



Viewpoint

Globalization in the asset management industry

This paper considers the progress of globalization in the asset management industry to date, and the potential impact of recent market disruption. It explores the fundamental drivers and enablers of greater globalization, as well as the key challenges facing individual firms. It also considers how the direction of globalization may change in response to the current financial crisis.

International operations are the norm for asset managers, but there is no standard industry approach

Asset management has a long history of developing international capabilities. The industry has been following its institutional clients' investment flows around the world since the mid-20th century. It now offers many retail investors their only opportunity to benefit directly from the growing convergence of the global economy.

Despite this pedigree, the industry has never developed a standard approach to cross-border business. Models of international development proliferate, with each asset manager striking its own balance of production and distribution, and domestic and foreign activity. This is particularly true in Europe, where investors, assets, managers, administrators and custodians are frequently located in different countries. Approaches vary according to the type of firm. Captives, networks, multi-boutiques and boutiques all follow their own strategies.

It is also interesting to note that low cost locations have so far played very little role in the industry's internationalization. This reflects the lack of a standardised operating model, as well as firms' desire to retain direct control of key staff and sensitive client information.

Globalization may be in vogue, but could its rationale be undermined by recent events?

Over the past decade, globalization has become an established strategic theme, with acquiring alternative product expertise and new clients becoming core rationales for cross-border development. Corporate activity among banks and insurers, many of which operate captive asset management arms, has also boosted the global agenda. Many of the largest European and North American firms consider themselves to be global businesses, and several have offices in more than 50 countries. Nor are global aspirations limited to the industry's giants; for example, one third of UK firms manage funds where less than half of assets sourced are domestic¹.

Even so, marketing can be deceptive. Most international firms are organised in silos, and in reality "global networks" are often a collection of relatively discrete businesses. The credit crunch has also reversed the growing cross-border investment flows of recent years, as institutions pull out of emerging markets and Asian retail investors halt their charge into foreign investment

funds². Global universal banks with perceived exposure to credit or liquidity risks – perhaps the keenest proponents of globalization – have been particularly badly hit. This reduction in risk appetite is putting profitability under pressure and placing the industry's short term focus on damage limitation, not empire building. On the face of it, the situation hardly sounds like a recipe for more rapid globalization.

So what does the future hold for globalization in the asset management industry? Could the recent bull market mark the high point of cross-border development? Or is globalization still on the march, despite market disruption? In the remainder of this paper we will set out our response to these questions. To do so, we will review the ongoing drivers of globalization, the additional enabling factors at work and some of the challenges that remain to be overcome.

We do not believe the current crisis will derail the underlying drivers of globalization

Asset managers are optimistic by nature. During the long run of growth years which the industry has enjoyed, they have typically preferred to expand operating leverage by accumulating assets than by reducing costs. As North American and Western European markets have matured, asset managers from those territories have naturally turned overseas in search of new clients, new opportunities and higher margins.

In recent years, managers' urge to expand has been matched by clients' growing desire for international diversification. Before the current crisis began, investors from developed markets had spent several years increasing their international exposure. Institutional allocations to global equities had reached approximately 30% in the UK and Canada, and were climbing fast from lower bases in the US, Japan and continental Europe³. Even US retirement schemes, frequently home-biased, had begun to establish global mandates. Asset managers worldwide had also been surfing a wave of demand from emerging market investors.

In our view, these underlying factors remain, despite short-term disruption. The financial crisis is forcing asset managers to focus on cost levels, but we believe that greater scrutiny on management fees will have a more lasting impact. We therefore expect asset managers' desire to go global will only increase. We also believe that emerging markets opportunities will exceed those of developed markets in the long term. It can only be a matter of time before cash-heavy institutions move back into international

equities, and where they lead retail customers will follow. Growth in the value of Asian, Middle Eastern and Latin American funds seeking professional management is likely to be driven by:

- ▶ Positive demographic trends
- ▶ Increasing economic productivity
- ▶ Emergence of new high net worth and mass affluent investor classes
- ▶ Government support for private pensions
- ▶ Financial market deregulation
- ▶ Hydrocarbon-based wealth seeking returns
- ▶ Asset allocations shifting away from cash

Enabling factors continue to support greater internationalization in asset management

In our view, the fundamental drivers of globalization are supported by a variety of enabling factors. In recent years these have included the increasing openness of stock exchanges to international investors, improvements in price transparency and the accelerating development of global indices and Global Investment Performance Standards (GIPS). These factors have all encouraged investors to shift towards more international asset allocations.

Up to now, the highest-profile enabler of globalization has been the growing regulatory consensus around UCITS⁴, a European Union initiative intended to create a single market for investment funds. UCITS has been a boon for the European funds industry, due in part to the willingness of supervisors in Hong Kong, Singapore and Taiwan to authorize UCITS funds on a notification basis. The fact that key UCITS domiciles Luxembourg and Ireland permit investors to roll up income and capital gains has not hurt either.

As UCITS develops, it should promote more internationalization in the industry. The standards' third iteration gave fund managers the scope to enhance performance with derivatives, and attracted heavy inflows from Asian retail investors from its launch until the third quarter of 2008. We expect a future UCITS IV will help to streamline and internationalize the European industry's complex structure. If adopted, the concept of management company passports will encourage cross-border activity. It should also help asset managers to consolidate their operations around a single European hub, chosen either for its expertise or, perhaps, for its low cost features.

1. Asset Management in the UK. (August 2008). *Investment Management Association*.

2. Trends in the European Fund Industry in Q3 2008. (December 2008). *European Fund and Asset Management Association*.

3. After the Belle Epoque. (December 2007). *Putnam Lovell*.

4. "Undertakings for Collective Investments in Transferable Securities"

The credit crunch is giving fresh impetus to globalization, by driving more rapid consolidation

We see one further factor acting as a powerful enabler of globalization in the industry – the credit crunch itself. The current downturn in profitability is encouraging asset managers to push for scale and efficiency, and consolidation is already emerging as a theme. This is particularly true in Europe, where the industry is relatively fragmented, and where firms which have taken on excessive debt are beginning to be absorbed by cash-rich competitors.

The crisis is also triggering a raft of asset management divestments. Weakened banks are particularly keen to sell off captive producers, either to raise capital or to realize the value of a business with a higher market rating than its parent. Increasing regulatory focus on the conflicts of interest raised by captive distribution could be another incentive for bank divestments, although many groups will still wish to retain these low-capital, cash generating businesses.

We expect consolidation to give a powerful boost to globalization in the industry. Many potential targets already operate across borders, particularly within Europe, and mid-to large firms coming to market will attract bids from around the world. Large asset managers from mature markets will have to compete with private equity firms, consolidation vehicles and foreign acquirers. The crisis presents a particular opportunity for emerging market firms to acquire international expertise.

Of course, consolidation will not be the industry's only response to the credit crunch. Firms that can rebuild profitability by streamlining their products and organizations will no doubt prefer to remain independent. The profusion of European investment funds offers clear scope for some thinning out, and at least one large European manager has already merged a Luxembourg fund with an Irish one without waiting for UCITS IV⁵. We also expect boutiques that can generate genuine alpha to prosper without deal making.

Despite the opportunities, barriers to further globalization remain significant

Despite the many factors we believe will continue to promote greater globalization among asset managers, we should also sound a note of caution. Considerable challenges remain to be overcome before anything more

than a handful of firms can claim to be truly global. In particular, we would identify:

- ▶ **Increasingly complex investor needs.** As asset management becomes more global in scope, so too are investor needs. High Net Worth (HNW) individuals, lucrative but demanding, illustrate the challenges involved. They typically have high expectations of their wealth managers, and their needs are frequently more global than many asset managers' ability to meet them. As their investment allocations become more complex, HNW clients are also demanding simpler global reporting from their advisers.
- ▶ **Regulatory and protectionist barriers.** Every country throws up its own regulatory and legal barriers, not to mention local market conventions, leaving the industry unable to offer a truly global retail investment product. Even in the European Union, some countries give favourable tax treatment to domestic funds and protect national champions from foreign buyers. Several Asian countries too favour domestic funds, either via tax – as in Taiwan and South Korea – or by requiring new entrants to partner with a local firm, as in China and India. Challenges of this nature will persist until, if ever, global regulation becomes a reality.
- ▶ **Competitive and market specific factors.** Asset managers entering new markets often underestimate the intensity of competition from entrenched players, and emerging markets throw up particular challenges. Many countries with attractive growth prospects are relatively small, whereas those offering greater scalability – such as industry favourites China, Japan, Brazil and Russia – attract hordes of entrants. The immaturity of local capital markets can be a problem, and the scarcity of skilled staff with local market knowledge is often a critical limitation. Mature markets pose challenges to new entrants too. In recent years several cross-border acquirers entering the US market have paid full prices only to see key talent and clients evaporate.
- ▶ **The limitations of distribution.** There may be a growing global institutional market, but every retail market has its own patterns of distribution. In Europe, banks and insurers tend to prefer “guided architecture” favouring captive producers or preferred providers. Even if some banking groups do divest their captive asset management arms, it is hard to see this pattern changing overnight. Asia too is far from open to new producers; state and private banking giants often dominate, and in

many markets a local partnership is essential to access established distribution networks and trusted brands.

- ▶ **Structural and operational factors.** Asset management groups often struggle to achieve positive operating leverage in their international operations. As well as the external challenges highlighted above, a number of internal factors can act against efficiency and profitability.
- ▶ On the structural side, every firm needs to identify whether asset allocation, stock selection, product design, research, IT and risk management should be managed locally, regionally or globally. Alpha, quantitative and structured products may also require different approaches. There is no definitive optimal structure.
- ▶ On the operational side, working internationally throws up challenges for any asset management firm, whether it is captive, independent, network or boutique. Successful integration of foreign acquisition targets is particularly hard, but even organic expansion can make communication, culture and talent harder to manage. Tensions are particularly likely to erupt over product development, distribution choices and revenue sharing.

Conclusion: opportunity and challenge

The ongoing financial crisis is taking up a lot of asset managers' attention. Even so, we do not believe that the current disruption undermines the industry's long-term rationale for globalization. The fundamental drivers remain intact, in our view, and the credit crunch has the potential to accelerate international consolidation.

Nonetheless, this does not mean that globalization will continue along the same path as before. Nor is greater globalization a panacea for all firms. We see a clear shift of power towards the emerging markets, but also stress the very real barriers which individual firms will have to confront as they expand in search of greater scale. The trend to greater globalization is clear, but the endgame remains a long way off.

5. Invesco pioneers fund move'. (7th December 2008). Financial Times.

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