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**2018 Investment
Management Outlook**
Vision and focus to drive success

Deloitte Center *for*
Financial Services

Challenges ahead in 2018

Let's imagine for a moment that it is 2019 and we are looking back at the investment management (IM) industry. Is the competitive landscape for IM firms identical? Are the strategies and operating models of the successful firms the same as they were in the past? Have customers' preferences changed? It is not likely that many people answer yes to all these questions. The industry will likely change, and some IM firms will likely make exceptionally good strategic choices that could enable success in a changing environment.

While some firms will likely thrive, overall the operating environment for the industry is likely to be difficult in 2018. Firms are expected to face margin compression as investors favor low-cost investment solutions, while at the same time the case for alpha may be difficult to make for many IM firms. Further, operating models at many IM firms could continue to face challenges while keeping pace with environmental changes driven by regulators, changing customer preferences, and advancing technologies.

Changing customer preferences

The US customer base for mutual funds and exchange-traded funds (ETFs) appears healthy. Approximately 95.8 million individuals invest in mutual funds (representing 44.4 percent of US households) and hold \$18.8 trillion in mutual funds and ETF assets.¹ Total assets in regulated open-end funds globally were also near an all-time high at \$40.4 trillion in 2016, growing at a compound annual growth rate of 7.7 percent over the last five years.² However, there are signals that customer preferences may experience a quantum shift, as opposed to the incremental changes that the industry has seen over the past decade. Seventy percent of Millennials were optimistic about stock returns in 2016, outpacing other age groups in their optimism about the future of the market.³ Within a generation, Millennials will likely be an important segment for many IM firms. Establishing relationships early with this segment will likely increase credibility of a firm's brand.

Investors favor lower-cost funds and making the case for alpha

It is the change in customer preferences that is likely to make 2018 challenging for many IM firms. Most investors in the United States are migrating to lower-cost funds. "The market shares of front-end and back-end load share classes have declined in recent years, while those in no-load share classes have increased substantially."⁴ Part of the shift to low-cost funds is linked to the shift from active to passive funds. However, in certain areas of IM, such as private equity, where firms have been able to credibly make their case for alpha or risk-adjusted return, gathering assets has been more business as usual. One of the keys to success for active mutual fund managers is to credibly "make the case" for alpha, which likely starts with having a product lineup with high "active share," meaning the percentage of holdings in a portfolio that differs from the benchmark index. Beyond that, managers demonstrating a well-capitalized and differentiated process to uncover investment opportunities will likely see more success. Growing the actively managed business in this environment may be challenging due to cost pressures, investing to satisfy changing customer preferences, and the pressure to improve investment processes that, on average, have fallen short of market indices.

New operating models

The story is a bit different for the few large-scale index providers. Index funds have had strong tailwinds for success over the past several years, as many investors shifted to lower-cost investment vehicles. At some point these tailwinds may become headwinds, driven by new operating models that combine low cost with digital community engagement. If these new operating models gain significant traction, an agile and efficient model that can create a differentiated investor experience may be an important success factor.

The next part of this challenge could be running the business. Agility is one way to meet changing regulatory and tax requirements with new processes, rather than just increasing the capacity of existing infrastructure. 2018 will likely see some firms doing more with less and becoming more agile by breaking down existing tasks into components such as people, processes, and technology. Some IM firms could explore which components can be outsourced, including tasks that are critical differentiators for the firm, because they carry a large portion of operating cost. Technology infrastructure rarely needs to be owned to be effective, and with the state of cloud computing today, the cloud has the potential to be cost-effective as well as capability-enhancing. It may be the case that the process portion of a task alone is the key differentiator for a firm, where both the people and the technology that support the process can be rented instead of owned or, employed, as it relates to personnel.

Customer service needs for IM firms also seem to be changing. While for many customer segments that change might be incremental, for some segments, such as Millennials, the difference in preferences could be dramatic. How quickly to invest in a digital customer service model may be a key decision for IM firms, and it is likely intertwined with each firm's growth strategy and its transformation to an agile operating model.

The average IM firm will likely be less profitable and have roughly the same assets under management (AUM) at the end of 2018 as in the beginning, even in a continuing bull market. The cure to the malaise of averageness is to be exceptional. To break away from average, IM firms may have to find new ways to grow, run their operations more effectively, and provide an excellent customer experience for existing and developing customer segments.



Growth through action in 2018

Investment managers are operating in a difficult environment: as passive funds register record inflows, active funds, on average, are battling a drought. In such a skewed scenario, the few firms that are growing successfully have managed to offer low-fee products or provide alpha.⁵ For growth in 2018, IM firms should consider bolstering their organic and inorganic growth strategies to be prepared for a potentially more challenging time ahead. Inorganic growth could prove to be a key strategy for smaller IM firms as it provides scale, which unlocks other benefits quickly.

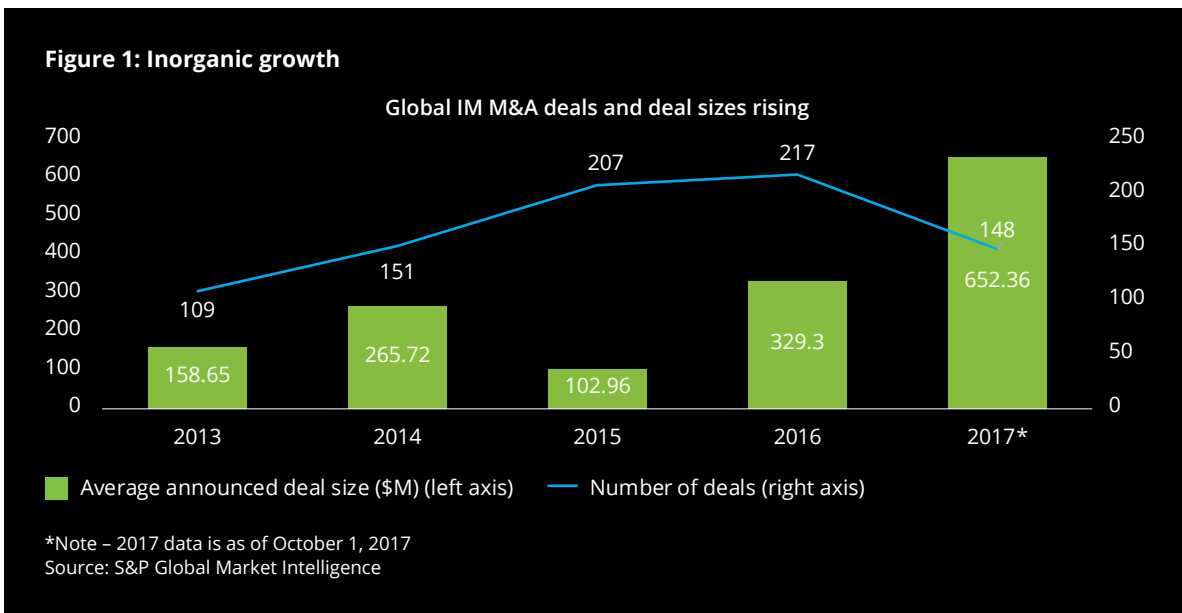
Growth through mergers and acquisitions could be compelling

Scale appears to be a key growth pillar for investment managers, with the industry concentration rising as larger firms gain a greater share of the assets managed globally.⁶ In fact, BlackRock, Vanguard, and State Street captured more than 70 percent of the net cash collected globally by ETFs and mutual funds in 2016 and seem on a similar path in 2017.⁷ Operating on a larger scale provides an investment manager with factors that can contribute to growth, such as greater distribution reach, a more diverse talent pool, broader product portfolio, and cost efficiencies. These factors can translate to higher, more stable margins for the largest IM firms. In the past year, the top three IM firms reported steady margins of about 34 percent while other public IM firms reported an 8 percent margin decline to 23 percent. Having a large and diversified product portfolio could

become key for investment advisers as distributors may seek to reduce the number of IM firms in their product lineup. Product breadth seems to be a key selection parameter in this rationalization process that distributors are undertaking.

Investment managers also require new skills to stand out amongst the competition. Mergers and acquisitions (M&As) often provide the ability to acquire these new skills and capabilities quickly. While not included in Figure 1, most IM firms making heterogeneous acquisitions of fintech firms are also expanding their capabilities. Many investment managers have already realized the importance of inorganic growth. With 217 deals undertaken globally in 2016, IM firms have almost doubled the number of transactions as compared with 2013.⁸ The strategic importance of these deals is clear. The average transaction size has jumped as well, with 2017 witnessing a few big-ticket transactions.⁹ The £11 billion merger between Standard Life and Aberdeen Asset Management to create Europe's second biggest investment manager is a prime example of this trend.¹⁰ The transaction provides the combined entity with scale across asset classes and geographies—servicing clients in 80 countries. Along with broadening investment management skills and capabilities, the merger also targets a cost savings of £200 million a year.

Inorganic growth appears to be an effective approach for IM leadership to achieve scale, product breadth, and analytical capabilities.



Alpha generation for organic growth

Many investment managers are augmenting traditional stock-picking methods with advanced analytical techniques and alternative datasets to stay ahead of the curve. These investment managers seeking organic growth via consistent alpha generation should be on the lookout for creative approaches utilizing technology and alternative data sources for making investment decisions. Alpha generation has shifted the focus from the stock-picking skills of portfolio managers and traditional financial analysis to augmented processes including:

1. Quantitative and analytical techniques, such as artificial intelligence (AI)
2. New alternative data sources that can provide investment insight

Rise of Man Group assets via AI and alternative data adoption

Finding the sweet spot between applying advanced analytical techniques and deriving insights from alternative data sets can be integral to IM firms growth. UK-based Man Group PLC began utilizing artificial intelligence algorithms for one of its funds from 2014, along with the analysis of alternative datasets including weather forecasts and container ship movements. The AHL Dimension fund has quintupled AUM from 2014 to 2017 based in part on its strong performance driven by artificial intelligence and alternative data. This has led Man Group to deploy AI techniques for an additional four funds managing \$12.3 billion (as of September 2017).¹² Man Group, which was skeptical of its early AI results, is now exploring utilization of these techniques more broadly across its business.

Investment managers are using a myriad of technologies in their investment decision process—including AI and other advanced analytical techniques to improve their traditional processes. In fact, many hedge funds and family offices are using AI not only for investment decision making, but also for finding better ways for executing trades.¹¹

The transition to such augmented investment processes seems to be accelerating as the volume of available data rises exponentially. Investment managers like Man Group PLC (see sidebar) are using a plethora of alternative data sources—such as satellite imagery, social media sentiment, consumer transactions, geolocation, online reviews, and web-crawled data—to generate alpha. The number and type of alternative datasets seems to increase almost daily.

While utilizing alternative datasets for making investment decisions, investment managers should also consider that each alternative data source may face degradation in alpha generation capability as it becomes widely adopted. IM firms will likely need to regularly refresh their analytical approaches with the type of creativity that comes from talent experienced in both investment analysis and advanced alternative data analytics, because of this degradation. Investment managers that seek to push the envelope in utilizing different technologies, analytical capabilities, and alternative data sources for generating alpha may be positioned for sustainable growth because indexing currently cannot derive investment value from advanced analytics or alternative data.



Predictions for 2018

Given the margin pressure on the IM industry and the potential for economies of scale inherent in managing money, 2018 could be the year that records the highest average M&A deal value for the IM sector.

With the exponential rise in data availability, and continued processing power increases, 70 percent of new hedge fund launches globally in 2018 will likely include investment processes that are supported by computer models, including AI and machine learning algorithms, as compared with 47 percent in 2015.¹³



Action steps

IM firms can consider the following action points for augmenting their growth strategies.

- Reevaluate the current technology architecture to align with growth plans, because a shift to alternative data and AI may require significantly more storage and processing capabilities.
- Manage the product portfolio to balance the need for product breadth with the firm's capabilities and investor and distributor preferences.
- Firms considering being acquired should also consider mergers with similarly situated firms as a way to achieve scale that may mitigate high-valuation roadblocks.

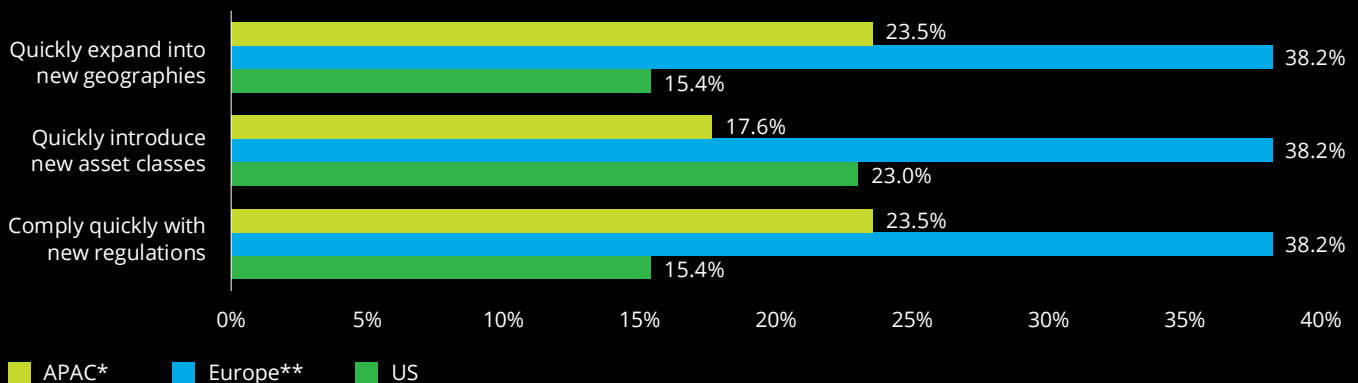
Investment managers may be best positioned to deliver on these action steps with agile information systems in place. These capabilities can facilitate introduction of new

products, compliance with new regulations, and expansion into new geographic markets. A flexible systems architecture may also provide management with a strong footing during M&A transactions, as integration of target-firm systems can be done more quickly with an advanced architecture.

To support growth efficiently, IM firms should have in place a flexible operating model to comply with changing regulations, manage product offerings, and cover diverse geographies. Based on an Ovum survey (figure 2), management confidence in their systems at US buy-side firms appears to lag slightly behind Asia Pacific countries (APAC) and European peers with respect to regulatory compliance, new asset class introduction, and expansion into new geographies.¹⁴ Especially in the United States, IM firms may have their work cut out for them to rise to the challenges in 2018 to achieve organic and inorganic growth because people, processes, and technology will likely have to improve in unison to achieve the full value of operational model transformation.

Figure 2: How would you rate your systems' ability to support the following?

(IM firms that responded as 5 - Highly effective)



* Includes North Asia, South Asia, and Southeast Asia
 ** Includes Eastern and Western Europe, and Russian Federation
 Source: 2016 Ovum ICT Enterprise Insights survey

Run more agile operating models

The chief operating officers (COO) at IM firms are being challenged in ways likely unseen in the past. Some of them are focusing on operational agility and cost containment, which could help achieve competitive advantage and future success in the challenging marketplace because cost efficiency can translate directly to either investor returns or profitability. The rising cost of regulatory compliance and margin compression, driven by the popularity of low-cost products, seems to have accelerated the need for operational restructuring. For an operational overhaul, COOs can deconstruct the existing operating model and look at the components of critical tasks again. That exercise could help spot some of the practices that have room for cost and agility improvement. One approach for cost control is to allocate resources based on the risk that the tasks bring to the firm. Firms may find that they can rent talent and technology while owning the processes and oversight to help achieve agility, increased efficiency, and reduced cost to manage risks at a tolerable level.

Talent

As margins often shrink and fees come under pressure, expense discipline has become critical for many IM firms. Engaging third-party providers for processes that are currently run in-house, while prioritizing seamless integration with them, is a strategic alternative that could reduce certain fixed operating costs. Outsourcing seems to have gathered momentum in the IM industry as firms gained confidence in the outsourced delivery model. Over the past few years, many IM firms have started to rely on full-service providers for various front- and middle-office functions, such as dedicated trading desks and settlement functions.^{15,16} In the past, most IM firms engaged functional service providers predominantly for back-office operations. As IM firms look again at their operating models to identify their optimal outsourcing approach, they could select the right fit from a variety of alternatives.

Managed services. This kind of engagement model can help firms tap into external specialists to supplement existing skill sets and bridge skill gaps.¹⁷ As the IM industry has grown in size and complexity, the number of business functions that could be outsourced has increased significantly to include regulatory compliance, middle-office services, operations, chief financial officer services, information technology (IT) management, tax compliance, marketing, business development, and talent-related services.¹⁸ Even some firms that have historically set up large teams of full-time employees are moving toward managed services to hopefully benefit from the subject matter expertise, quality, cost-efficiency, and scalability. For instance, a British IM firm, Legal & General Investment Management Limited, adopted a know-your-customer managed-service platform to accelerate onboarding for customers. The firm expects to drive operating efficiencies, reduce costs, and enhance risk management procedures under this new operating model.¹⁹

Staff augmentation. In a staff augmentation engagement model, firms use a service provider's personnel to complement the in-house team in execution of projects. This ranges from adding staff to an in-house project team to using a traditional consulting project model.²⁰ This approach could be the model of choice for temporary support needs. For instance, a service provider specializing in regulatory frameworks could provide personnel to assist with the assessment of the firm's compliance programs, including policies, controls, procedures, and internal and external risks to determine if there are any deviations from the regulatory guidelines. In a recent Deloitte survey, 81 percent of IM firms cited regulatory risk as a top challenge, and expected this risk to become more important over the next two years.^{21,22} Developing these procedures and controls to be managed by IM firms will likely be an important area for staff augmentation in 2018.

Processes

It is important to understand that even if firms' reliance on outsourced service partners increases for various functions across the value chain, the ultimate responsibility to control the processes remains within the firm. Functional leaders should own the following key components of the business processes while working with external service providers:

Control. They should establish policies and procedures to ensure that management's risk mitigation guidelines are met.

Monitor. They should conduct ongoing evaluations into the business processes at different stages of service delivery and communicate the requirements and expectations to the service providers.

Long-term partnership. They should ensure that the service providers' long-term road map matches their own requirements and they invest in their personnel and infrastructure. The ultimate goal should be to establish a long-term relationship with a provider that understands the business of the firm, and offers domain expertise at a competitive cost structure.

Even as IM firms may get creative about how the processes important to their business are performed, ownership of the process ultimately resides with IM firm management. The challenge for 2018 will likely be in balancing improving efficiencies in the operating model while maintaining or even strengthening oversight and control.

Technology

Technology innovation has enabled many IM firms to access integrated, scalable infrastructure and systems under a variable cost structure while simultaneously lowering the overall operating costs. Cloud computing technology provides an opportunity to move away from building IT infrastructure on-site to host applications and data. IM firms across the globe could adopt cloud-based delivery models as the business seems to demand greater agility and cost curtailment amid the market pressures noted above. A survey of 179 buy-side firms across the globe provides insights into adoption trends of software as a service (SaaS)—a cloud-based software delivery model for various IM functions. The United States (figure 3) leads APAC (figure 4) and European (figure 5) countries in IM firm deployment of SaaS for middle-office functions with an adoption rate of about 40 percent.²³ However, front-office deployment of SaaS trails middle-office globally, but growth in this area is expected due to high levels of trialing SaaS for the front office.²⁴ SaaS, in its various forms, could be an attractive proposition for operational transformation, owing to its ability to provide scalability, flexibility, and compatibility.²⁵ The operating models of many IM firms are on the verge of a significant transformation.

Figure 3: Functions for which US buy-side firms are implementing SaaS as primary delivery model



Source: 2016 Ovum ICT Enterprise Insights survey

Figure 4: Functions for which APAC* buy-side firms are implementing SaaS as primary delivery model



*Includes North Asia, South Asia, and Southeast Asia
Source: 2016 Ovum ICT Enterprise Insights survey

Figure 5: Functions for which European* buy-side firms are implementing SaaS as primary delivery model



*Includes Eastern and Western Europe and Russian Federation
 Source: 2016 Ovum ICT Enterprise Insights survey

The survey results are supported by real world examples of IM firms that are investing in cloud-based solutions in an effort to gain operational advantage. Polen Capital Management is one such firm. In 2016, the firm implemented a fully managed platform for portfolio

management, trading, and compliance by deploying a SaaS-based IM solution.²⁶ Survey results indicate that many IM firms may follow suit in 2018 as they scale business and transition from trial phase to deployment.



Predictions for 2018

Cloud computing. Many large IM firms appear to have identified a mix of on- and off-premises technology infrastructure.

They are implementing low-cost, agile cloud-based solutions across functions. In 2018, expect to see more medium- and small-size IM firms adopting cloud-based solutions instead of upgrading their existing proprietary infrastructure as they feel the pressure to improve efficiency and agility.

Outsourcing. In 2018, IM firms will likely continue to experience a complex and disruptive environment, which would demand outsourcing of various business functions ranging from back office to front office. Third-party service providers are offering solutions for a gamut of outsourcing needs, with notable additions in front-office functions. In 2018 and beyond, we could see an accelerated adoption of outsourced functions, including the front office.



Action steps

In 2018, IM business leaders should formulate operational strategies with a focus on streamlining the three components of the operating model. Considering the following action steps could help make rent vs. buy strategy decisions with respect to technology and talent:

- Review the current and future operational needs against the existing headcount and technology infrastructure.
- Target the business functions that require sizeable technology investment and the processes that require costly and fast-moving skills for potential transformation.
- Determine if implementing cloud solutions or engaging external service providers fits with the strategic plans for future expansion or increased capabilities.
- Develop management controls around process changes and around the new processes themselves, which may be on rented infrastructure and operated by nonemployee talent, tailored to the peculiarity of the outsourced components.
- Consider risk-based resource allocation as part of operating model transformation.

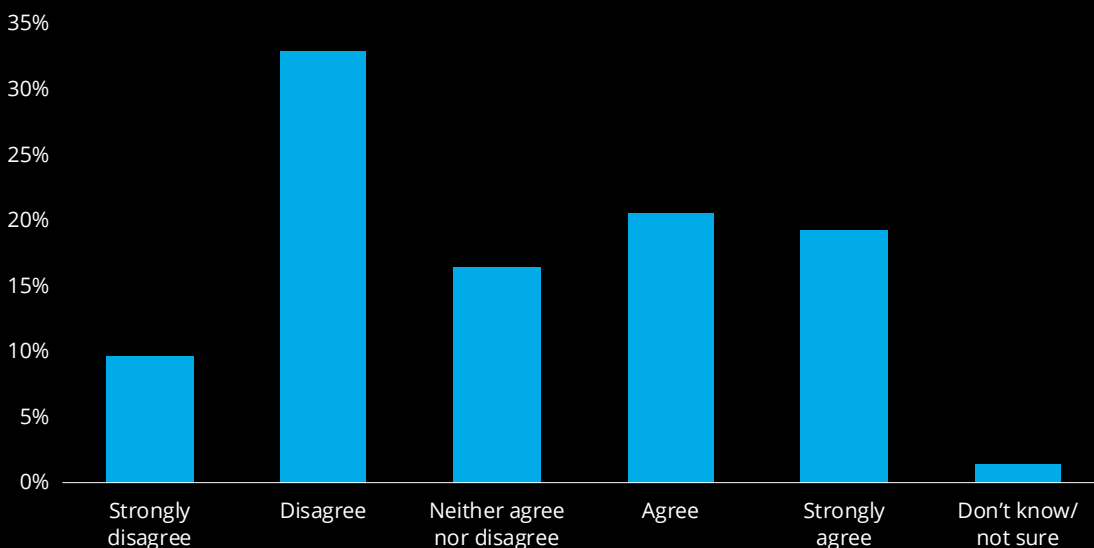
Incremental or quantum change to digital service

For some firms, the way they service customers may undergo incremental change in 2018, while other firms could take bolder steps to transform the customer experience. The key determining factor for which future may unfold for IM firms might be the strategic focus given to targeting investors with low balances or digital interaction preferences. For some firms it may make sense to target Millennials, who tend to have both of these characteristics. For others, such as private equity firms and hedge funds, the digital experience may not focus on Millennials, but on wealthier segments that also have rising digital experience expectations. Targeting Millennials could demand quantum change because of their supposed different relationship-building approaches and their digital expectations. Leading or early adoption of new approaches is often needed to target them. Millennials' preferences for interaction are typically different from those of other segments, requiring more digital trust and online relationships. Further, Millennials' investing approaches are usually more peer- and community-influenced. In contrast, keeping up with digital expectations for other segments can be more of an incremental change strategy, calling

for an early majority technology adoption strategy. Approaches that may be off-putting to Baby Boomers (such as an AI chat bot), may be engaging for Millennials.

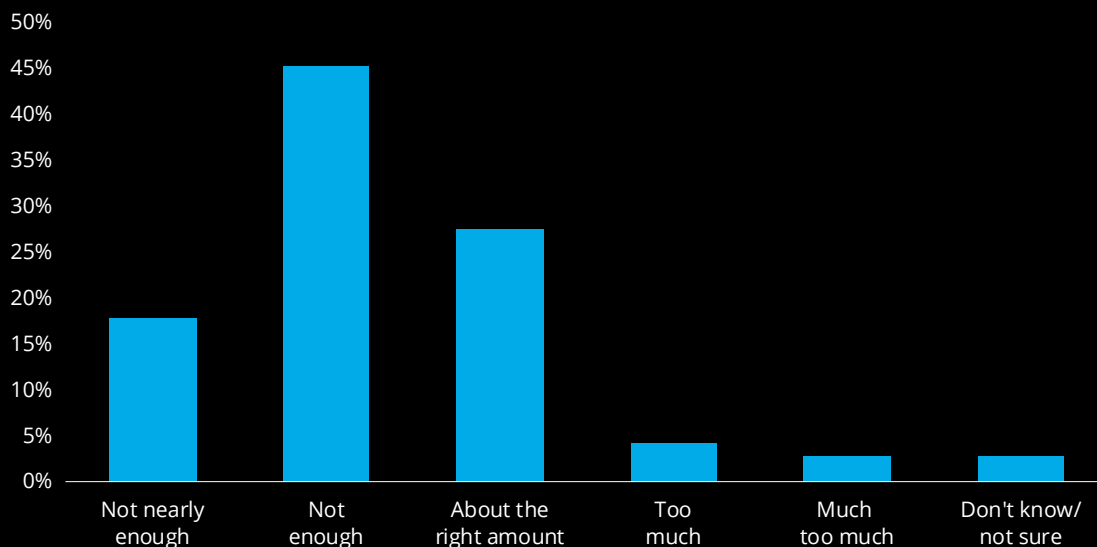
In order for any firm to shape its digital future, a strategy for that future should be in place, and the plan should have organizational commitment behind it. Too many IM firms seem lacking in both categories. In *MIT Sloan Management Review* and Deloitte's 2017 digital trends study, just 40 percent of respondents from IM firms agreed or strongly agreed that their organization had a clear and coherent digital strategy (figure 6).²⁷ It appears that a minority of IM firms are taking the first necessary step to shape their own digital destinies. To add to these results, 63 percent of respondents at IM firms report that not enough time, energy, and resources are currently being spent implementing digital business initiatives (figure 7). Both of these results point to a future where most IM firms appear to be falling behind customer expectations for a digital experience and are not likely to catch up in the next few years.

Figure 6: Investment management firms: To what extent do you agree with the following statement: Our organization has a clear and coherent digital business strategy



Source: "Achieving Digital Maturity," *MIT Sloan Management Review* and Deloitte University Press, July 2017.

Figure 7: Investment management firms: How much time, energy, and resources does your organization spend implementing digital business initiatives?



Source: "Achieving Digital Maturity," *MIT Sloan Management Review* and Deloitte University Press, July 2017.

Where does that leave the IM industry? Adding in one more pertinent survey result clarifies the picture further: only 2 percent of IM firms have a digital strategy that projects beyond five years.²⁸ The picture this paints is that very few IM firms have a digital strategy in place to serve Millennials in 10 years, when they are expected to begin to control significant investable assets. Their wealth could amount to \$15 trillion in the United States and \$12 trillion in Europe over the next 15-20 years.²⁹ This may be an important factor in shaping the industry. On the other hand, these results indicate that the IM industry seems more focused on short-term change, as shown by the 58 percent that project three years or less for the future for their digital strategic planning. Strategic planning horizons at IM firms should be driven by real-world events, such as demographic change, rather than time-boxed exercises that may miss the tsunami of change coming from just outside their time horizon.

Digital disruption?

Healthy skepticism is a good element in strategic planning. There are many examples of prior futuristic

visions that have not come to fruition, but interestingly some do. There is typically value in identifying the leading indicators that significant change is coming. In this case the test seems to be whether low-cost, low-touch digital investment products and services can gain enough traction to transform investment management.

Transformation appears to be coming. Look at Alibaba and the largest global money market fund to see evidence of that transformation in China. The Yu'e Bao money market fund, with more than \$200 billion in AUM and nearly 400 million customers in 2017, is the result of processes and technology coming together to meet the needs of a large, underserved segment. The fund name translates into "found treasure" and it has generated its AUM by locating idle balances in the largest digital payment platform in China and sweeping them into the fund. It is a fintech partnership between digital payments and investing. The fund services customers digitally, has low acquisition cost, and has many very low-balance accounts.

This accomplishment may be difficult to replicate, but its success elements can be reproduced. The success appears driven by ease of use, low-touch, digital investing, and returns that initially just outpaced alternatives. Now that the fund has tremendous scale, it can offer highly competitive returns derived from the ability to take a large portion of investment offerings, sometimes even the whole offering, of a short-term securities issuer. Funds investing in smaller

increments have less negotiating power with issuers and distributors, and may receive a lower yield as a result. Clearly, scale is not the only contributor to yield, but it can make a difference. In this case, a popular online payment processor extended its services to include a simple money market account as a savings option for its subscriber base. The key was making it easy for investors. Who is to say that something similar cannot happen in other markets around the globe?



Predictions for 2018

A Fortune 500 firm, IM incumbent, or digital experience leader offers an integrated digital customer experience investment platform that raises the standard for customer experience, outpacing smaller stand-alone fintech startups in the US and European markets, and raises AUM at an unprecedented pace. Why? Because there seem to be millions of underserved customers with small balances, and technology has reached a level of capability and ubiquity that enables acquiring and serving them profitably.

Fintech and IM will likely continue to complement each other with new products and approaches gaining traction within niche markets. Robo-advice is expected to see continued, but slowing, growth as the base expands. Newer community-based approaches to IM may see faster growth, but the base will likely continue to be small in 2018. Millennials, a potential target segment for community-based investing, are still expected to control just a minority of the wealth.



Action steps

To keep up with the ever-changing customer service landscape, it is important for IM leaders to monitor current customers and to understand new customers. There are many questions to answer to reach this understanding.

- What are their service preferences?
- How were they won?
- How healthy is the relationship?
- What is the cost of acquisition?
- How profitable are they?

- How does my customer profile differ from key competitors' customer profiles?

- Is there a customer segment that should be targeted?

Once important customer information is gathered and understood among management, a digital service strategy can be developed. Matching products and services to target segments over time is one of the important goals of the strategy, recognizing that target segments and their preferences will likely change over time. Most firms will likely adopt an incremental-change strategy, while a few standouts will likely aim for quantum change. There is probably no single digital strategy that is right for all IM firms, but it is likely that most successful firms will have a coherent digital business strategy.

2018: A pivotal year

2018 will likely be the year of exceptions. Some exceptional firms could get the elements of growth, agility, and service right for their unique strategies. Executing these plans may also set them up to deliver on their brand promises to current and future investors, whether that be risk-adjusted return, alpha, or another important customer experience metric. These exceptional firms will likely set the stage to meet or exceed their five- and 10-year goals. A vision of the future and a will to apply the resources in the present to make that future come into being could be the prerequisites for success in 2018, and the years ahead.



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