

Asset management tailwinds

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Today's winning asset managers differentiate themselves by contemporary products, captive distribution, and a strategic focus on core capabilities despite a challenging marketplace.

Growth in a unique industry

Initially, the asset management industry appears attractive, averaging a 25% pretax margin and 12% return on equity. Assets under management growth has been supported by favorable market conditions, with the S&P 500 generating annualized total returns of 15%, 13%, and 14% over the last 5, 10, and 15 years, respectively. However, organic growth (AUM growth excluding investment returns) has been muted. In reviewing the organic growth of 36 publicly owned asset managers with significant US businesses, we found that the average organic growth rate was 0.6% from 2018-2023. Market volatility and shocks to investor confidence hurt inflows given changes in interest rates and inflation while adjusting to a global pandemic.

Differentiated archetypes

As shown in exhibit 1, there is significant dispersion in growth rates by firm archetype. Alternative players with differentiated products offering non-correlated returns and passive-driven firms led the industry with 5% organic growth from 2018-2023. Passive players with lower-cost index funds and ETFs followed immediately afterward. Global financial firms with broad distribution and capital markets business followed at 4% organic growth. Insurance-owned firms that are more focused on fixed income generate flat organic growth in line with industry averages. Finally, equity-dominant firms and active traditional independents that are finding distribution and differentiation more

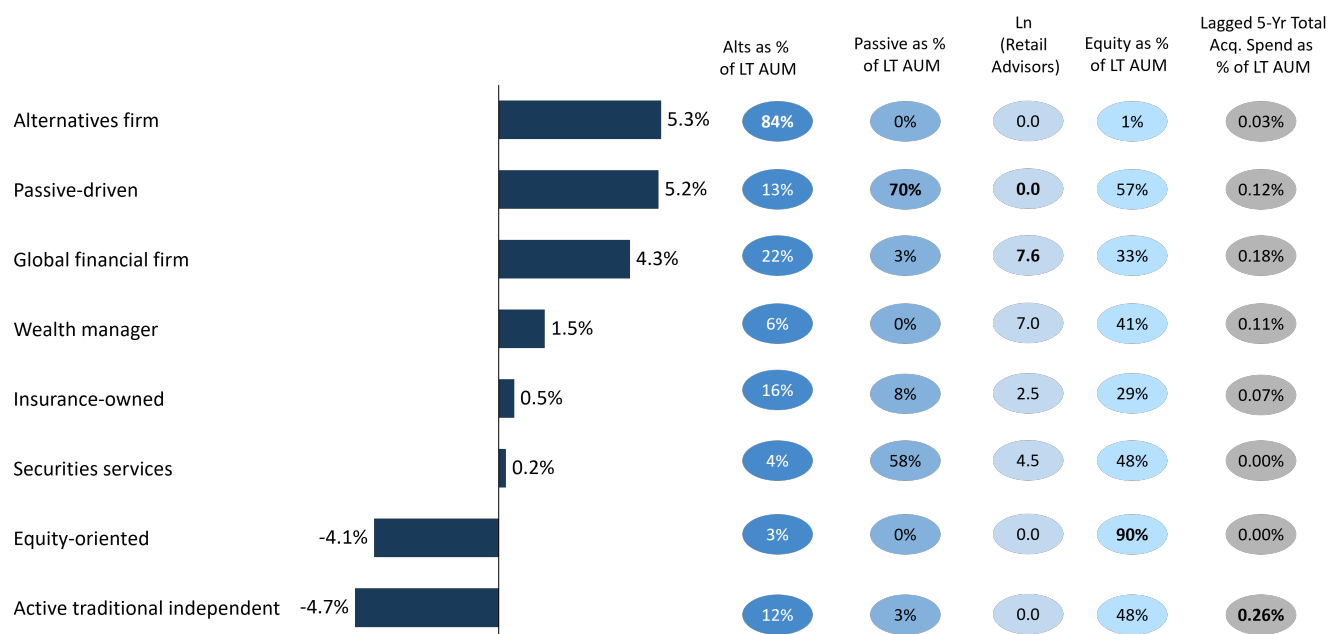
challenging averaged -4% and -5% organic growth, respectively, over the period.

Flow vs revenue dynamics

This analysis tracks success in aggregating net flows, not revenue. In some cases, they move differently. For example, passive players will generate flows from ETFs and index funds that typically have lower expense ratios or revenue yields than active funds. Many top-performing funds also have lower expense ratios, which lead to lower revenue growth per new flow compared to lower-rated peers with higher expense ratios. Finally, active equity funds typically have higher expense ratios, which magnify the benefit they receive from rising stock markets, offsetting client outflows.

Exhibit 1: Organic growth by asset manager archetype

2018-2023 organic growth rate by asset manager archetype



Source: Public filings and investor presentations

Organic growth drivers

Five factors drove organic growth from 2018-2023. First, firms with a higher share of Alternatives AUM attract more flows. Clients want unique, non-correlated market exposures. Next, the percent of LT AUM in passive products drives flows. Passives have attracted strong flows as investors seek liquid, low-cost solutions enabling targeted exposures. Third, captive distribution attracts net assets. Having a sales force of thousands of financial advisors creates more avenues to reach investors. Advisors may nudge retail clients to investment products where they may have closer connectivity to investment processes. Fourth, firms with a higher ratio of Non-Advisory Investment Banking revenue/Long-term AUM attract higher flows. Firms with global capital markets capabilities are closer

to market developments, new product ideas, and CFOs and Corporate Treasury decision-makers. Finally, investment performance is a key driver, as firms with a higher percentage of top-performing funds enjoy larger flows. Investors will continue to pursue solutions that will enable them to maximize their risk-adjusted returns. As such, asset managers should have a portfolio of relevant investment strategies and portfolio management approaches to maintain competitiveness in all market environments.

Organic growth inhibitors

Complexity hurts organizations. We have found that asset managers who spend more on M&A as a percent of AUM experience lower organic growth. These organizations must deal with complex integration needs and organizational design issues. Second, equity has been the most challenged asset class over the last five years in driving organic growth as investors struggle with equity differentiation, seek passive products, or pursue multi-asset class solutions with a better risk management profile. A higher percent of AUM in equities is correlated with lower organic growth. Finally, firms with a focused business on investment management or wealth management outperform. In contrast, firms with a greater mix of securities services revenue attract fewer flows. Our hypothesis is that securities services firms are at a branding disadvantage as alpha-driven investors are less likely to consider them for investing solutions.

Path to prosperity

Asset management remains a profitable business with compelling tailwinds. To drive organic growth, firms must:

1. Pursue a nimble strategy of offering lower-cost passive products or differentiated alternatives
2. Facilitate thoughtful distribution partnerships with wealth managers and capital markets participants to broaden client touchpoints and strengthen market intelligence
3. Cultivate and invest in portfolio management teams with broad resources that can deliver strong results

Asset managers should carefully consider:

1. Adopting a longer-term growth horizon for large-scale M&A, considering organizational complexity that can challenge near-term distribution effectiveness or product capabilities
 2. Managing investment in active equity (unless there are strong product or distribution advantages) given intense competition and inroads from passive players
 3. Culling initiatives that veer from core asset or wealth management or capital markets business activities
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