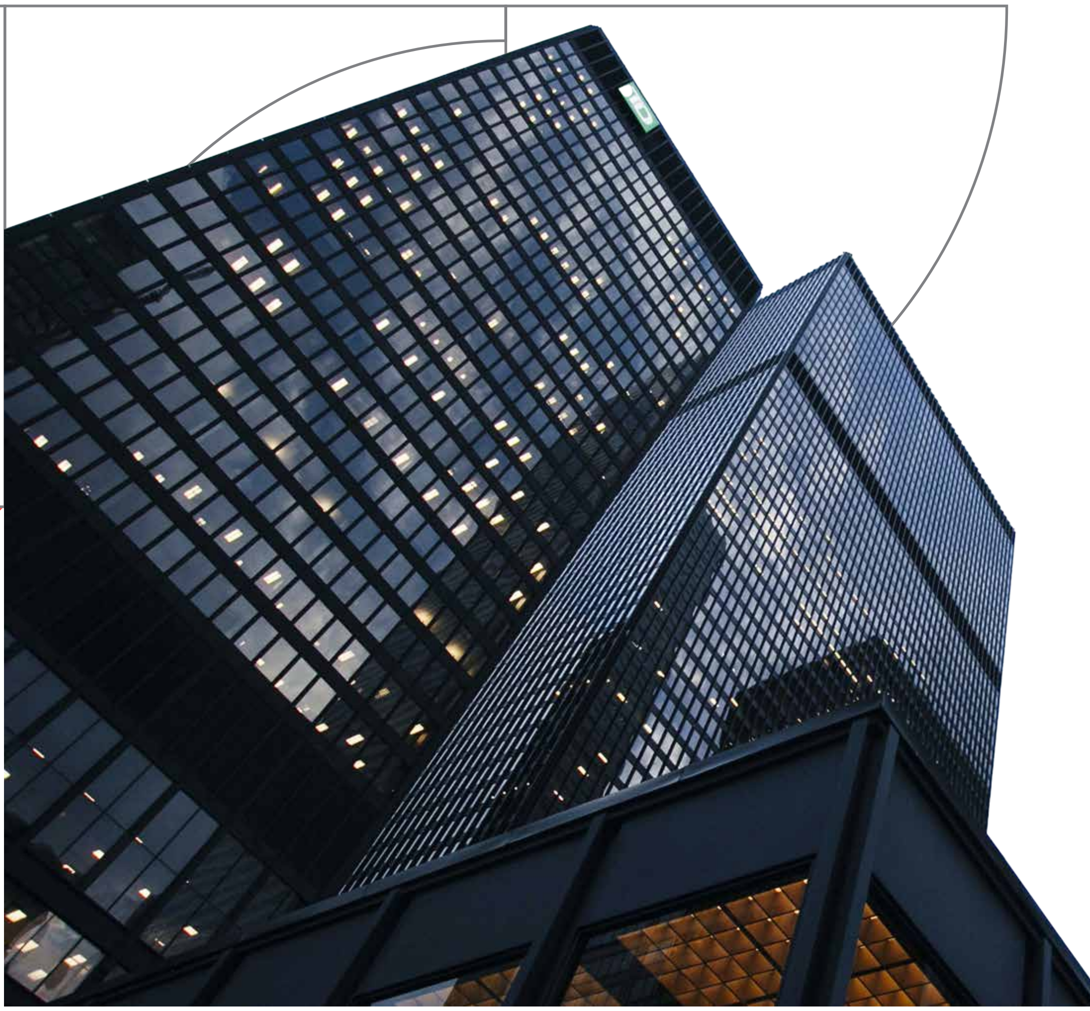
zensar



Top 5 Trends Transforming Asset Management

The **ABCDE** Forces Reshaping the Industry

Whitepaper

Abstract

The asset management industry is now in a state of transition. Many products that defined asset management were conceived decades ago for a generation with different needs. Mutual funds were the most reasonable investment option of that era without charging investors exorbitant fees or exposing them to unwanted risks. Since then, the industry has changed in fundamental ways. Over the years, the sheen of active asset management was replaced with passive asset management. Not surprisingly, this change is again being challenged by new technologies — bringing hungrier and high return seeking new generation investors to capital markets. Disruptive technologies such as blockchain and artificial intelligence (AI) are revamping operating models and the factors influencing investment choices.

In the decades to come, any investment by asset management firms to leverage AI, blockchain, and data strategy will have a profound influence on their operating costs. Another emerging dimension influencing investment decisions is the environmental, social, and governance (ESG) principle. Many of these dimensions are still in early stages and expect regularization and standardization in the coming years. This white paper explores some of these trends that are reshaping asset management.

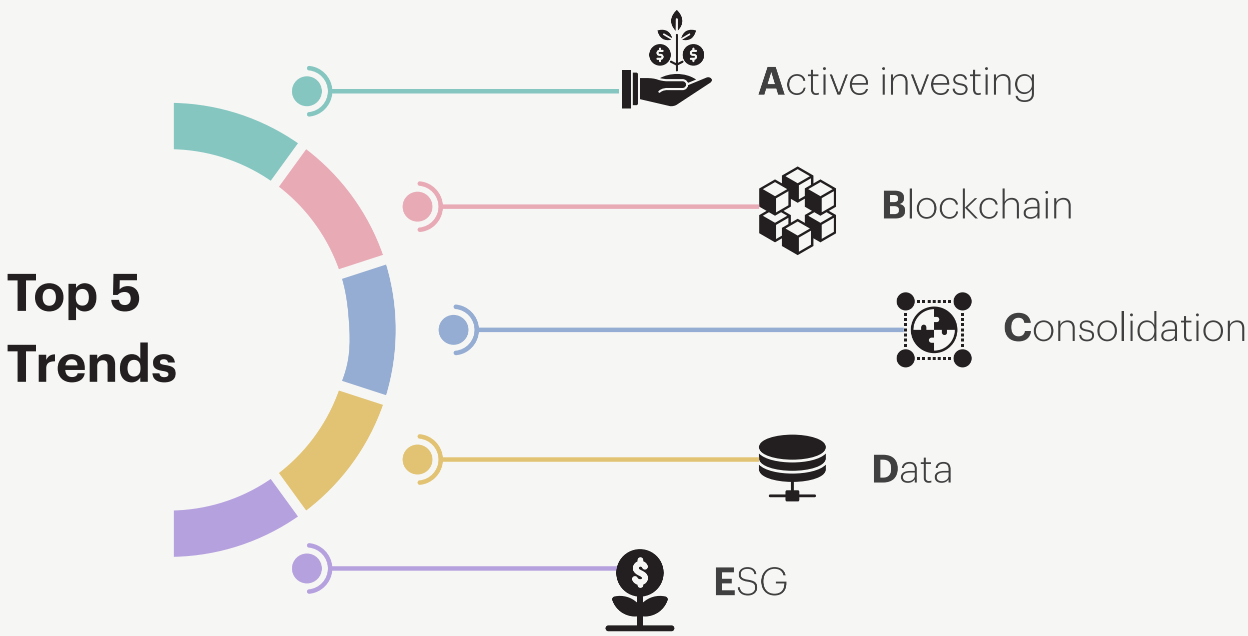
An industry in flux

The asset management industry's net revenue as a share of assets under management (AUM) fell from 29.1 basis points in 2014 to 23.7 basis points in 2020[1]; indicating that the industry is influenced by forces exerting a downward pressure on the revenue, while the firms have a continued obligation to maintain margins and profitability. There is a need to understand why the traditional ideas of asset management are being upended. In 2019, we witnessed passive investing surpassing active investing. The pandemic-induced volatility in 2020 once again enabled asset managers to prove the lucrativeness of active stock selection by outperforming their passive asset management peers.

The advent of revolutionary technologies are transforming asset management substantially. One such technology is blockchain, bringing efficiency and reducing costs to improve the bottom line.

With shrinking margins, asset management firms are looking to expand their value chain and compensate with scale. In this endeavor, collaborating with other entities, especially financial technologies (FinTechs) and regulatory technologies (RegTechs), will solidify their position in the marketplace. Asset managers have always relied on data for investment decisions. As data availability has become more accessible, organizations need to frame data strategies and deploy the latest technologies to extract insights from diverse sources.

ESG factors are influencing how corporates operate in the real world. These factors are driving stock prices as investors prefer such companies. Asset managers are also creating new avenues for investors to invest in firms with high ESG scores.



Active investing

A new resurgence

September 2019 marked a significant milestone in the investing world as passive investing surpassed active investing for the first time in terms of AUM, after exhibiting high rates of growth in the United States for many years. Though index funds and exchange-traded funds (ETFs) have been growing steadily over the years, the pandemic has accentuated the volatility, favoring active investing once again.

Passive Owns 53.8% of U.S. Domestic Equity Funds

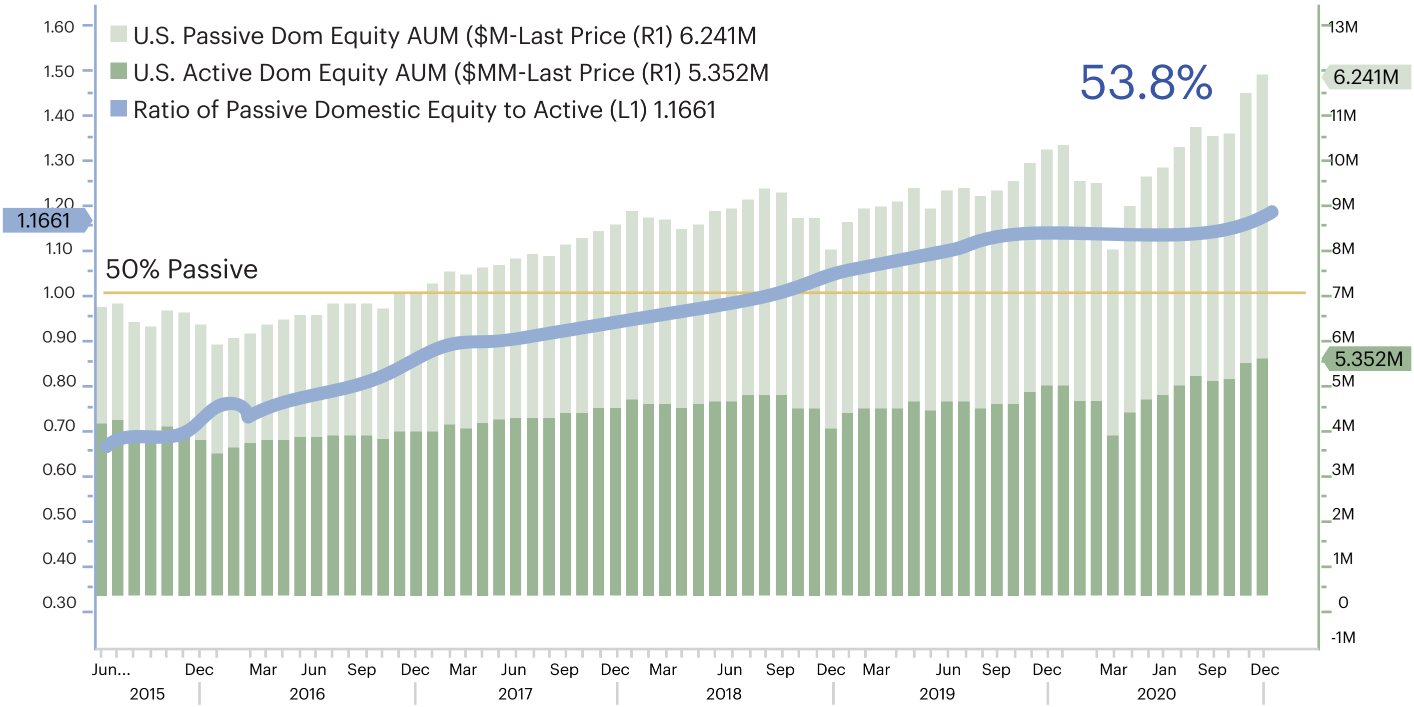
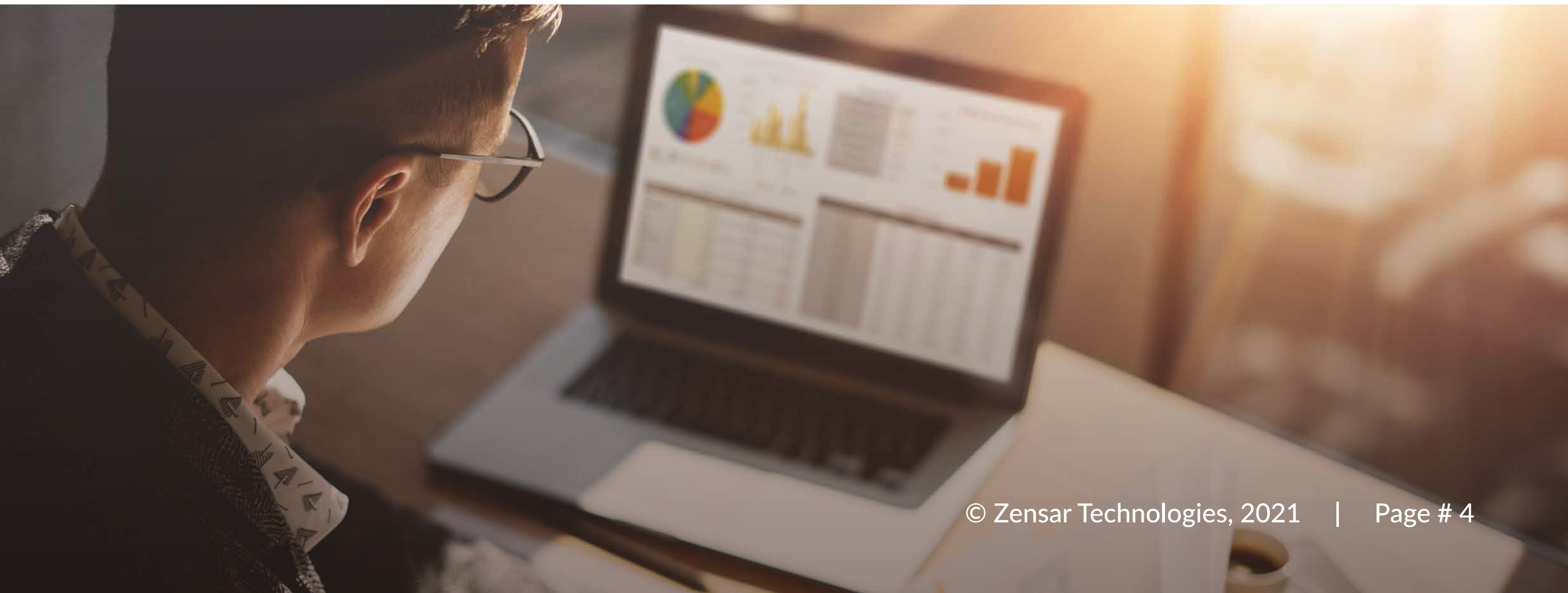


Figure 1: Passive AUM vs. active AUM (Bloomberg Intelligence)[2]



After March 2020, active funds managers reduced their exposure to severely affected sectors like hospitality and aviation. They were able to reallocate assets toward more buoyant sectors at the time, like healthcare and technology. On the contrary, passive funds plunged along with the markets. The holy grail of any asset manager is to determine a stock's intrinsic value. Passive investments shift the focus from price discovery to simply mirroring the index, paving the way for market inefficiencies. While the index-inclusion effect distorts asset prices, investment strategies that exploit these distortions can generate the much sought-after alpha.

Some firms like Ark Invest capitalized on the post-pandemic market by investing in disruptive technologies and thematic portfolios in ways that went against the general market consensus. The AUM of its flagship Ark Innovation Fund rose from $1.86 billion at the end of 2019 to nearly $22 billion in March 2021.

Considering such market volatility and unforeseen challenges, the investment strategies that could combine the best of both active and passive management styles will be the future of investments. One such strategy is Smart Beta, which seeks to outperform the markets like active funds while maintaining a fee structure similar to passive funds.

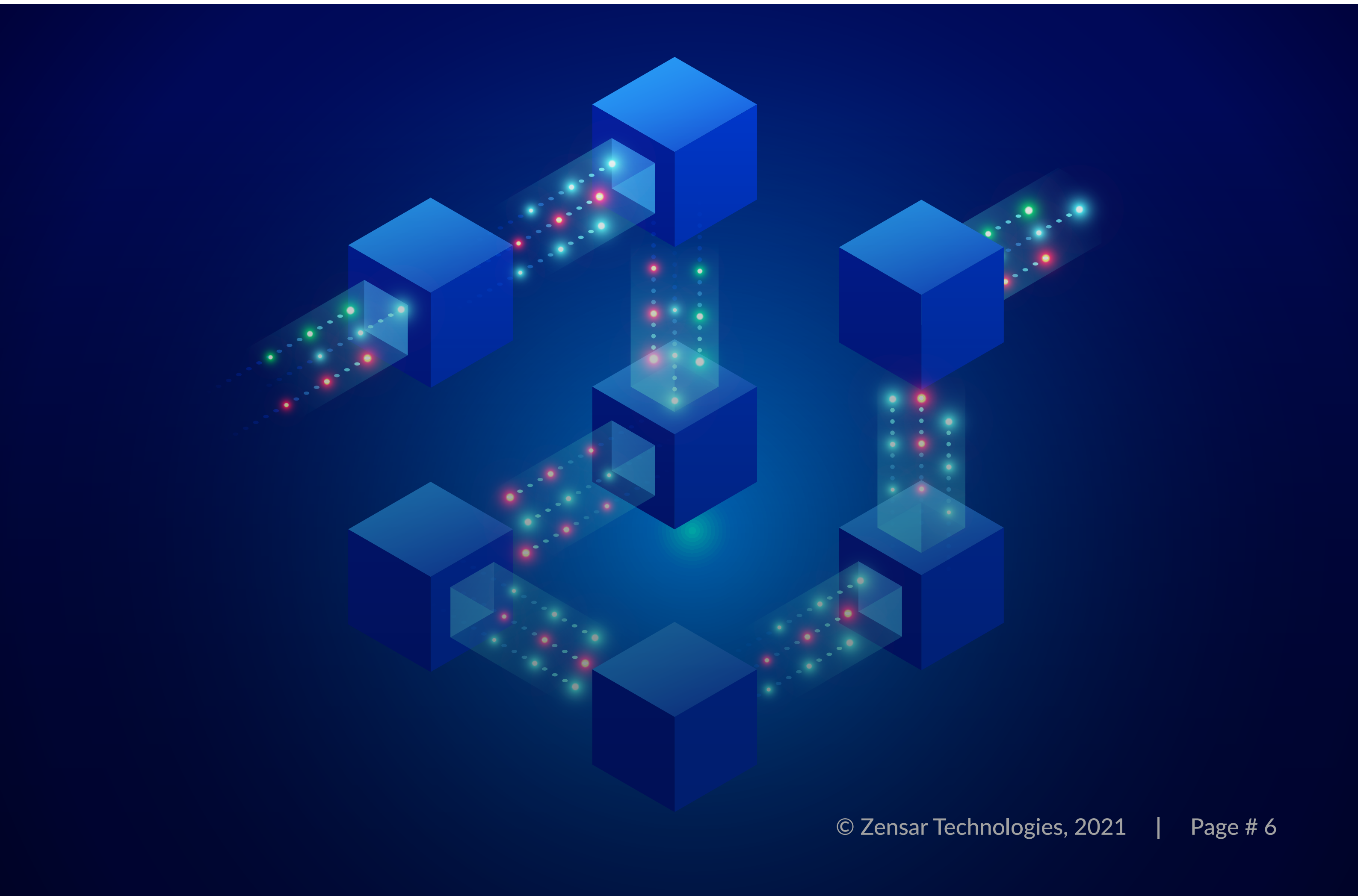
Blockchain

Endless possibilities and immutable records

Asset management firms are eager to secure the first-mover advantage with the disruptive decentralized financing using distributed ledger technology (DLT). The records of transactions are distributed across multiple market participants, and each block of transactions is encrypted before being linked to another. This makes it well-suited for sharing sensitive information with service providers and partners, while its immutability works effectively against data manipulation and falsification. This helps asset managers to verify transactions and enhance their risk analysis and planning.

The client onboarding process can be accelerated by validating the identity of clients on the shared network with other financial institutions. Tracking the fund trail can also be expedited, facilitating anti-money laundering (AML) checks. Smart contracts can be used to reduce the time taken for settlement and clearing.

DLT's decentralized characteristic makes data accessible across all capital market participants and eliminates the need for reconciliations. It also helps streamline processes and improve portfolio management and regulatory compliance efficiencies. According to a study, such efficiencies can reduce infrastructure costs by $15-$20 billion per annum by 2022[4].



The trade flow depicted in the image below leverages blockchain for tokenization of liquid assets and creation of marketplace for trading.

For further details, read our complete white paper on the [Emergence of DLT-based Futuristic Marketplace.]

Lack of familiarity with the technology and incipient regulations stand as obstacles in the way of blockchain's immediate and widespread adoption. However, one-third of asset management executives at middle-market organizations reported that they are already deploying DLT and nearly half of them are contemplating using this technology, as per a 2020 survey[7].

Tokenization is another exciting avenue for asset management. It permits assets to be converted into tradable tokens, thereby creating a marketplace for illiquid assets such as private equity and art using DLT. This will infuse liquidity into the markets and reduce the transaction cost and the dependence on intermediaries.

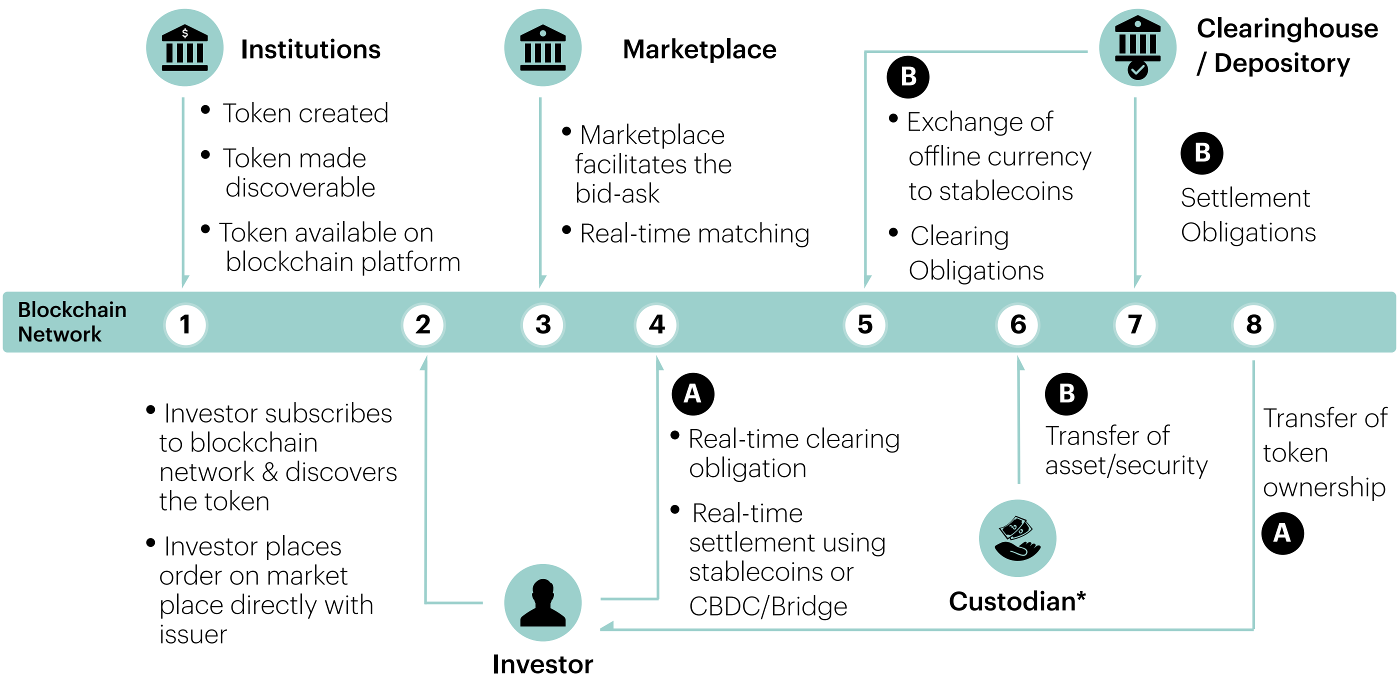


Figure 2: Blockchain network[5]

A On-chain settlement – real-time using stablecoins/CBDC Bridge | **B** Traditional, off-chain settlement – optional feature in DLT based trade solution

Consolidation

The rise of the mega-funds

The firms in the largely fragmented asset management industry are now consolidating. The recent spate of acquisitions signals the emergence of mega-funds. Some significant acquisitions are Eaton Vance and Parametric by Morgan Stanley, Aperio by BlackRock, Sigfig by UBS, eMoney by Fidelity, and Motif by Schwab. The top five asset management firms in the U.S. are expected to control about 68 percent of the total mutual fund AUM by 2025 (from 53 percent in 2019).

The industry is also witnessing vertical integrations apart from the horizontal amalgamation. Blackrock's investments in Envestnet (advisory platform) and in iCapital Network (alternative investment marketplace provider), and Invesco's acquisition of RedBlack (a technology provider in the investment management space) are testaments to this trend. These mergers and acquisitions allow traditional firms to gain access to a wider range of product offerings, distribution networks, capabilities, and new customer segments. Increasing the scale helps organizations to make up for shrinking margins.

Collaboration with RegTechs enables asset managers to streamline background verifications, anti-money laundering (AML) checks, and maintain compliance with information security and privacy laws. In the coming years, asset managers will also be seen partnering closely with market administrators, custodians, and digital innovators. According to a survey[9], 50 percent of asset managers expect their firms to undergo mergers and acquisitions (M&A) or some other type of consolidation.

These consolidations will have consequences such as disparate organizational structures and differing philosophies that these companies will have to grapple with. Organizations will need a shared vision across the acquired companies, from talent management to cybersecurity.

Data

Insight-driven investments

Data has always been critical in asset management for making investment decisions. However, like other industries, the asset management industry also has new data coming in numerous forms. Organizations that do not invest in building a solid data foundation will find the competitive advantage of their better-prepared peers increasingly insurmountable.

Artificial intelligence (AI) and machine learning (ML) can be leveraged to scrape news, events, and social media activities for market insights to determine investor sentiment. Firms can no longer rely only on financial data providers, as the role of social media in the development of new investment trends cannot be overlooked — from the infamous 'GameStop' saga on Reddit to Elon Musk's tweets on cryptocurrencies. Under these industry dynamics, investments in data and analytics can help firms improve their alpha, manage risks more efficiently, save costs, and reduce human resource. A recent survey shows that two out of three asset management firms believe their data management needs reinvention[10] .

Asset management firms also need to learn from other industries that have already deployed technologies to create valuable and personalized customer experiences. The competition is not just from the traditional industry peers but also from FinTechs, who are chipping away the market share.

Most global asset managers will continue to ramp up their investments in hiring data scientists and data analysts and technologies such as AI, ML, and big data. However, firms must focus on the quality and authenticity of their data. They also need to be mindful of the complexities caused due to the absence of industry-wide data interchange policies and regulations.

ESG investing

Cultivating a newer approach and a greener planet

The emergence of sustainable investing was gradual, but it has gained momentum in recent years. Asset managers are increasingly using ESG metrics as parameters for stock selection. According to a recent report[11], about 60 percent of ESG-themed ETFs and mutual funds outperformed the S&P 500 in the first five months of 2021.

Investments in ESG-linked mutual funds are expected to reach $2.08 trillion by 2025[12], signaling a compounded annual growth rate (CAGR) of 8.5 percent. The institutional investors are at the forefront of driving demand for ESG-oriented funds, increasing their investments by 1318 percent from 2019 to 2021.

Investors, especially millennials, are inclined toward incorporating their social and moral standards into their investment choices. As a result, securities of firms that indulge in sustainable practices will be in demand. Other firms may find it challenging to raise capital from the markets, and will eventually have to follow suit to remain afloat.

As a part of ESG initiatives, firms are setting targets for carbon emissions and actively meeting quotas for diversity and inclusion. Cementing this trend already underway is a June 2021 bill passed by the US House of Representatives requiring listed companies to report ESG metrics.

The European Commission established the European Green Deal for promoting sustainable investments and amended the MiFID-II legislative framework to include new sustainable finance legislation.

However, some skeptics still believe that the impact of ESG on financials is not significant as there are no standardized frameworks for evaluating ESG metrics. Also, the investments based on such ESG frameworks aren't sound due to inconsistencies in the data reported.

Global asset management firms such as Goldman Sachs, Vanguard, and BlackRock have already launched ESG-friendly products in 2020, reinforcing that ESG investing style is here to stay. It would not be an overstatement to assert that ESG could very well become the third pillar of investment criteria after fundamental and technical analysis.

The road ahead

In the coming years, asset management firms will be increasingly driven by cloud, AI, ML and blockchain technologies. Asset managers will leverage digital platforms to respond more effectively and efficiently to clients' needs. Investors will have an enhanced digital experience that will provide detailed market insights, data, tools and ESG metrics for making prudent investment decisions.

The prominent influencers driving these trends will be millennials and Gen-Z investors. Though they control only a small share of wealth today, it will significantly increase in the near future, deepening these trends futher and rendering them effective for an extended period.

Asset management firms must observe these emerging trends keenly and adopt a multi-pronged growth strategy to ensure long-term success.

References

[1]https://web-assets.bcg.com/79/bf/d1d361854084a9624a0cbce3bf07/bcg-global-asset-management-2021-jul-2021.pdf

[2]https://www.bloomberg.com/professional/blog/passive-likely-overtakes-active-by-2026-earlier-if-bear-market/

[3]https://www.reuters.com/business/cathie-woods-ark-funds-still-favor-despite-poor-q1-performance-2021-03-31/

[4]http://santanderinnoventures.com/fintech-2-0-paper-highlights-the-multi-billion-dollar-opportunity-open-to-financial-technology-businesses-which-can-help-to-reboot-financial-services/

[5]https://www.zensar.com/sites/default/files/white_papers/Emergence-of-DLT-based-Futuristic-Market-Places.pdf

[6]https://www.pwc.com/us/en/industries/financial-services/library/mutual-fund-outlook.html

[7]https://www.statestreet.com/content/dam/statestreet/documents/Articles/consolidation-in-the-asset-management-industry.pdf

[8]https://www.accenture.com/_acnmedia/PDF-129/Accenture-The-Power-of-Data-Driven-Asset-Management.pdf

[9]https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/most-esg-funds-outperformed-s-p-500-in-early-2021-as-studies-debate-why-64811634

[10]https://www.theasianbanker.com/press-releases/background-notes-on-%E2%80%9Cpersonal-wealth-in-a-changing-world-%E2%80%93-we-are-all-responsible-for-ourselves%E2%80%9D

[11]https://www.im.natixis.com/us-offshore/research/esg-investing-survey-insight-report

Authors

Kamlesh Kosare
Global Head of Consulting -
BFS Capital Markets

Vishwanath Donti
Lead, Business Consulting -
BFS Capital Markets

Deepak Prabhakar
Senior Business Consultant -
BFS Capital Markets

zensar
An RPG Company

We conceptualize, build, and manage digital products through experience design, data engineering, and advanced analytics for over 130 leading companies. Our solutions leverage industry-leading platforms to help our clients be competitive, agile, and disruptive while moving with velocity through change and opportunity.

With headquarters in Pune, India, our 10,000+ associates work across 33 locations, including San Jose, Seattle, Princeton, Cape Town, London, Singapore, and Mexico City.

For more information please contact: velocity@zensar.com | www.zensar.com