INDUSTRY OVERVIEW – PRESENT AND FUTURE

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Content

- “Historic” structural aspects of asset management sectors
- Ongoing and prospective forces for change
- Asset manager views on the structure and dynamics of the industry, present and future

“Historic” structural aspects of asset management

- US specialised wholesale, US retail, UK retail – monopolistic competition with many specialised firms, few economies of scale or entry barriers, differentiated products - low fees
- UK generic and balanced wholesale, US generic wholesale – contestable markets with few large managers dominating owing to economies of scale, but potential competition and low sunk costs - low fees
- Most Continental, Japanese wholesale and retail – oligopoly dominated by few domestic firms, owing to relationships, distribution channels and (in some cases) regulations - high fees

Pressures for change - overall

- Wholesale management
  - Rising costs, notably for medium size firms
  - Shift from active to passive
  - Cross border entry
  - Prospective retirement of baby boomers, with lower inflows
- Retail management
  - “Instividualisation”
  - Increased competition/costs of gathering assets
  - Competition from direct holdings, exchange traded funds, etc.
- Consequent tendencies to industry concentration – and globalisation?

The globalisation hypothesis

- In favour
  - Growth in cross border investment, equity investment and defined contribution advantage to international firms, notably from US
  - Ageing, increased funding and deregulation
  - Cost difficulties for medium size firms
- Against
  - Diseconomies of scale for giant firms, including market liquidity problems
  - Agency costs in conglomerates (e.g. corporate finance and asset management)
  - Investor preferences and limitations of distribution channels

UK asset management

- Threat to balanced manager paradigm
  - Rise of passive and specialist management
  - Response, core-satellite approach
- Shift to defined contribution
- Stakeholder pensions and low fees
- Regulatory issues, including new CAD

EU asset management

- Ongoing forces for change
  - EU “passport” directives
  - Shift to passive and international investment
  - Shift to independent managers, which are often foreign
  - Professional bodies in asset management, enhancing competition

- EMU and pension provision
  - Increases pressure for public pension reform
  - German book reserves, ratings and tax reform
- Improved conditions for investment in EMU
  - Lower inflation
  - Better risk-return tradeoff
  - Easing of regulations on international investment – pressure for more
  - Increased competition among asset managers
  - Pressure on banks’ traditional business, increasing focus on asset management
- Scope for changes in financing

ADJUSTMENT TO FINANCIAL STRUCTURE IN E.U. COUNTRIES IF THERE WERE CONVERGENCE ON THE U.S. PATTERN: ADJUSTMENTS ($ BILLION/% OF GDP)

	Equities (Market Cap)	Percent of GDP	Government Bonds	Percent of GDP	Private Bonds	Percent of GDP	Bank Assets	Percent of GDP	Total	Percent of GDP P	Institutional Investors	Percent of GDP
E.U.-15	5093	62	3298	40	1963	24	–11695	–134	–1223	–14	5962	71
E.U.-11	5733	82	2846	41	1828	26	–9246	–133	0	0	5890	86
Belgium	173	69	–42	–17	15	6	–657	–253	–522	–201	234	87
Denmark	127	75	46	27	–73	–43	–65	–36	32	18	135	78
Germany	2024	88	1253	57	315	14	–2893	–127	433	19	2395	99
Greece	104	95	7	6	59	60	–15	–12	173	143	N.A.	N.A.
Spain	528	80	353	53	341	53	–554	–99	320	57	605	107
France	1278	80	802	51	382	24	–2235	–132	271	16	1082	70
Ireland	41	63	35	53	19	57	–113	–156	9	13	N.A.	N.A.
Italy	1004	93	–247	–23	249	23	–1173	–96	49	4	1394	125
Luxembourg	–12	–64	15	90	0	–1	–590	–3552	–592	–3566	–341	–1797
Netherlands	51	14	146	40	154	42	–498	–131	–171	–45	–52	–13
Austria	224	102	131	61	58	27	–354	–160	38	17	258	110
Portugal	79	89	40	45	36	40	–149	–139	41	38	114	111
Finland	74	64	59	50	33	28	–45	–37	121	98	120	95
Sweden	50	20	90	36	–13	–5	–79	–32	–2	–1	67	29
United Kingdom	–344	–29	723	60	504	42	–2267	–180	–1399	–111	–188	–17

Survey - structure and dynamics of asset management

- Sample – 72 firms, $2 tn, 15% of pension and mutual funds
- Mainly Anglo-Saxon – “prospective entrants” to Continental markets
- Preponderance of value or growth-based active managers, focused on equity investment

Issues addressed

- Elements in competition among asset managers
- Barriers to entry in domestic markets
- Barriers to entry in foreign markets
- Expectations regarding industry structure
- Economies of scale
- Influences on asset management over coming years

WHAT ARE THE KEY ELEMENTS OF COMPETITION IN ASSET MANAGEMENT?

Answers Ranked from 1 (Unimportant) to 5 (Very Important)	**5**	**4**	**3**	**2**	**1**	**Mean**	**Percent Response**
Low fees and charges	12	26	45	14	3	3.31	90
Performance in terms of absolute return	39	36	14	3	8	3.97	92
Performance in terms of risk-adjusted return	17	38	29	15	2	3.53	92
Performance relative to other institutions	**55**	**31**	**9**	**5**	**0**	**4.37**	**90**
Specialization in terms of asset class or sector	14	25	49	9	3	3.37	90
Use of innovative portfolio management techniques (including index tracking)	8	11	34	39	8	2.72	89
Advertising/name recognition	12	35	25	20	8	3.25	90
Level of assets under management	6	31	34	25	5	3.09	90
Reputation with consultants and advisors	**39**	**38**	**16**	**3**	**5**	**4.03**	**89**

WHAT ARE THE MAIN BARRIERS FOR YOUR FIRM IN ENTERING DOMESTIC SECTORS WHERE IT IS NOT CURRENTLY ACTIVE?

Answers Ranked from 1 (Unimportant) to 5 (Very Important)	**5**	**4**	**3**	**2**	**1**	**Mean**	**Percent Response**
Reputation of existing firms	**14**	**43**	**29**	**9**	**5**	**3.52**	**78**
Existing firms' relationships with clients	**20**	**38**	**32**	**5**	**5**	**3.61**	**78**
Existing firms' distribution channels/selling networks	**29**	**36**	**27**	**5**	**4**	**3.8**	**78**
Existing firms' expertise/technical capabilities	9	43	30	14	4	3.39	78
Existing firms' lower unit costs	2	24	40	24	11	2.82	76
Capital or marketing costs	4	18	53	20	6	2.95	76
Existing firms' local information	6	18	40	24	13	2.8	76
Established investor preferences	6	29	51	11	4	3.22	76
Regulatory barriers	0	9	36	38	16	2.38	76

WHAT ARE THE MAIN BARRIERS FOR YOUR FIRM IN ENTERING FOREIGN MARKETS?

Answers Ranked from 1 (Unimportant) to 5 (Very Important)	**5**	**4**	**3**	**2**	**1**	**Mean**	**% response**
Reputation of existing firms	**20**	**48**	**20**	**2**	**11**	**3.63**	**64**
Existing firms' relationships with clients	**29**	**38**	**18**	**4**	**11**	**3.69**	**64**
Existing firms' distribution channels/selling networks	**40**	**36**	**13**	**0**	**11**	**3.93**	**64**
Existing firms' expertise/technical capabilities	7	33	35	13	13	3.07	64
Existing firms' lower unit costs	7	7	50	17	16	2.48	61
Capital or marketing costs	4	28	43	13	13	2.98	63
Existing firms' local information	15	38	28	6	13	3.36	65
Established investor preferences	11	38	34	9	9	3.34	65
Regulatory barriers	13	24	31	18	13	3.07	63

WILL THERE BE MORE OR FEWER ASSET MANAGERS IN YOUR PRINCIPAL MARKET FIVE YEARS FROM NOW?

	Percent
Over 50% more	0
15–50% more	17
Roughly the same	36
15–50% less	45
Over 50% less	2

Will There Be More or Fewer Asset Managers Servicing an Intercontinental Client Base Five Years from Now?

	Percent
Over 50% more	3
15–50% more	51
Roughly the same	18
15–50% less	28
Over 50% less	0

Note: 18% of managers were in a merger last year.

WHAT ARE THE MAIN BENEFITS OF LARGE SIZE FOR ASSET MANAGERS IN TERMS OF ASSETS UNDER MANAGEMENT?

Answers Ranked from 1 (Unimportant) to 5 (Very Important)	5	4	3	2	1	Mean	Percent Response
Greater name recognition	**27**	**42**	**26**	**5**	**0**	**3.92**	**92**
Lower average operational costs (e.g., by duplicating portfolios for different clients)	**12**	**41**	**36**	**11**	**0**	**3.55**	**92**
Ability to negotiate price with broker-dealers	11	20	47	21	2	3.17	92
Overview of market prices, trading pattern, order flow, etc.	5	23	42	30	0	3.02	92
Ability to offer international coverage to clients	11	23	31	23	13	2.97	86
Ability to take on primary issues	5	25	34	28	8	2.91	89
Greater ability to attract top portfolio managers	17	30	35	14	4	3.41	92
Greater ability to communicate direct with clients	11	28	40	15	6	3.22	91

What are the Main Costs of Large Size for Asset Managers in Terms of Assets Under Management?

Answers Ranked from 1 (Unimportant) to 5 (Very Important)	**5**	**4**	**3**	**2**	**1**	**Mean**	**Percent Response**
Costs from market impact of large transactions	**26**	**42**	**29**	**3**	**0**	**3.91**	**91**
Costs from market impact of the firms' name	6	19	42	31	3	2.94	91
Higher regulatory costs (external and internal)	5	8	40	42	5	2.63	91
Costs from inability to retain top portfolio managers	3	20	34	30	12	2.72	89
Costs from lack of personal contact with clients	6	20	33	28	12	2.8	89
Costs from client perceptions of possible conflicts of interest	5	19	31	32	13	2.71	86

INFLUENCES ON THE ASSET MANAGEMENT INDUSTRY OVER THE NEXT FIVE YEARS

Answers Ranked from 1 (Unimportant) to 5 (Very Important)	**5**	**4**	**3**	**2**	**1**	**Mean**	**Percent Response**
Reduced regulatory barriers to entry for domestic fund managers	0	25	33	35	7	2.77	84
Increased regulatory barriers to entry for domestic fund managers	0	24	36	27	14	2.69	82
Reduced regulatory barriers to entry for foreign fund managers	5	31	36	24	5	3.07	82
Increased regulatory barriers to entry for foreign fund managers	3	17	32	34	14	2.63	82
Domestic mergers of fund management firms	**16**	**46**	**33**	**5**	**0**	**3.74**	**85**
Cross-border mergers of fund management firms	**15**	**43**	**32**	**10**	**0**	**3.63**	**83**
Growing competitive benefits to large fund management firms	12	45	28	13	2	3.52	83
Growing competitive benefits to small fund management firms	2	15	37	42	3	2.69	82
Growing competitive benefits to "global" fund management firms	**17**	**40**	**23**	**18**	**2**	**3.52**	**84**
Declining security trading costs	3	25	38	33	2	2.95	85
Rising security trading costs	3	15	20	41	20	2.41	82
Growth in supply of investable funds	**15**	**45**	**30**	**10**	**0**	**3.65**	**84**
Decline in supply of investable funds	14	14	17	42	14	2.71	82
Growth in small cap stock markets	0	25	50	22	3	2.97	84
Growth in emerging market securities	5	25	45	25	2	3.05	84
Growth in Internet use (e.g., for selling mutual funds)	20	23	42	13	2	3.47	84
Greater participation of commercial/investment banks in asset management	**18**	**36**	**38**	**8**	**0**	**3.64**	**85**
Social security privatization	22	28	24	17	9	3.38	81
European Monetary Union	9	29	34	25	3	3.14	82

Conclusions

- Structural change underway in asset management, strongly affecting Europe, manifestations include mergers and cross border competition
- Extent should not be exaggerated, given influence of relative return, expertise, relationships and distribution channels – all of which help preserve existing structure
- Some possible issues
  - How will large firms cope with market liquidity?
  - Will dominant firms entail market power abuses?
  - What are the consequences of failures of global firms?
  - (How) should regulation adapt?