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The Changing Shape of European Investment Management

The European investment management industry is undergoing unprecedented change. The financial crisis and an evolving regulatory environment have reinforced cost pressures that have been building in recent years, creating an urgent need to achieve scale and efficiencies through a focus on core competencies. Already, a wave of consolidation has begun that is set to continue at pace, while asset managers embrace new ways to reengineer their businesses amid changing investor needs. The industry is likely to look very different within five years.

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*As of June 30, 2010

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Foreword

For Europe's asset managers, the reversal in equity markets experienced in the wake of the financial crisis is forcing the end game in a restructuring of the industry that began more than a decade ago. After 30 years of rapid expansion, mostly during a sustained equity bull market, the economics of the industry are changing, creating an urgent need to build greater scale. Bank and insurance ownership of asset managers has traditionally been high, but now some banks are under pressure to sell their asset managers, chiefly to bolster balance sheets but also as a condition for receiving state financial support. Regulatory change is also having a major impact, in some cases assisting the efficiency drive and in other areas, particularly for alternatives managers, intensifying the cost pressures that are forcing the need for consolidation.

Game-changing deals, such as BlackRock's acquisition of Barclays Global Investors (BGI), are leading to the emergence of groups with competitive advantages that are based on scale. Scale brings cost efficiency, distribution power and the budget to buy the best portfolio management expertise. Over the next five years, the pursuit of scale through mergers and acquisitions (M&A) and fund range consolidation by asset managers is set to be a defining trend, with the potential to significantly enhance the efficiency of Europe's €12.8 trillion asset management industry.[1]

Much of the pressure on asset managers has arisen from shifting investor preferences. Investors are analysing more deeply than ever before the value offered by asset managers. While there has been downward pressure on fees for many years, the crisis has crystallised investor attitudes — they are scrutinising more closely than ever before the performance they are getting for their money. As a consequence, they are increasingly adopting the so-called 'barbell' investment approach, allocating the majority of their assets to passive managers to gain low-cost index exposure and the balance to active managers, including alternatives managers, which offer the potential to generate alpha.

Across the industry, cost is being extracted wherever possible. The new Undertakings for Collective Investments in Transferrable Securities (UCITS) IV Directive is intended to make fund mergers easier, as

[1] Estimate for 2009 year end. European Fund and Asset Management Association (EFAMA), *Asset Management in Europe*, Annual Review, published April 2010

well as introduce new master-feeder fund pooling structures that many managers will exploit to reduce costs. Furthermore, the outsourcing of investment operations is being embraced by increasing numbers of asset managers, including many that had previously been hesitant to pursue this option.

With €1.8 trillion in assets under custody in Europe, State Street provides investment servicing solutions to some of the region's largest asset managers, through a network that extends to 11 European countries. In addition, our investment management business, State Street Global Advisors, has €187 billion in assets under management in Europe.* Our years of working with clients in Europe give us unique insights into the needs of the region's asset managers. In this Vision Focus paper, we examine the trends that are driving change within the European asset management industry and we outline the likely shape of the industry in the coming years.

*As of June 30, 2010

M&A: Enhancing Product Ranges and Building Scale

One of the most powerful factors in the current restructuring of the European asset management sector is the rising tide of M&A. Healthy levels of M&A activity will always be a hallmark of the asset management industry. Barriers to entry are low, as establishing an asset management company requires little capital investment, and owners of successful boutiques will eventually want to monetise their investment by exiting their firms. But M&A activity has been lifted by both the broader restructuring of Europe's financial services industry and asset managers' urgent need to gain scale.

Traditionally the dominant owners of asset managers in Europe, banks are at the eye of the storm of current M&A activity. While bank ownership is likely to remain significant, capital challenges are forcing some universal banks to re-examine their business models and to sell non-core assets. When capital is scarce, they need to make tough decisions about where the available capital can generate maximum value. For banks with profitable, growing asset managers that have sufficient scale and are considered core, there are strong reasons to continue to own these businesses. However, some of the banks that are facing capital shortages are choosing to sell their asset managers — and thereby realise the higher value they represent — and deploy the capital in other areas where they can achieve greater returns. Asset management is not always viewed as the source of low-risk profitable growth that it was before the financial crisis.

Banks based in some southern European countries such as Greece and Italy, which have recently experienced economic problems and where bank ownership of asset managers is traditionally high, are potentially the most likely to seek to divest their asset managers. In addition, some banks are being forced to make divestments as the price for receiving financial support packages. For example, UK-based Royal Bank of Scotland (RBS) received significant government support during the financial crisis, and then sold its fund of funds business to Aberdeen Asset Management in January 2010, as part of its post-crisis restructuring efforts.

Product-Driven Acquisitions

A close alignment of interests has emerged between sellers of asset management businesses and potential buyers, which is leading to a stream of deals that would have seemed unlikely two years ago. Banks are eager to make divestments in order to bolster their capital positions, while the most progressive and ambitious asset managers are looking to acquire investment firms that will help them extend their product proposition and achieve scale. This trend comes amid a post-crisis shift in investor needs, where investors are scrutinising the performance of their portfolios and gravitating toward strategies that represent best value.

Against this backdrop, asset managers realise that they need to offer an increasingly wide range of investment options. This is leading to the emergence of 'barbell' asset allocations, whereby investors blend index strategies to gain efficient market exposures with a wide range of active strategies to enhance portfolio returns. Investors are increasingly seeking comprehensive, holistic solutions from providers that can offer the benefits of scale.

Acquisitive asset management companies are seeking to adapt their product ranges to these requirements. While 'barbelling' has been talked about within the investment management industry for some years, it has taken the catalyst of the financial crisis to truly establish this trend. For the traditional balanced active managers, the question is how they can most effectively differentiate themselves within this environment.

Another example of this trend is UK-based Lloyds TSB's sale of its Insight Investment asset management business, one of the UK's leaders in liability-driven investment, to Bank of New York Mellon for £235 million in 2009. Insight Investment won more new pension fund business in 2009 than almost any other asset manager[2] — an indication of the increasing shift by pension funds toward liability-driven approaches, particularly in the wake of the crisis.

In addition, Aberdeen Asset Management's acquisition of RBS Asset Management gives it an established fund of hedge fund business, which expands Aberdeen's ability to offer active strategies with the potential to generate high returns for investors.

Boutique Sales

In 2010, recovering valuations for asset managers — lifted by a rise in equity markets and a recovery in cash inflows — have encouraged sales of boutique-type asset managers, including two of the most successful London-based hedge fund managers. Switzerland's Man Group has announced plans to acquire GLG Partners, the US-listed but mainly UK-based hedge fund manager, for US$1.6 billion, while on a smaller scale Thames River Capital was bought by F&C Asset Management for £53.6 million.

Man Group's planned acquisition of GLG illustrates the advantage of scale even in a business that is highly dependent on intellectual capital. Announcing the GLG acquisition, Man Group stressed the strength of its distribution and its ability to sell GLG funds, which have qualitative investment styles that complement its own quantitative 'black box' strategies. Man also anticipated cost savings of US$50 million over two years.[3]

The current wave of M&A activity is likely to further underpin the rise of multi-boutiques — or so-called 'alpha shops' — whereby large and medium-sized asset management houses assemble, organically or through acquisition, a range of boutique investment approaches under one roof. Within this structure, fund managers have the autonomy they need to generate strong performance, while being able to share resources and therefore reduce costs in areas such as reporting and compliance.

A key factor that is driving consolidation within the hedge fund space is the pressure from a combination of tighter regulation and fee deflation. Both the EU's proposed Alternative Investment Fund Managers Directive (AIFMD) and the need to register with the US Securities & Exchange Commission as investment advisors for the first time are raising the burden of compliance. Meanwhile, institutional investors, who are increasing their allocations to hedge funds, are asking for more disclosure and beginning to request lower fees, leading to a squeeze on profitability. In response, some hedge fund managers are taking the opportunity to realise a return on their investment by selling up, whether they remain with the business or not.

Different Models

Outright sales and acquisitions are not the only route being pursued. Some banks that have sub-scale asset management businesses are recognising the benefits of continuing to own them, but choosing to build scale through joint ventures.

In January 2009, Société Générale and Crédit Agricole announced plans to merge their asset management businesses to form Amundi, now Europe's third-largest asset management group, demonstrating an alternative way of achieving scale and creating value from asset

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[2] FT Research/FTfm, 6 June 2010

[3] Man Group press release, 17 May 2010

management subsidiaries. As the logic behind the joint venture, they cited €120 million of cost savings, as well as the ability to offer investors a wider range of products.[4] Italian bank UniCredit announced a similar approach in June 2010, saying it was examining similar strategic options for its Pioneer Asset Management subsidiary.

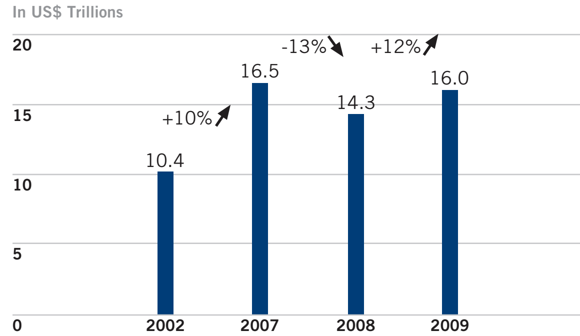
Illustrating the value to be created from building large firms of multi-product asset managers, private equity firms are beginning to scout the sector. They are looking to carry out typical private equity buy-and-build strategies, acquiring a number of asset managers to create the multi-product offering that investors want.

Deals Likely to Continue

Following the crisis, asset managers face a number of challenges. Fees are under pressure, investor demand is polarising between passive and alpha-driven strategies, and compliance costs are rising, particularly for alternatives managers. Many asset managers are choosing to tackle these challenges through mergers that build bigger organisations with lower costs and wider product ranges that satisfy today's investor requirements.

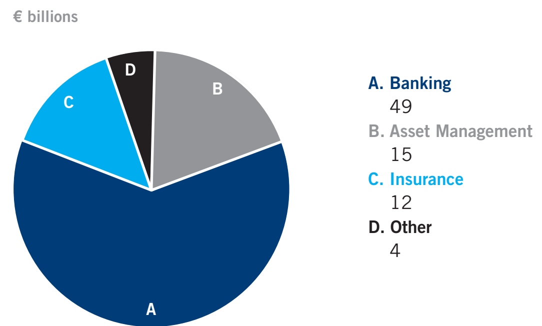
At a time when both banks and boutique asset managers are willing sellers, the recent stream of deals is likely to continue. Over the next five years, mergers will lead to the creation of larger firms with logical structures — some with low-cost, scalable business models and others focused on building stables of boutique managers.

Figure 1: European Assets Under Management, 2002–2009



Source: BCG Global Asset Management Market Sizing Database 2010

Figure 2: 2009 European Financial Services Deal Value By Sector



Source: PricewaterhouseCoopers analysis of mergermarket, Reuters and Dealogic data

[4] Crédit Agricole/Société Générale press release, 26 January 2009

Fund Rationalisation: The Efficiency Holy Grail

Both asset managers and the European Commission (EC) are targeting a reduction in Europe's exceptionally high ratio of investment funds to assets managed. Europe's asset management industry is significantly less efficient than that of the United States, with funds tending to be smaller and therefore less cost efficient. Figures cited by the EC indicate that UCITS funds are on average five times smaller than US funds and the cost of managing them is twice as high. Furthermore, 54 percent of UCITS manage assets of less than €50 million, meaning many UCITS funds lack the scale to justify the costs of running them.[5]

Remedying this situation is one of the motivations behind the new UCITS IV Directive. When UCITS IV becomes a reality in July 2011 — the deadline for all 27 EU member states to implement its measures at a national level — managers are likely to take advantage of its measures to create far greater economies of scale across their fund ranges.

Opportunities of UCITS IV

UCITS IV will introduce measures to facilitate fund mergers across the borders of EU member states. To some extent, the feasibility of fund mergers is likely to be restricted by the continued existence of tax differences between EU member states — in some countries, a fund merger would trigger a capital gain, and the different tax regimes are likely to make some domiciles more attractive than others.

The measure in UCITS IV that is set to be the greatest catalyst for consolidation — at least in the short to medium term — is the new master-feeder fund. This pooling vehicle allows feeder funds to feed into a single master fund, so a UCITS manager could decide to have a European hub in one particular centre and run all its EU feeder funds into that master. With the majority of assets held in the master fund, the manager benefits from significant economies of scale. Meanwhile, the feeders have the flexibility to adapt to the tax and cultural requirements of each individual member state. While the anticipated cost reductions are not as great as they are for fund mergers — because there is some duplication of cost between the master and feeder — they are nonetheless substantial. Although the master-feeder structure does not actually reduce the number of funds, it presents considerable scope for efficiency gains.

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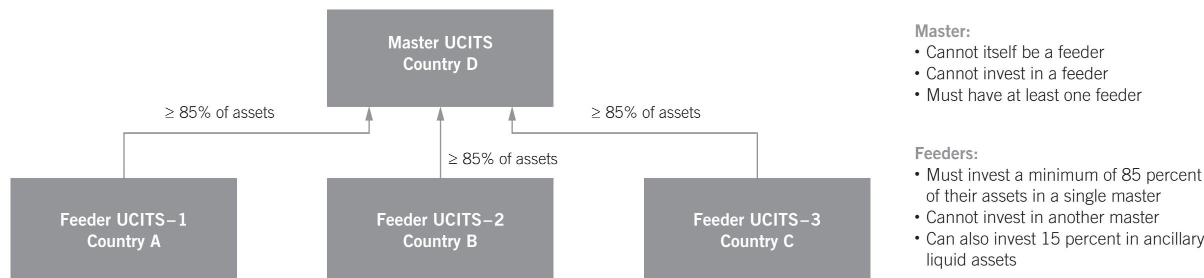
[5] Press release: Commission proposes improved EU framework for investment funds, July 2007

Figure 3: Example Master-Feeder Structure Under UCITS IV



Falling Fund Numbers

Reacting to the financial crisis, large asset managers are already beginning to rationalise fund ranges, for example by consolidating more funds within a single fund domicile. In March 2010, HSBC Global Asset Management reportedly closed 35 Dublin-domiciled funds, giving investors the choice of relocating to its Luxembourg UCITS III range.[6] Another asset manager to have consolidated fund ranges is Aberdeen Asset Management — after making three acquisitions, Aberdeen sought to integrate them in part by folding the acquired funds into its Luxembourg UCITS platform.

In terms of funds, numbers have been falling in recent years. According to the European Fund and Asset Management Association (EFAMA), the total number of UCITS funds decreased by 1,384 in 2009 to reach 35,946 — a decline of 3.7 percent.[7] This trend suggests that some asset managers took immediate action to rationalise their fund ranges after the crisis struck, although the Committee of European Securities Regulators (CESR) reports a slight increase in numbers of UCITS funds in the first quarter of 2010.[8]

Impact on Servicing

The consolidation being seen across Europe will have implications for fund domiciles and service providers. Already Europe's dominant fund domiciles for cross-border marketing, Dublin and Luxembourg are likely to gain a still greater proportion of the EU's assets under management. Luxembourg is likely to reinforce its dominance as the retail fund centre, with 25.6 percent of UCITS assets based there, while Dublin has the most institutional funds, with 10.6 percent.[9]

As asset managers consolidate their investment funds into larger pan-European pools, they are likely to rationalise their asset servicing relationships. Even if they opt for the master-feeder route, appointing one large asset servicing company to look after both master and feeders appears the most logical option. Having one depositary would greatly simplify the job of servicing the funds, especially with regard to reporting requirements, and give the asset manager greater leverage when negotiating fee levels.

[6] Reported in Ignites Europe, 3 March 2010

[7] EFAMA Quarterly Statistical Release, March 2010

[8] *Trends, Risks and Vulnerabilities in Financial Markets,* CESR, July 2010

[9] *Asset Management in Europe,* EFAMA's Third Annual Review, published April 2010

Newcits Numbers Grow

While the number of investment funds is generally falling in Europe, the hedge fund sector is an exception. In particular, the measures in the UCITS III Directive that allow funds to invest in financial derivatives have led to an explosion of so-called "Newcits" — funds that pursue hedge fund-style strategies, such as long/short equity or absolute return type strategies, which can be freely marketed across the EU as long as they comply with the UCITS III investment restrictions. Fund managers have launched more than 200 Newcits funds as they respond to investor demand for more regulated and liquid alternative-style funds,[10] although concerns exist that the more innovative strategies may create investor protection issues that cause damage to the UCITS brand.

Meanwhile, the keenly debated Alternative Investment Fund Managers (AIFM) Directive is likely to impose significant curbs on hedge fund managers' activities, including limits on leverage and increased reporting requirements. It may also prevent hedge funds based in non-EU jurisdictions judged not to have equivalent standards from being marketed within the member states. It is likely to be a factor in the trend for funds based in the Cayman Islands — until now the hedge fund domicile of choice — being 're-domiciled' to Europe.[11]

Potential for Significant Savings

Rationalisation in fund ranges is already occurring and is set to continue. After 30 years of rapid growth — both organically and through mergers — Europe's fund industry has ended up with a large number of sub-scale funds. The combination of the urgent need to save costs and the advent of UCITS IV will ensure that fund numbers continue on a downward path. The tax complexities across the 27 member states of the EU will represent an obstacle to widespread fund mergers under UCITS IV, but master feeder pooling is set to play a valuable role in enhancing overall fund efficiency.

When planning UCITS IV, the EC envisaged that fund mergers alone could realise savings of €2–6 billion.[12] Because of the tax obstacles to fund mergers in some countries, savings at the top end of this range might not be possible. Even so, there will be savings and they will be significant.

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[10] *Future Newcits regulation?*, PricewaterhouseCoopers, March 2010

[11] Figures from Hedge Fund Research, cited by Ignites Europe on 29 April 2010, show that the percentage of global hedge funds domiciled in the Cayman Islands dropped from 39.6 percent in Q1 2009 to 37.3 percent in Q1 2010

[12] EC White Paper on enhancing the single market framework for investment funds – executive summary to the impact assessment, November 2006

Streamlining the Model: Making Fixed Costs Variable

Cost pressures are forcing asset managers to examine the value contributed by their investment operations more closely than ever. Where previously they might have decided against outsourcing — perhaps because of the desire to maintain full control over the entire value chain — the financial crisis has forced a rigorous reassessment of priorities. Amid exacerbated cost pressures, they must devote all of their energy, resources and expertise to their core competencies — the areas that affect investor perception, such as generating investment returns and implementing strategic growth plans. Consequently, after a decade when investment operations or middle-office outsourcing has built a proven track record and demonstrated its advantages, many asset managers are gravitating toward this model.

Costs and Investment Implications

Outsourcing of the middle office — loosely defined as post trade/pre-settlement — offers the greatest potential for cost efficiencies. While the front office carries the highest cost, it is where the asset manager's core competency lies, and so by definition the scope for outsourcing is limited. The cost benefit to managers of outsourcing can be significant. A study undertaken over a six-year span by Alpha Financial Markets Consulting shows that savings achieved on new outsourcing arrangements are typically around 15–20 percent. Furthermore, Alpha FMC's Operations Benchmarking Study shows that, across the industry, outsourced operations are on average around 9 percent more cost-efficient than in-house operations.[13]

Yet immediate cost savings are only part of the story. Outsourcing removes the need to continually upgrade middle-office systems at a time when the cost of doing so is high and can reach many millions of dollars each year. With increasingly widespread investment in derivatives, particularly for hedging and risk management purposes — and both investors and regulators seeking more transparency and independent valuation — the expense of developing systems that can meet today's requirements is rising fast. Middle-office systems need to operate efficiently across greater numbers of currencies, share classes, domiciles and underlying financial instruments. Outsourcing introduces far greater certainty into forecasting the cost of middle-office development, enabling asset managers to turn mounting fixed costs into predictable variable costs.

Reassuring Investors in Alternatives

For alternatives managers, there is increasing pressure from both regulators and investors to adopt third-party administration. High-profile scandals, notably the Bernard Madoff fraud, cast a shadow over the industry. Regulators and institutional investors are demanding independent position verification and auditing trails, leading to greater expense. Through outsourcing investment operations, alternatives managers can give greater assurance that positions and trades are being monitored independently.

Where outsourcing does occur, investors take comfort from it — and the fact that the provider is large and well known often provides additional reassurance to clients. Institutional investors are increasing their investments in

[13] Alpha Financial Markets Consulting, Outsourced vs. In-House Operations — Findings from Alpha Benchmarking Studies 2003–2008

Asset Servicing Mergers: The Race for Scale

Just like the asset managers they serve, asset servicing firms have good reason to build scale. Fees are under pressure at a time when the cost of investing in the technology is high and rising, especially as derivatives processing becomes automated. In fact, the technology spend required to keep pace in the asset servicing arena represents an increasingly challenging barrier to entry. With the prospect of regulation that could increase custodian liability, asset managers are set to focus more intently than ever before on the balance sheet strength and capital ratios of their investment service provider — thereby driving consolidation within the investment servicing space.

Recent examples of M&A activity in the sector include several acquisitions in Italy. State Street has acquired the securities services business of Intesa Sanpaolo, while BNP Paribas Securities Services and RBC Dexia have also acquired the custody units of Italian banks.

Amid consolidation in the asset management industry, and continued rationalisation of fund ranges, asset managers will be looking for investment service providers to have a presence in each European market where they operate. They will be looking for integrated pan-European solutions that are aligned with their own operational reach and ambition.

alternatives managers once more — especially hedge funds — but they will only invest with managers that can offer the transparency and reassurance they need.

Scalable Operational Platform

Furthermore, outsourcing supports the growth ambitions of today's asset managers by creating a scalable operational platform to which additional assets can be easily added. This priority gains in importance as more concentrated fund ranges are sold not only across Europe but also into major developing markets such as those in Asia, as asset managers take advantage of the global success of the UCITS brand. In addition, a range of risks — operational, compliance, regulatory and reputational — can be mitigated by outsourcing, leaving the investment manager in a better position to manage change.

Indeed, in order to maximise the potential efficiencies from M&A and fund range consolidation, asset managers need to ensure that their operational functionality is streamlined through the front, middle and back offices. Following the M&A of recent years, manual workarounds in processing are common. Legacy operating platforms have been joined together in ways that may pose challenges for future scalability and efficiency. Outsourcing can provide the single, unified platform that is essential to efficiency and growth.

Significant Increase in Outsourcing

This steady rise in interest in outsourcing since the financial crisis first hit in 2008 is starting to accelerate. A number of outsourcing deals have been struck, and others will follow as their detailed scope is agreed over time. Although large asset managers have traditionally been the primary users of outsourcing, small and medium-sized managers are now beginning to accept that outsourcing can help them manage costs, gain global access and leverage automation and scale.

In the next few years, outsourcing is likely to increase significantly. Asset managers will focus on generating performance, marketing their funds and setting business strategy. They will pass responsibility for operations to asset servicers, which have the scale to provide an efficient service and make the mounting investment in technology systems that is required.

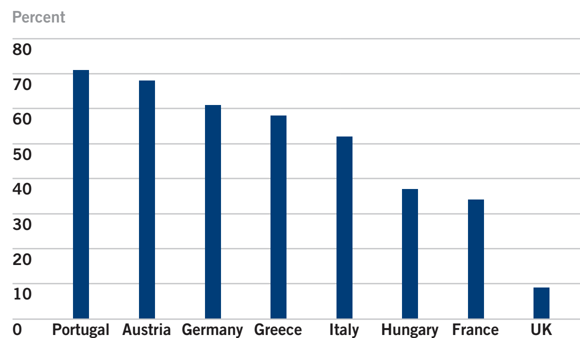
Distribution: Part of a Virtuous Circle

The trends currently under way in Europe present unique opportunities for asset managers with a powerful distribution network to gain market share. They will have the scale to afford the greatest marketing spend and to remunerate the best individual fund managers, while keeping costs low. In addition, they will be able to build the best-known brands and offer the lowest fees. Groups that swiftly capitalise on the opportunities of UCITS IV to build their business across Europe will increase their competitive advantage.

Increasing willingness by the banks to embrace 'open architecture' — whereby they sell not only their own funds but also their selection of third-party funds — will help the large independent managers gain share, as long as they have the strong brands and investment track record to secure a position on the roster. They have an opportunity to gain wider access to a bigger market of retail investors and high net worth individuals.

Furthermore, those banks that choose to sell their asset managers will increasingly seek to maintain a proprietary investment management proposition by marketing 'white-labelled' third-party products. Again, this trend will benefit the asset managers that can offer a strong and differentiated proposition. In many European countries, banks have historically dominated the distribution and they have packaged and sold asset management products through their retail banks and insurance companies. More open architecture and white labelling would be of particular benefit to independent managers in countries such as Germany, Austria, Greece and Italy, where asset managers have tended to be part of financial services groups owned by banks and retail investors' shares of total assets under management are high.[14]

Figure 4: Share of Asset Management Firms Owned by Banking Groups at End of 2008



Source: EFAMA

New Regulation Disrupts Established Channels

In the UK, where banks are a less dominant part of the value chain, regulation is set to have a transforming impact on distribution. Beginning in 2013, the Retail Distribution Review (RDR), the brainchild of UK regulator the Financial Services Authority (FSA), will prevent fund providers from paying commission to independent financial advisors (IFAs).[15] Rather than an agreement between the advisor and the product provider, the cost of investment advice will be agreed upon between

[14] *Asset Management in Europe*, EFAMA's Third Annual Review, published April 2010, p. 25

[15] Press release: FSA announces further work on the future of retail distribution, June 2006

the investor and the advisor, based on the provision of expert, objective advice about the best quality and lowest-cost funds. The objective is to increase transparency and boost competition within the market.

The RDR may lead to consolidation within the IFA and wealth management sector, as some IFAs choose to sell their businesses rather than tackle the challenges that the new regulations will bring. New types of wealth managers could emerge, with a shift toward holistic solutions for high net worth individuals, replacing a more product-focused approach.

In continental Europe, where the retail investor tends to buy investment products more commonly in packaged forms, such as life assurance products, the EC is similarly proposing new legislation around disclosure and selling processes.[16] Its review of packaged retail investment products (PRIPs) was sparked by concerns that these products may be too complex for investors and that conflicts of interest may exist where distributors are remunerated by sales commission from the product manufacturers. While the outcome of the PRIPs review has not yet been finalised, any measures are unlikely to be as far-reaching as the UK's RDR.

Increasing financial literacy among investors — in the wake of the losses experienced during the financial crisis — is another factor contributing to a change in European distribution. This means investors are more likely to make a dispassionate assessment of the merits of individual funds, rather than simply accepting the products sold to them through familiar channels. Funds will, consequently, find that historical performance and total expense ratios (TERs) become even more important in determining how effectively they can distribute. The introduction of the Key Information Document — the only compulsory element of UCITS IV — will further aid transparency for investors by improving the consistency and presentation of information about performance, risk and fees for each fund product. This document is likely to benefit the large asset managers who can generate the best combination of these three factors.

The Rise of Defined Contribution

The decline of defined benefit (DB) pensions will similarly blur the line between institutional and retail investors — again handing the advantage to large asset managers. With the shift toward defined contribution (DC), individuals will increasingly be responsible for choosing the underlying investment funds in which their pensions are invested. When doing so, they will make better-informed judgments on the same grounds as they are increasingly using for straightforward retail funds.

Specialist boutiques with proven ability to generate alpha are the one niche where scale and distribution power will not be as important. Genuine alpha is hard to find and institutional investors tend to seek it out, although even in this niche area the rising proportion of institutional investors versus high net worth investors is leading to fee pressure.

Greater Transparency

Europe's distribution channels are evolving, as the banks and IFAs that distribute funds are gradually moving to sell a wider range of funds to investors. Increasingly sophisticated investors are likely to demand greater openness within distribution across Europe. Regulation is also aiding the trend toward greater transparency, as European regulators take action to ensure that investors are advised to buy the products that most effectively meet their needs.

For large independent asset managers in particular, the gradual evolution of distribution presents an opportunity. They should, over time, find more distribution channels open to them across Europe, enabling them to build their market shares and increase brand awareness. A handful of managers may emerge with the ability to buy brand recognition, pay the best managers and keep fund fees low. The opening up of distribution channels has its part to play in creating a more efficient European asset management sector — to the benefit of managers and investors alike.

[16] Press release: Commission proposes better investor protection measures for packaged retail investment products, April 2009

Endnote

The Future for European Asset Management

The financial crisis has accelerated an evolution of Europe's asset management industry. Reacting to changed investor requirements, asset managers are striving to build efficient structures with distinct investment propositions. Over the next five years, passive managers, multi-boutique managers and specialist boutiques will grow in terms of assets under management, as their balanced manager rivals struggle to maintain recent growth rates.

Several factors will ensure that change continues. Reverberations from the financial crisis will drive ongoing restructuring among Europe's financial services groups, maintaining the pressure to sell or merge asset managers. The approaching wave of regulation will bring opportunities — but may also threaten some business areas. UCITS IV and the AIFMD are about to subject Europe's asset managers to the most substantial regulatory changes they have ever experienced at one time. In the UK, the RDR is also on the horizon. (In a follow-up paper to this one, we will examine the evolving regulatory environment in more detail.)

From today's challenging financial environment, a more efficient and logically structured European asset management industry is likely to evolve. The emergence of a few European asset managers that have the scale to market compelling investment products relatively inexpensively across the continent will put pressure on the rest. At the same time, the smaller boutique managers that prove they can generate alpha on a consistent basis will thrive.

There will be some obstacles to progress with consolidation. Lack of acquisition capital, shareholder fears over mergers and integration in an industry where intellectual capital is such a differentiating factor, and banks' continuing dominance over distribution will slow the trend. Even so, within five years Europe's asset management industry will be very different from today. A few large groups will have emerged with the scale to dominate Europe. At the same time, passive and boutique asset managers will continue to increase their share of the continent's assets under management — at the expense of traditional balanced managers.

For Europe's asset managers, there are pressing strategic questions. Business models need to adapt to changes in investor preferences, regulation and distribution channels, as well as fee deflation. Asset servicers, too, need to reassess their strategies in a world where scale has become even more crucial.

Above all, asset managers must develop businesses that can meet investors' changing needs. Success will come to those firms that can offer investors clear, relevant and compelling propositions. Asset managers will need a sharp focus on what they do best, underpinned by a lean and efficient operating structure. For those that succeed, the opportunities are enormous.

This report is the first in a series of three Vision Focus papers that explore the drivers of change in European asset management. Our next paper will take a detailed look at the evolving regulatory environment in Europe, while a third paper will examine how the changing needs of investors are redefining the investment proposition.

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