of growth, managers cited improving internal operational efficiency ahead of investment and distribution capability (Figure 6).

Leading investment banks are already using machine learning systems to increase the automation of pre- and post-trade processes, and asset managers must now follow suit. Our research suggests managers

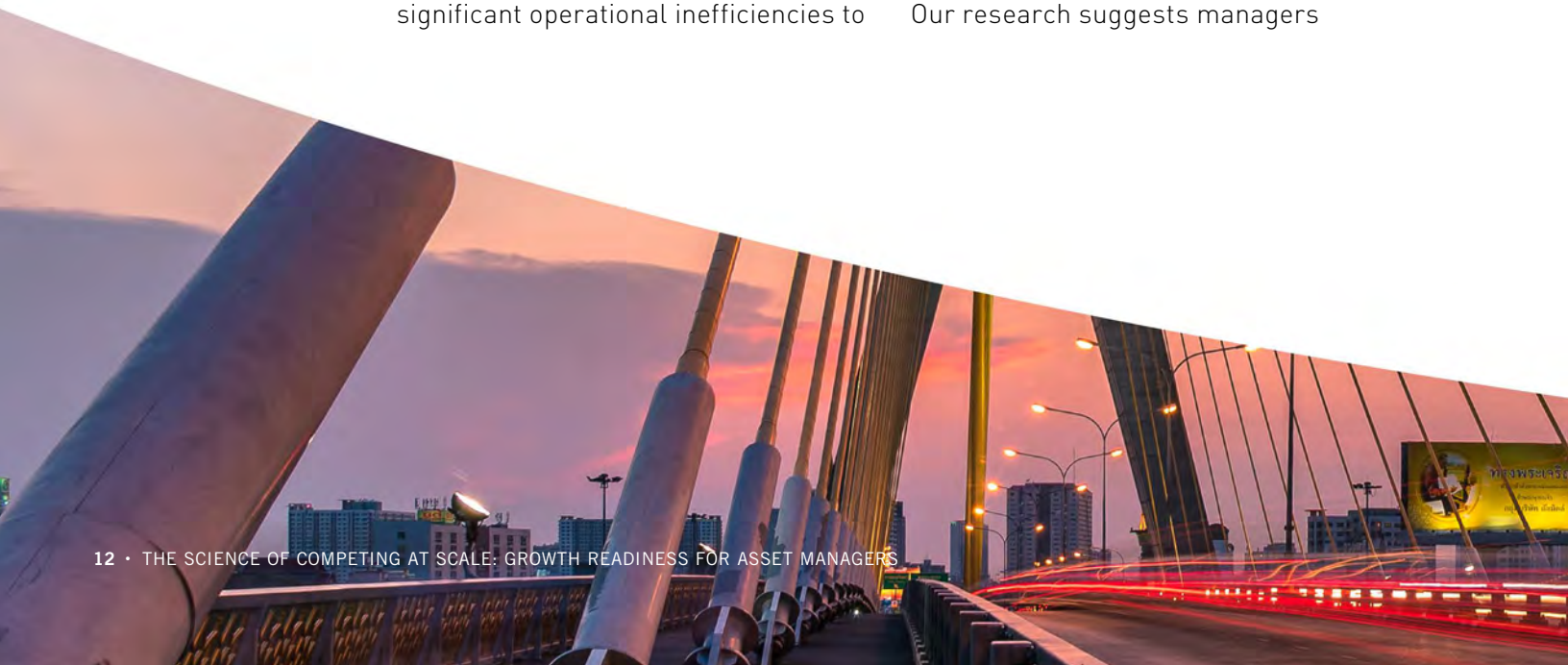


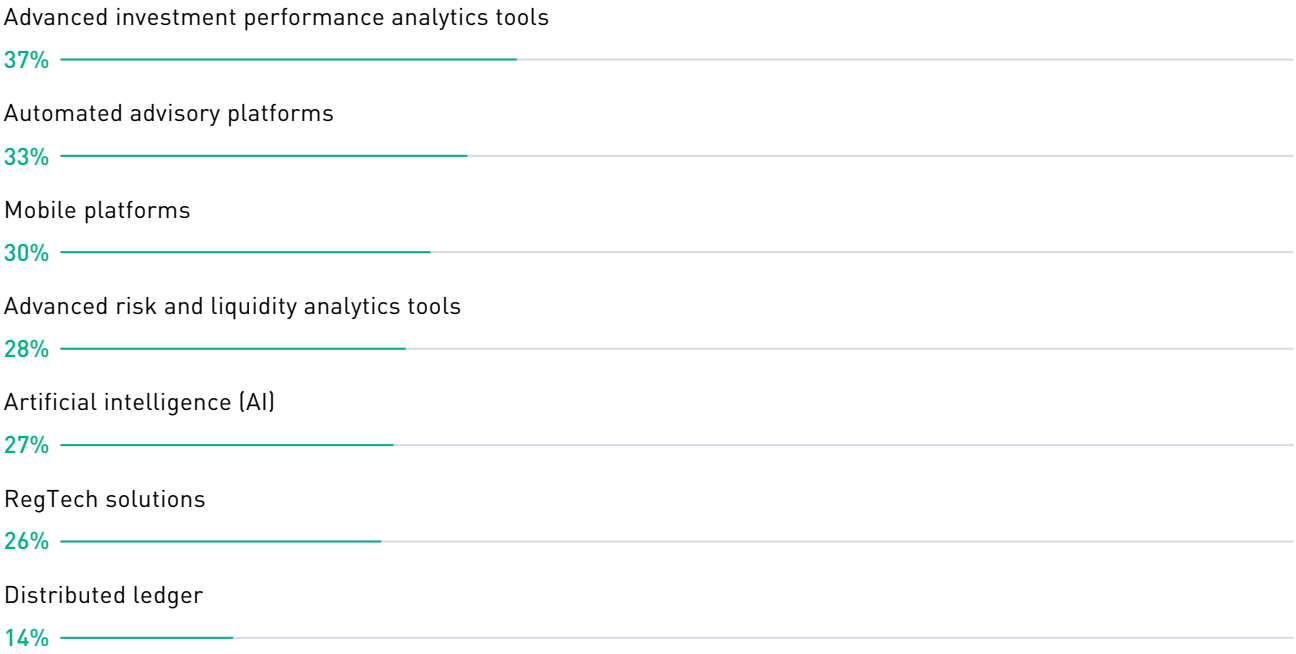
Figure 6: Efficiency and growth

Which of the following areas do you think will be most important in enabling your organization to meet its growth targets over the next five years?

Source: State Street 2017 Growth Readiness Study

Figure 7: Redirecting IT spend

What are your institution's top technology priorities for the next year?



Source: State Street 2017 Growth Readiness Study
Note: Respondents could select up to three options.

are currently prioritizing front-office technology innovation ahead of the middle and back office (Figure 7).

Managers will need to look to external collaborations as they introduce these innovative technologies. Some are already working with partners in the Fintech community. Early movers have joined cross-sector consortia, aimed at developing blockchain-based solutions that could transform the efficiency and speed of transactions.

Outsourcing strategy will also play an important role in the new growth model (Figure 8). External partners can often handle the activities that are not "mission critical" more cost effectively and efficiently than managers can themselves, which frees managers to pursue more differentiating, high-growth initiatives.

Among the traditional asset managers we surveyed, 40 percent say the desire to focus in-house resources on value-adding activities is one of the most important factors driving their decision to outsource. Investment operations is a key area of focus for deeper outsourcing.

For alternative managers, an inability to scale a given function quickly enough in-house to support growth needs is the biggest driver of their outsourcing plans, according to 44 percent of respondents. As they launch larger, multi-regional funds to capitalize on market opportunities, they're running into more complex reporting requirements. According to our research, their appetite for outsourcing is expected to grow.

Figure 8: Outsourcing support for growth

Will your institution seek to outsource (or increase outsourcing of) any of the following functions over the next year?

Source: State Street 2017 Growth Readiness Study

ENGAGE DIFFERENTLY

The rules of client engagement are changing fast. The asset managers in our study believe that proficiency in digital distribution is one of the key competencies that will support their future growth — and it's an area where they're lagging today.

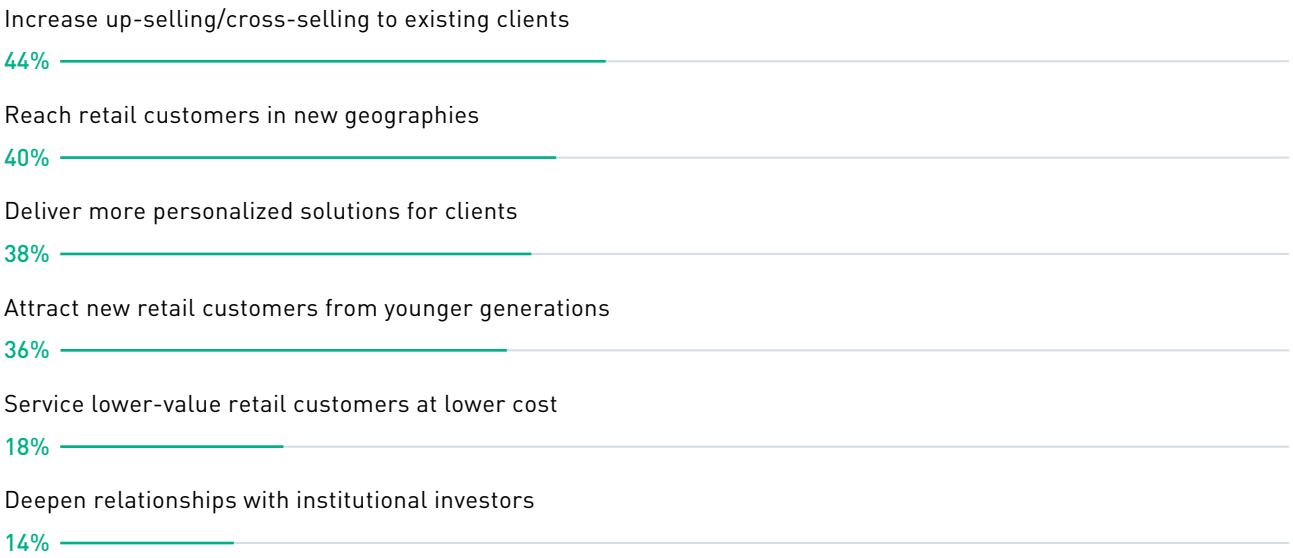
For the distribution-focused respondents we surveyed, expanding their reach among retail investors, and delivering a more personalized client experience top the agenda (Figure 9).

The industry is pursuing different strategies to strengthen its digital distribution capability. Some managers are building robo-allocation platforms in-house and proving that this can be done quickly with the right approach. Some are acquiring start-ups to onboard fully formed platforms, while white labeling has helped others to access the capability rapidly without incurring the risks associated with acquisition.

In the near term, the biggest recruitment focus for business development will be building in-house client experience and data science expertise (Figure 10).

Figure 9: Digital distribution strategy

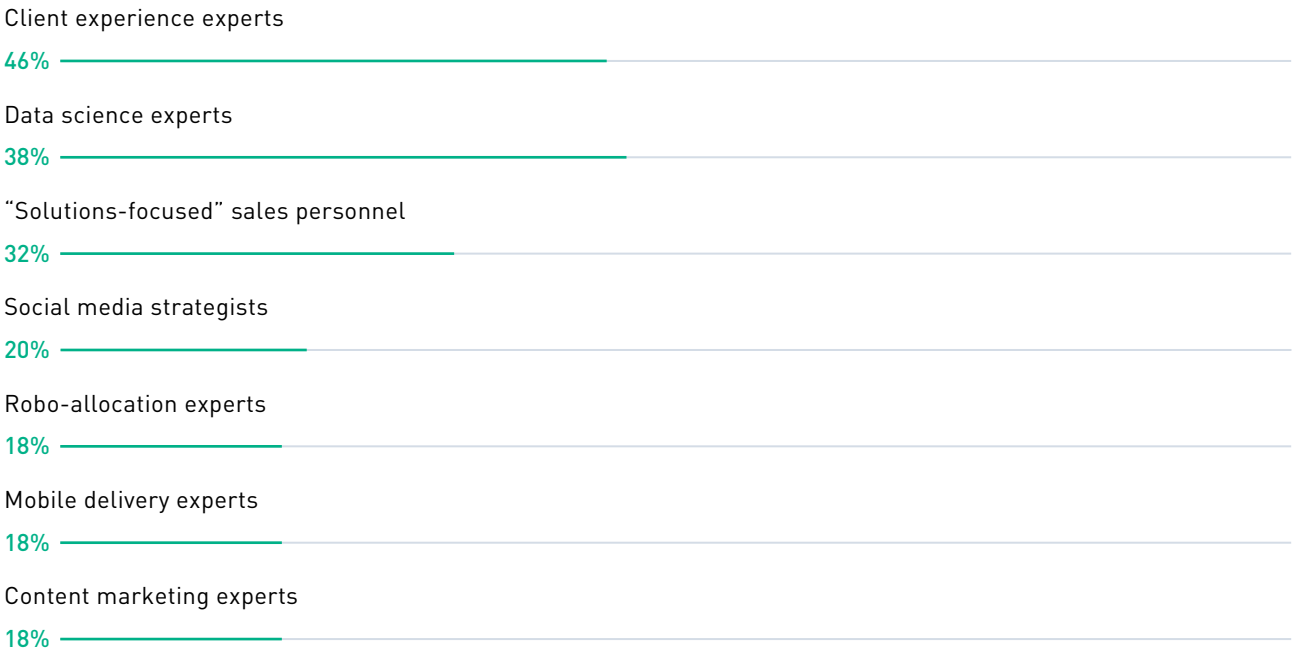
Which of the following is the biggest priority for your distribution function's digital strategy over the next year?



Source: State Street 2017 Growth Readiness Study
Note: Respondents could select up to two options.

Figure 10: Building new skills

What skills will be the top recruitment priority for your institution's distribution function over the next year?



Source: State Street 2017 Growth Readiness Study
Note: Respondents could select up to two options.

TARGETING THE MODEL

An end to easy conditions for growth means that asset managers must embrace a more precise, scientific approach to address a new set of competitive challenges. They need a targeted plan to compete in an environment where scale provides an edge, and they must root out inefficiency wherever they can.

Managers find themselves in a crowded and increasingly homogenous marketplace, so they must couple their growth strategies with intelligent digital innovation that offers clear value for clients on investment approach and service quality. It is more difficult than ever to demonstrate to investors the value of choosing one manager over the other, so the leaders of the future must show they can change with their clients' needs.

For firms seeking to accelerate their growth, emerging technologies and strong external partnerships will be critical. By embracing a flexible, disciplined mindset and better aligning with investors' long-term goals, asset managers will be able to achieve powerful growth.

Benchmark your institution's growth readiness at
growth.statestreet.com

About the Research

State Street commissioned Longitude Research to conduct a global survey of more than 500 executive respondents representing institutional asset owners, asset managers and insurance companies during March and April of 2017.

The respondents span investment, operations and distribution roles and collectively represent 19 countries. Approximately 36 percent of respondents were located in the Americas, 40 percent in Europe and 24 percent in Asia Pacific.

In addition to the survey, we conducted a range of in-depth interviews with select leaders across the industry about their priorities and strategies for growth.

For more information, please visit growth.statestreet.com

For more industry insights, please visit listen.statestreet.com

For more information about our solutions for asset managers, please contact:

APAC
Mark England
+852 2840 5349
MEngland@StateStreet.com

NORTH AMERICA
Jane Mancini
+1 617 662 2476
JMMancini@StateStreet.com

EMEA
Andrew Wilson
+44 20 3395 8397
AWilson2@StateStreet.com

STATE STREET.

State Street Corporation
State Street Financial Center
One Lincoln Street
Boston, Massachusetts 02111-2900
+1 617 786 3000

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