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broad trends in market segments and product development and usage

THE FUTURE OF ESG AND SUSTAINABLE INVESTING
assessing the demand and the associated challenges and opportunities for asset managers and distributors

HOW LEADING-EDGE TECHNOLOGIES WILL IMPACT ADVICE AND SOLUTIONS
a look ahead at how Artificial Intelligence, machine learning, predictive analytics, and blockchain may transform the advice business

DISTRIBUTION EFFICIENCY IN A LOWER FEE ENVIRONMENT
strategies for making Manager-Sponsor-Advisor-Client interactions more effective and productive
Journal of INVESTMENT ADVISORY SOLUTIONS

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Article submissions and questions about the Journal can be directed to Joan Lensing at jlensing@mminst.org or (646) 868-8500.
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LETTER TO MEMBERS

July 2018

To MMI Members and Friends,

Welcome to the second edition of the new *MMI Journal of Investment Advisory Solutions*, a compendium of research reports and articles on topics critical to the ongoing evolution of investment advisory solutions. The *Journal* is one of the many ways we are providing MMI members with informed perspective from industry thought leaders and subject matter experts.

In this edition of the *Journal*, we address four major topics:

- **Investment Advisory Solutions Data and Insights**—broad trends in market segments and product development and usage

- **The Future of ESG and Sustainable Investing**—assessing the demand and the associated challenges and opportunities for asset managers and distributors

- **How Leading-Edge Technologies Will Impact Advice and Solutions**—a look ahead at how Artificial Intelligence, machine learning, predictive analytics, and blockchain may transform the advice business

- **Distribution Efficiency in a Lower Fee Environment**—strategies for making Manager-Sponsor-Advisor-Client interactions more effective and productive

Response to the inaugural *Journal* published in January was extremely positive. We trust you will find this new edition equally valuable and welcome your feedback.

Patty Loepker  
MMI Chair  
Wells Fargo Advisors

Craig Pfeiffer  
President & CEO  
Money Management Institute
INVESTMENT ADVISORY SOLUTIONS
DATA AND INSIGHTS

broad trends in market segments and product development and usage
Leadership in Times of Plenty:
Future Winners in China's Asset Management Industry

China will account for nearly half of the global industry’s net new flows to become the second largest asset management market in the world by 2019. By 2030, China will reach over USD $17T in addressable AUM.

Individuals – Retail and High Net Worth – will power China’s growth, accounting for over half of AUM by 2030. Asset management product usage will grow from less than 4% of investable assets today to 10% by 2030 (comparable to the US market in the early 1990s).

As China’s asset management industry matures, the position of current incumbents will erode unless they develop:

i. Business Model Clarity: “Empire-building” firms without a strategic focus will be weakened in the face of coming hyper-competition

ii. Systematic Edge: This can be achieved through either superior investment skills, innovative products and fee models, or sophisticated distribution

iii. Scale Orientation: Firms that consistently grow faster than the market today will have a competitive advantage in the future, when growth slows and pricing starts to come under pressure

Casey Quirk has identified five winning China asset management business models. Firms should consider how their strengths align with the following models:

1. China Champion. Dominant local brand with focus on addressing demand for domestic asset classes and domestic investor requirements

2. Global Leader. Top 10 global asset manager with comprehensive global investment and distribution capabilities anchored by world’s second largest home client base

3. Pan-Asia Alternatives Specialist. Expertise in illiquid asset classes across Greater China and Asia region


5. Bespoke Virtual PM. Technology-driven investment solution combining algorithmic security selection and personalized portfolio management

The Five Winning Models will win 70% of China’s market. Local players should define today which model they intend to pursue.

We estimate foreign firms will achieve 6% market share by 2030, their strengths largely limited by China’s demand for foreign asset classes. Access to the bulk of Chinese growth will require close collaboration with strong local players.
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Casey Quirk helps clients develop broad business growth strategies, improve investment/product appeal and growth prospects, evaluate new market and product opportunities, and enhance incentive alignment structures. Our unparalleled industry knowledge and experience, detailed proprietary data, and global network of relationships make Casey Quirk a leading advisor to the owners and senior executives of investment management firms in the world.
I. Introduction

Asset management in China is a young industry and, as a consequence, Chinese investors, intermediaries and asset managers are not constrained by legacy infrastructure, regulatory frameworks and investment approaches. New thinking can be seen in the proliferation of investment strategies, products and distribution approaches. Powering all of this development is a furious pace of asset growth that no other emerging market has yet been able to replicate.

In this paper, we briefly sketch the size and distribution of Chinese assets today and in 2030. We then shift our focus to the five business models that we expect will increasingly come to dominate Chinese asset management. We conclude with two distinct views: one for Chinese firms steering toward one of the five winning models, and the second for foreign managers looking into China.

Table I

<table>
<thead>
<tr>
<th>Definitions</th>
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<tr>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td><strong>Chinese Assets</strong></td>
</tr>
<tr>
<td><strong>Asset Managers</strong></td>
</tr>
<tr>
<td><strong>Note:</strong></td>
</tr>
</tbody>
</table>

II. China Demand Snapshot

Casey Quirk has in previous reports written about the challenges facing asset managers in the mature Western markets (see: Survival of the Fittest, December 2016). Most acute of those hurdles is the secular slowdown in organic growth across North America, Europe and Japan to near-zero, compared with high single digits as recently as 2007.

In contrast, China is the only large, multi-trillion dollar market that has seen net new flows in excess of 30% per year. We expect Chinese growth rates to average 15% per year through 2025, moderating to 12% per year for 2025 to 2030. In total this will result in $8.5 trillion in new assets flowing into the industry from Chinese investors between 2017 and 2030. Put another way, China will account for about the same amount of net new flows as all other global markets between today and 2030.
Incorporating conservative, single-digit equity and bond appreciation into our projections implies that by 2030 China will have $17 trillion in managed assets, the second largest market for asset management globally, behind only the US. However, we don’t need to wait until 2030: as early as 2019, China could overtake the current #2 market (the UK) in total managed assets.

How aggressive are our assumptions? And what is driving this maniacal growth? Asset management strategies broadly defined account for 4% of total Chinese wealth. Our 2030 projection implies an increase to 10% of national wealth in asset managers’ hands—roughly comparable to where the US stood in 1990.

The growth drivers are the confluence of demographic factors (rapid increase in retail investors’ wealth), structural factors (the limits of the Chinese banking system to efficiently allocate national savings through corporate lending), and policy (the central government’s sustained support of a funded defined-contribution retirement system and sounder domestic equity and debt capital markets).

We segment China’s current assets under management (AUM), about $2.8 trillion, into six distinct investor/channel types, as seen on Table II below. Individual investors (labelled “Mass Affluent” and “HNWI”) represent the greatest future growth opportunity. This is broadly consistent with global trends, where individual growth has outpaced traditional institutional growth.
### Table II
#### China Investor Segments

<table>
<thead>
<tr>
<th>Segments</th>
<th>Description</th>
<th>AUM 2016, USD $B</th>
<th>Organic Growth Average NNF, 2017-2030e</th>
<th>Growth Drivers</th>
</tr>
</thead>
</table>
| HNWI     | • Business owners  
          • Second-generation wealth  
          • Mostly through intermediaries | $392 B                | 14%                             | • High levels of wealth creation and accumulation  
                                              • HNWIs are entrusting a larger share of wallet to fund managers |
| Mass Affluent | • General public  
                     • Mostly through intermediaries | $657 B                | 9%                               | • Rapid household disposable income growth  
                                              • Improved financial literacy  
                                              • Unattractiveness of bank deposits and property |
| Pension  | • Enterprise Annuity (EA)  
          • Occupational Annuity (OA)  
          • National Council for Social Security Fund (NSSF) | $371 B                | 10%                             | • Further expansion of OA/EA coverage  
                                              • NSSF takes over public pension assets from municipal govt and will issue new mandates  
                                              • Expected ~8% of annualized growth in wages |
| Insurance | • Insurance General Accounts | $285 B                | 11%                             | • Improved financial literacy leads to further increase in insurance penetration rates  
                                              • Subscale insurers will continue to outsource assets to professional managers |
| Other Institutional | • Corporate Treasury  
                          • Wealth Management Products | $927 B                | 3%                              | • Excess capital generated from business activities  
                                              • Proceeds from equity and debt issuances awaiting deployment |
| Sovereign | • China Investment Corporation (CIC)  
                  • State Administration of Foreign Exchange (SAFE) | $191 B                | 2%                              | • Limited new flows into CIC/SAFE  
                                              • AUM growth will be driven primarily by capital appreciation |
Domestic asset classes (including domestic alternatives) will continue to dominate Chinese investors’ allocation, across all segments. We anticipate that the continued, gradual opening of China’s currency controls will enable foreign allocations to grow to, on average, 15% for retail/high-net-worth (HNW) segments and 16% for institutional segments, by 2030. However, we expect that regardless of any currency control relaxation, Chinese investors will exhibit a strong home-country bias: this is a function of both a preference for the familiar and a rational decision to seek higher prospective returns.

**Exhibit C**

**China Assets Under Management**

By Channel & Asset Class, 2030e, USD $T

![Chart showing distribution of assets under management by channel and asset class in 2030](chart.png)

*Note:* Money market funds not included in above analysis
*Source:* Casey Quirk Global Demand Model, Casey Quirk Analysis

**III. Oversupply and Maturation**

Perhaps to make up for a late start, China’s asset managers have blossomed and evolved in a manic and seemingly haphazard fashion. A cacophonous universe of mutual funds, trusts, pension funds, private funds, vaguely defined “wealth management products” and mobile-only money market funds try to outdo each other, or at least copy the latest hot seller. Thousands of new firms have entered the market, and incumbents have responded with product proliferation to try and maintain market share.
IV. Five Business Models

China’s future asset management leaders will come in the form of five distinct business models. In the appendix, we outline the building blocks required for each model. We encourage today’s players, both incumbents as well as new entrants, to see which of these models best fits their strengths and aspirations. Over time, winners within each of these models will come to dominate the Chinese market, leaving less-competitive firms to fight over a decreasing slice of the pie.

This kind of environment is emblematic of a young, high-growth market with a brand-new investor class. However, as the Chinese market matures and buyers become more discriminating, we expect to see clear winners start to emerge.

Three attributes will characterize winning firms in China:

1. **Business Model Clarity:** A clear sense of purpose and focus will be a competitive advantage against managers who dabble at everything.
   
   *Relevant question:* Who are our clients and what do we do for them?

2. **Systematic Edge:** Excellence and leadership in at least one key area, be it product design, investment process and return consistency, or client engagement, not me-too products.
   
   *Relevant question:* What do we have that no one else has?

3. **Scale Orientation:** Leadership in the Chinese market will require size and scale—so build up business lines and capabilities that can scale up. Scale will also help insulate firms from pricing pressures when growth slows.
   
   *Relevant question:* How big can this product area or distribution channel become?
Table III

Five Winning Business Models

<table>
<thead>
<tr>
<th>Description</th>
<th>China Champion</th>
<th>Global Leader</th>
<th>Pan-Asia Alternatives Specialist</th>
<th>China Distribution Specialist</th>
<th>Bespoke Virtual PM</th>
</tr>
</thead>
</table>
| Client Coverage | - Client-focused asset manager with superior fund manufacturing and distribution capabilities | - Global manager with broad range of globally saleable capabilities and distribution network | - Characterized by:  
  - Top 10 global AUM  
  - >50% revenue ex-China | - Focus on capturing the investor access/advisory segment of asset mgmt. value chain | - Security selection by “big data” driven algorithmic inv. engine |
| Primary Value-Add | - Localized, on-the-ground client servicing | - Comprehensive domestic asset class offering  
- One-stop access to all major products/asset classes | - Specialized, in-demand asset classes | - Fund gatekeeping & advisory for mass affluent and HNWIs | - Customized AM products and servicing based on client preferences |
| Success Requirements | - Strength in domestic distribution  
- Local brand reputation  
- Disciplined investment philosophy and process  
- Relevant AM licenses (EA, mutual fund, etc) | - Dedicated int’l strategy  
- Solid existing foundation in China  
- Sound balance sheet to support overseas initiatives  
- Appropriate alignment and ownership structure | - Compelling investment expertise and edge in regional alternatives  
- Robust risk mgmt. framework that can stand up to global scrutiny  
- Well-aligned compensation structure | - Fund distribution licenses  
- Marketing and client service talent  
- Advice: well-resourced, qualified advisor coverage to provide objective planning  
- Scalability of platform | - Convenience from bypassing traditional fund vehicles |
| Local | - Mass affluent  
- Pension  
- Sovereign Insurance | - Mass affluent  
- Pension  
- Sovereign Insurance | - HNWI  
- Sovereign | - Mass affluent  
- HNWI | - Mass affluent  
- HNWI |
| Int’l | - Offshore Chinese wealth  
- Sub-advisory business | - Offshore Chinese wealth  
- Sub-advisory business | - Offshore Chinese wealth  
- HNWI  
- Institutional | - Offshore Chinese wealth | |
| Why This Works | - China as a standalone market offers attractive potential and opportunity  
- Chinese distribution requirements, regulations, and demand characteristics are unique and require specialization | - Fast-growing, at-scale home base serves as ground zero for firms to aggressively expand overseas and springboard to global prominence | - China and Asia represent a large investable universe of inefficient markets  
- High demand for alternatives from regional investors  
- Supply of Asia region alternatives limited to date | - Burgeoning number of retail investors are entering the industry in search of one-stop wealth platforms  
- Distribution platforms represent a more natural extension for securities/trust orgs than investment engines | - Technology has become widely accepted as a lifestyle norm  
- Advances in computing have made mass market tech platforms economically feasible  
- “Big data” opens the door to individualized analysis and service |
Exhibit E

Business Models China Market Share
2030e AUM in USD $T and Average Firm Size in USD $B

Market Share Rationale:

**China Champion:** Recognized local providers of asset management products to retail investors and institutions.

*Rationale:* Deeply embedded relationships established with distributors help existing players thwart competition. As investor sophistication grows, product quality, not quantity, becomes key differentiator in attracting assets.

**Global Leader:** Local asset managers with an established global presence, closing in on global top 10.

*Rationale:* Only one or two Chinese firms will break into global top 10 by 2030, managing assets for Chinese and foreign investors. Like China Champions, Global Leaders will also enjoy protected market access, but having an internationally proven global product set goes a long way in securing offshore allocations of onshore clients.

**Pan-Asia Alternatives Specialist:** Firms that match high risk appetite, long investment horizon assets with non-traditional investment opportunities currently facing a funding gap.

*Rationale:* A regionally-based firm is better positioned to take advantage of emerging Asia’s market inefficiencies owing to the region’s unique political and economic landscape. Promising underlying drivers and rich returns are also incentivizing local investors to put money into an Asia-focused alternatives strategy.

**China Distribution Specialist:** Firms that prioritize providing unbiased advice over product manufacturing.

*Rationale:* Distribution specialists focus on AUM-based advisory fees, not management fees, which explains the smaller market share by AUM. This is “ahead of its time” thinking: security selection is no longer sufficient as needs for advice grow; while strong products raise assets in the short-run, trusted advice will retain assets.

**Bespoke Virtual PM:** A leapfrog model that brings low-cost, scalable investment offering to retail customers.

*Rationale:* Lower regulatory hurdles in China to access customers’ data footprint simplify data collection and analytics, which in turn help accelerate the development of an algorithm-driven investment engine. Once developed, adoption rate will be unprecedented: Yu’e Bao (the world’s largest money-market fund) has already made an undisputed, resounding case.
V. Target Business Models for Mainland Firms

Not all firms can pull off becoming a China Champion or Global Leader—just as today's leading asset management players may struggle to morph themselves into a Bespoke Virtual PM. Taking into account appetite for business investments and resourcing constraints, firms should identify the business model that plays to their competitive strengths. Only once a clear intended end-state is defined can Chinese asset managers focus their efforts against the critical building blocks for each model (outlined in more detail in the appendix).

Table IV
Alignment of Business Models With Each Firm Type

<table>
<thead>
<tr>
<th>Firm Type</th>
<th>Business Model</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mutual Fund Company</td>
<td>China Champion</td>
<td>• Banks and insurance companies with established brand, large balance sheets and extensive distribution network are much more likely to “win at the starting line”</td>
</tr>
</tbody>
</table>
| Banks                | Global Leader           | • Mutual fund firms with international aspirations will need to consider listing as a means to raise funds for overseas initiatives  
|                      |                         | • Asset management business lines of insurers can leverage existing international branches and offshore balance sheet to build a global presence |
| Insurance            | Pan-Asia Alternatives Specialist | • Private funds already have the investment track record and client base in alternatives strategies  
|                      |                         | • Insurance assets have a long-term risk horizon and appetite to accept illiquidity in exchange for higher returns |
| Private Fund Company | China Distribution Specialist | • Banks and securities firms already own extensive distribution footprint in the nation, which make distribution platforms a much more natural extension than investment engines  
|                      |                         | • Fund manufacturing is not core to business, rather firms in this model will need to ensure product neutrality to investors |
| Security or Trust Company | Bespoke Virtual PM | • Technology companies already have a broad user population and ready access to customer data footprint to develop algorithmic investment engine |

VI. Foreign Managers Looking in

The Chinese market will continue to be dominated by Chinese firms. This is not simply a function of regulatory hurdles on foreign entrants. Rather, the pronounced Chinese bias for domestic asset classes favors local firms. In addition, local firms’ sustained market presence, entrenched distributor relationships and extensive brand-building efforts all add up to a clear advantage which foreign entrants will have trouble replicating. By way of comparison, look at a large market with similar home-country biases and embedded brands: the mature US market. Even with no Chinese-style protectionist rules, the US asset management market remains dominated by domestic players: we expect a similar dynamic in China.

This doesn't mean, however, that foreign entrants have no role: on the contrary, we expect foreign firms are positioned to capture about 6% of future Chinese asset pools. Foreign managers have an advantage in international asset classes and will see the greatest traction among sophisticated institutions and the HNW segment. Additional gains are possible, but will require taking on a Chinese shareholder: likely a local firm aiming for the “Global Leader” business model outlined previously.
Foreign Asset Managers’ China Market Entry Checklist:

- **Clear and realistic objectives for China:**
  (i) Financial return, (ii) Fundraising, (iii) Local investment capabilities

- **Business model flexibility:** Demonstrated willingness to work with and adhere to a fast-evolving regulatory framework (e.g. set up local fund structures, apply for foreign institutions licenses such as WFOE & QDLP)

- **Commitment to take root and be local:** Appoint local, Chinese-speaking business development officers and ensure product design caters to Chinese investor needs

- **Seriously consider M&A:** Assess and prioritize inorganic initiatives to accelerate growth:
  (i) Boutique acquisition, (ii) Joint venture, (iii) Sell equity stake to strategic partner

**VII. Conclusions**

We expect that as China’s demographic profile continues to become wealthier and older, asset management will see a sustained period of growth which will outpace overall Chinese GDP growth. On top of the sheer scale of growth, China’s unique attributes and conditions mean that bold thinking and pushing boundaries are needed. For Chinese firms, this means comfort in experimenting with new products and distribution methods, mindful of the power of scale. For foreign firms, this requires assigning responsibility for their China strategy to senior management (not the regional sales organization), and taking a clean-sheet approach to products, client engagement, and collaboration with local players.
### Appendix: Building Blocks for Each Winning Business Model

Table V

<table>
<thead>
<tr>
<th>Building Blocks</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Engine</strong></td>
<td>- Investment identity—firm's core asset classes and underlying investment</td>
</tr>
<tr>
<td></td>
<td>philosophy</td>
</tr>
<tr>
<td></td>
<td>- Investment process—how firm conducts investment research and makes</td>
</tr>
<tr>
<td></td>
<td>buy/sell decisions</td>
</tr>
<tr>
<td><strong>Distribution Capability</strong></td>
<td>- Distribution reach—direct/intermediated client access, mobile &amp; on-the-</td>
</tr>
<tr>
<td></td>
<td>ground presence</td>
</tr>
<tr>
<td></td>
<td>- Distribution quality—comprehensive relationship-based client engagement</td>
</tr>
<tr>
<td><strong>Financial Planning/Allocation Advice</strong></td>
<td>- Unbiased financial advice to achieve client goals—based on client income, tax</td>
</tr>
<tr>
<td></td>
<td>considerations, risk appetites</td>
</tr>
<tr>
<td></td>
<td>- Personalized asset allocation and portfolio construction—not stock tips</td>
</tr>
<tr>
<td><strong>Technology</strong></td>
<td>- Use of new technologies to improve capabilities and functions, for example,</td>
</tr>
<tr>
<td></td>
<td>artificial intelligence to power investment engine or enterprise data</td>
</tr>
<tr>
<td></td>
<td>management to improve operational efficiencies</td>
</tr>
<tr>
<td></td>
<td>- Leveraging advances in computing power to provide convenient and</td>
</tr>
<tr>
<td></td>
<td>customized engagement</td>
</tr>
<tr>
<td><strong>Incentives Alignment</strong></td>
<td>- Clear linkage of incentives payout to employee performance goal achievements</td>
</tr>
<tr>
<td><strong>Ownership/Governance</strong></td>
<td>- Clarity of owner's goals and expectations for the asset management business</td>
</tr>
<tr>
<td></td>
<td>- Distinction between the responsibilities and decision rights of the board</td>
</tr>
<tr>
<td></td>
<td>vs. senior management</td>
</tr>
<tr>
<td><strong>Strategic Internationalization</strong></td>
<td>- Rationale and purpose for internationalization of business – e.g. following</td>
</tr>
<tr>
<td></td>
<td>client demands</td>
</tr>
<tr>
<td></td>
<td>- Strategic approach that matches purpose of internationalization</td>
</tr>
</tbody>
</table>
### Table VI

**China Champion Building Blocks**

<table>
<thead>
<tr>
<th>Building Block</th>
<th>Requirements</th>
</tr>
</thead>
</table>
| **Investment Engine**        | • Breadth of investment capability in asset classes aligned with China market investor demand  
                                | • Credible investment process coupled with repeatable outperformance |
| **Distribution Capability**  | • Localized, differentiated client engagement model designed specifically for Chinese investor segments  
                                | • Distribution resourcing overweight relative to other functions with a focus on capturing market share |
| **Financial Planning/ Allocation Advice** |                                                                 |
| **Technology**               |                                                                             |
| **Incentives Alignment**     | • Incentives program incorporating short-term/long-term compensation to attract, retain, and motivate talent  
                                | • Senior management's long-term incentives program aligned with overall firm growth, not individual business unit performance |
| **Ownership/ Governance**    | • Ownership structure empowers management team with business growth decision-making  
                                | • Autonomy of business decision-making – e.g. product development makes commercial sense and aligns to strategy, not subject to guidance or override by parent |
| **Strategic Internationalization** |                                                               |

### Rationale

- China as a standalone market offers high growth rates and a large asset pool – markets outside China are less appealing
- China has unique distribution requirements, regulations, and demand characteristics – managers with a China focus can better navigate this market

### Critical Success Factors

- China fund licenses
- Strong brand recognition
- Localized client engagement
- Dedicated China product specialists
- China market thought leadership
- Long-term relationships with key Chinese clients and intermediaries
### Table VII

#### Global Leader Building Blocks

| Investment Engine | • Comprehensive product offering across asset classes and geographies  
|                   | • Disciplined investment philosophy and process  
| Distribution Capability | • Business anchored by strength in home market  
|                   | • Extensive on-the-ground presence and localized client engagement in key international markets  
| Financial Planning/Allocation Advice | • Ability to offer one-stop strategic/tactical portfolio allocation advice based on firm’s comprehensive product suite  
|                   | • Dedicated asset allocation advisors with cross-asset expertise  
| Technology | • Implementation of unified technological tools in investment research, portfolio attribution and risk management across products and geographies  
| Incentives Alignment | • Incentives program incorporating short-term/long-term compensation to attract, retain, and motivate talent  
|                   | • Senior management’s long-term incentives program aligned with overall firm growth, not individual business unit performance  
| Ownership/Governance | • Public listing as a source of funding for strategic internationalization initiatives and currency for long-term incentives programs  
| Strategic Internationalization | • Business growth plan incorporates large scale inorganic internationalization initiatives  
|                   | • Strong firm culture that remains intact after acquisition and integration  

<table>
<thead>
<tr>
<th>Key Requirement</th>
<th>Key Differentiator</th>
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</thead>
<tbody>
<tr>
<td><img src="#" alt="Rationale" /></td>
<td><strong>Strategic Internationalization</strong></td>
</tr>
</tbody>
</table>

**Rationale**

• China is one of the few markets where domestic managers can rely on large core businesses to financially support substantial and meaningful global expansion aspirations

**Critical Success Factors**

• Clear development objectives to build product and distribution capabilities

• Robust home market demand creating balance sheet strength to support inorganic initiatives

• Shared goals/objectives in partnership arrangements
Table VIII
Pan-Asia Alternatives Specialist Building Blocks

| Investment Engine | • Well-articulated investment philosophy with compelling edge in regional alternatives products supported by sustainable investment performance  
• Demonstrated ability to identify/source and execute difficult-to-replicate alpha-generating investments |
| Distribution Capability |  |
| Financial Planning/Allocation Advice |  |
| Technology |  |
| Incentives Alignment | • Incentives program incorporating short-term/long-term compensation to attract, retain, and motivate talent  
• Long-term incentives program aligns investments team with client interests |
| Ownership/Governance | • Ownership structure empowers management team with business growth decision-making |
| Strategic Internationalization | • Opportunistic strategic expansion through acquisitions/partnerships/teamb team lift-outs of other alternatives specialists to achieve scale, new markets, or product synergies |

Key ✔ Requirement ✔ Key Differentiator

Rationale
• Opportunities for infrastructure investing and private financing are strong in developing markets
• There are limited alternatives providers with credible and scalable investment engines to produce non-correlated absolute return

Investment Engine
Critical Success Factors
• Consistent, high conviction investment philosophy
• Long track record and reputation in a specialized alternative asset class
• Robust risk management framework that stands up to global standards
• Specialist investment talents
Table IX
China Distribution Specialist Building Blocks

<table>
<thead>
<tr>
<th>Investment Engine</th>
<th>Distribution Capability</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Heavily resourced distribution function including on-the-ground and online sales and marketing capabilities</td>
</tr>
<tr>
<td></td>
<td>• Value-added servicing and client engagement for mass affluent and HNWIs to capture investor access/advisory segment of value chain</td>
</tr>
<tr>
<td>Financial Planning/Allocation Advice</td>
<td>• Dedicated financial advisory team to provide investor education, asset allocation, and portfolio management advice – not market tips or trade-of-the-month</td>
</tr>
<tr>
<td>Technology</td>
<td>• Convenient, accessible app and web platform as a one-stop client portal for investment information, advice, and servicing</td>
</tr>
<tr>
<td>Incentives Alignment</td>
<td>• Compensation scheme aligns advisory professionals to provide long-term investment advice rather than push product</td>
</tr>
<tr>
<td></td>
<td>• Senior management’s long-term incentives program aligned with overall firm growth, not individual business unit performance</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Key Requirement</th>
<th>Key Differentiator</th>
</tr>
</thead>
</table>

**Rationale**

- Fund manufacturing is not a prerequisite for wealth management – successful business can be built on standalone distribution capabilities
- Client advisory is lucrative as the future battlefield shifts from asset raising to asset retention

**Critical Success Factors**

- Strong brand recognition
- Convenience & accessibility of cross-platform interactions
- Standardized professional quality customer servicing
- Long-term relationships with clients and product providers
- Distribution economies of scale
### Table X

**Bespoke Virtual PM Building Blocks**

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
</table>
| **Investment Engine**             | • Automated, algorithm-based investment engine used for security selection  
|                                   | • A differentiated investment process based on use of “big data” and machine learning to inform investment algorithms                           |
| **Distribution Capability**       | • Intensive, widespread investor education and marketing campaign to promote and raise awareness of “Virtual PM”  
|                                   | • Scaled client engagement achieved through mobile app/online platforms                                                                          |
| **Financial Planning/Allocation Advice** | • Automated and highly customizable asset allocation based on client characteristics and preferences  
|                                   | • Dedicated financial advisory team to provide “human touch” and answer queries on asset allocation algorithm and advice                       |
| **Technology**                    | • Proprietary investment engine driven by “big data” analytics and individual client profiles (preferences and data footprint)  
|                                   | • Robust mobile application creating seamless customized investment experience for end users                                                   |

### Key Requirement

- **Rationale**
  - China is quick to adopt technology and new forms of investment products  
  - Technological advances and the growing availability of data open the door to tailored quantitative investing for the mass market

- **Technology**

  **Critical Success Factors**
  - Integration with lifestyle tech ecosystem to capture client touchpoints and preferences  
  - Access to “big data” and detailed client profiles  
  - Strength of investment engine in utilizing data sources to create automated investment decisions  
  - Quality of technology experience
Leadership in Times of Plenty:
Future Winners in China's Asset Management Industry

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NAVIGATING THE STORM: MODERN INSTRUMENTS FOR A NEW ERA IN ASSET MANAGEMENT

White Paper | March 2018

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Executive Summary

There is a lot of evidence already. Even the recent bull market could not mask it. The asset and wealth management industry is in the midst of a significant disruption, a transformation that we believe is likely to go far beyond the return of volatility or the setback of a correction.

The relentless stampede toward low-cost investments and the threat to profit margins now appear to be a permanent part of the investment management landscape, impossible to ignore. Demographic changes and new technologies like artificial intelligence and blockchain are impacting traditional business models, products and distribution strategies, opening the door to a potential reckoning across the industry.

A few forward-looking asset and wealth managers seem to be tackling these challenges head-on. They are spurring changes in leadership, significant investments in technology and business intelligence, and a clear-eyed examination of the client experience, well aware that the impending storm could sink the laggards and position the leaders to thrive.

The test for senior leadership is to challenge traditional mindsets and rethink their entrenched cultures. Their firms are restructuring management teams, modernizing technology and mandating data-driven business strategies, mindful that the industry could be at a true inflection point.

In this report, we present four changes that we believe asset managers should consider. To be clear, we believe the transformation of our industry is sweeping enough that firms no longer have the option of merely hunkering down, hoping to somehow ride out the storm. To the contrary, we believe that managers need to embrace this new era of asset and wealth management with modern instruments like business intelligence and advanced technology to:

1. Position products on core strengths
2. Develop competitive pricing models
3. Align relationship management resources on key business relationships
4. Deliver a seamless, personalized client experience based on data and analytics
A perfect storm is forming

The long bull market delivered windfall after windfall. Assets under management continued to break records and operating margins for asset management firms rose strongly in the third quarter of 2017, reaching an average 34.2% — the highest in the last eight quarters — for the 15 publicly-traded asset management firms that comprise the DST Research, Analytics, and Consulting Asset Manager Composite.

But just under the surface, a complicated and daunting picture emerged for many asset and wealth managers. In the third quarter of 2017 alone, the top ten asset managers accounted for 50% of all net flows, while more than half of all asset managers experienced net outflows. Active funds and active ETFs suffered negative flows of $485.6 billion, as $1.3 trillion poured into passive funds and ETFs.¹

For wealth managers and broker-dealers, the picture is similarly complicated because of the growing influence of RIAs and robo-advisers. Our research indicates that many advisors, especially for the Independent and Regional B/D channels, are wondering what kind of firm model will best fit their business. This broad restructuring is visible in FINRA statistics, which show a decline in the number of member firms from 4,999 in 2007 to 3,726 in December 2017.²

When markets are strong, it is often easy to ignore the tough choices confronting our industry. Complacency dulls any sense of urgency, hindering many firms from making the changes and long-term investments that we believe are needed to weather the disruptive forces that are likely to transform financial advice, investment solutions and business models.

But for executives at a few forward-looking firms, the euphoria over the long bull market has long been tempered by the belief that lasting, underlying trends — including changing demographics, innovative technology and enduring fee pressure — will result in lower operating margins. With that in mind, they have installed new leaders with backgrounds in technology and business management to inject the fresh ideas that will likely be central to the next era of asset and wealth management. They have restructured customer-facing and investment management teams, modernized their firm’s technology and put advanced analytics at the core of their business strategies. Upending deeply entrenched cultures can be painful for any firm, but the price of delaying may be even harder to bear.
Against this backdrop, we focus on the trends we see transforming our industry. And we review the implications for change in four areas that we believe are necessary for firms to remain viable in the long term:

1. Position products on core strengths
2. Develop competitive pricing models
3. Align relationship management resources on key business relationships
4. Deliver a seamless, personalized client experience based on data and analytics

PREPARING TO WEATHER THE PERFECT STORM

- Innovative Technology
- Demographic Change
- Fee Pressure

- Position products on core strengths
- Develop competitive pricing models
- Align relationship management resources
- Deliver a client experience informed by data
Trends that are transforming asset and wealth management

Demographic change, technological advancements and relentless pricing pressure are fundamentally rewriting the rules of asset and wealth management, forcing firms to evaluate their business models and find a sustainable place in the value chain.

A new type of investor is emerging

In younger generations, we are seeing the emergence of a new type of investor, one who prefers customized, holistic financial planning over standalone investment advice. Changing demographics require new business models and solutions. While one cohort of investors is shifting away from accumulation and entering a withdrawal phase, younger investors are deeply skeptical of traditional financial advice and products, posing a major challenge to the tried-and-true methods of courting and keeping assets that firms have long relied on. Millennials alone could drive $15 trillion to $20 trillion of inflows over the next two to three decades, roughly doubling the size of the U.S. equity market.

Instant access to information and full transparency have become basic expectations of consumers across all sectors of the economy, imposing a new set of standards for engaging the next generation of investors. Technology is not only critical to delivering the kind of information and engagement investors now expect, it is also essential to optimizing operations and services, enabling firms to drive down the costs of delivering advice.

Investors still want access to human advisors, but most of them also want digital advice, engagement and access to be a core component of wealth management. The 2016 Wells Fargo/Gallup Investor and Retirement Optimism Index survey found that 74% of investors want digital advice to play some role in their wealth management solution and 6% of investors actually prefer a fully digital advisor. Only 21% of investors want their wealth to be managed exclusively by people. Investors now prefer a combination of digital and human (hybrid) advice over purely digital advice by a margin of 11 to 1. They even prefer hybrid advice over purely human advice by more than 3 to 1.

As we discussed in our white paper on Preparing Distribution Organizations for Digital Advice, the availability of wealth management platform technology has quickly become ubiquitous. New entrants and the largest incumbent wealth managers are now offering access to technology-driven portfolio management platforms. The degree of automation and sophistication of these technical-driven wealth management platforms will vary widely, but the writing is on the wall. More and more processes and functions once performed by the advisor are expected to continue to be taken over by technology. The enhancement of consumer engagement and the ability to control fees is central to the increased use of technology in the provision of financial advice.

Technology is disrupting traditional ways of doing business

Automated wealth management platforms have already streamlined a range of activities, from client on-boarding to portfolio management. These platforms have quickly moved beyond portfolio monitoring services like automatic rebalancing to include investment selection, tax optimization and risk management strategies. Many also offer client-facing account aggregation tools, allocation monitoring (e.g. ensuring that client portfolios remain in line with client risk tolerance), as well as performance and fee benchmarking, which has had a tremendous impact on all aspects of the wealth management business.

While technologies like artificial intelligence, machine learning and blockchain have been around for some time, they are only beginning to see broader adoption across the asset and wealth management industry.

A few firms have implemented these technologies in various forms to improve operational efficiencies, investment expertise or client engagement. A few examples include Bridgewater's application of AI to management and investment processes, BlackRock's utilization of algorithms, models and machine learning to complement its fundamental research, and Vanguard's work with the Center for Research in Security Prices (CRSP) on a publicly-available blockchain to instantly distribute index information and lower costs. The common ground is that asset and wealth managers are turning to technology to drive operational efficiencies, improve investment outcomes and reduce costs.

For asset managers, the benefits of technology apply well beyond portfolio and product management. Technology-minded asset managers are also looking to new methods to overhaul their distribution and marketing efforts. These firms are forging ahead with business intelligence programs to bolster their customer acquisition, engagement and retention efforts, make better use of their resources, lower their operational costs and increase profitability.

We believe a focused execution of the distribution and marketing strategy — with an eye on best-of-breed customer engagement — will help to separate winners and losers. Advisors are increasingly utilizing practice and portfolio management technology, while outsourcing certain aspects of investment management. As a result, we see two major trends gripping the advisor community.

1. Pressure on advisory fees and a focus on the total cost of investment product ownership
2. A more holistic approach to financial planning and investments

From what we have seen, both trends are having a tremendous impact on asset managers' distribution, marketing, product and pricing strategies. Fee compression is forcing asset managers to drive distribution, marketing and product efficiencies, while the broader application of holistic financial planning is challenging asset managers to build more effective customer engagement and service models.

As technology continues to be utilized more broadly for investment-related tasks, technology-driven wealth management platforms are being used to scale business and deliver customized portfolio solutions. The result is that advisors are spending less time on investment selection and portfolio management activities, putting that task in the hands of the home office or a dedicated investment manager in the advisor's team.

Technology is effectively moving investment decisions out of the purview of the advisor and into the hands of dedicated investment and research professionals. Some advisors will choose to completely outsource the investment aspect of their practice, while others will add value based on their skillset and experience. Either way, advisors have less discretion over portfolio management decisions, completely altering the dynamics between asset managers and advisors. The professional buyers become the focal point of asset management organizations. The traditional asset manager view of advisors as “producers” is obsolete, and the new paradigm is an emphasis on strategic business relationships with key decision makers.
Fee pressure is challenging traditional business models

We expect significantly lower fees for all products and services — whether active, passive or “smart beta” — to continue to shape the investment management industry. In 2017 alone, equity mutual funds lost $31.4 billion in outflows, while equity ETFs gained $332.1 billion. We see little, if any, likelihood that this migration will change course. We believe that concentrated portfolios and solutions specific to the needs of particular distributors, rather than undifferentiated commoditized products that compete with ever-cheaper ETFs, will increasingly be required to manage the trend effectively.

Managers should also experiment with different approaches to fees, perhaps implementing performance fees (in spite of their acknowledged difficulties) instead of, or perhaps as a complement to, the traditional percentage of an AUM pricing model. Simply put, we believe that change is coming, and that, in all likelihood, the managers who embrace the new reality — sometimes failing, sometimes succeeding — will survive. Those who wait too long to act decisively might not.

Advisors are grappling with many of the same pressures. In response to the changing demographics among investors and the increasing role of technology, advisors are embracing holistic financial planning as central to their value propositions. According to DST Research, Analytics, and Consulting’s Advisor Insights in association with Horsesmouth, advisors had an average of 63% of their assets under management (AUM) dedicated to fee-based accounts by mid-2017, an 11% increase from 2009. This clearly indicates that the industry is in the middle of an economic shift away from transaction-based (brokerage) business toward fee-based (advisory) business.

Our research shows that advisors are migrating to fee-based platforms for two primary reasons: Managed accounts enable them to take a more holistic approach to overseeing client assets and scaling their practices most effectively. As advisors look to build scale and cost efficiencies into their practices, they are turning to technology and model-based portfolio solutions to deliver better client outcomes. This fundamentally alters the products and services they need from asset managers — and how asset managers need to approach advisor engagement.
It’s clear the transition to a predominantly fee-based world of advice has a rippling impact across the industry. More fee-based business supports the growth of managed account platforms. That, in turn, fuels the increased use of technology-driven wealth management platforms, which include everything from automatic rebalancing to tax and risk management services.

These changes have altered the sphere of influence and redrawn the map of advisor/asset manager relations. As home office product due diligence and research teams — as well as third-party research and consulting organizations — increase their influence over product approvals, research teams — rather than individual advisors — are likely to become a key point of influence. Even advisors who continue to focus on investment selection are increasingly becoming more selective and institutional-like in their decisions, altering engagement techniques and requirements. Product design and pricing, the delivery of information and the provision of value-added services like thought leadership and portfolio construction expertise should all align with these changing spheres of influence. The impact to asset managers is profound, to say the least.

Preparing to weather the storm
We believe that thriving in the new era will require upending traditional, brand-centric practices in favor of customer-focused product development, competitive pricing models, agile and adaptive business relationship management, and a seamless, personalized client experience. Advanced analytics and sophisticated technology are the modern instruments firms need to use to focus on the four specific goals introduced above, as further discussed below:

1. **Position products on core strengths**
2. **Develop competitive pricing models**
3. **Align relationship management resources on key business relationships**
4. **Deliver a seamless, personalized client experience based on data and analytics**
Position products on core strengths

We believe that several types of businesses will not only survive the coming storm, but have the opportunity to prosper in the new environment. That said, the definition of prospering may need to change somewhat in order to reflect lower margins. Still, we believe that true best-of-breed active management, not closet indexing, delivered by firms focused on stock picking and high active share will continue to create significant value for both end investors and for the shareholders of publicly-traded investment management firms. Whether as standalone firms or boutique members of a multi-affiliate investment manager, investment managers should be able to thrive as long as management possesses a clear view of a firm's strengths and weaknesses, adapting to deliver the best possible investment product and investor experience.

We are confident that asset managers with scale and operational excellence will do well in an environment that rewards their ability to reinvest in growth. They will likely be vehicle- and geographically-agnostic, delivering their products in an array of wrappers, like mutual funds, investment trusts, ETFs, SMAs, UCITs, and interval funds. Some of these firms will diversify across asset management, wealth management, and direct-to-investor and, often, they will be globally integrated and diversified.

We caution, however, that too many managers likely have an unrealistic sense of the scale required to afford the significant investments needed to operate at this level. As a result, we anticipate additional M&A activity as the difficulty of operating effectively in sub-scale businesses becomes clear.

Furthermore, operating margins are likely to settle in at a much lower rate — perhaps in a range between 15–20% — than the level currently built into most publicly-traded firms’ share prices. This implies a lower valuation for many firms in the future, and whether this valuation reset happens gradually or dramatically remains to be seen.

Best-in-class managers should enjoy a higher degree of pricing resiliency and are more likely to do well. Many of these firms will be private or part of larger entities like insurance companies or other holding company structures that can help insulate them to a certain degree from the ups and downs of the market. Private firms, particularly those owned to a large degree by their employees, have the ability to sacrifice profitability during market downturns in order to retain or even add talent while continuing to invest in technology and distribution. For these firms, it will be about delivering alpha in distinct areas, whether alternatives, small/mid cap, fixed income or international. In many instances, these firms will benefit from having a strategic relationship with one of the larger, more globally diversified investment managers, or by building long-term relationships with individual distributors that enable them to cater to the specific needs of a particular distributor’s advisors and clients. Importantly, these firms will need to learn how to outsource all but the most important core functions in order to retain a focus on operational excellence. This trend toward outsourcing will be facilitated by technology developments in areas like the Cloud, AI, Big Data, and blockchain, which can make access easy and affordable.

For most firms, the fundamental choice is likely between scale and specialization. For those firms caught in the middle, worried that neither option is viable, we do not suggest a one-size-fits-all strategy to survival and prosperity. Some managers may decide there is value in becoming part of a larger organization, such as an insurance company, or even going private. Either way, a proactive approach is essential. When the storm comes, many managers who decided to wait may find that avenues they once thought were open to them have shut down. This may be the result of financing no longer being available or previous merger targets being targeted by others. If your firm needs to scale up, we don't think waiting is a good option. If you have an area of distinct strength, build on it. If you have a weakness, fix it. Be the best at what you do, wherever possible, while culling weakness and getting used to margins that are likely to be lower in the foreseeable future. Simply put, we do not believe that margins in the high 20s to low 30s are sustainable, and we believe they will fall due to a combination of market changes, pricing pressure and the need to invest heavily to maintain investment, distribution and operational excellence.
Develop competitive pricing models

Managers should think about alternatives to the traditional fee-as-a-percentage-of-AUM model and explore structures that enable investment management in a more transparent, cost effective and tax-efficient manner. Large managers are beginning to experiment with non-traditional fee approaches that attempt to align the interests of investors with those of the investment manager. Although still limited in adoption and hampered by regulatory constraints, performance fees can be implemented in the form of a fulcrum fee on traditional ’40 Act funds or in a more traditional, hedge fund-like manner in new and innovative structures such as interval funds. As always, the challenge when doing something new is acceptance from various stakeholders and outside constituencies, including portfolio managers, Boards of Directors, regulators, distributors and financial advisors. This can be seen most vividly in the multi-year process that is currently underway to make active management available to investors in some form of a lower-priced non-transparent ETF.

Source: Morningstar and DST Research, Analytics, and Consulting analysis.*

*Excludes Fidelity Investments, T. Rowe Price, and Vanguard due to their significant AUM from direct investors.
For the foreseeable future, we remain convinced that the traditional fee as a percentage of AUM model will continue to dominate. Naturally, managers that are able to lower their fees and maintain margins will enjoy a long-term advantage that other managers will struggle to match. Of course, this balancing act will be different for each firm, depending on its size. Above, we provide estimates for how much a firm’s assets would need to grow in order to lower fees and preserve revenues at the same time. Not surprisingly, these targets may not be possible for many firms. Again, we believe that many firms will have to get used to lower profit margins to remain competitive.

Historically, National Accounts teams at many asset managers have been understaffed, with national account managers acting as lone operators, responsible for managing too many large, complex relationships with inadequate resources. But the importance of home offices has grown at the same time as the number of advisors with investment discretion has plummeted, with many stakeholders influencing the decision to do business with an asset manager.

A survey of asset manager chief marketing officers in 2017 found that at 77% of firms, marketing is planning to shift resources to provide more support to National Accounts teams. Already, one in 10 firms is using comprehensive analytics on targeted relationships to develop highly customized marketing programs and content, and to deploy tools to identify next best actions with key decision-makers and influencers. National Accounts and Marketing teams should be tightly integrated in identifying and prioritizing target accounts based on deep analysis of the fit between investment practices and solutions, defined needs for value-added programs that yield sales opportunities, and shared strategies for growth.

Align relationship management resources on key business relationships

The responsibility for relationship management must be expanded to include distribution and marketing. Both are customer-facing, whether in person or via digital engagement, and it is only in cooperation that each can be effective in achieving business goals for acquisition, retention and growth. Together, they need to address the reality that power is shifting to distributors and a shrinking number of advisors that have investment discretion, by considering a corresponding investment in national accounts management.
As Marketing increases support for National Accounts, it has to become strategic and focused in its support of retail intermediary sales to avoid spreading valuable resources too thinly to be effective. While distribution is reorganizing relationship management teams to support the professional buyers it can actually influence — the home offices, model portfolios and advisors with investment discretion — marketing has to leverage data-driven marketing automation platforms to implement results-oriented, individualized campaigns that connect the dots between advisor needs and the firm’s solutions. In anticipation of the need for greater efficiency and demonstrable effectiveness, CMOs at a few firms are already rationalizing and upskilling their marketing teams, shedding non-core roles like web development, design and content production, while expanding capabilities in analytics, the use of integrated marketing technology platforms and retail marketing strategies.

Distribution and marketing executives recognize that aligning their teams is not only fostered by shared objectives, but also by key performance indicators and incentives. Our research finds that Sales and Marketing teams already report on shared key performance indicators at one in four firms. That keeps them oriented on the same goals, using the same metrics, like lifting lead conversion rates by x% or reducing sales cycle length by y% in the first quarter.

At one in 10 firms, compensation for Marketing and Sales provide incentives for achieving shared goals. Of course, the incentives don't have to be the same for each team. While commissions and direct rewards spur salespeople to greater performance, they don’t work as well for marketing teams. Instead, marketing executives should use incentives like bonus pay, paid leave, or points programs to earn gift cards to collaborate with sales on shared goals.

Deliver a seamless, personalized client experience based on data and analytics

With power shifting to home offices, we believe that the course forward has to focus on developing and expanding long-term relationships with distributors. But instead of casting a wide net in hopes of capturing the attention of as many distributors as possible, we believe the more successful firms will fish with spears and focus their valuable marketing and sales resources intensively on a clearly-defined set of target accounts.

To do that, we think firms should seek, to the extent permissible, to leverage the significant investments they have made in technology with the vast troves of data they have: sales transactions, digital and personal interactions, investment needs of investors and advisors, and communication preferences. The powerful combination of business intelligence and sophisticated marketing technologies should improve their ability to focus their marketing and sales resources much more effectively on a clearly-defined set of target accounts.
Using DST’s Radar for Assessing Distributor Relationships (RADR) framework — which helps firms drill down on alignment, relationship, profitability and demand — asset managers can uncover the best opportunities with the most valuable prospects.

Applying the RADR framework to analyze distributors helps firms rank potential distribution relationships in tiers, enabling managers to pinpoint the most important relationships and the best ways of pursuing them.

Complex business relationships like the ones between asset managers and distributors involve an array of stakeholders and decision-makers, and they can’t be built or sustained with disjointed support. A seamless client experience based on deep alignment between sales and marketing, real-time buyer insights and sophisticated technology is essential to winning and retaining lasting business relationships.

Leading firms can manage these relationships with account-based marketing (ABM) strategies that include:

- Specific objectives and milestones for each relationship
- Mapping of account organization and identification of key stakeholders and decision-makers
- Decision journeys for each stakeholder, with triggers and conversion points
- Optimal channels and content to address specific challenges and decisions
- Individualized campaigns and associated metrics
- Dashboards tracking account updates, delivering insights and recommending next steps
Effective ABM mobilizes business insights on buyer behavior, portfolio management, sales history and demographics, enabling firms to develop decision journeys for each stakeholder and influencer (which no firms we’ve surveyed have fully implemented). This helps identify the key influencers, touchpoints and triggers that advance the decision to do business with your firm.

There are three tiers of account-based marketing: strategic, segmented and programmatic. The Strategic tier should include a very small number of one to three strategic relationships that merit white-glove personal service and customized digital support, with a goal of increased product exposure and sales.

The Segmented tier includes small groups of accounts (a small number of RIAs with common needs, or a few regional broker-dealers focusing on similar investors) that share similar business attributes, challenges and needs. ABM programs focus on shared solutions with tailored existing content.

The Programmatic tier uses an automated, but personalized approach for a much larger group of accounts that repurposes content, journeys and personas from the first two tiers.

In our opinion, the key to all of this is taking full advantage of the data and technology firms have at their disposal, to the extent permissible. Our 2017 survey of CMOs finds that more than two-thirds of firms have invested in marketing automation platforms that greatly simplify the process of collecting advisor insights, targeting campaigns and lead conversion. But while most firms have invested in the sophisticated technology that makes it much easier to scale individualized coverage online, they are often not leveraging the behavioral insights that bridge human and digital interactions.

In our view, firms that ignore the storm clouds and continue with channelized distribution coverage, one-size-fits-all marketing, and underinvestment in business intelligence will rapidly become sidelined by competitors that efficiently pinpoint prospects, offer relevant solutions and develop the long-term relationships that are critical to thriving in the new era.
Finding safe harbor in the storm

Agile and adaptive players are more likely to successfully navigate our changing industry by developing value propositions that are sustainable for the long term. Understanding your value — and building competitive advantages around it — is vital to success in the new environment.

Researchers have long explored the importance of “Value Disciplines” — Customer Intimacy, Product Leadership and Operational Excellence — arguing that successful businesses need to perform in each area, but truly excel in one of them to become a market leader.

This framework is particularly useful for asset managers today as they think about standing out from the crowd. Building a leadership position in one of the three Value Disciplines will be essential for the future leaders in our industry.

Focus is the watchword for firms preparing to thrive — a focus on customer needs and institutional strengths.

Reward innovation in product leadership

Throughout 2017, we were encouraged by the steps many managers took to weather the forces buffeting the industry: mergers, investments in robo-advisers, experimentation with artificial intelligence, new business lines with lower fees, the consolidation of ETF managers and innovative performance fee structures. All of these are indicative of a dynamic and competitive industry. We fear, however, that for many managers, especially active managers, it will not be enough.

We believe that too many managers continue to invest and distribute products the way they have always done it. We recognize the value of stability, but we urge our clients to guard against inertia and complacency. Organizations must find a way to encourage and reward innovation to drive toward product leadership positions. Otherwise, those with lower costs or unique performance advantages will continue to take assets away from more expensive, undifferentiated and poorly performing products. In today’s market, the ability to think outside the box and to experiment with new ways of meeting the needs of your clients is likely to be a business requirement.
Instill operational excellence with sustainable business models

It is essential that firms focus on their core competencies, invest in new ways of improving that competency or adding new ones, while outsourcing non-core business activities and tasks at lower costs than what could be done internally. Firms should reallocate their resources to focus on areas where opportunity exists. Whether it’s focusing sales resources on the best targets, increasing the focus on National Accounts to capture professional buyers, or focusing data and technology resources on the same sales strategy, asset managers must determine where opportunity exists and align their resources to those hotspots.

At the strategic level, management must pick and develop a sustainable business model. It may be based upon scale, specialization, being private or public, or part of another larger company. But we believe that it is essential to choose. Many firms will likely experience difficulties during the next market downturn, but it will be worse if they fail to make strategic decisions now.

Use data to go after the right customers and build customer intimacy

Becoming a provider of choice requires knowing your customers very well and developing solutions that address their needs. Firms should look to marshal data, analytics and business intelligence to identify the advisors they can actually influence, then focus their resources on those targets alone — the ones who have the discretion to make decisions and can be swayed to do business with your firm. That requires close collaboration between distribution, marketing and product strategy to analyze and segment the market based on influence (Is there opportunity to impact investment decisions?), value (Are the financials favorable?), and opportunity (Do the needs of advisors align with competitive products from the asset manager?).

Build long-term competitive advantages

Product leadership should be a central concern for asset management organizations. In our view, there is no place for asset managers with sub-par products in this new era of asset management. However, for distribution and marketing organizations, product leadership is not in their control. Distribution and marketing executives should strive for both operational excellence and customer intimacy advantages. Both of these are controllable and are essential for the long-term success of the asset management organization.

All of these efforts reinforce one another. A sound business intelligence strategy is essential for efficient and effective operations, and for customer engagement. Likewise, effective and efficient distribution and marketing efforts result in profitable organizations, and best-in-class customer engagement builds durable organizations. Similarly, distribution and marketing efforts that are aligned will be in a better position to ride out current and future waves of disruption.
Forward-looking firms should use this relative calm before the storm to reinvent their businesses for a vastly different future. Charting a successful course will likely require significant investment in modern instruments like business intelligence and advanced technologies that help your crew know precisely who your customers are and where your best business opportunities lie. It requires restructuring customer-facing teams to support mutually beneficial and valuable relationships with a seamless experience relevant to each stakeholder and decision-maker. And it requires developing sustainable and competitive business models that create long-term value.
Are you prepared to ride out the storm?

| Product Development | We have rationalized our product set to focus on our core strengths | 0 No plans  
1 Planning  
2 Partially implemented  
3 Fully implemented |
|---------------------|--------------------------------------------------------------------|-----------------|
|                     | We only develop new products in collaboration with business partners | 0 No plans  
1 Planning  
2 Partially implemented  
3 Fully implemented |
|                     | We use comprehensive behavioral, transactional and portfolio management insights to inform the development of new solutions | 0 No plans  
1 Planning  
2 Partially implemented  
3 Fully implemented |
|                     | We have invested in machine learning and AI technology to make portfolio management more efficient | 0 No plans  
1 Planning  
2 Partially implemented  
3 Fully implemented |
|                     | We have ensured that our fees are aligned with our value proposition | 0 No plans  
1 Planning  
2 Partially implemented  
3 Fully implemented |
|                     | We are exploring alternatives to traditional fees as a percentage of AUM models | 0 No plans  
1 Planning  
2 Partially implemented  
3 Fully implemented |

| Business Relationships | Our national accounts, product development and marketing teams work together to identify and prioritize strategic business partners using comprehensive analytics | 0 No plans  
1 Planning  
2 Partially implemented  
3 Fully implemented |
|-----------------------|-----------------------------------------------------------------------------------------------------------------|-----------------|
|                       | We have mapped decision journeys for each type of stakeholder and influencer at key accounts | 0 No plans  
1 Planning  
2 Partially implemented  
3 Fully implemented |
|                       | We develop account-based marketing strategies for each strategic account | 0 No plans  
1 Planning  
2 Partially implemented  
3 Fully implemented |
|                       | We use jointly developed KPIs, metrics and score cards to measure and analyze the development of our business relationships | 0 No plans  
1 Planning  
2 Partially implemented  
3 Fully implemented |
### Client Experience

Client insights are captured from every touchpoint and integrated in a centralized data warehouse

We provide a seamless, personalized experience across digital and traditional touchpoints and devices

Behavioral, transactional and portfolio management analytics personalize the digital experience we provide prospects and clients

We have integrated machine learning and trigger marketing in our client experiences

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<th>0 No plans</th>
<th>1 Planning</th>
<th>2 Partially implemented</th>
<th>3 Fully implemented</th>
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<tbody>
<tr>
<td>Client Experience</td>
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### Culture

We are a customer-focused business

Innovation is at the heart of our product development process

Our business leaders believe in and require data-informed decision making across the company

We are agile, responsive — and empowered to explore new ways to further business growth

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<th>0 No plans</th>
<th>1 Planning</th>
<th>2 Partially implemented</th>
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<tbody>
<tr>
<td>Culture</td>
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**Points:** 0-25 **Lagging** 26-40 **Building** 41-54 **Leading**
Related Research and Services

Reports and Subscriptions
Advisor Segmentation: A Unified Approach
Destination Inbox: Increasing Email Relevance and ROI
Digital Engagement Leadership: What It Takes and Why It’s Worth It
Effective Product Marketing Strategies
Prevailing in a Changing Distribution Landscape
Solving the Marketing Attribution Mystery
Uncovering Hidden Opportunities with Data-Driven Marketing Campaigns
Using Business Intelligence to Optimize Sales Strategies

Digital Strategy Insights and Digital Benchmarking
Product Strategy Compass

Distribution Intelligence
Advisor Practice Analysis
Holding Period Analysis
SalesConnect
WalletShare
Sources
1Morningstar and DST Research, Analytics, and Consulting analysis
2http://www.finra.org/newsroom/statistics
3Scottrade’s 2017 Retirement Study: “Younger cohorts (Millennials and Gen Xers) are far more likely than their older peers to express hesitation and cynicism about the choices their advisors make on their behalf and are more likely to wish for advice they can trust. Among Millennial participants in the survey, 67% think their adviser “sometimes recommends products and solutions that are in their advisor’s own best interest,” with the percentages declining to 64% for Generation X, 22% for Baby Boomers and 15% for seniors.”
4Bank of America Merrill Lynch
5DST Research Analytics, and Consulting with data from Wells Fargo/Gallup Investor and Retirement Optimism Index Survey conducted Jan 29–Feb 7, 2016.
9Morningstar and DST Research, Analytics, and Consulting analysis
11Survey of asset management chief marketing officers on Modernizing Marketing for 2018. DST Research, Analytics, and Consulting. 2017
12Survey of asset management chief marketing officers on Modernizing Marketing for 2018. DST Research, Analytics, and Consulting. 2017
13Prioritizing Distributor Relationships. DST Research, Analytics, and Consulting, LLC. 2016
Redefining Risk
The Revolution Coming to Financial Services
EXECUTIVE SUMMARY

As a goals-based investment manager, we believe investment problems and challenges are best addressed in the context of investors’ goals—the purpose behind their investment programs. By aligning investment solutions with investor goals, investors may be able to increase their probability of achieving the actual “real world” outcomes they seek.

Each investment-related goal consists of three stages—accumulation (or gain), protection (or protect) and distribution (or spend). Importantly, investors face different primary risks in each of those three stages.

1. A reasonable risk metric for the Accumulation client is volatility. The mathematical rationale behind why volatility as a measure of risk can be valid under the proper conditions is well-understood by the financial services industry in an efficient frontier or mean-variance framework. However, we suggest an additional behavioral explanation for why volatility is an appropriate definition of risk for the Accumulation investor.

2. For the Protection client, a better metric for risk is drawdown—absolute loss. While volatility can accompany investment losses, it is a secondary effect. Defining risk-as-drawdown for the Protection client provides a much more straightforward treatment of the primary risk during this stage of the investment journey.

3. The Distribution stage client with ongoing expenses (such as paying for expenses in retirement), we designate longevity as the primary risk. Thinking in terms of longevity can provide startling insights as to the type of investment management strategy and the type of portfolio construction that can best address this risk.

Ultimately, the fundamental definition of risk must change and adapt over time as investors transition into a new stage of their goals-based program. Likewise, the investment strategies and portfolio construction decisions aimed at mitigating risk must also change and adapt to each new stage. A portfolio in the Accumulation stage should have different characteristics and attempt to mitigate different risks than should a portfolio in the Protection or in the Distribution stage, for example.

This approach stands in contrast to traditional methods of portfolio construction and management that treat risk in more static ways. These methods do not, in our opinion, maximize the probability of investment success. That is, we do not believe that they do nearly as good a job as goals-based investment strategies do at seeking to ensure investors will meet or exceed the financial goals that are the fundamental drivers behind their decision to invest in capital markets.
Redefining Risk
The Revolution Coming to Financial Services

Overview
As a goals-based investment manager, Horizon frames investment challenges in the context of investors’ goals—and the future cash outflows they’ll need to achieve those goals.

That means our starting point is always the “why” of investing: What is the purpose of a client’s investment program? Are they saving for retirement, to send kids to college, to buy a different house, or perhaps to leave behind legacy assets? Typically, the answer is a combination of these and other goals. All the various “why’s” represent a client’s series of goals.

Goals-based investment management is the “how”—the strategies that will be used to achieve that series of goals.

Using this framework, we break each client goal into three investment stages—each with its own overarching objective:

1. Accumulation stage. The period of time when the client is actively investing with the objective of growing assets to fund the goal. At Horizon, we call this the GAIN stage.

2. Protection stage. The period of time shortly before the actual funding of the goal, when the client’s objective is to ensure that potential investment losses don’t jeopardize the goal. We call this the PROTECT stage.

3. Distribution stage. The period of time when the client’s objective is to actively use their accumulated assets to fund the goal. This is what we call the SPEND stage.
It’s vital to understand that investors face very different risks in each of these investment stages. That makes perfect sense given that each stage has its own specific and unique objective. Therefore, each stage should address the investment management question differently—that is, the “how” should follow from the “why.”

This is not how most investment managers view investing, however. Traditional organizations tend to view investment problems in terms of exposure to various assets—for example, through a style-box approach and a diversification lens. This approach says, essentially: create a certain to exposure to U.S. small-value stocks, plus some exposure to real estate and a sprinkling of emerging markets and—voila!—you’ve got your diversified investment portfolio!

A traditional, exposure-based investment management firm may have difficulty matching their institutionally-focused and exposure-based portfolios to a series of client-centric goals—or even to a single goal, for that matter. (That’s not the portfolio’s fault, of course. This is a job it wasn’t designed to do in the first place.)

This is part of a broader, industry-wide problem: traditional investment approaches and metrics around issues of performance and risk have developed based entirely on institutional investors’ needs—not the objectives of individual investors and families. The investment “language” spoken by institutions is fundamentally different than the language spoken by individuals.

Going forward, then, the individual must be placed at the center of the investment universe—not the institution—so that advisors don’t make the mistake of continually describing an investing experience with language that does not reflect their clients. Advisors must be able to speak to clients in ways so that the investments make sense, measurements actually mean something, and the evaluation criteria reflect their reality.
Horizon believes one way to address the issue of fitting a square peg (the exposure-centric portfolio design) into a round hole (a portfolio managed to achieve clients’ actual life goals) is to frame it in terms of the primary risk a client faces during each stage of their investment journey. If a portfolio is managed to minimize the most pertinent risk at each of the three stages, clients can gain clarity on why certain exposures or investment techniques are being used at various times. That, in turn, can help them stay the course over time and maximize the probability of reaching their stated goals.

With that in mind, let’s examine the specific primary risk that investors must address in each investment stage.
Accumulation Stage
The vast majority of the investment world—institutional investors and investment firms, in particular—adhere to the traditional view that volatility is the best metric for assessing risk.

While we don’t believe that volatility is the accurate proxy for risk in all cases and for all investors—more on that later—we do agree with the broad-based institutional investment community that volatility is the primary risk on which investors in the Accumulation stage of their investment journey should focus.

The assumptions of Modern Portfolio Theory help support the idea that volatility is an appropriate risk gauge for certain individual investors—namely, those Accumulators who are decades away from needing their wealth to fund their goals. Such long-term timeframes are the closest individual investors can get to the infinite, in-perpetuity time horizons used by institutional investors that view risk as volatility (endowment funds, state pension plans, index-based mutual funds and the like).

The second reason volatility should be the main barometer to gauge risk during the Accumulation stage has to do with investor behavior.

Whether from Dalbar studies of “investor vs. investment” returns (investor returns are always worse) or from our own experience, we know that clients tend to want to do the “wrong” thing at the wrong time, based on the movements of the markets. In times of intense volatility or declining markets, they often want to sell their portfolio to reduce risk—a decision that often leads them to end up paying a higher price later on when they want to buy back the portfolio. Since higher volatility is more likely to generate bad investor behavior than is lower volatility, it follows that volatility is a good metric for risk among Accumulators.
Protection Stage
Measuring risk as volatility is about as traditional an approach that you can get, of course. And, as shown, it’s an approach that can make sense for some investors in the Accumulation stage who are decades away from their goals’ starting points.

However, a modern-day discussion of both the Protection and Distribution stages of a goals-based investment management strategy requires a fundamental shift away from the 70-plus-year dogma of risk-as-volatility.

The reason: While volatility certainly can impair a Protection or Distribution strategy, it is not the dominant risk that investors in these two stages must address and mitigate. One size does not fit all.

Take the Protection stage of goals-based investment management. It begins at a moment somewhat close to when the Distribution stage is set to begin. Just when, exactly, that moment starts is a bit loose and nebulous by necessity. There are simply too many variables that can be at play to definitively state, “THIS is the moment at which the goal enters the Protection stage.” Such variables include:

- How well funded is the goal?
- How much time remains until the Distribution stage is expected to begin?
- How long is the Distribution stage expected to last?
- Where does the goal sit on the client’s hierarchy of goals—that is, how important is it relative to other goals?

We can design elegant mathematical approaches to help us answer all of these questions and more, simultaneously. But if we’re being honest, the output from those models will be a time range—a continuum.
We know that Protection becomes increasingly important as the Distribution stage nears. But, frankly, pinpointing an exact moment in time when a magical switch flips from Accumulation to Protection isn’t nearly as important as understanding the implications of this transformation on goals in the client’s portfolio.

The biggest implication: Drawdown—absolute dollar losses in the client’s portfolio—replaces volatility as the dominant investment risk in the Protection stage. There are two main reasons why drawdown becomes the major concern at this point, both of which concern timing:

1. The fact that the Protection stage begins reasonably close to the desired start of the Distribution stage means there isn’t much time for investors to recover from investment losses they could suffer. For investors approaching the Distribution stage, volatility or losses relative to a benchmark don’t matter nearly as much as do absolute dollar losses. Just ask an investor who was hoping to retire in 2010!

2. Likewise, absolute dollar losses are what most directly threaten the client’s ability to adequately fund the goal (whether it is a one-off or ongoing expense). Volatility doesn’t threaten the goal—losing money at the wrong time does.

The upshot: A goals-based investment management framework must address risk-as-drawdown—actual investment losses in the portfolio—during the Protection stage. There are multiple ways to address this risk, including investing in low volatility stocks, using options-based strategies, or implementing an active de-risking approach.

Important: A balance still must be struck between building wealth and protecting wealth during this stage. First and foremost, step back and acknowledge that investment gains can be a fundamental risk management tool. Additionally, the Protection-stage investor may not have accumulated quite enough wealth to fund the upcoming goal, and still needs to earn positive investment returns. Therefore, an overly myopic focus on avoiding losses can be harmful to the investor’s goal if it greatly diminishes or eliminates the opportunity to continue to earn investment gains.

Defining “risk” as drawdowns during the Protection stage provides the flexibility to design strategies that balance the need for additional investment gains against the specific threat of drawdowns. It also helps communicate to clients about the nature of the tradeoffs being made in order to meet their goals.
Distribution Stage
As a client moves into an ongoing-expense Distribution stage, goals-based investment management once again re-defines and re-assesses the concept of risk.

The objective during the Distribution stage is to spend money to pay for a goal. It follows, then, that the dominant investment risk a client in this stage faces is **longevity**: running out of money before the goal is fully met. In goals-based investment management, longevity means both having the money set aside for that goal and having that money last long enough to fund the goal completely.

*Important*: Although the concept of risk-as-longevity incorporates many other types of risk—including sequence of return, inflation, volatility, liquidity, behavioral, and others—the risk of running out of money is the foundation risk that must be mitigated above all others.

Identifying longevity as the primary Distribution stage risk has important implications for a Distribution-stage investment strategy. The bottom-line question that must be asked is: What investment strategy and what portfolio construction are needed to avoid running out of money before the goal is achieved?

For answers, consider what is undoubtedly the most difficult goals-based investment management problem in existence: retirement.

1. **Addressing Longevity Risk: Retirement Investment Strategy**

The specific investment strategy that will best minimize longevity risk question will be determined largely by the methodology behind how each client withdraws money during the Distribution stage.

During the retirement stage, both the timing of withdrawals and the amount of withdrawals are at least as important as generating reasonable returns. This means finding the best withdrawal pattern for cash flows taken from investments, and converting those cash flows into current spending, is critical to maximizing retirement income and minimizing longevity risk.

The withdrawal pattern is inseparable from a retiree’s overall asset allocation when viewed through a goals-based investment framework. The typical withdrawal pattern suggested by many advisors
and investment managers seeks to maintain a “constant proportions” solution to the asset mix of the retiree—that is, to withdraw funds in proportion to the portfolio’s overall asset mix.

Example: If a client has a 60% stock/40% bond portfolio, then 60% of a withdrawal would come from the equity allocation and 40% would come from the bond allocation.

Such a solution may seem reasonable at first glance, as it maintains a mean-variance solution for the overall asset allocation – and mean-variance strategies are widely accepted as the “solution” to a problem where risk = volatility.

But to see if this strategy is actually effective, consider if the requirements for a mean-variance solution are met. For example, we know empirically that retirees overwhelmingly prefer the option of having assets left over when they die to the option of running out of money several years before death. That preference strongly suggests that retirees do not face a symmetric cost structure—and that a mean-variance (constant proportions) solution may not be optimal.

Horizon’s extensive research into withdrawal methodologies designed to minimize longevity risk cause us to favor an investment strategy that segregates assets between a “current income” portfolio and a “future income” portfolio, along with a set of rules designed to balance the trade-offs between the two. The exact methods and full research summary are beyond the scope of this paper, but our research shows that this type of investment strategy can be effective to reduce investors’ longevity risk.

2. Addressing Longevity Risk: Retirement Portfolio Construction

Using longevity as the main risk metric during the Distribution stage has another important—possibly surprising—implication for a client’s portfolio.

With a traditional risk = volatility framework, equity exposure during retirement is reduced as the client ages. This makes some sense if you believe that the client’s risk is primarily volatility-related. It makes much less sense, however, if your goal is to avoid running out of money (or, similarly, to maximize legacy wealth).

A portfolio that is heavily tilted toward fixed income, which becomes even more tilted over time, may help to minimize volatility. But is not likely to be the most effective approach to minimizing longevity risk and, in turn, maximizing the amount of time that portfolio can produce cash flows.

To achieve that latter goal, the portfolio must grow at a rapid enough rate to help offset the cash flows coming out of it. This growth is best achieved by tilting the portfolio toward equities throughout retirement. Likewise, there is ample research to show an equity tilt increases the probability of ensuring and preserving legacy wealth for heirs.

Of course, on the surface it may appear “risky” to construct an equity-heavy portfolio for a retiree. But once again, it comes down to the definition of risk in the retirement (Distribution) stage. Risk defined as longevity requires that withdrawal patterns and target legacy wealth be considered.
When considering these additional goals and risks, a portfolio with a larger-than-traditional equity allocation may actually be less risky than a bond-heavy portfolio that may not generate adequate growth of capital over time.

Conclusion
Goals-based investment management seeks to link investment management and portfolio design decisions directly with clients’ desired outcomes in order to maximize clients’ ability to achieve those outcomes.

One way goals-based investment management pursues this objective is to address the evolving types of risk that clients encounter as they move through the three main stages of the investment journey.

By understanding the primary risk that must be mitigated in each of these stages—volatility in the Accumulation stage, drawdowns in the Protection stage and longevity in the Distribution stage—investors (and advisors who serve them) can make more informed decisions around ongoing investment strategy, portfolio construction and performance benchmarking.
Scott Ladner, Head of Investments

Mr. Ladner serves as Head of Investment Management and is the Chair of the Investment Committee for Horizon. In these capacities, he oversees all aspects of the Investment Management division for the firm. He also provides the Investment Management division with Macro analysis and interpretation of global derivatives, credit, foreign exchange, equity, and funding markets. His previous roles at Horizon included Head of Risk and Director of Quantitative & Alternative Strategies.

Prior to Horizon, Mr. Ladner was a founder of Charlotte Global Advisors and Principal Guard, LLC. Mr. Ladner helped to launch an equity index volatility and dispersion trading unit at PEΔK6 Investments in Chicago, a proprietary listed option and volatility trading firm. Previously at First Union/Wachovia, Mr. Ladner founded and ran the equity swap and forwards portfolio while also managing equity option and volatility portfolios. He also co-founded and managed the Risk Arbitrage and Special Situations portfolio. Mr. Ladner then managed the swaption and cap/floor portion of the bank’s interest rate derivatives portfolio. Mr. Ladner received his BA in Economics and Russian Language & Literature from the University of North Carolina at Chapel Hill.
We’ve all become accustomed to using technology to help make individualized decisions in our daily lives—faster, cheaper, and smarter. We rely on algorithms to tell us what to watch on Netflix, make hotel suggestions on TripAdvisor, and consume news “recommended for you” on various websites.

A recent announcement by industry leader Morgan Stanley regarding its goals-based wealth management platform is the point of the spear of a small group of disruptive industry leaders that are leveraging algorithms and combining advanced software systems to create risk-smart, tax-smart, comprehensive and coordinated platforms for the optimal management of all accounts and products in a household. These platforms are designed to include robos at the same time as they make a quantum leap beyond these simple product offerings.

The quantum leap we will describe is the next significant advance for retail investors and follows in the footsteps of earlier important shifts that have occurred in the advice business over the past 50 years:

1. In the late 1970s when short-term interest rates rose to the high teens, money poured out of savings and into a new invention at the time: the cash management account.
2. Interest rates fell through the 1980s and trillions of dollars found their way to a variety of mutual funds as savers became investors, often creating diversification by chasing five-star funds.
3. In the 1990s as investors pursued more customized solutions and help in managing risk across multiple accounts and products.
4. Recently, we’ve seen the rise of the robo advisor, a product solution that underscores the importance of a simple, low-cost technology-based user experience to manage retail assets. Although robos accelerated the embrace of technology, we will argue the real generational shift is that thanks to technological advances, comprehensive household portfolio management will become the new norm because it improves after-tax outcomes for investor households without increasing risk.

Wealth managers, asset managers, and technology providers are now building comprehensive platforms that will benefit investors by leveraging new-age technology to optimize and coordinate the typical five to six accounts in a household and create improved after-tax returns and income without additional risk. At the same time, financial advisors will benefit by providing enhanced advice, enjoy greater practice efficiency, and attract held-away assets while retaining current client assets.

This next generation of optimized platforms is helping investors, advisors, and firms make more and keep more money. All advisors and firms will have no choice but to follow the leaders.

The next big disruption isn’t robo advice; it’s risk-smart, tax-smart, optimal multiple account management.

ROBO LESSONS LEARNED

The importance of the robo role is clear—but limited. Robos have done a very good job of offering:

- low cost;
- simplified and engaging online user experience;
- more intuitive platforms for younger investors to get started saving for retirement;
- a way for the industry to provide digital advice with albeit simple, single-account asset allocation; and,
- stirred all financial advisors and firms to awaken from our collective slumber to fully embrace and incorporate technology to more efficiently and effectively serve clients.

But as you follow the money, the original disruptor robos that started this seismic shift have more headlines than
assets. Investors who use robos have largely made single-account purchases, bought and maintained low account balances, and are younger, on average.

As the more traditional—and much larger—fast follower entrants into the robo arena, such as Vanguard, Fidelity, and Schwab are excluded, the assets raised by the initial disruptors are tiny. The two leaders are Betterment with $10 billion in assets under management and Wealthfront with $7.4 billion in assets under management. These two leaders account for 0.047 percent of retail assets—not even a rounding error.

The later entrants such as Schwab and Vanguard (with many more traditional firms launching similar programs) are getting the vast majority of the assets. They offer their robo capabilities as a product, not as a stand-alone solution.

And although robos have lowered the barrier to entry to encourage novice investors to get started, that is insufficient for investors nearing retirement.

Older investors don’t have the luxury of getting it wrong. They are largely on their own. Except for a lucky few, they don’t have pensions. They find themselves with more products, accounts, and the confusion and complexities of an accumulated life but not the comprehensive guided solution they want and need.

They purchased products from two or three advisors—with no hint of a comprehensive strategy or a plan—but they are unaware that by coordinating the jumble of products they’ve accumulated, they can achieve a more productive way to improve their prospects.

Robos provide low-cost, easy-to-use products but not comprehensive and optimized household solutions. And unless robos offer products other than their own, you won’t see them become anything more than just another product.

**Table 1**

<table>
<thead>
<tr>
<th>Morningstar</th>
<th>EY</th>
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<tr>
<td>Asset allocation: 0.38%</td>
<td>Increase in income: 33%</td>
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<td>Asset location: 0.52%</td>
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<tr>
<td>Dynamic withdrawals: 0.54%</td>
<td>Increase in legacy: 45%</td>
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<td>TOTAL: 1.44%</td>
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**THE PROBLEM WITH ROBOS—AND OTHER UNCOORDINATED INVESTMENT STRATEGIES**

Robos don’t provide a holistic, multi-account retirement strategy. Simply put, they are just another financial product. Like many other financial purchases, they often are acquired in a vacuum. The typical investor nearing retirement owns five to six accounts and products, managed by two to three advisors. Maybe there’s even a robo in the portfolio.

Most of these investors have taken a haphazard approach to investing, tending to buy what just worked and sell what didn’t. According to the 2016 DALBAR Quantitative Analysis of Investor Behavior, the 20-year annualized S&P return was 7.68 percent but the 20-year annualized return for the average equity fund investor was only 4.79 percent, a shortfall of 2.89 percent annualized.

Using a “grass is greener” approach of buying the next product or strategy from the next advisor or firm in hope of doing better than the last time clearly doesn’t work.

But as the DALBAR study demonstrates, investors’ behaviors leave them in a position of falling behind. Buying high and selling low in an uncoordinated way falls far short of what investors need to get where they intend to go.

It’s often overlooked that with a robo you can only invest with cash. You can’t transfer assets to a robo because they only offer proprietary products. For the older investor, this means coming up with cash, or liquidating holdings and possibly suffering significant unwanted tax consequences.

When investors who have accumulated assets in these various robo products get serious about how best to prepare and manage their retirements, they have a lot of frustrations and questions but not a lot of clarity about what to do.

Morningstar and Ernst & Young (EY) have prepared separate studies finding that when multiple household accounts and products are managed in a coordinated and strategic way investors can realize significant incremental after-tax returns and income.

The Morningstar study says this approach can produce an additional 100–200 basis points per year in enhanced returns. EY found that investors can improve after-tax returns and income by as much as 45 percent over an investor’s lifetime (see table 1).

**NEXT BIG DISRUPTION: COMPREHENSIVE, DIGITALLY ENHANCED ADVICE**

Systematically managing multiple accounts for an investor over many decades can add hundreds of thousands dollars in improved outcomes. A handful of wealth management, asset management, and fintech firms are partnering to create comprehensive, connected, and optimal platforms.

To be clear, we are not referring to a new and improved hybrid robo offering. We are describing the post-robo era, which is far beyond anything we’ve seen from these upstarts.
DIGITALLY ENHANCED ADVICE DEFINED

We define digitally enhanced advice in the post-robo era as the combination and coordination of tools, capabilities, and products designed to optimally improve investor outcomes across all holdings, investment strategies, accounts, and income sources—up to and through retirement.

Through account aggregation and planning tools, advisors already have the data needed to provide digitally enhanced advice across an investor's portfolio. Advisors don’t have the connections and full tool set, however, to take advantage of this holistic view and actually implement optimal solutions across multiple taxable and tax-advantaged accounts as well as income sources such as Social Security.

With connected data flow, tool set, products, models, and income sourcing, we can provide optimal guidance and decision-making across the household portfolio. And, if this is rendered consistently over a decades-long timeframe, significantly more assets are accumulated, distributed, and ultimately passed on to heirs.

The specific tools, products, and capabilities of this comprehensive and coordinated platform include the following:

- Financial planning
- Account aggregation
- Risk management/asset allocation guidance
- Investment and product proposal generation
- Tax optimization across multiple products and account types to ensure tax-smart asset location
- Ongoing household-level management and rebalancing of all holdings, products, and accounts, including: advisory models, brokerage holdings, and annuities
- Optimal income sourcing and sequencing from multiple accounts, products, and other income sources such as Social Security and pensions, as well as Roth individual retirement account (IRA) conversions
- Trading platforms
- Household-level reporting

The individual technology elements already exist. What has been missing until recently is the connective tissue. That connective tissue is not limited to tools and data flow but includes the art—the handholding, understanding, interpretation, experience, and guidance only a human advisor can provide.

The art will be in combining all these elements of existing taxable and tax-qualified products and accounts with human advice. These connected tools empower financial advisors to deliver improved individual financial advice and counsel. This combination of human interaction and digitally enhanced advice is all part of the new post-robo future.

Wealth managers, asset managers, platform providers, and fintech firms are now collaborating, connecting, competing, enhancing, and quantifying the benefits of these comprehensive platforms that empower financial advisors to provide guidance on how to manage all accounts and products owned by a household.

These platforms provide advisors and clients with the following benefits:

**Integrated workflow**

Various tools designed to enable advisors to help investors do the right things have been available for a long time. What’s been missing is the connection and coordination of the data that needs to flow to ensure a comprehensive approach to the management of their accounts. These digitally enhanced advice platforms connect and streamline—and most importantly—work from the same set of data and assumptions for each household to clarify and provide customized guidance as to what to do in a more efficient, consistent, and effective way.

**Improved outcomes**

There are only three ways to improve investor outcomes:

**Consistently beat the market.** This is no small challenge and is rarely achieved.

**Reduce investment costs.** The industry has been in a race to the bottom on costs over the past many years. Costs continue to spiral down for the benefit of investors.

**Reduce taxes.** Hearts & Wallets found that for families with $500,000 or more in investable assets, taxes are the single largest investor expense—more than all other expenses combined.5

The Morningstar and EY studies found that investors can enjoy significant after-tax improvement of as much as 100-200 basis points per year when assets are managed in a tax-smart, tax-smart household fashion.
For example, a $1-million household managed in this way could improve retirement assets by up to $250,000 over 10 years during the accumulation phase. A multi-account income optimization could add another $250,000 over a 20-year period of retirement income.

There are only two predictable ways to improve investor outcomes: lower costs and reduce taxes. Digitally enhanced advice is predicated on delivering both.

Quantified financial benefit
It’s one thing to improve investors’ outcomes, but it only matters if the investor can see it. Software exists that shows investors how much their after-tax returns and income can be improved through coordinated, optimal management of household assets.

Complexity made simple
Digital tools can help advisors provide an optimal level of guidance. Most investors have accumulated holdings in a less than cohesive way in preparation for retirement. The variety and complexity of product structures, not to mention the complexity of different tax treatments, extends beyond the capacity of any human being or spreadsheet.

That’s why algorithms and software exist. Software provides a level of efficiency to benefit an advisor’s practice that makes it efficient in terms of both time and cost to have software do the work.

A study by behavioral research firm Boston Research Technologies found it takes an advisor from one to three hours to determine a single optimal income recommendation across multiple accounts for a single client using spreadsheets. Software now exists in which that computation takes less than five seconds.

Optimal implementation across multiple accounts
All goals-based financial plans produce a household-level recommendation on what to own to meet the target allocation. What those plans don’t suggest is how to organize the holdings to maximize asset location among the various account types, which can generate up to 50 basis points per year in incremental after-tax returns, according to the Morningstar study. New software capabilities exist to suggest how to implement optimal asset location among multiple accounts in a tax-smart way.

Optimal sequence of withdrawal
Capabilities also exist to do the following:
- show when to take Social Security benefits to maximize income;
- suggest the optimal timing to convert assets from a traditional IRA to a Roth IRA over time without kicking into a higher tax bracket;
- illustrate the optimal sequence of withdrawal from taxable, tax-deferred, and tax-free accounts, and,
- coordinate all the above to create a strategic approach to maximize income from multiple account registrations, investment products, annuities, Roth conversions, pensions, and Social Security.

Implementing a financial plan is complex and fundamentally important. The hardest part is creating a maximized income strategy. Tools now exist to coordinate all the different elements to maximize accumulation and income across multiple accounts.

If advisors can make optimal recommendations, shouldn’t they?
Recent industry trends such as fee compression and regulatory change—especially the Department of Labor fiduciary rule—have made it more necessary for advisors to embrace new tools. Advisors intuitively understand the need to tap into the next wave of fintech to help manage client portfolios cost-efficiently and holistically.

There is technology that suggests optimal rebalancing and income generation across all the accounts in a household that can also quantify the financial benefit for the client. Managing multiple accounts, products, and income sources in a risk-smart, tax-smart way over the course of accumulation and retirement in one fell swoop is a powerful offer, especially when the benefits can be quantified in dollars, cents, and basis points. In light of the clear trend toward the fiduciary standard, if you can do all this, isn’t it malpractice if you don’t? Clearly those advisors who are embracing digitally enhanced advice in the post-robo era recognize this is the right thing to do and a real differentiator for their practices.

User experience
These connected, digitally enhanced advice tools have been designed to improve results. But as has been the case with any kind of digital offering in any industry, the user experience must be so simple and intuitive that anyone could connect the dots and reap the enhanced rewards.

Identifies clients in need
By combining client data available through digital account aggregation and customer relationship management tools along with asset location and tax-smart income generation software, the advisor can easily identify a list of clients who would benefit most from digitally enhanced advice as well as the dollar benefit the clients would enjoy.

Everyone wins
What’s most significant about these emerging capabilities is that everyone benefits—clients, advisors, and firms.

- Clients enjoy improved returns and income, and a higher likelihood of a comfortable retirement and peace of mind. The good news for investors is that they will be far more successful as their assets are managed at the household level, which is an incentive to consolidate.
- Advisors improve customer retention, asset consolidation, referrals, and compensation. Advisors report that...
when taxes are reduced across a household portfolio, fewer assets leave to pay taxes, freeing more investments to compound in value over time. Advisors find that improved results for investors increase asset consolidation and referrals, leading to an increase in the book of business.

Firms see a reduction in compliance issues and costs as well as an improvement in revenues and profitability.

CONCLUSION

We are now in the early stages of this brave new post-robo world. As these technologies become more broadly available and more fully connected, those who embrace them will come out ahead. By taking full advantage of the advances in multi-account technology, advisors will be able to provide smarter, more-comprehensive advice and improved investor outcomes, allowing investors and advisors alike to make and keep more money. The emerging post-robo world provides significant and quantifiable benefits for clients, advisors, and firms.

Wealth management, asset management, and fintech firms are now forging partnerships to create tools and connectivity that offer digitally enhanced advice as part of a larger platform to aid financial advisors in providing comprehensive solutions. This approach goes well beyond supporting one-off accounts and takes entire households with all their intricacies and complexities into perspective to provide the following:

1. more effective management of risk across all the accounts and products in the household;
2. reduction of taxes through optimal asset location as well as multi-account, multi-product, and multi-model optimization; and,
3. suggestions for the optimal sequence of withdrawals from those multiple account registrations, products, models, and income sources.

As investors move closer to retirement and work with their advisors to embrace a more coordinated, tax-optimized full-portfolio management approach, they will bolster their nest eggs with additional assets and income, becoming the ultimate winners in this post-robo world.

Jack Sharry is executive vice president and chief marketing officer of LifeYield LLC, a transformative software company that helps forward-thinking financial firms, advisors, and investors make and keep more money by taking a comprehensive view of investors’ assets. He is also co-chair of Money Management Institute’s Digitally-Enhanced Advice Committee. Contact him at jack.sharry@lifeyield.com.

ENDNOTES

THE FUTURE OF ESG AND SUSTAINABLE INVESTING

assessing the demand and the associated challenges and opportunities for asset managers and distributors
MAKING A POSITIVE IMPACT

By Lee Qian
Investment Manager, Baillie Gifford
Living standards have improved around the world since Mandela’s speech in 2005 that coincided with the global ‘Make Poverty History’ campaign. However, although poverty levels have fallen, there are still over 760 million people in the world living on less than $1.90 a day. Humanity also faces other significant challenges, not least the problems associated with climate change.

The recent evolution of impact investing – which has the dual objectives of achieving positive social and environmental outcomes as well as good financial performance – offers an opportunity to combine successful allocation of capital to areas of social importance without any negative impact on investment returns, so delivering a more sustainable future for all.

Traditionally, impact investing was confined to the private market, with initiatives, such as the Ford Foundation’s Program Related Investments in the 1960s, often invested directly in targeted projects in local communities. More recently, it has broadened out and is increasingly being adopted by investors in the public market. The Dutch pension manager PGGM, for example, has committed to investing at least €20 billion into companies that have a positive impact on areas such as the climate, environment, water, food and health.

“Overcoming poverty is not a gesture of charity. It is an act of justice. It is the protection of a fundamental human right, the right to dignity and a decent life...”

Nelson Mandela
Former President of South Africa
OPPORTUNITIES ABOUND

The World Bank estimated in 2016 that the total market capitalisation of listed companies was US$65 trillion. The sheer size of that number underlines the extent to which public equity markets offer a large and liquid universe in which to find impact investment opportunities. That is not to say that all listed companies are suitable bedfellows for impact investors. However, many do have the potential to make significant inroads into addressing some of the issues that are of global impact. Among those with businesses set up to meet both objectives are companies such as the electric vehicle manufacturer Tesla, which is driving the adoption of eco-friendly cars that will have a more favourable impact on the environment than traditional combustion engines. Another is Safaricom, a telecoms operator that is bringing mobile banking to the masses across Africa with the stated aim of transforming lives. By investing in the shares of this type of company in the public equity market, investors are increasing the amount of capital that is being made available for projects that help to meet social and environmental challenges. But it is not as simple as finding the ‘right’ companies to invest in.

Short-term shareholders, who trade regularly in and out of companies in their portfolio, have little claim to making an impact through their investments.

Short-term shareholders, who trade regularly in and out of companies in their portfolio, have little claim to making an impact through their investments, even if they are taking holdings in companies that are solving the challenges faced by society, e.g. poverty. It takes the patient mind-set and the capital of the long-term equity investor to give companies the freedom and focus they need to deliver on their long-term growth plans and ambitions.
POSITIVE CHANGE

There is a big gap to plug in financing sustainable development. The Brookings Institution – an influential American research group – has estimated that between US$5 trillion and $7 trillion of investments are required annually to finance the United Nations Sustainable Development Goals – a set of 17 objectives covering a range of social and economic development issues including issues such as poverty, hunger, health, education and climate change.

As allocators of capital, investment managers have a role to play. They have a role to play in contributing to a more sustainable future by directing capital to those companies that are addressing the challenges our world is facing. By doing so, it is possible to take responsibility and contribute to global progress.

Delivering impact and investment returns can be complementary. This dual objective manifests itself in a desire to generate attractive investment returns and to deliver a positive societal impact. The key to achieving this is to build it into the investment process, from the initial analysis of a company, particularly with regard to the societal challenge that a company is tackling. It can be difficult to make comparisons between different companies and their potential to deliver impact. Investors should consider positive change in its broadest sense across different investment themes, namely social inclusion and education, environment and resource needs, healthcare and quality of life, and base of the pyramid. Although these labels may differ from those applied by others taking a similar approach to investing, they bring consistency to how we should think about the challenges facing society and assess the impact of companies.
MEASURING OUTPUTS

Analysing the social and environmental impact of listed companies is a challenge. But it is necessary if impact investing in listed equities is to be seen as a credible and socially acceptable way of allocating capital. Although there are many companies providing data on ESG issues, they often capture only part of the picture, especially when it comes to assessing more nuanced areas such as corporate culture and management intent. Reporting companies’ impact is also difficult: not all impacts can be quantified and even those that can be are not always disclosed.

In-house fundamental research is crucial when examining a company’s impact on society, and should focus on both quantitative and qualitative aspects. Before making an investment, it is important to conduct an impact analysis which looks at management intent, product impact and business practices. Doing this helps to build a fuller picture of a company’s ability to deliver on the dual objectives of achieving positive social and environmental outcomes as well as strong financial performance. Likewise, having a long-term investment horizon builds rapport with management teams over time, making it easier to engage with them on matters such as impact and disclosures.

A BRIGHTER FUTURE

Impact investing in listed equities is a new and exciting area for those wishing to contribute their capital to shape a better world. Although there are many challenges ahead for this sector of the market, not least measuring impacts, the long-term benefits for companies, investors and society could be significant.
Lee Qian grew up in China during a period of incredible economic and social progress, when hundreds of millions of people were lifted out of poverty and the standard of living improved for the majority of the population. Witnessing that has influenced Lee deeply about the role of businesses in society.

Lee graduated BA (Hons) in Economics and Management from Oxford University in 2012 and joined Baillie Gifford in 2012.

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Sustainable Signals
Asset Owners Embrace Sustainability

Executive Summary

Sustainable investing has gone from a niche investment idea to attracting enough capital to start having an impact on global challenges at a meaningful scale. Globally, more than $22.8 trillion are invested sustainably, representing more than $1 in every $4 under professional management.¹ The intensity of recent growth has been driven by a fundamental shift in how investors and asset owners view environmental, social and governance (ESG) factors.

In this paper, we discuss the results of a recent survey conducted by the Morgan Stanley Institute for Sustainable Investing and Morgan Stanley Investment Management. It reveals that among institutional asset owners, sustainable investing is increasingly pursued for its potential to manage risk and drive returns.

The survey polled 118 public and corporate pensions, endowments, foundations, sovereign wealth entities, insurance companies and other large asset owners worldwide and gathered insights about trends, motivations, challenges and implementation approaches in sustainable investing. By rounding out the sustainable investing landscape with the views of asset owners, this work builds on our previous Sustainable Signals studies focused on individual investors and asset managers.

Key Insights: Momentum and Shifting Perspectives

FIGURE 1
Three signs of momentum among asset owners

- 84% are pursuing or considering pursuing ESG integration in their investment process.
- 60% of those began doing so in the last four years.
- And 78% seek to align with the U.N. Sustainable Development Goals.

This material is developed by Morgan Stanley Investment Management and the Morgan Stanley Institute for Sustainable Investing.
Momentum: Sustainable Investing Has Arrived

Across asset classes, sustainable investing seems to have reached a tipping point. We find that sustainable investing has entered the mainstream and has overcome past inertia that may have associated the inclusion of ESG criteria with discounted returns.

We find that 84% of the asset owners surveyed are at least "actively considering" integrating ESG criteria into their investment process, with nearly half already integrating it across all their investment decisions. While respondents see public equities and real assets as the sectors with the most attractive sustainable investing opportunities, the interest in sustainable investing holds across asset classes, including fixed income and private equity. Only hedge funds were viewed as attractive by fewer than half of respondents.

Compared to the investment universe as a whole, more than one quarter of the world’s professionally managed assets—roughly $22.9 trillion—now have some sort of sustainable investing mandate, with about $8.7 trillion of that in the United States, $12 trillion in Europe and the rest shared by other regions. The steady climb we have seen for two decades has accelerated over the past few years; sustainable investing assets are growing at a compound annual growth rate of 11.9%. According to our survey, 60% of asset owners integrating ESG into their investment process have only begun doing so within the last four years and 37% within the last two.

Still, there is significant room to grow. The responses of asset owners to our survey reveal a gap between interest and implementation. While more than one-quarter of professionally managed assets now have a sustainability mandate, more than three-quarters of institutional asset owners feel they have a responsibility to address sustainability through their investments. Among our respondents, 77% agree they have this responsibility, with 44% agreeing strongly.

Most Asset Owners Have at Least Considered ESG Integration

FIGURE 2
Does your organization seek to integrate sustainable investing or environmental, social and/or governance (ESG) criteria into the investment process, including selection of third-party investment managers? (n = 118)

In this survey, we defined sustainable investing as the practice of making investments in companies or funds that aim to achieve market-rate financial returns while considering positive social and/or environmental impact. Environmental, social and governance (ESG) refers to the range of factors that are considered by sustainable investors.
Opportunities Exist Across All Asset Classes

FIGURE 3
In your experience, in which sectors has your organization been able to find quality sustainable investing strategies/managers? (n = 74)

- **Public Equities**: 65% Yes, 20% Sometimes
- **Real Assets***: 50% Yes, 34% Sometimes
- **Fixed Income**: 37% Yes, 37% Sometimes
- **Private Equity**: 36% Yes, 26% Sometimes
- **Hedge Funds**: 7% Yes, 24% Sometimes

* Including Real Estate

Most Asset Owners Have Been Integrating ESG for Less Than Four Years

FIGURE 4
How long has sustainable investing or ESG criteria been integrated into your investment process? (n = 83)

- 5+ years: 40%
- 3-4 years: 23%
- 1-2 years: 25%
- <1 year: 12%

Asset Owners Feel They Have a Responsibility to Address Sustainability

FIGURE 5
To what extent do you agree or disagree with the following statement: “Asset owners have a responsibility to address global sustainability issues through their investments” (n = 116)

- 77% Agree
- 44% Agree strongly
- 33% Agree somewhat
- 10% Neither agree nor disagree
- 7% Disagree somewhat
- 6% Disagree strongly
Motivations and Challenges: Investing First

We believe the recent momentum in sustainable investing is the result of a convergence of several trends, but the relative importance of risk management and return potential among asset owners’ top motivations is an important signal of sophistication and changing perceptions of sustainable investing.

Motivated by Risk and Returns
Sustainable investing has enabled investors to think more systematically about risks of unexpected, costly issues arising from ESG factors that can hurt long-run returns. Incorporating these criteria as a value-added part of the investment process provides an element of downside protection; fully 78% of respondents listed risk management as an important factor driving their adoption of sustainable investing.

Indicating a sense of optimism about sustainable investing, 77% of respondents also focused on generating returns. The benefits of sustainable investing may accrue through positive corporate reputation, reduced operating costs, new market opportunities or ethical management practices. Moreover, consumer trends point toward greater returns for sustainable companies. Nearly nine in 10 (87%) U.S. consumers say they will purchase a product because of a company’s stance on an issue they care about, and 78% say they want companies to address important social issues. Among millennials, this is even more pronounced. Our 2017 survey of individual investors found that millennials are more than twice as likely as other generations to purchase products from companies they view as sustainable.

Risk and Returns Lead as Drivers of Sustainable Investing

FIGURE 6
How important are each of the following factors in driving sustainable investing adoption at your organization? (n = 94)

<table>
<thead>
<tr>
<th>Factor</th>
<th>Extremely important</th>
<th>Somewhat important</th>
<th>Neither important nor unimportant</th>
<th>Somewhat unimportant</th>
<th>Extremely unimportant</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk management</td>
<td>33%</td>
<td>45%</td>
<td>78%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return potential</td>
<td>35%</td>
<td>42%</td>
<td>77%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mission alignment</td>
<td>34%</td>
<td>43%</td>
<td>77%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Evolving policy/regulations</td>
<td>25%</td>
<td>51%</td>
<td>76%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constituent/stakeholder demand</td>
<td>35%</td>
<td>39%</td>
<td>74%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Senior management directive</td>
<td>32%</td>
<td>35%</td>
<td>67%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Activities of peer organizations</td>
<td>14%</td>
<td>52%</td>
<td>66%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Mission alignment rounded out the top three drivers of sustainable investing adoption (77%). In an era of big data and transparency, mission-aligned asset owners are better able to understand and tailor what they own—whether in the form of equity, bonds, real estate or any other asset class—in a way that genuinely reflects their mission statements.

Proof in the Performance
The presence of risk and return among the primary drivers for institutional asset owners is interesting in light of our individual investor survey which showed that a majority (57%) continued to believe that investing sustainably requires a financial trade-off. While this perception may have grown out of early views of ESG as a negative screen that narrows the investment universe, it appears that large institutional asset owners may be replacing this view with a more sophisticated recognition that ESG factors provide unique insights into long-term risks and opportunities that might not be captured by traditional financial factors. The belief in a trade-off appears to be fading.

Nevertheless, proof of market-rate financial performance remains a challenge to be addressed by the market. Twenty-four percent of survey respondents listed this as their top challenge to adopting sustainable investing.

Fewer Than Half Feel They Have Adequate Tools to Assess Sustainable Investments
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Nevertheless, proof of market-rate financial performance remains a challenge to be addressed by the market. Twenty-four percent of survey respondents listed this as their top challenge to adopting sustainable investing.
Asset Owners Want to Learn More About Sustainable Investing Approaches

FIGURE 9
Which of the following topics, if any, would you like to learn more about? (n = 107)

<table>
<thead>
<tr>
<th>Topic</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>ESG integration</td>
<td>62%</td>
</tr>
<tr>
<td>Impact investment</td>
<td>53%</td>
</tr>
<tr>
<td>Thematic investing</td>
<td>51%</td>
</tr>
<tr>
<td>Shareholder engagement</td>
<td>25%</td>
</tr>
<tr>
<td>Restriction screening</td>
<td>18%</td>
</tr>
</tbody>
</table>

The Need for Tools

Increased adoption of sustainable investing practices ultimately depends on being able to identify clear benefits for investors. As with any investment process, it is important to have meaningful data and the right tools. Among the top challenges cited by asset owners are the availability of quality sustainability data (23%) and lack of knowledge about sustainable investing (16%). When the top three-ranked challenges are aggregated, the availability of quality ESG data stands out, with 68% listing it as one of their biggest challenges. Three out of the top four challenges address some form of informational inadequacy—evidence, data and knowledge.

When asked specifically about tools used to inform sustainable investing strategies, only 42% of respondents indicated that they felt they had access to adequate tools to assess the alignment of investments with sustainability goals. Among them, they rely most heavily on in-house research (75%) to support those investments, with third-party specialty research following close behind (73%). In short, those respondents who are satisfied by the information available to them have either built the capabilities themselves or turned to specialists over mainstream investment information.

On the other hand, those not satisfied with ESG tools felt that reliable third-party data would be most helpful for assessing alignment of investments with sustainability goals, with 67% looking for mainstream third-party data providers; 57% looking for specialist third-party research; and 57% looking for third-party ratings, rankings and indexes. Only 35% felt that developing in-house research would be most helpful for their organizations.

The lack of reliable data is a real challenge for asset owners but within that challenge lies opportunity for asset managers and third-party data providers. With better tools, information and training, interest in sustainable investing is poised for continued growth. In fact, although 16% of investors described a lack of knowledge as their biggest challenge to adopting ESG by and large, they expressed interest in learning more about sustainable investing approaches. Eighty-four percent of survey respondents want to learn more about at least one approach to sustainable investing.
Implementation: Sustainable Investing in Action

The increased integration of sustainability and ESG criteria into the overall investment process among global asset owners has been accompanied by an increase in the sophistication of approaches. Over 80% of institutions integrating sustainability criteria rely on request for proposal (RFP) processes and Investment Policy Statements to ensure alignment and commitment to sustainability objectives. But there is no single “right way” to engage in sustainable investing.

Accordingly, asset owners employ a full spectrum of approaches. As they become more sophisticated about sustainable investing, asset owners are using multiple approaches and overlapping strategies to design solutions that meet their specific objectives and constraints.

ESG Integration
ESG integration—proactively considering ESG criteria alongside financial analysis—emerged as the most common approach, with nearly all asset owners who are engaged in sustainable investing using it at least opportunistically as part of their mix of approaches. More than half are required to do so by their Investment Policy Statement. This is in line with the role of risk and return as important drivers of the move toward sustainable investing, since integration tends to be focused on identifying long-term risks and capturing opportunities arising from sustainability trends. While ESG integration is practiced quite widely by the asset owners we surveyed, they still expressed a strong desire to learn more (62%).

Restriction Screening
Restriction screening, employed by 85% of respondents, intentionally avoids investments generating revenue from objectionable activities, sectors or geographies. Such strategies can provide downside protection and risk-mitigation benefits depending on the nature of the screen. If restriction screens lead to avoiding company-specific risk, they can play a positive role in maximizing risk-adjusted returns. However, the leading screens in our survey—for things like firearms, tobacco and pornography—seemed to be more tailored toward values-alignment goals.

Thematic Investing
Thematic investment strategies, used by 81% of respondents, focus on themes and sectors dedicated to specific ESG issues. The more material the issue is to the valuation of each company, the more impactful the approach is likely to be on financial returns. The top thematic investments in our survey were those addressing climate change adaptation and mitigation, with 44% of respondents already seeking to address...
it or considering doing so. This may in part reflect the size of the asset owners we surveyed, given that large institutional investors tend to have highly diversified portfolios that are exposed to not only ESG risks from individual companies but also disruptions that span the entire economy, such as those likely to be caused by climate change and a transition to low-carbon energy sources.

**Shareholder Engagement**

Direct shareholder engagement on ESG issues, an approach used by 80% of respondents, gives investors additional opportunities to reduce risk and drive change in the direction they want, even within companies that may start off with poor ESG performance, but can potentially improve over time.¹⁰

To get the full benefit of these implementation approaches, particularly in light of the challenges identified by asset owners in accessing adequate tools and data, manager selection matters. Whereas restriction screens can be achieved with a passive portfolio, approaches like direct engagement may require a manager that is active, able to engage company management and takes a structured approach to sustainable investing.

**The Most Common Exclusionary Screens Focus on Values Alignment**

*FIGURE 12*  
When employing Exclusionary/Negative/Values-Based Screening, which of the following screens does your organization seek to apply? (n = 63)

<table>
<thead>
<tr>
<th>Screen</th>
<th>Required by Investment Policy Statement</th>
<th>Wherever possible across portfolio</th>
<th>Opportunistically</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weapons (Firearms)</td>
<td>63%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tobacco</td>
<td>57%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pornography</td>
<td>49%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Coal*</td>
<td>46%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gambling</td>
<td>41%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Note: Only 21% of respondents seek to apply a screen for Fossil Fuels broadly*
Impact Investment
Impact investing, the practice of allocating investments to enterprises or funds structured to deliver specific social or environmental impacts, was used by 72% of respondents, and was least likely to be required in investment policy statements (8%). The opportunistic nature of impact investing approaches is perhaps unsurprising given the bespoke nature of such strategies and potentially more limited availability of investment products. Nevertheless, more than half of all respondents (53%) expressed an interest in learning more about impact investing practices.

A New Framework for Sustainability
The United Nations Sustainable Development Goals (SDGs) are increasingly gaining traction as an organizing framework for many global asset owners, particularly those looking for a thematic investment approach. The SDGs are a set of 17 global goals focused on sustainable-development themes ranging from poverty, equality, education, climate change, infrastructure, land and water, and production/consumption, with a target date of 2030. Among asset owners in our survey, 78% of institutions integrating or considering sustainable investing are also at least considering an alignment with the SDGs as part of their investment strategy. Within the context of thematic investing, the SDGs are both a framework for thinking about and pursuing impact.

The Sustainable Development Goals Are Gaining Traction with Asset Owners
FIGURE 14
Does your organization seek to address or align with any of the U.N. Sustainable Development Goals (SDGs) as part of its investment strategy? (n = 93)

- Addressing SDGs: 78%
- Under consideration: 45%
- No: 33%
- Not sure: 14%
- Under consideration: 8%

* Climate Change: Investment seeking to adapt to and mitigate the effects of a changing climate and/or enable transition to lower carbon economy
** Inclusive Growth: Investments seeking to deliver economic growth and employment opportunities capable of lifting people out of poverty and promoting human rights
*** Gender Diversity: Investments that consider a commitment to gender diversity and/or that promote gender equality through their products or services
A Call to Asset Managers

A strong majority of asset owners surveyed believe third-party managers have an opportunity to support sustainable investing through a variety of mechanisms—providing reporting on ESG performance (78%), providing education about ESG investment approaches (73%) and writing investment policy statements incorporating ESG criteria (64%). And 43% of asset owners integrating or considering sustainability/ESG criteria can envision a time when allocations will be limited to managers with a formal approach to sustainable investing. Most (75%) anticipate this shift happening within the next two years.

While the accelerating interest in sustainable investing presents a clear business opportunity for managers, only half of the asset owners we surveyed are satisfied with the response of third-party investment managers to ESG and sustainable investing. At the same time, 50% identify the supply of quality managers as a “top three” challenge. This low level of satisfaction among asset owners should serve as a call to action.

Sustainable investing has benefited from an increase in investor sophistication, with implementation approaches that span the full spectrum from restriction screens to specific proactive engagement. But the rapid entry of new asset managers attracted to this product opportunity may not have kept up with the needs of asset owners. In a previous survey of asset managers, we found that among those not currently engaged in sustainable investing, a majority said they planned to implement such approaches in the next 12 months. This wave of new entrants lacking experience can potentially create a wide disparity in quality, and may explain some of the lower reported satisfaction. In our view, this further underscores the need that asset owners identified for better tools, information and education on sustainable investing.

Given the new momentum in sustainable investing and the resulting growth of product opportunities, it is more important than ever for investors to seek out managers with a clear and well-documented approach to sustainable investing. Asset owners evaluate managers based on firm-level and product-level policies, along with communication and reputation. Beyond offering investment products and helping with reporting, education and implementation, active third-party investment managers have an opportunity to help customize and align portfolios with owners’ unique objectives.

Asset Owners Are Looking to Third-Party Managers for Information and Advice

FIGURE 15
To what extent do you agree or disagree with the following statements: “Third-Party Investment Managers can play a role in helping my organization by...” (n = 116)

<table>
<thead>
<tr>
<th>Statement</th>
<th>Strongly Agree (%)</th>
<th>Somewhat Agree (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Providing relevant portfolio reporting on sustainability and ESG performance</td>
<td>27%</td>
<td>51%</td>
</tr>
<tr>
<td>Providing education on ESG/sustainable investing approaches, issues and trends</td>
<td>23%</td>
<td>50%</td>
</tr>
<tr>
<td>Helping to write an appropriate IPS incorporating ESG or sustainable investing criteria</td>
<td>21%</td>
<td>43%</td>
</tr>
</tbody>
</table>

There is Room for Third-Party Managers to Improve

FIGURE 16
To what extent do you agree or disagree with the following statement: “My organization is satisfied with the response of Third-Party Investment Managers to ESG and sustainable investing” (n = 116)

<table>
<thead>
<tr>
<th>Satisfaction Level</th>
<th>Strongly Agree (%)</th>
<th>Somewhat Agree (%)</th>
<th>Neither Agree nor Disagree (%)</th>
<th>Disagree Somewhat (%)</th>
<th>Disagree Strongly (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>50% Satisfied</td>
<td>5%</td>
<td>45%</td>
<td>36%</td>
<td>11%</td>
<td>2%</td>
</tr>
</tbody>
</table>
Conclusion: Acceleration and Adoption

Our survey of asset owners brought to light a meaningful market shift, shedding light on the drivers of recent momentum in sustainable investing. Not only do more than three-quarters of asset owners now agree that they have a responsibility to address global sustainability through their investments, but they also list risk and return as driving forces behind their adoption of sustainability.

The perception of a trade-off between good ESG practices and financial performance is being replaced by an understanding of how environmental, social and governance issues can contribute to higher potential returns and mitigate risk. Fueled by a convergence of long-term performance considerations with trends like mission alignment, regulations and stakeholder demand, interest in sustainable investing has both accelerated and evolved.

As asset owners continue to integrate sustainable investing into their overall investment process, and third-party managers improve the tools for measuring both impact and performance, we expect many more opportunities to open up for those managers who are able to build the products, relationships and trust that can help investors generate strong risk-adjusted returns while having a positive impact on the world.

Survey Methodology

This paper is based on an online survey about sustainable investing conducted by Greenwald & Associates on behalf of the Morgan Stanley Institute for Sustainable Investing and Morgan Stanley Investment Management. Survey responses were collected from November 3, 2017, to December 19, 2017. Conducted in English and Mandarin Chinese, the survey was completed by 118 large global institutions, including public and private pension funds, endowments, financial institutions, insurance companies, sovereign wealth funds and other large asset owners. Of those who completed the survey, 60% had total assets of over $10 billion. The most common job functions of the individuals who answered the survey on behalf of their organization were portfolio managers, chief investment officers and sustainability officers. Survey results have been weighted to adjust for differential response rates by region. The margin of error at the 90% confidence level for the global sample is +/-7.3%.

<table>
<thead>
<tr>
<th></th>
<th>GLOBAL</th>
<th>NORTH AMERICA</th>
<th>EUROPE</th>
<th>ASIA/PACIFIC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Completes</td>
<td>118</td>
<td>20</td>
<td>67</td>
<td>31</td>
</tr>
</tbody>
</table>
Notes

1 “2016 Global Sustainable Investment Review,” Global Sustainable Investment Alliance, 2017
5 “ESG Risks and the Cross-Section of Stock Returns,” Gloßner, Simon, 2017
6 “2017 Cone Communications CSR Study,” Cone Communications, 2017
7 “Sustainable Signals: New Data from the Individual Investor,” Morgan Stanley Institute for Sustainable Investing, August 2017
8 “Sustainable Signals: New Data from the Individual Investor,” Morgan Stanley Institute for Sustainable Investing, August 2017
10 “ESG Shareholder Engagement and Downside Risk,” Hoepner, Andreas, Ioannis Oikonomou, Zacharias Sautner, Laura Starks and Xiaoyan Zhou, February, 2018

Disclosures

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The returns on a portfolio consisting primarily of Environmental, Social and Governance (“ESG”) aware investments may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria.

For more information on Morgan Stanley Investment Management, visit www.morganstanley.com/im

For more information on Morgan Stanley Institute for Sustainable Investing, visit www.morganstanley.com/sustainableinvesting

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Morgan Stanley 85
A growing body of compelling investment research suggests a positive correlation between the presence of women on corporate boards and/or in senior management and superior corporate performance. Some of the findings in the studies are particularly striking:

- From 2010 to 2016, companies with at least one female board director generated an excess return on equity of 3.5% per annum according to Credit Suisse.1
- MSCI reported in 2015 that companies in the MSCI World Index with strong female leadership generated a return on equity of 10.1% per year vs. 7.4% for those without.2
- MSCI research on US companies over the five-year period of 2011–2016 found that those that began the period with at least three women on the board experienced median gains in Return on Equity (ROE) of 10% and Earnings Per Share (EPS) of 37% — while companies that began the period with no female directors experienced median changes of -1% in ROE and -8% in EPS.3
- According to a January 2017 report by The Conference Board, companies with boards that comprise women had significantly lower incidence of corporate fraud, corruption and governance issues than those that do not. The report suggests that the reason for this is the outside perspectives brought into the boardroom by adding women to the board.4

Every asset manager has their own distinct approach toward investment management and brings their own values to bear on how they influence the companies in their portfolio. At State Street Global Advisors, we’ve sought to take an aggressive stance on Environmental, Social, and Governance (ESG) issues including diversity and talent development, board composition and governance and climate change because they may represent both the greatest risks to capital investment and the greatest opportunities for long-term value creation.

As one of the largest asset managers in the world, with $2.78 trillion in assets under management as of December 31, 2017, our Asset Stewardship and ESG framework seeks to leverage our size, global scale and investments in companies, to actively engage with such companies to promote the long-term value of our clients’ investments. In every engagement, we look at board composition to assess a company’s probable long-term performance, irrespective of sector, market cap or geography.9

Board quality, in our experience, is a pre-condition of long-term profitability. Good boards — effective, independent of management and diverse — make good long-term decisions and take fewer unnecessary risks. And, at a time of short-termism that’s unlikely to change anytime soon, boards are the brakes that prevent management from making hasty short-term decisions with negative long-term impacts simply to meet or beat capital markets’ quarterly expectations.9

In the first quarter of 2017, State Street Global Advisors called on the more than 3,500 companies it invests in on behalf of its clients, to take concrete steps to increase gender diversity on their boards and directly engaged with 476 companies who did not have any women on their boards.
When, 400 of these companies didn’t take any action to increase their gender diversity, we used our proxy voting power to effect change by voting against the reelection of the chair or most senior member of the Nominating and Governance committee at those companies. Of the remaining 76 companies, 34 didn’t have members of the Nominating and Governance committees up for reelection, and the remaining 42 had productive conversations with us on how they plan to rectify the issue.

The Implications for Investors of Low Female Board Composition

Research into gender differences show that men and women have different risk tolerances, weigh criteria differently when making decisions and define whether an investment is successful using very different measures — all of which helps to create a healthy system of checks and balances on boards that comprise both genders. Research suggests that the inclusion of female board members also signals the sincerity of corporations’ commitment to increase gender diversity throughout the entire organization and provide career progression for women.10

The factors impeding equal representation of women on corporate boards and in senior management are manifold and institutionally entrenched. The assumptions and biases — both conscious and unconscious — about women’s work choices, strengths and preferences were shaped in a very different era, when women had few options for childcare and much lower levels of educational attainment than men, placing career trajectories beyond their reach. Many accepted support roles and chose jobs in lower-paying fields that would allow them to get out the door in time to get to their second job: parent.

As evidenced by study after study, many companies have failed to address these behavioral biases in their culture, especially around pay and promotion gaps and hiring practices. Furthermore, many human resources policies still do not adequately accommodate the needs of women, who shoulder a disproportionate share of childbearing duties. And their salaries, which still lag men by 20 cents on the dollar, often place women with families in the unenviable position of having to weigh the costs of childcare to calculate if they can afford to work. This holds especially true early on in the formative years of their careers.

According to a recent joint study from Lean In and McKinsey & Co., the promotion gap starts early in their careers — when, for every 100 women given their first promotion, 130 men are given theirs — a pattern that replicates itself at every point in their careers, when they are 15% more likely to be passed over by a man. The result? Women in the US comprised a scant 17% percent of the executive suite, from which board membership is often culled.14

In addition to board nomination processes, which haven’t been suitably broadened to factor in the experience and expertise of women, board tenure is also an issue when many board members’ tenure is longer than that of the CEO. Simply put, boards that don’t turnover can’t diversify their ranks and apply new, relevant and fresh insight that may improve performance over the long haul. This matters: boards should be accountable to shareholders, not management.

The Rise of the Gender Lens Investor — and its Intended Impact

A new breed of impact investors, often referred to as Gender Lens Investors (GLIs), aims to redress this imbalance, drive companies to deploy corporate policies and initiatives that solve for workplace inequities and demonstrably improve the lives of women while simultaneously enhancing shareholder returns.

GLIs could prove critical in creating a level playing field for the workplace of the future. Entrenched mindsets and biases can take decades to change — and they change most when the people who hold them come to understand how inaccurate they are experientially. If the efforts of GLIs are successful, companies a decade from now will have experienced measurable, improved operational performance and higher earnings. Old biases will be replaced with new truths. To apply an old but relevant chestnut, many men become feminists upon the birth of a daughter. Companies will place a higher value on women’s contributions if they see increased positive performance as a result of increased female leadership.

In the Fall 2014 Stanford Social Innovation Review on “The Rise of Gender Capitalism,” Sarah Kaplan and Jackie VanderBrug have defined gender lens investing as “the use of capital to deliver financial returns and improve the lives of women and girls and their communities.” And Criterion Institute, an activist think tank, provides an excellent summation of the “gender lenses” through which investors can determine how to invest their capital.16

- Increasing access to capital for women This means not only access to equity, loans, and financial training, but also consideration of larger structural barriers to access such as land ownership, power dynamics between women borrowers and male bankers and loan officers, and even implicit societal biases.
Investors Steering into the Gender Gap

• **Workplace equity** This includes increasing the number of women on boards and in senior leadership positions to alter the gender landscape at the top, as well as policies that benefit women more broadly, such as wage equity and paid maternity leave. This category also applies to issues of supply chain management, in jobs where women tend to hold the lowest paying, most vulnerable, and sometimes most dangerous positions.

• **Products and services that benefit women** This encompasses a wide range of business models selling products that range from reproductive/maternal health innovations to daycare services, from water wheels to money management training. In general, investments revealed through this lens respond to a need, whether biologically or socially driven, that is particularly unique to female consumers.

It’s important to note that the use of the term gender rather than female to describe this investment approach is purposeful. The positive impact of improving the lives and future prospects of women and girls through greater access to education, capital, equal pay, and quality healthcare extend to all society. The McKinsey Global Institute estimates that in a “full potential” scenario in which women play an identical role in labor markets to that of men, as much as $28 trillion, or 26%, could be added to global annual GDP by 2025.17

The universe of GLIs includes individual investors, mandate-driven investment managers including early stage venture capital firms, private equity funds, investors in social impact bonds, pooled funds and philanthropic foundations — many of which have extensive experience in sustainability-driven investing.

**Inclusive Economic Practices May Lead to Increased Prosperity for All**

The extent of work that has yet to be done to achieve gender equality and accurately express women’s contributions to society is formidable. As with all groups that face disparities, true equality is most likely to be achieved through financial equality. Companies should be forces for positive change — and investors must hold them accountable for achieving it.

Gender Lens Investors have acquired considerable influence and expressed their collective voice with millions in invested capital in just the public equity space alone in just a few short years, and if the investor class continues to grow at its current rate, the effect on driving corporate change could be staggering in the decades ahead.

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1 Credit Suisse Research Institute, The CS Gender 300: The Reward for Change. September 2016. Credit Suisse’s study covered close to 3400 companies worldwide.
2 MSCI, Women on Boards: Global Trends in Gender Diversity. November 2015. A company is considered to have strong female leadership if the company’s board has three or more women or if it’s percentage of women on the board is above it’s country average.
15 Spencer Stuart, Spencer Stuart Board Index: A Perspective on U.S. Boards, 2016.
16 Criterion Institute, The State of the Field of Gender Investing. October 2015.
About Us

For four decades, State Street Global Advisors has served the world’s governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world’s third largest asset manager with nearly US $2.73 trillion* under our care.

* AUM reflects approx. US$36B (as of March 31, 2018) with respect to which State Street Global Advisors Funds Distributors, LLC serves as marketing agent; SSGA FD, LLC and State Street Global Advisors are affiliated.

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The cornerstone of our business is helping advisors succeed. We are inspired to make a difference by delivering a comprehensive practice management platform offering actionable insights and consultative solutions.

Our programs are grounded in proprietary research and leverage the latest thinking and trends from both industry and academia. We offer a diverse range of capabilities that address forces shaping the investment landscape; best practices to drive results and optimize your business; conversation starters to guide and engage with clients; and continuing education to hone techniques and accentuate your value.
HOW LEADING-EDGE TECHNOLOGIES WILL IMPACT ADVICE AND SOLUTIONS

*a look ahead at how Artificial Intelligence, machine learning, predictive analytics, and blockchain may transform the advice business*
RISE OF THE NEW WEALTH PLATFORM

How collaboration will drive innovative wealth platforms
The wealth management landscape is transforming—driven by the modern investor who insists on a new experience. An investor who requires humans and technology to work together, seamlessly.

What does this landscape look like? Human and digital-led advice, delivered via a hybrid model. Evolving channels and products—the entire scenario increasingly powered by data-driven intelligence.

Delivering this transformed client experience requires a new platform; one that is flexible enough to support a spectrum of advice.

Contrary to the past, today’s wealth firms must rely on a bevy of tech-savvy ecosystem partners. They cannot be differentiated solely through internal technology and custodial relationships with wealthtechs. The firms who are "in it to win it" are already focused on retaining critical differentiation, while orchestrating a broader set of wealthtech partners.

Tomorrow’s leaders will rely on partnerships to help them continuously innovate. This innovation will deliver differentiated, personalized client service on demand.

This is the new wealth platform.
FIRMS MOVE FROM INSULAR TO INVOLVED

Traditionally, wealth firms have kept things simple—serving clients with a dedicated advisor-led proposition, stable products, and technology that evolved incrementally.

That scenario no longer spells success due to the industry’s structural shifts. With changing demographics, evolving investor behaviors and new industry economics, wealth management companies now need to transform the client experience in a digitally scalable way. To differentiate a successful hybrid proposition, innovation driven from the wealthtech ecosystem is an essential part of the mix.

Wealth firms cannot transform alone. The pace at which they launch and evolve platforms—along with the new technology capabilities necessary to innovate—compel some degree of partnership. This is true in many industries, and is reflected in the rise of partnerships. More than one-third of firms are working with double (or more) partners than they were just one year ago.¹

For years, the fintech market has disrupted traditional financial services companies through unbundling and differentiating across the value chain. Now, the wealth management sector is using that disruption to its advantage. A survey of U.K. financial services providers found that 87 percent cut costs by partnering with fintechs, while 54 percent increased revenue.² Within the fintech sector, wealthtech has been a recent growth area—representing $655M in 2016 investment³—on pace to grow up to 25 percent over 100 deals in 2017.⁴
FOUR KEY AREAS OF FOCUS

Our experience shows the wealth platform of the future will be defined by four major areas of investment: Engagement with wealthtech providers, applied intelligence, new lightweight architectures, and operationalizing ongoing innovation.

How do you cut through the noise to drive relevant differentiation? While the right partner can become a critical source of innovation, many wealth management firms have struggled to navigate the landscape efficiently. Despite this struggle, many firms have begun their journeys. Those not already underway might find themselves behind the curve. For example, J.P. Morgan has hired and taken a stake in InvestCloud, a software company that makes online transactions easier for customers. The asset manager—BlackRock—has acquired FutureAdvisor to partly help it make a dent in the 401k market. And the Americas wealth unit of UBS is partnering with online financial advisor SigFig Wealth Management to develop technology and investment tools for the Swiss bank. As your firm seeks the right ecosystem partners, it is important to engage an experienced expert to de-clutter the landscape—identifying which providers would best serve your needs. We are working with numerous clients to do just that.

Advice propositions requiring increased personalization and diverse interaction mean wealth managers must not only find a way to better capture data, but also drive deeper insight to target client desires at scale. Nearly 80 percent of respondents to a recent Accenture study estimate that 50-90 percent of their data is unstructured. Structuring data is the first step to leveraging applied intelligence in your value proposition. By using analytics, machine learning and artificial intelligence in a potent mix, companies could unlock the trapped value of their data, and drive new growth. Leading firms recognize this potential and are already making meaningful investments. Capital market firms’ AI spending from 2016 through 2021 is expected to rise by 50 percent, reaching $57.6B by 2021.
Monolithic technology cores—clearing platforms or custodian partners—are still the foundation of most wealth architectures. However, what once spelled power now imposes constraint. Wealth firms are executing a “digital decoupling” to provide the agility they need. Riding the wave initiated in digital banking, these firms are abstracting the core back office—employing lightweight architectures driven by application programming interfaces (APIs) and microservices. Doing so increases their development speed to market, whilst freeing their core systems to execute clearing and custody at scale.

Microservices are not a type of technology, but rather an approach to IT architecture. By using a suite of tools like APIs, containers and cloud, microservices break applications into simple, discrete services.

APIs are at the heart of technology-based partnerships, which is why microservices are so critical to any business looking to build partnerships at scale. APIs are the pathways by which businesses make services and data available to partners. APIs are built down to the level of individual services. The result is a library of APIs—mapped to specific services, covering every part of each application—all of which can be made easily available to potential partners.

Leading companies have already jumped ahead with microservices transformations, starting the clock for those that hope to keep up. Notable digital-born companies, such as Google and Netflix, are pioneers—every Google search calls more than 70 microservices to generate results—but they’re increasingly joined by other industry leaders like Comcast and Capital One. In fact, 95 percent of IT executives we surveyed report that their organization’s use of microservices will increase over the next year.

Source: Accenture 2018 Technology Vision
The future wealth platform

The future wealth platform requires a set of capabilities to come together and deliver personalized client service and experience.

DIFFERENTIATED HYBRID ADVICE EXPERIENCE

Powered by wealthtech providers

- Robo advice
- Partially assisted
- Virtual advisor
- Dedicated advisor

Data driven intelligence

- Data foundation
- Rich client profile
- Analytics
- Insight delivery

Lightweight architecture

CORE RECORDKEEPING

- Clearing & custody
- Trust & other record keepers

Operationalized by ongoing innovation

Source: Accenture
THE BIG PICTURE

Reengineering for the client

By investing in these four areas, wealth managers are reengineering to create the differentiated advice and experience that clients demand. Gone are the days when stability and operational efficiency alone could drive technology investment. Executives now rank designing a comprehensive customer engagement strategy—one that addresses both digital and physical channels—as the top contributor to operational agility.10

Today’s investor desires a holistic financial engagement. The investments and partnerships that established firms will create in the digital realm will hopefully meet this desire. Digital decoupling from crippling legacy systems is the top requirement of a true digital competitor.

FIRST STEPS

As incumbents transform their own wealth platforms, many will likely stall due to the sheer size of the undertaking. Focusing on delivering value over multiple waves of change throughout your journey, will minimizing the impact to your core business. As Accenture helps wealth management firms around the globe create their new platform, we see several crucial first steps to ensure you are truly transformative.

Thoroughly understand and engage the ecosystem. Understand the breadth and depth of the ecosystem specific to your needs. Know the capabilities unique to you, and narrow your provider list. Focus on enterprise-ready players that can go to market with you effectively, and partner with leadership teams that will continue to drive innovation.

Focus on three key areas of investment. Invest in ecosystem leaders who differentiate in customer experience, data and analytics, and emerging technology. Own your customer experience. Retain control through the functions you do well. Invest in partners who will drive innovation and scale for your needs.

Balance flexibility with scalability and sustainability. While aiming for the flexibility inherent in a startup, ensure you do not sacrifice scalability or sustainability. In a constantly shifting digital world that has redefined what it means to be “long-term”, you should be planning for the indelible future of your organization.

The new era of wealth management is all about partnership—not only with clients, but an entire ecosystem of digital providers. Both are key to providing the personalized service investors now demand.
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THE IMPACT OF ARTIFICIAL INTELLIGENCE ON THE ROLE OF THE FUNDAMENTAL ANALYST

MARCH 2018
INTRODUCTION

In 1809, man first faced a machine across the black and white battleground of the chess board when Baron Wolfgang von Kempelen hoodwinked Napoleon with a magical chess-playing robot. It turned out to be a short man hidden behind a trick door. Fast forward to 1997 and a real machine, IBM’s Deep Blue, beat the then World Chess Master, Gary Kasparov.

For many years, chess was seen as a key milestone for software developers in the search for artificial intelligence (AI) because it is a game that requires strategy, foresight and logic — qualities that form the bedrock of human intelligence. With Kasparov’s defeat came new horizons for computer programmers to test their creations against, with the ancient Chinese game Go and poker having been conquered by early 2017.

So why not turn IT genius to the game of picking stocks? In reality, the world of software development already has and according to reports, 40% of all hedge funds launched in 2015 used AI for investment decision-making. The question is, does this mean machines replace fundamental stock pickers going forward, and how does this change the world for investors today?
Before we explore this in more detail, it is worth taking a moment to frame what people mean by the much-used term, AI. Arend Hintze, responsible for research into creating AI at Michigan State University, defines four levels of AI:

1. **Narrow, reactive systems** — these can still be incredibly powerful; it was a narrow AI system that defeated Kasparov in 1997.

2. **Experiential AI, or machine learning** — this is what drives driverless cars.

3. **“Other-aware,”** where there is an understanding that others in the world have thoughts and emotions that affect their own behavior, and that each individual will have different thoughts, emotions and motives.

4. **“Self-aware,”** where a representation of the self can be formed, with the recognition of one’s own motives, strengths and weaknesses.

Although we have come closer than ever to “true AI,” as described in by the third and fourth points above, essentially all AI to date is from the first two categories, and simply uses varying degrees of classification of data — from fairly simple to deeply complex with multiple layers.
THE CASE FOR AI

The nature of AI today, although limited, is actually very well suited to the world we find ourselves in, because today’s AI works well when enormous amounts of data are available to classify. Particularly, the more data a system handles, the more able it is to recognize patterns and sort and classify more accurately. Studies have shown that increasing the volume of data improves the results of machine learning far more than trying to improve the algorithm the machines are using to learn.\(^3\)

Fortunately for AI, an ever-increasing volume of data is available: In 2013, IBM asserted that 90% of all available data had been created in the past two years,\(^4\) and IDC estimates that the volume of data will double every two years.\(^5\)

“Big Data,” as it is often referred to, challenges the ability of humans to process such vast volumes of information.

AI is also unemotional and, as such, should be able to reach more objective conclusions and avoid the pitfalls of hubris and behavioral biases to which all humans are predisposed.

Clearly, machines are more efficient than humans at managing and processing large volumes of data. With the data, they are able to identify patterns in the data and, in theory, exploit these patterns to earn returns. AI is also unemotional and, as such, should be able to reach more objective conclusions and avoid the pitfalls of hubris and behavioral biases to which all humans are predisposed. The “motives” of the system could also be considered purer than a human’s, with no personal financial gain conflicting with the desire for highest possible returns. In addition, machines do not need sleep or a break of any sort, facilitating around-the-clock market monitoring and analysis.
THE IMPACT OF ARTIFICIAL INTELLIGENCE ON THE ROLE OF THE FUNDAMENTAL ANALYST

Although the case for AI may seem solid, a number of arguments can be made against it.

The nature of AI today
The first and, arguably, the greatest challenge to the expectation of AI replacing fundamental stock pickers today is inherent in the very nature of AI. As already mentioned, all AI to date simply classifies data, but it cannot draw insights from the classification that could then be applied to data in another category. It cannot place the classifications into context, and, although it may recognize patterns, many of these patterns may be meaningless. 7

In addition, machines cannot understand human emotions and motives, and will therefore assume perfect logic. Related to this is the distinction between what have been described as small and large world problems. 8 So-called small world problems tend to be structured and, as such, have been the focus of much decision-making theory, and can be characterized by attributes such as:

- A well-defined task and goal
- A known set of choices and potential outcomes
- Highly replicable processes
- Known (or at the very least knowable) probability distributions associated with outcomes given any choice

In contrast, large world problems are more reflexive — that is, they depend on estimating the likely actions of other participants within the system who are themselves basing their actions on the likely actions of others. Such problems may also be characterized by time stress, shifting goals and multiple stakeholders with differing perspectives. Typically, this group of problems is characterized by:

- Ill-structured problems
- Deep uncertainty (unknown and sometimes unknowable probability distributions)
- Complex and dynamic environments
- Little replicability

As technology and algorithms improve, computers are becoming highly effective tools for tackling small world problems, as they are less subject to failures of probabilistic reasoning. However, computers are poorly suited to solving large world problems. This is a domain where humans seem to have a distinct advantage (at least for now).
Data
As we have already established, there is a staggering volume of data. However, the fact that much of the data has only recently been created and the need for millions of data points for machines to learn means that, perversely, there are not enough data points for any investor with a time horizon beyond a few days. In addition, investment data is not the same as data from one of the hard sciences — it is not based on absolutes, as can be found in the world of physics. Instead, the relationships within the data can and do change over time.

This leads to one of the key concerns raised by those skeptical of AI strategies — that any pattern in the data or anomaly in the market will be quickly arbitrated away as other strategies climb onto the same trade. Those in favor of AI strategies believe that by differentiating their algorithms, they can stay ahead of this risk, but research suggests that, at large volumes of data, there is little differentiation between algorithms.

As technology and algorithms improve, computers are becoming highly effective tools for tackling small world problems, as they are less subject to failures of probabilistic reasoning.
THE REAL IMPLICATIONS OF AI

It was widely reported that Google’s AlphaGo system beat the reigning Go world champion. However, what was not as publicly discussed is that, when matched against a mediocre player empowered by AlphaGo, the combination of man and machine was able to consistently beat the AlphaGo model playing on its own. Why? Because humans are incredibly intelligent and astute at picking up on data that doesn’t fit. And this is where there seems to be a sweet spot for the current status of AI: the combination of humans and machines.

To explore what might be a more realistic expectation for the role of AI, we turned to the investment management community to understand what it is doing about the rise of the machines. The managers we spoke to were, in aggregate, responsible for in excess of $11 trillion in assets under management. Although some managers are more active in AI than others, every fundamental manager we spoke to has, at the very least, allocated some manpower to consider this important evolution in the industry.

From these discussions, it becomes clear that AI can and should have a role to play in investing today. Overall, there are three categories into which this role can fall:

- **Part replacement**, where some human roles are replaced by machines. This would predominantly be in mundane and repetitive tasks, such as investment report writing, where much of the production work is repetitive and simply collates data into a single output.

- **Augmentation**, where machines enable humans to do a better job — this can be seen in the example of collecting data from the increasing number of sources and reshaping it so that it can be fed into spreadsheets and models, or even extended to providing some basic level of analysis.

- **Empowerment**, where human analysts would be able to do more with machines than they could have done without, such as monitoring their internal system usage to ensure that cyber security is being enforced.
Of the managers we spoke to, the vast majority were focusing on using AI to augment or complement their human analysts, each playing to their comparative strengths. The extent of this adoption depends on:

- **Culture of the business**: Being committed to such integration may be challenging; it is initially expensive and potentially prone to failure. In addition, fundamental teams may not be trusting of data in the same way that quantitative teams are. The commitment needs to come from every level of the organization and has the best chance of success if there is broad acceptance rather than a pocket of adopters.

- **Past success of the strategy**: The investment industry can be described as one that rewards success. Often, that success has been achieved from a specific approach, so it is the successful strategies/processes/individuals who will find it most of a challenge to change and incorporate new quantitative tools into their processes. Not only does a change in process potentially put at risk the success in the future of what has worked in the past, but “smart” people who have done well have to relinquish some of the glory and subordinate their “smartness” to a machine.

With new and unusual sources of data available and increasingly accessible, information might flow through to stock prices more quickly, perhaps reducing the level of market volatility.

The commitment needs to come from every level of the organization and has the best chance of success if there is broad acceptance rather than a pocket of adopters.

What might this mean for the investment industry? Building on the comments from managers, and with some creative license, we might suggest the following:

- With new and unusual sources of data available and increasingly accessible, information might flow through to stock prices more quickly, perhaps reducing the level of market volatility.

- The investment decision-making period might shrink as insights are reached more quickly, because analysts are provided with detailed analysis faster.

  - Might this mean that inefficiencies in the market are more quickly ironed out as teams act more quickly and, as a result, active management becomes even more of a challenge?

  - Although it may take less time to find the opportunities, the analytical requirements to shape the insights may shift. Teams may need to dig deeper to reach differentiated views, and there may be the need for a greater focus on discovering causation, building relationships, conceiving disruption and adjusting for it. In addition, secondary issues such as governance, employee well-being and relationships with third parties may become more important as distinguishing features not captured by models.
• Could the configuration of investment teams change?

  - We have already noted an increasing number of data scientists within traditionally fundamental teams — this is a trend that is likely to continue.

  - Could the size of the investment team shrink because fewer analysts are needed to do the “grunt work”?

  - Perhaps age diversity will become more important within the make-up of the team to ensure teams have sufficient input from younger generations, who will typically embrace technological changes more readily, as well as input from the older generations, who bring greater levels of experience and judgement.

• With possibly smaller teams and technology doing a large chunk of the initial work, might there be fee reductions for clients?

• The industry already has a bifurcation between systematic and non-systematic strategies. Might this increase further with the nonsystematic evolving to offer only unconstrained, judgmental, high active share strategies?

With a focus on areas that cannot be easily replicated by machines, extending analysis over a longer time horizon may be an “easy win” for humans over machines.

• Or might the bifurcation be more evident in time horizons? Because AI struggles to construct a reasonable representation of the more distant future, the further out the time horizon of the investor stretches, it can be expected that AI-driven strategies would be less useful. With a focus on areas that cannot be easily replicated by machines, extending analysis over a longer time horizon may be an “easy win” for humans over machines. Therefore, the active, fundamental strategies might take on an even longer-term perspective, creating a market that is characterized by systematic (AI-led) short-term strategies and nonsystematic (human-led) long-term strategies.
What should investors be doing about the increasing trend toward AI? Although it might not be time to rush out to replace your fundamental portfolio manager or analyst with a machine, there are some questions we can ask to gauge asset manager readiness and response to this evolution in the industry:

- **What actions are you taking?**
  What are you doing to incorporate AI to empower your analysts? To what extent are you being selective in the data sources or thinking about the uses of their output and the consensus views they may reflect if everyone else has access to the same data? What infrastructure are you putting in place? How is the shape of your research team changing? Do you have the resources to focus on areas that are difficult to replace by machines?

- **What insights are you developing?**
  What is your time horizon? Are you focusing on areas that will bring you into direct competition with systematic strategies? Where do you see your analysts really adding value above systematic approaches? What breaks in the patterns do they identify and build the case for? How can they identify when the future will be different to the past?

- **What voice do you have?**
  Do you meet companies? Some managers maintained that while humans manage companies, humans are best-placed to evaluate the worth of those companies by understanding the actions and motivations of the company’s human management. Do you engage with management? The power to bring about positive change through engagement remains in the hands of human investors.

As teams acknowledge both the weaknesses of human judgment and the limitations of AI, we believe that the industry will increasingly shift toward a model combining the strengths of humans and machines that will shape the investment world of tomorrow.
NOTES


2 Arend Hintze recently was named Assistant Professor, Department of Integrative Biology, in the College of Natural Science, after serving as a post-doctoral researcher with the BEACON Center for the Study of Evolution at Michigan State. Hintze, who was retained as part of the university’s Global Impact Initiative, researches the evolution of natural and artificial intelligence, using computational modeling to understand what environments and evolutionary pressures give rise to intelligence, and how cognitive mechanisms evolved.

3 Ferragu P. “Google and Bernstein Analysis,” Weekend Tech Byte.


7 Martin Froehler, former Senior Quantitative Analyst at Superfund Asset Management GmbH, said in his experience, the failure rate with machine-learning algorithms in live tests is about 90%. Available at https://www.bloomberg.com/news/articles/2016-11-10/hedge-funds-beware-most-machine-learning-talk-is-really-hokum.


DISTRIBUTION EFFICIENCY IN A LOWER FEE ENVIRONMENT
strategies for making Manager-Sponsor-Advisor-Client interactions more effective and productive
Tracking trends to target your next customer

Products and partners are disappearing. And it’s not just digital natives who are turning to online digital platforms, once primarily the purview of discount brokers. Boomers with significant wealth are active digital users. Investors want holistic solutions, migrating from a relationship focus with advisors to investment education geared to their life cycle changes.

With fund companies overwhelmed by data, the power of investors growing, and model portfolios proliferating, data analytics will be key to identify the most detailed and timely insights in a rapidly changing industry.

Now, data that identifies larger, global trends in retail and institutional investing can help fund manufacturers anticipate changes in investing behavior.

SEVEN KEY MARKET TRENDS BROADRIDGE FINANCIAL SOLUTIONS TRACKS

Retail investors expect institutional advantage

The rise of the “insta-vidual”—or individual with institutional access—continues to grow and evolve. A lot of the recent attention on active managers has focused on their battle with index funds and how active managers pushed back on index funds and ETFs in 2017 by cutting fees on actively managed funds. Less noticed and perhaps a more significant trend has been the introduction of institutional shares for existing funds. Where the typical retail share class came with a load that was either waived by fee-based advisers or assessed by transaction-based ones, the institutional share never carries a load. Also unlike retail shares, institutional shares only occasionally (about 25%) carry a 12b-1 fee; instead, distribution is based either on a revenue-sharing arrangement (such as embedded sub-transfer agency fees) or no distribution fees at all, which formerly was only available to larger defined contribution plans. Retail assets invested in institutional shares—less than 37% at the end of 2012—are today nearly 50% and certainly have a lot of momentum: The focus on lower fees drove the growth of institutionally-priced actively managed funds with over $600 billion of net inflows in 2017. As advisors dive into low-cost products the funds industry will compete for their attention by launching institutional classes 2-3 times more than traditional load classes.

Advisor channels are evolving

Changes are also occurring by advisor channel as private banks and RIAs lead institutional asset growth. Today, private banks are the predominant driver with $878 billion in institutional share assets—a significant uptick from 2012’s $518 billion. Following closely, RIAs now command over $852 billion in institutional-priced products, up from $500 billion in 2012. The historically largest user of institutional-priced products, trust companies, also gained ground with $697 billion in assets versus $369 billion in 2012.

With fund companies overwhelmed by data, the power of investors growing, and model portfolios proliferating, data analytics will be key to identify the most detailed and timely insights in a rapidly changing industry.
**Channel relationships are changing**

Even the most dependable brokerage clients are changing their ways. Today, 37% of wirehouse business is now fee-based, up from 24% in 2009, which reflects the extent to which price sensitivity is altering our notions of how a distribution channel “should” operate. As business models evolve and the longstanding transaction-based model declines in popularity, advisor needs will also change. No longer will advisors be pleased with factsheets and product pitches: as home offices increasingly play larger roles in research delivery to advisors, asset allocation and investment expertise (including a solid understanding of competing products) will be paramount and wholesalers will need to acquire these skills to stay in the game.

**The next generation of investors have different needs**

Demographics are also changing the equation, as millennials look to digital for advice and forgo the personal service their parents rely upon. Robo advice is attractive: In just three years Vanguard’s Personal Advisor Services unit surpassed $100 billion in assets. But going head-to-head with Vanguard isn’t necessarily the first step to grow your business—knowing your business strategy is. Is it direct-to-retail brokerage, a branch-based financial advisor sales-to-direct retail investor, or direct-to-retail robo? Millennials have grown up seeking industry disruptors and appearing part of the “disrupted” is no way to approach them. Consider as well that 63% of millennial investors are already using robo advisors—a number that is only expected to grow as these tools didn’t exist a few years ago.

“Millennials have grown up seeking industry disruptors and appearing part of the “disrupted” is no way to approach them.”

**12b-1 fees are disappearing**

The future for advisors is in transparency: fewer are earning a transaction fee and more are operating fee-based businesses. Further reliance on institutionally-priced products means less dependence on 12b-1 fees to support client servicing. By our estimates, over $2.5 billion in distribution fees went away in 2017 due to this shift. As the disintermediation of advice continues, asset managers need to find creative ways to stay relevant to advisors. Gone are the days of golf outings and steak dinners: today’s advisors want better and timelier access to asset management research, deeper product insights, and even business coaching.

**Passive products are here to stay, but active won’t disappear**

In core domestic equity funds, passives will be the main growth driver as they have increased their share of total assets by 13% in the past five years and today contain just under half of those assets. But “passive” doesn’t necessarily mean “exchange-traded.” In fact, within the total passive space the market share of exchange-traded fund assets has grown slowly, from 36% to 41% in ten years. While exchange-traded products receive a lot of attention these days, passive mutual funds aren’t giving ground easily and advisers still rely on them as a source of commission- and spread-free access to indexed assets. The focus here will always be on cost, as the retail channel is far less tuned-in to institutional concerns such as liquidity and tracking error. On the active side, fixed income leads the charge, growing assets 8% last year and maintaining an AUM lead over passive assets by a 3-to-1 margin. Bond products have always had a reputation for being “sold, not sought” and while this position is slowly changing, there are still ample opportunities for fixed income managers to attract retirees and near-retirement savers and. Here, too, product positioning is critical as not all retirees are completely risk-averse nor are they identically risk-averse about issues such as interest rates, inflation, volatility, and taxes. Active managers have the opportunity to navigate clients around these rough waters in a way that passive products typically only sail into.
WHERE ARE THE NEXT OPPORTUNITIES?
As the industry rapidly evolves, new opportunities abound. Four thought starters:

• Millennials will force the adoption of new distribution models that include a focus on ETFs and raise the demand for digitally-led advice. ETFs make up more than 30% of millennial investments as a percentage of mutual fund assets (higher than any other cohort) and their comfort and trust of phone-based apps is well-established.

• In the managed accounts space, expect model portfolio delivery to accelerate, with sponsoring firms acting as overlay manager, including new trade execution and account reconciliation duties. The power of the professional buyer is also poised to strengthen as increased discretion at the home office level will lessen the influence wholesalers have over many advisors. Next generation architectural platforms are also under development, which will fuel more fee-based business by streamlining management by household across product and registration type.

• Subadvising is a burgeoning opportunity for small and mid-sized asset managers, instead of launching their own products. With fund distributors paring their offerings by 2,000-4,000 this year alone, shelf space is limited and getting tighter all the time. For asset managers that have struggled with the distribution side, it’s vital to partner with firms that have the resources to quickly bring scale.

• The next battleground will be smart beta and multi-factor funds, especially as smart beta assets climbed to $1 trillion globally versus a mere blip in 2011. Organic growth is slowing, however, as the industry has already found the early adopters and is challenged to find new converts. Education is key as advisors often report a willingness to use these products strategically when their diversification and downside protection benefits are understood.

FINAL THOUGHTS
The landscape for research and data providers supporting the asset management industry has changed dramatically over the past 10 years, driven by budgetary pressures, industry consolidation and an overall push by clients to derive more value from their considerable research spend. As the pace of innovation quickens, investment firms will need partners with deep insights into industry data and analytics to help blend this external market intelligence along with firm-specific metrics to create actionable business intelligence. Although still in its infancy, data will fuel advanced distribution analytics which is poised to become the next competitive frontier.

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Connection Quotient: First Make Relationships Personal, Then Personalize

What financial advisors expect from their relationships with asset managers, and how asset managers can use personalization to deliver

By Jason Brown and Rubesh Jacobs
Connection Quotient: First Make Relationships Personal, Then Personalize

What financial advisors expect from their relationships with asset managers, and how asset managers can use personalization to deliver

By Jason Brown and Rubesh Jacobs
What if there was a way to interact with financial advisors more broadly, more cost-efficiently and with more impact? Solving this puzzle—a sort of holy grail of distribution—is a goal for nearly every asset manager these days. New strategies and technology have created a groundswell of excitement and anticipation around sophisticated, personalized, omnichannel commercial approaches to distribution. And most asset managers are chasing the goal of creating individualized client experiences that their peers in the retail industry now boast of: tracking customers throughout their buying journey and providing the right information and offer at the right time via the right channel.

There’s good reason for asset managers to pursue this goal: The pressure on distribution economics is real, and likely only to get worse. A variety of well-known industry trends—regulation, the rise of index and low-cost products, and the growing influence of home offices—are forcing asset managers to look to streamline distribution costs while at the same time improving effectiveness. It’s a tall task, for sure, but one that must be accomplished in order to thrive in this new environment.

Fortunately for asset managers, this puzzle can be solved. In our experience, firms that focus on the needs and preferences of financial advisors (as individuals or small groups) and orchestrate their distribution using that insight will gain access to decision makers and have greater impact in each interaction. And in doing so, asset managers will realize tangible benefits while also helping their clients succeed.

Over the past several months, ZS collected feedback from more than 350 financial advisors in order to better articulate the requirements for and benefits of personalized communication. This study:

- Defines a framework for assessing the relationship between asset managers and advisors
- Highlights the types of interactions that could truly benefit advisors
- Measures the mutual benefits to advisors and asset managers

There has always been a strong industry belief that asset managers and financial advisors have a symbiotic relationship. Asset managers strive to fuel this relationship by providing value during each advisor interaction. In this pursuit, to complement the value from investment products, asset managers also provide advisors with perspectives on the market, updates on industry trends and programs to build their businesses. Advisors, by way of investing their portfolios with asset managers and recommending them to colleagues, deliver value to asset managers. But the industry is inundated with investment products, perspectives and tools, so in this era of fee pressures, new regulations, innovation and generally rapid change, how can asset managers differentiate themselves?
The Power of CQ

Driving the Connection Quotient (CQ) Benefits Everyone

Asset Managers

Benefits:
- Retaining/increasing business
- Raising brand recognition
- Receiving client referrals
- Increasing access
- Expanding willingness to try new products

Financial Advisors

Benefits:
- Making well-informed decisions
- Achieving personal success
- Feeling valued

Re-energize the Relationship
Boosting CQ Demands Organization-wide Collaboration

Realize the Value

The Firms with the Highest CQ See the Benefits*

<table>
<thead>
<tr>
<th></th>
<th>Increasing access</th>
<th>Increasing business</th>
<th>Receiving client referrals</th>
<th>Retaining business</th>
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<td>Performance</td>
<td>91</td>
<td>62</td>
<td>79</td>
<td>16</td>
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</tbody>
</table>

Making well-informed decisions

- Provides me with timely perspectives
  - Importance: 91
  - Performance: 62
- Prepares me to speak knowledgeably
  - Importance: 79
  - Performance: 16

Achieving personal success

- Helps me have better conversations
  - Importance: 100
  - Performance: 27
- Improves my business
  - Importance: 63
  - Performance: 32

Feeling valued

- Understands me and my business
  - Importance: 54
  - Performance: 33

Firms with High CQ*

<table>
<thead>
<tr>
<th>Asset Manager</th>
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<th>Putnam</th>
<th>First Trust</th>
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<td>PUTNAM</td>
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<td>50</td>
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</table>

*Identified by respondents as more thoroughly meeting their high-priority advisor needs.
In our research, we found that the first step is to actually get through to advisors—to have them take a meeting, open content, attend an event or visit the website. Once that contact occurs, it’s imperative to share relevant, valuable content and offers that reflect a true dialogue with the advisor. Doing so ensures continued access, and creates real value. We’ve summarized this relationship between the asset manager and advisor in a new metric: the connection quotient (CQ).

Defining the Connection Quotient

CQ is a measure of the degree to which the dialogue between asset managers and advisors creates mutual benefits [see figure 1]. From their side of the relationship, advisors benefit from:

1. **Making well-informed decisions:** At the end of the day, advisors exist to help their clients reach their investment goals. In this pursuit, advisors have to make well-informed decisions about portfolios and the actual advice that they share with their investors. The more effective the asset manager is in supporting these decisions, the higher the CQ.

2. **Supporting personal success:** Advisors, like any other professionals, yearn to be successful in their careers. They aspire to attain financial success, mastery of their craft, and recognition from their peers and communities. When advisors perceive that asset managers have their personal success in mind, CQ is likely to be higher.

3. **Feeling valued in the relationship:** “Partnership,” “respect,” “trustworthy” and “loyal” are words that advisors commonly use when describing their best relationships with asset managers. The more these qualities are exhibited in a relationship between an asset manager and an advisor, the higher the CQ.

Asset managers benefit from having a higher CQ, too. In our research, we found that in high-CQ relationships, financial advisors will continue, or even increase, their level of investment; show higher brand recognition and loyalty; express an increased openness to taking meetings and calls; and show a willingness to try new products. The most crucial takeaway here is that both advisors and asset managers benefit more when CQ is higher.

Framed this way, the implications of this symbiotic relationship are subtle, but their consequences reverberate across the firm:

1. **The relationship between advisors and asset managers isn’t just a result of the pivotal role played by the sales [or national accounts] team. The whole organization, including marketers, portfolio managers and product managers have to cohesively play their parts to drive CQ.**
2. The goal of the interactions between advisors and asset managers—driving product performance notwithstanding—is to drive CQ. That means that every interaction should be helping advisors make well-informed decisions, nudging them toward their personal success or ensuring that they feel valued. And this would be highly aligned with a fiduciary standard of service as well.

3. The more personal, customized or personalized the interaction, the higher the opportunity to drive CQ.

4. CQ is not just a measure of mutual benefits with advisors. It can be extended to professional buyers at home offices and consultancies as well.

DRIVING THE CONNECTION QUOTIENT BENEFITS ASSET MANAGERS AND FINANCIAL ADVISORS

BENEFIT FROM:
+ Retaining/increasing business
+ Raising brand recognition
+ Receiving client referrals
+ Increasing access
+ Expanding willingness to try new products

BENEFIT FROM:
+ Making well-informed decisions
+ Achieving personal success
+ Feeling valued

A low CQ (red) indicates that a firm is not differentiating itself from the industry in many of an advisor’s most important personalization attributes. A medium CQ (orange) indicates that the firm may differentiate itself from the industry on some of the attributes. However, it’s likely that the firm’s differentiation is on the attributes that aren’t important for advisors. A high CQ (green) indicates that a firm is differentiating itself highly among the most important attributes and approaching levels that are consistent with top-performing firms in other industries.

Figure 1: The connection quotient measures how the dialogue between asset managers and advisors creates mutual benefits.
What Matters to Financial Advisors

Perhaps the most stark and immediate finding from our research is that the industry as a whole has a low CQ. In general, we found that asset managers fall short of meeting advisor expectations in each of our three key drivers of CQ.

Financial advisors’ connection to asset managers is strongest when firms are perceived to help them make more informed decisions (see figure 2). In examining the top three ways in which asset managers are perceived to help financial advisors, we find opportunities for firms to perform better in areas that are of the highest importance to advisors. (The Performance Index is a measure of how well a particular firm performs compared to the industry average, while the Importance Index is a measure of how important advisors perceived a particular personalization attribute to be.)

Asset managers expend considerable resources to help advisors understand their views and help them explain the role of specific products in a portfolio, yet research suggests that even firms that advisors selected as providing the best service are missing the mark and aren’t standing out from the crowd. We believe that this troubling incongruence may be an illusion. According to one of the survey respondents, “They have great products and I have invested a significant amount of my portfolio with them, so they must also be providing me value.” Drilling down into performance ratings for these firms on detailed attributes (such as “prepares me to speak knowledgably about their company’s funds and investment capabilities”) sheds light on this story.

**Figure 2: Asset managers can help advisors make better decisions by providing them with timely information and knowledge.**
Our research tells an even more intriguing story when it comes to asset managers’ ability to help advisors succeed in their careers (see figure 3). Nearly all firms fall short on differentiating themselves from others when it comes to the most important attributes: “helping advisors serve their clients better” and “helping advisors think about how to improve their business.” First, this finding confirms the mixed reviews on business-building ideas and value-added programs that have been launched to date. Second, and more importantly, it’s exactly these attributes that wholesalers are expected to address in their “consultative selling” efforts.

**TOP THREE WAYS ASSET MANAGERS CAN HELP ADVISORS SUCCEED**

![Graph showing the top three ways asset managers can help advisors succeed](image)

*Figure 3: Success for advisors happens when asset managers help them improve their business and show value to their clients.*

That, coupled with the gap in “understanding my business and clients,” should prompt us to ask ourselves about the root causes of this miss. Could it be that asset managers focus too heavily on selling their product sets and not enough on what their partners (financial advisors) deem important? Could the commoditization of products be the underlying root of this behavior, forcing sales and marketing teams to focus more on product performance and less on building mutually beneficial relationships? Our belief is that asset managers must differentiate themselves from the pack by focusing on CQ-increasing, consultative efforts and not through a transactional, product-based relationship.
To their credit, but contrary to asset managers’ beliefs, they’re beating advisor expectations on respecting their time. On average, small and large firms are scoring about 5% higher than medium-sized firms in this attribute.

Most asset managers we speak to are worried that they’re throwing too much information at advisors. For example, we know of several asset managers who have undertaken initiatives to reduce the number of emails that they send to any particular advisor. However, based on this feedback, asset managers are actually doing a pretty good job of giving advisors the right amount of attention, and they don’t think that it’s very important, anyway.

On the other hand, asset managers really seem to be missing the mark on using that time to understand advisors. Asset managers are likely too transactional and one-sided, and subsequent communications don’t reflect the understanding that asset managers already have. It’s this idea of a true back-and-forth dialogue that lies at the heart of CQ, and consequently the heart of personalization.

**Interaction Methods That Increase Benefits to Advisors**

We also believe that delivering on the basic types of personalization could yield more marginal value for firms than the more sophisticated approaches [see figure 5]. Interestingly, our analysis of the data from the survey generally confirms our hypothesis: Advisors recognize and value a more cohesive experience with asset managers.
What Does Good Look Like?

There are certainly bright spots exemplifying the amazing moments that left lasting impressions with advisors. These testimonials help the industry visualize what a high-CQ moment can look and feel like:

+ “Early in my portfolio management career, [name] became my mentor regarding the construction and ongoing management of individual portfolios, [and] taught me the importance of building a model and then sticking with a discipline, which I have done for 22 years.”

+ “I have a third-party asset manager. They reach out to me about once a quarter by phone while giving me monthly e-mail updates that talk about their economic and investment outlooks. This has worked out very well because of the consistency and value of the advice.”

+ “They are willing to support my team with seminars, information and small meetings. They’re a trusted partner.”

Asset managers who are doing these things today are mostly relying on their sales teams as the hub of these communications, but we’ve seen that this can be enhanced to include other channels such as events, emails, websites, social media and the like. Other industries such as pharma have been moving to this multichannel approach (not omnichannel yet) with very promising economic results.
According to our research, the three firms with the highest CQ are Schwab, First Trust and Putnam. Our quantitative and qualitative analysis suggests that they rose to the top because:

+ Financial advisors think that Schwab does an exceptional job at “helping them serve their client better”—their key differentiator. The average rating for Schwab in this attribute was about 12% higher, on average, than for other top firms. Perhaps Schwab (added to the study as a top ETF manager) benefited somewhat from the similar services that it offers to advisors through its platform as well.

+ Financial advisors think that First Trust differentiates itself from other top firms by providing objective, independent perspectives on economic issues, markets and products. On average, advisors rated First Trust 20% higher than other top firms on this attribute. First Trust, also added as an ETF manager, has a significant number of advisors who follow the company’s chief economist Brian Westbury. Perhaps that positively impacted its CQ score.

+ Putnam’s key differentiator is how the firm cares about the advisors’ business and career success. Putnam is rated, on average, about 13% higher than other top firms on this attribute. Putnam has been known for its special programs, such as FundVisualizer, and its efforts to help advisors use digital tools—social media, in particular—more effectively. This may have positively impacted Putnam’s CQ score.

While these aren’t all big brands, by our calculation they appear to be providing advisors higher value than their peers—connecting or “punching” above their weight, so to speak.
While Schwab, First Trust and Putnam had the highest CQs in our survey, other firms were more frequently noted as providing the best overall service. The three firms that were selected by almost half of the respondents as providing the best service overall—Capital Group, Blackrock and Franklin Templeton—are known to invest significant amounts of resources to help financial advisors. In addition to being large, successful brands, they’re also among an exclusive club with a lion’s share of advisor portfolios, and they have brand and asset momentum among advisors. We contend that if these firms further enhanced their CQ, they would further enhance their already strong brand and portfolio positions.

How to Improve CQ

In a time of rapid change, innovation, heightened competition and squeezed profitability, we believe that there’s a greater need to focus on mutual benefits between asset managers and advisors. This CQ can be enhanced by even simple coordination across communication methods, but our analyses also suggest a heightened opportunity for an even more dynamic, personalized approach.

This means that asset managers should continue their journeys to improve the quality of their data, leverage it for understanding the needs of advisors, and carefully use channels for interacting with advisors. But there are other subtle changes in their mindset (or approach) that could change the way that asset managers view their distribution approach and bring cohesion to their efforts:

1. **Measure the success of personalization by CQ**: The goal of interactions with advisors should be to help them make more informed decisions, help them succeed and help them feel valued. These are compatible with the industry trends of solution-oriented investing, consultative selling and a fiduciary standard of service.

2. **Master the basic communication methods**: The highest CQ, and thus the highest benefit for advisors and asset managers, is created when the basic communication methods are executed well. Targeting the right advisors and matching relevant messages with interest and channel preferences is easier said than done. Those who achieve more sophisticated, artfully sequenced, omnichannel approaches are likely to further stand out from their peers.

3. **Increase cohesion with orchestration**: The sales team, wholesalers and national account managers are the orchestrators of an asset manager’s relationship with advisors and home office executives in their territory. In many respects, they “call the plays” on everything from focus lists to marketing campaigns and invitations to events. Asset managers should embrace this mindset and empower and guide sales in this role for certain segments of advisors, while also working to make operations easy and seamless. But to make this work, asset managers have to work through the
messy, unruly and nitty-gritty details related to truly increasing cohesion, collaboration and teamwork across their organizations. They also should become comfortable with salespeople playing the role of orchestrator and calling the shots.

Our research has provided a new lens through which to view the advisor/asset manager relationship, and has helped quantify how and why to build CQ. In subsequent publications, we’ll further explore how CQ varies across different types of advisors, how top firms are succeeding today, and how best to pursue and build these capabilities going forward. In the meantime, asset managers would be well served to look to their current practices and ask, What’s my CQ?

**METHODOLOGY**

Data for this study reflects survey responses from 366 financial advisors. The sample represents the U.S. financial advisors with portfolio discretion, and reflects various channels, levels of assets under management and a mix of mutual funds and exchange traded funds (ETFs).

Survey respondents identified a firm that they perceive as providing the best service. They then compared the performance of their selected firm to that of other firms across almost 20 variables. Respondents also rated the importance of each of these variables on a scale of one to 10.

The identification of the firms in this report is for informational purposes only based on the survey results and is not intended to be and does not constitute an endorsement of any firm, or its services or offerings. ZS is not affiliated with any of the identified firms.

For more information, please visit www.zs.com/cq.
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About ZS

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