2022 investment management outlook

Canada's investment managers squeezed on margins, facing generational shift

Gone are the days when investment management firms could sell a few mutual funds, each with a fee of 2% or so, and keep their clients for life. Now, for companies to succeed, they must be digital, have a diverse product lineup, and cater to the unique needs of multiple generations of clients.

Over the last decade (2011–20), Canadian investment fund assets have more than doubled, to $2.04 trillion at a 10-year compound annual growth rate of 9.6%. Changing investor preferences, technology advances, continuing fee pressure and margin compression, evolving regulations, and the COVID-19 pandemic have fundamentally changed the conditions to win in the marketplace.

Asset managers today are increasingly investing in ESG, product innovation and diversification, and digital capabilities. They are also pursuing scale for better operational efficiencies and cost competitiveness. While doing so, they are prioritizing three organizing areas—operations, talent, and active financial management—to emerge stronger in the post-pandemic world.

That's according to a recent Deloitte report, *2022 investment management outlook: Positioning for a greater impact*, for which 400 investment and wealth management leaders were interviewed, including 55 Canadians. Their responses helped us identify several pivotal trends that the industry should be ready to tap into. Organizations without appropriate plans in place risk falling behind. Here are the most important trends identified in the report.

Meeting generational needs

There's no single approach to servicing clients anymore. With more Canadians retiring and decumulating their assets, an increase in investors who expect a more digital experience, and an impending generational wealth transfer that could see trillions of dollars change hands, clients want investment firms to adapt to their needs—not vice versa.

Our report indicates that millennials, for example, are socially active, digitally savvy, cost conscious, value-driven, and more focused on outcomes. If investment managers are going to meet this generation's needs, they must rethink everything from their operating model and digital capabilities to their product offerings and client communications. They must act quickly, too: assets under management (AUM) could decline as baby boomers start spending and bequeathing their savings, and millennials will not hesitate to take the assets they inherit to a firm that satisfies their needs. Indeed, 60% of the Canadian investment and wealth management leaders participating in our survey see the changing digital expectations of investors as the single most important trend.

Decreasing margins amid increasing regulation

Investment management companies are facing significant margin pressures. Fees on actively managed mutual funds have fallen by 33% globally since 2000, while more Canadian consumers are purchasing passive and low-cost exchange traded funds (ETFs). (Net assets in ETFs increased by 497% between 2011 and 2020, according to the Investment Funds Institute of Canada (IFIC).) This coincides with rising operational costs, including from regulation-related expenses. Many Canadian investment managers say they're facing an increasingly complicated regulatory and compliance risk environment.

All of this is putting pressure on the industry's value proposition and revenues. Going forward, firms must be prepared to continually innovate their business models, find new sources of revenue (i.e., alternatives), and pay more attention to solutions and services rather than product sales.

Undertaking digital transformation and technology modernization

Investment managers are increasingly recognizing technology as the key enabler for achieving operational efficiency, speed to market, and enhanced customer and employee experience and are making significant investments in technology modernization and digital transformation initiatives. Technology adoption is also advancing on the operations side, with industry players making ever-greater use of data analytics and artificial intelligence (AI). The leaders of an overwhelming majority of firms that already use AI—85%—agree that technology has helped them generate alpha. However, many also agree that they need to make further investments in data infrastructure to begin realizing the benefits of analytics.

Asset managers also want to digitally transform their own operations by investing in cloud technologies and outsourced services, as noted in our report, and admit the pandemic has accelerated their need to become more agile, develop a hybrid operating model, and change internal cultures. Their clients are demanding it and they recognize that evolution is essential to compete on the basis of exceptional services and strong operational efficiency. When Canadian financial services firms were asked to describe their digital transformation experience over the past year, 53% of respondents chose accomplished (15%) or optimistic (38%). This demonstrates that although they are making progress on their transformation initiatives, there is still room for improvement.

Increasing M&A activity

One way that companies are managing costs and increasing scale is by merging with or acquiring other industry players. The number of deals in this sector worldwide reached 548 for the first three quarters of 2021, compared to 457 and 484 during the same period in 2020 and 2019, respectively. The deal value in the period increased to US$31.6 billion, compared with

US$26.3 billion in 2020 and US$22.2 billion in 2019. In Canada, this activity is especially visible among public-sector pension and asset managers, who are consolidating their investment management functions and outsourcing back-office operations in an attempt to manage costs.

Investment managers are also making acquisitions to add alternative asset management capabilities in the areas of infrastructure, real estate, private equity (PE), and private debt.

Investing in crypto

With the global value of cryptocurrency surpassing US$2.5 trillion in the fall of 2021 and some 200 million people owning crypto assets, more investment management firms are taking digital cash as an asset class seriously. It's not just financial technology providers that are paying attention; traditional managers are increasingly incorporating securities, such as bitcoin ETFs, into their offerings. Thanks to a favourable regulatory environment, Canada is among the global leaders in crypto ETFs. By the end of 2021, crypto asset ETFs grew from zero to $5.9 billion in assets across more than 30 different products in under a year. Recent events, such as spectacular crash of Luna stable coin, underscore the need for investment firms to carry out proper due diligence on crypto exchanges and custodians before investing in this asset class.

Rise of alternatives

The demand for alternative investments (e.g., PE, private credit, direct lending, digital assets, infrastructure, and multi-asset strategies) is increasing across both retail and institutional investors, making this asset class is a key area of focus for investment managers. PE investment in particular is gaining traction among Canadian pension plans. A CIBC Mellon survey of 50 pension fund leaders, for example, found that 90% of them plan to increase their allocation to PE over the next 12 to 24 months. Investors of all stripes increasingly want exposure to PE investments as a hedge against inflation and a source of yield, compelling investment managers to seek more efficient deal sourcing.

Incorporating ESG

Young investors, especially, are more frequently asking for socially responsible investment products. According to the Responsible Investment Association of Canada, assets managed using at least one responsible investing strategy account for more than 60% of total AUM in the country. And an IFIC and Pollara survey found that while 24% of mutual fund investors and 25% of ETF investors already own responsible investments, 61% in each category say they are likely to add them to their portfolios within two years.

This increase in interest has led to a run on the talent qualified to assess ESG criteria for various investments. It has also spurred many public companies to improve their ESG reporting and standards, alongside a push by investment managers to expand their socially responsible investment offerings.

Reimagining the workforce

Many asset managers see their workforce as a way to gain or keep a competitive edge. They're working to boost employee engagement, raise skill levels in key areas, strengthen their corporate culture, and increase employee diversity. In our global survey, there was a strong correlation between the firms reporting that they achieved alpha from AI and those with improved cultural indicators, such as employee engagement, productivity, and well-being. This suggests an important link between a strong employee experience and the delivery of beneficial outcomes, including from advanced capabilities.

In the next few years, the investment management industry could look a lot different than it does today. With investors becoming ever-more savvy, intent on digital experiences, and ready to move money to organizations that meet their needs, it's imperative for firms to embrace these trends and the opportunities they present.

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