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A regular analysis of strategic issues in the institutional investment business

Deeper Perspectives

2016 trends in Institutional - a year of change

In this special edition of Deeper Perspectives we look at three of the major themes prominent in the global institutional asset management business in 2016

2016 has been a year of change. We have said goodbye to heroes such as David Bowie, and royalty such as Prince, and we have said hello to President-elect Donald Trump and understood that Brexit means Brexit.

We have also seen terrific change in the institutional investment business. In this edition of Deeper Perspectives we take a look at how Asia Pacific institutions, driven by weaker and more volatile local market outlooks, are increasingly pursuing investment opportunities beyond their own shores.

We analyse how Diversified Growth Funds in the UK have also looked overseas, with great success, and look to the future for what it means for the European multi-asset business.

Finally we look to European insurers who have faced a challenging 2016 on many fronts, but we focus on the investment challenges they face and how they are partnering with asset managers in pursuit of positive outcomes.

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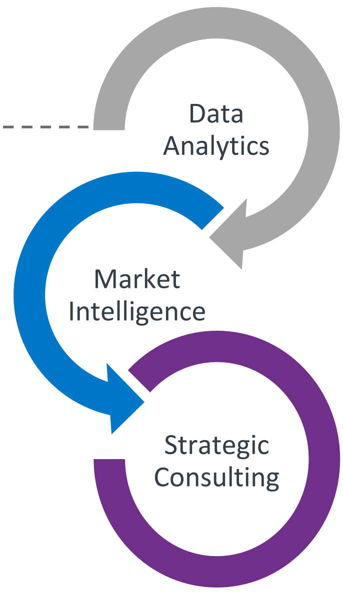
We use iMiM and our Market Intelligence

This special edition of Deeper Perspectives uses our data analytics project, Institutional Money in Motion (iMiM), and draws on three of our Market Intelligence reports.



Institutional Money in Motion (iMiM) generates an unrivalled view of institutional markets and clients, backed by a unique dataset populated by over 100 institutional managers

Our Market Intelligence service requires a deep understanding of core institutional markets and is delivered in close partnership with our clients

Our Strategic Consulting is backed by a working knowledge of the institutional asset management business, and is driven by our data analytics, market intelligence and team of industry experts

Institutional Money in Motion

Generates essential institutional data to help asset managers better understand the markets they operate in, the clients they serve and the products in demand.

>100
Asset Manager Members

40,000
Segregated Accounts

4 Trillion
Institutional Gross Sales

Market Intelligence

By leveraging the iMiM data set, as well as hundreds of other sources, research partnerships and sophisticated models, our MI service identifies trends, challenges and opportunities across distribution, sales, products and competitors.

This Deeper Perspectives relies on 3 of our MI service reports in particular:

- **APAC Client Opportunities**
- **Diversified Growth Funds & European Multi Asset**
- **Insurance Asset Management**

Overview of EMEA Flows

MEA outflows continue to dampen overall net flow growth in H1 2016, with strong outflows in most liquid markets. Germany tops the growth table with strength across the board, whereas Italy has had a tough quarter with net outflow in most fixed income strategies.

EMEA Institutional net flow growth rates

Net flow over H1 2016 as a percentage of AUM as of end of Q4 2015

		United Kingdom	Germany	Netherlands	Switzerland	France	Nordics	Italy	MEA	Other/undefined EMEA	Total
Alternatives	Commodities		s			s		s	s	s	-2.5%
	Hedge fund										2.6%
	Infrastructure					s		s	s		10.2%
	Private Equity								s		0.1%
Equities	Active quant equity							s			-0.1%
	Active fundamental equity										-3.3%
	Passive Equity										-1.1%
	Alternative Index Equity			s		s		s			0.6%
	Undefined Equity										-2.9%
Fixed Income	Absolute Return			s					s		0.5%
	Aggregate										-2.0%
	Corporate/Credit										-1.0%
	Government										-2.3%
	High yield/Aggregate HY										3.3%
	Multi-Sector								s		-2.3%
	Other/undefined fixed income										2.2%
Multi-Asset	Multi-asset - Pooled Multi-asset								s		3.8%
	Multi-asset - Undefined Multi-asset			s	s		s	s	s	s	5.1%
	Solutions - Fiduciary management				s	s			s		0.9%
	Solutions - Segregated multi-asset solution						s				-0.8%
	Solutions - Other solutions		s				s	s			3.3%
Other	Fund of funds		s				s	s			-0.5%
	LDI				s	s	s	s	s		4.6%
	Money market										-1.7%
	Property										4.0%
	Other/undefined			s	s	s	s		s		0.0%
	Total	1.0%	3.7%	0.5%	1.6%	-0.1%	0.5%	-2.2%	-7.2%	1.7%	0.6%

Source: Spence Johnson Institutional Money in Motion

Colour Key

Net flow as a % of previous period AUM.

Negative net flow

Positive net flow

S AUM <€500m

APAC investors continued to ‘go global’

Assets from APAC institutional investors addressable to international managers are projected to increase to US$4.4 trillion by 2025 and this may increase if protectionist politics in the west contribute to local market instability.

Total Institutional assets in Asia Pacific Addressable to 3rd Party International Managers by 2025

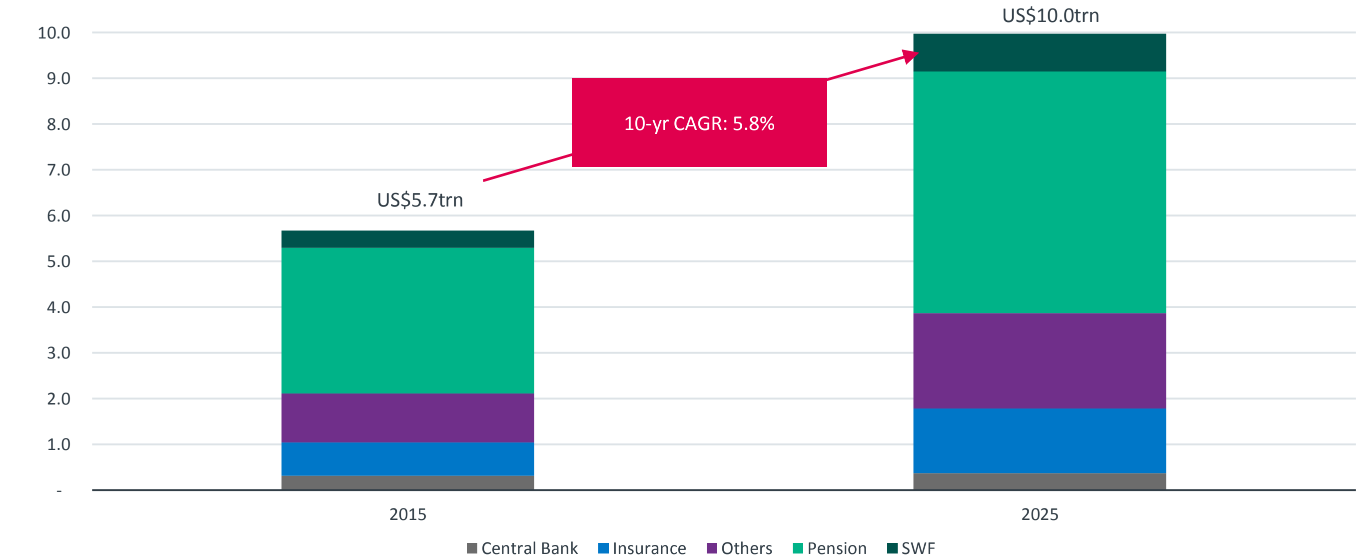
Spence Johnson APAC Market Metrics

With weaker local market outlooks and the possibility of significant volatility, the hunt for yield and diversification will continue and increasingly see local institutions pursuing investment opportunities beyond their own shores.

Data from our Institutional Money in Motion consortium shows both emerging market debt and equity witnessing significant inflows this year. The trend towards alternatives is also expected to accelerate, with private equity and listed infrastructure leading the way.

However even as we take these conditions into consideration, the fact that more domestically focused markets like China and Southeast Asia have grown faster compared to their peers means that addressable opportunities to international managers still remain less than half the total addressable asset pool.

Total Institutional assets in APAC Addressable to 3rd Party Managers, 2015-2025
(US$trn)



Spence Johnson APAC Market Metrics

Managers in APAC look to ‘go local’

Over the next 10 years, international managers are expected to get 44% of the increase in assets and 49% of the increase in revenues. The bigger opportunity set accessible to local managers together with regulatory shifts may strength foreign managers’ conviction to go local.

It is a constant struggle for managers to strike the right balance of resource allocation to a lofty future growth target but our projections for both assets and revenues suggest that the need for a local presence in certain markets, particularly China, could be necessary for asset managers looking to get a bigger slice of the asset and revenue pie.

Furthermore, regulatory pushes have meant foreign asset managers have had to devote heavier resources to the region in recent years and this is expected to continue tilting in favour of those with a domestic presence.

Selected examples of different regulatory approaches by country

“The Carrot” Approach

Singapore: The central bank of Singapore, Monetary Authority of Singapore, aims to boost onshore manufacturing presence by awarding mandates for more external fund managers (EFM) to set up operations in Singapore.

Korea: Relaxing of capital and staffing requirements for foreign managers to set up local hedge funds, streamlining of process for the marketing of offshore funds.

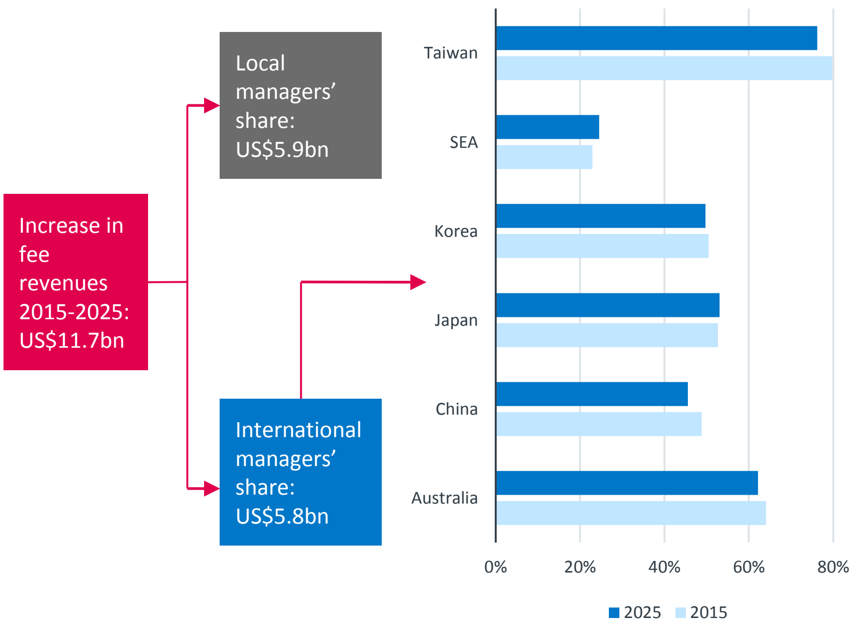
“The Stick” Approach

Taiwan: Introduction of the commitment scorecard will increase the amount of resources foreign managers need to dedicate to operate in Taiwan. They either need to have a SITE, SICE license with minimum capital requirements or be handing out sub-advisory mandates to local firms.

“The Quota” Approach

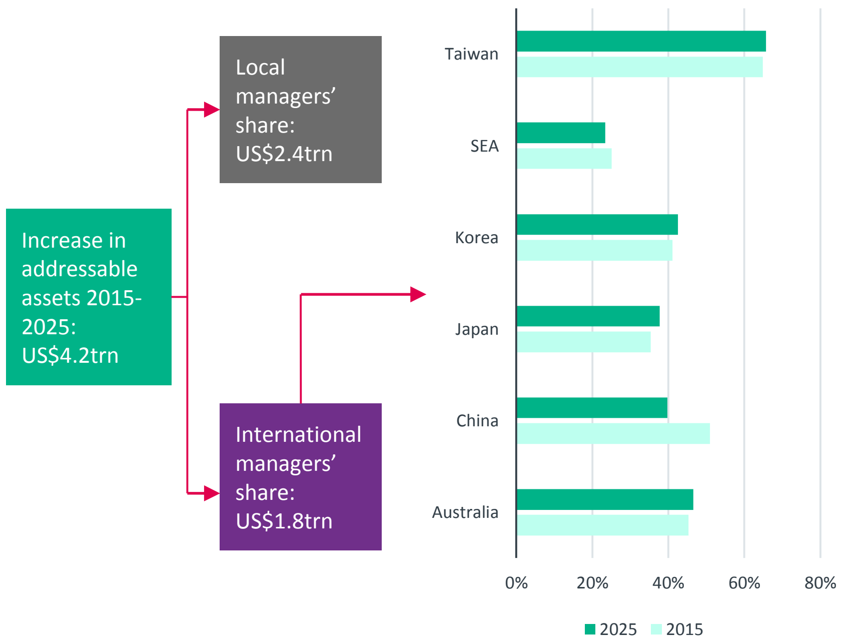
China: With the alphabet soup of quotas (QDLP, QDII, QFII, RQFII) already in operation in China where capital flows are tightly regulated, the latest proposal mooted by the local regulatory body, China Securities Regulatory Commission (CSRC) to introduce the Investment Management Wholly Foreign Owned Enterprise (IM WFOE) scheme for foreign managers is getting everyone excited. It will enable foreign managers to hold 100% ownership in a firm which can invest locally.

Total institutional revenues in Asia Pacific for 3rd party international managers 2015-2025



Spence Johnson APAC Fee Metrics

Total addressable assets in Asia Pacific for 3rd party international managers 2015-2025



Spence Johnson APAC Market Metrics

UK Diversified Growth Funds looked overseas

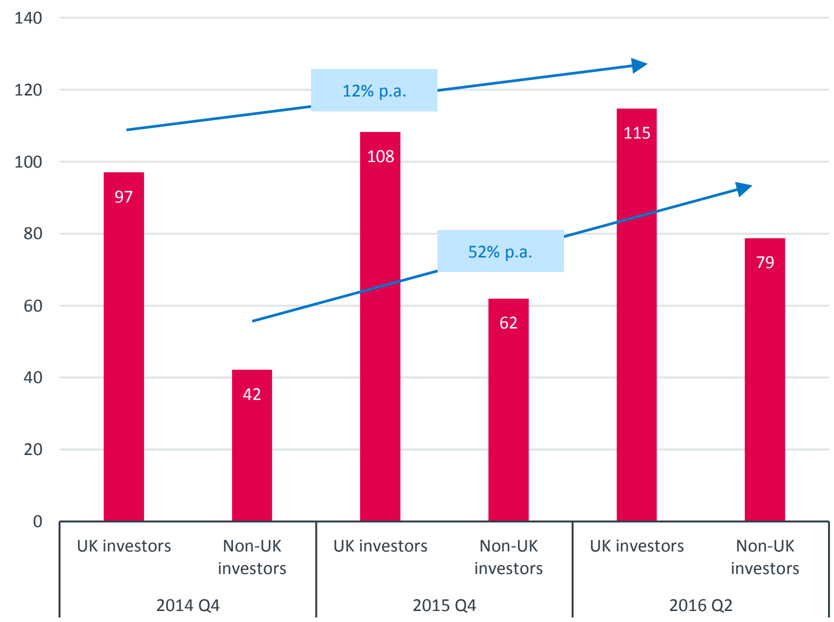
The AUM of UK clients in DGFs grew from £97bn to £115bn between end 2014 and Q2 2016, while the AUM of non-UK investors grew from £42bn to £79bn. Net flows from non-UK investors were three times larger than UK net flows.

The UK still accounts for most assets in Diversified Growth Funds. At the end of Q2 2016, DGF managers managed £115bn in AUM from UK clients, and £79bn from non-UK clients.

Non-UK client assets are growing faster however, at an annualised rate of 52% per year since Q4 2014, compared with 12% per year from non-UK clients. A similar picture can be seen by looking at net flows over the period. We estimate that net inflows from UK clients amounted to £12bn, while net inflows from non-UK investors were £32bn.

AUM by client region

£bn, 2014 Q4 – 2016 Q2



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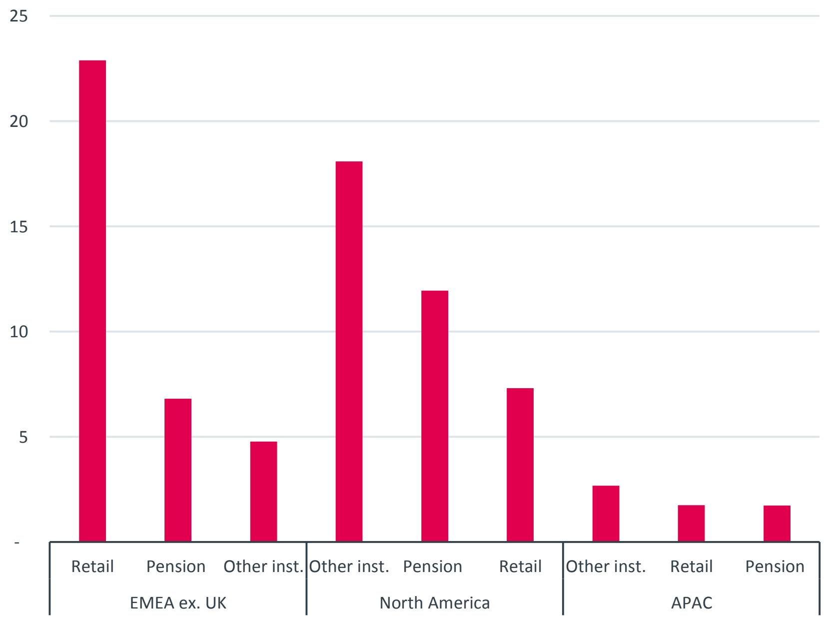
AUM by client segment – non-UK investors

£bn, 2016 Q2



Spence Johnson analysis

DGFs stand to benefit from the non-UK efforts

We expect that DGF providers' revenues will grow at an average rate of 9% per year to 2020 to reach £2.5bn. Revenues from outside of the UK will grow fastest, as DGFs continue to attract assets from retail clients.

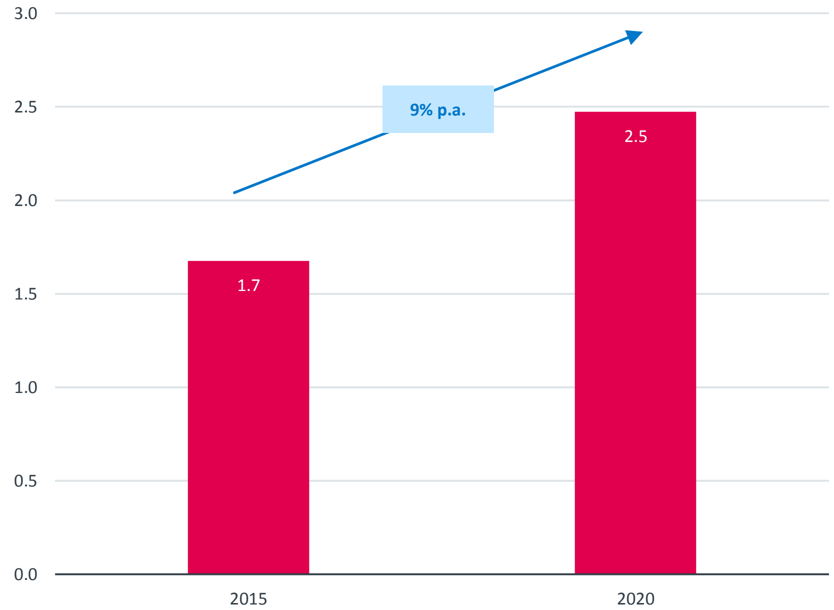
We expect the total revenues of DGF providers to grow to £2.5bn by 2020, up from £1.7bn in 2015.

While this revenue growth is still substantial, we are predicting slower revenue growth than was seen between 2014-2016. This is partly due to increased fee pressure, especially from price-sensitive UK DC pension schemes, which we expect to account for an ever greater share of net flow over the next 5 years. We also predict a slow down in the net flow coming from more established DGF client segments, such as UK DB.

We also expect that non-UK clients will be a faster growing source of revenue than UK clients. By 2020 we expect that the total revenues received by DGF managers will be broadly commensurate for both UK and non-UK clients, at approximately £1.2bn.

Although the UK market will still be the most important in terms of AUM and flow, providers will face substantial fee pressure, particularly with the growing importance of UK DC, and this will act as a drag on revenue. Outside of the UK we are expecting less pressure on fees. This is particularly true for the EMEA region, where we expect a continuation of demand from European retail clients, which generally pay a higher fee than institutions.

Total DGF revenues
£bn, 2015-2020



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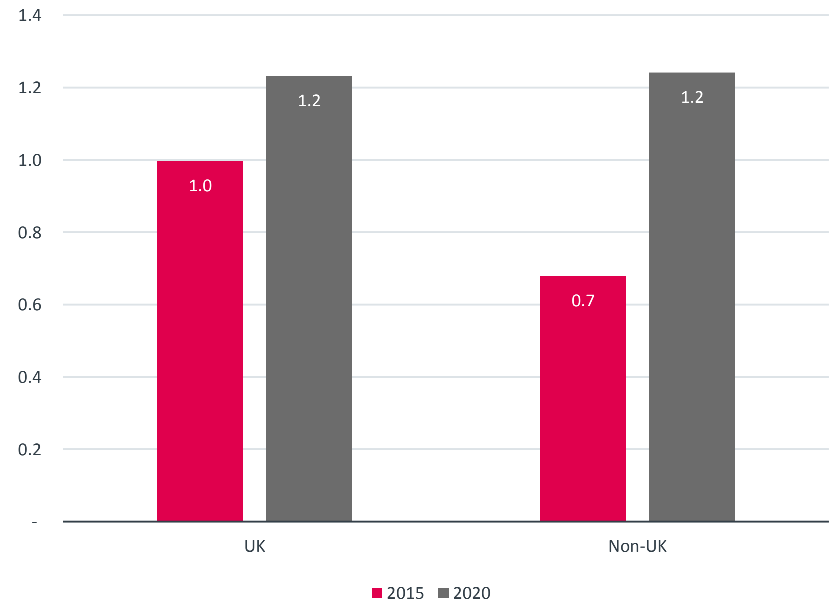
Total DGF revenues by client location
£bn, 2015-2020



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Insurers focused on investment outcomes…

Insurers' investment decisions are driven by outcomes that they seek, and problems they need to solve. Each insurer will have their own different set of outcomes, making each one unique. Understanding this 'mind-set' is crucial for asset managers.

European Insurance Investment Outcomes and Products Map

In order of priority of outcome

		Equity			Fixed Income						Loans		Cash	Alternatives				Solutions	
	Europe Investment Outcome Sought (in order of priority)	Traditional equities (European & Global)	Income equities	Volatility-targeted equities	Government and Agency Debt	Investment Grade Corporates	High yield fixed income	Convertible bonds	Multi-sector fixed income	Buy-and-maintain fixed income strategies	Commercial /Residential Mortage Loans/ Securities	Corporate loans (Direct & CLOs)	Desposits/ short duration securities	Infrastructure/ Real Estate - Equity/Debt	Infrastructure/ Real Estate - Direct	Private equity	Hedge funds	Multi-asset	LDI & 'Other' Solutions
1	Improve yields		■			■	■	■	■		■	■		■	■			■	■
2	Improve market returns	■	■	■												■	■	■	■
3	Improving capital efficiency of the portfolio				■			■	■	■	■	■		■	■			■	■
4	Reducing exposure to market volatility		■	■						■				■	■	■	■	■	■
5	Protect against credit quality deterioration								■	■	■	■							■
6	Protect against a sharp rise in interest rates	■								■		■							■
7	Improved longevity hedging/matching								■	■				■	■				■
8	Ensuring adequate liquidity of portfolio				■	■							■						■
9	Inflation-hedging	■									■			■	■	■			■

Spence Johnson analysis

Our research into European Insurance Asset Management has led us to conclude that insurers are not product-led in their investment decisions, but are instead focused on achieving certain outcomes.

Product selection is secondary in this process, and is dependent upon the outcomes and problems of the particular insurer. This chart reveals the products that can be used to help insurers achieve those outcomes. For example, an insurer that needs to improve its capital efficiency position should look to invest in those Fixed Income classes which are treated favourably under Solvency II (Convertibles, Multi-Sector, Buy and Maintain), Loans, Infrastructure, or Solutions.

Third party managers become relevant where insurers are unable to make these investments in-house. Rather than merely offering a range of products, the role of the asset manager is far more focused on providing a bespoke solution, dependent on the unique outcomes of the particular insurer. This highlights the importance for the asset manager of understanding the mindset of the insurer coming to them.

There are numerous implications for viewing insurance outsourcing in this manner.

Firstly is the lack of scalability of product solutions. Instead, asset managers will have to scale competency, rather than scale products, adding another layer of difficulty.

Secondly, this demonstrates why the role of consultants in this market is minimal. With no products that are in demand by all insurers, there are no one-stop solutions that can be sold to everyone.

Finally, as the sale procedure is complex, time-consuming and expensive., insurers are looking to reduce the number of asset managers they outsource to, even if they are looking to increase overall outsourcing. The expensive, time-consuming process also means that relationships that develop between insurers and asset managers tend to be 'sticky', and remain in place for longer.

..and will rely more on 3rd parties to achieve them

Third party asset managers currently manage 12% of European insurers' general account assets: 9% comes directly from the insurers and 3% from insurer affiliated asset managers. By 2025 third party asset managers will manage 16%: 12% will come directly from insurers and 4% from affiliated asset managers.

Given the regulatory environment, the trends in asset allocation among insurers and the trend towards outsourcing asset management services, we predict a combination of key changes in the future market landscape.

The most important changes will be:

1) Today insurers give 9% of their assets directly to third party managers, but this will increase to 12%. Third party managers (those not directly affiliated with an insurance company) will increasingly become better equipped to take on insurance general account business directly, partly because some affiliates are developing their offerings and client management capabilities to court third party insurance clients and partly because several non-affiliated asset managers are also developing teams and offerings to serve the insurance market.

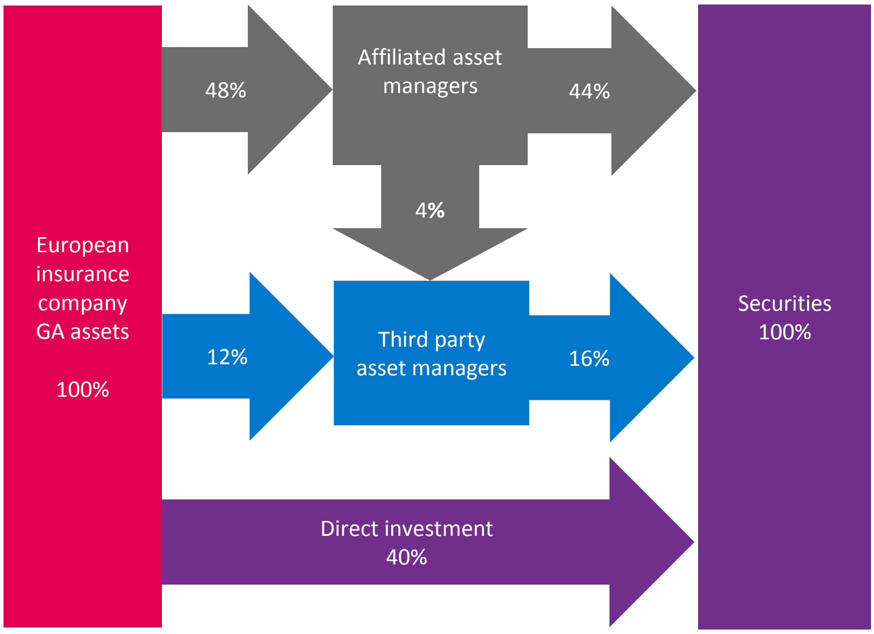
2) Affiliates outsource 3% of IAM assets, but this will rise to 4%. Affiliates (asset managers directly linked to insurance companies) will, wherever possible, seek to avoid the use of third parties to help them invest, again driven by their own economics. But to an increasing degree, they will find the need to obtain third party manager help for their own specialist challenges due to the more esoteric asset classes and strategies the search for yield is pushing the towards.

3) As a result, **third party managed general account assets will rise from current 12% to 16%.** Thanks to a rise in assets flowing from affiliates and overall growth in outsourcing by insurers, there will be an overall increase in the assets outsourced to third party asset managers.

4) In terms of how the remainder of general account assets are invested we predict that there will be **a slight increase in the assets entrusted to affiliates, from 47% to 48%,** and **a decrease in direct investment, from 44% to 40%**. Both these movements will be driven by insurers looking to find solutions for the investment outcomes listed in the table on the previous page.

European insurance company asset flows 2025

%



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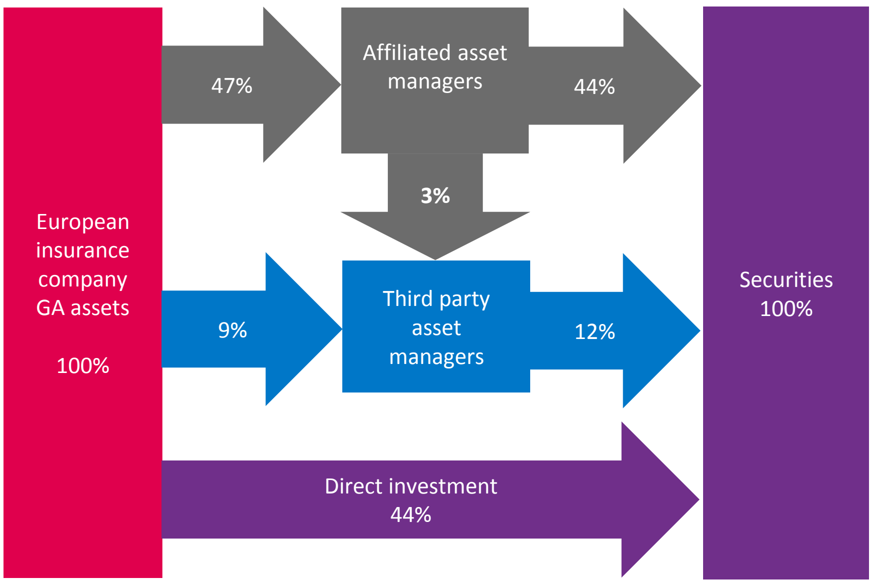
European insurance company asset flows 2015

%



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Previous editions

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Local authority pension schemes are merging into at least 6 pools. This means that asset managers will have to adjust to a vastly different competitive environment

September 2016 – Number 39 – UK DB: A market looking for solutions
As a result of the difficult situation faced by schemes, providers of 'solutions' have been the main beneficiaries of the continued growth in private DB assets.

September 2016 – Number 38 – APAC Institutional opportunity doubles by 2025
Strong growth from existing investors and emergence of new investors mean the region could see a close to doubling of addressable assets in the next 10 years.

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Smart beta growth reflects a face-off between more 'active' multi-factor strategies and more 'passive' alternative index approaches

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Outsourcing growth 6% pa to €1.1trn by 2024

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Only 13% of schemes are still open, net contributions are falling and the investment needs of DB schemes are fundamentally changing.

October 2015 – Number 30 – DGF, New Players win Market Share
The DGF market grew 15% last year and sits at the heart of the growth portfolios of many UK pension funds.

July 2015 – Number 29 – Smart Beta - Our fastest growing MI segment
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We project future annual growth rates in institutional assets varying from -0.5% to 31%.

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The search for yield in a low interest rate environment and regulatory pressure are driving outsourcing opportunities.

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