OUTSOURCING FOR PROFITABILITY

As markets mature and country profitability levels converge, distributors are likely to outsource asset management in order to maintain competitiveness

Whether we call it sub-advisory, white labelling or outsourcing the phenomenon of delegating asset management capabilities to a third-party is sweeping across Europe.

Behind this growth is the need for financial institutions to focus on their core competency and find partners to help fill product or capability gaps

Indeed, as KPMG commented in a report released last summer: "Such alliances are gradually replacing vertical integration within individual firms by horizontal integration between firms ...gradually this is spreading to... institutional through the sub-advisory route."

In the same line, last October McKinsey released a report highlighting that distributors are focusing on asset gathering rather than asset management. "Distribution channels are moving up the value chain. Some distribution channels are capturing a greater share of industry value by managing their product offerings more actively, by means of managed accounts, multi-manager structures or white labelled products, for example."

Although sub-advisory is on the increase across Europe, in many countries this trend is not new.

The UK, Scandinavian and Swiss markets are the most mature sub-advisory markets, in terms of size, the sophistication of the manager selection process as well types of sub-advisory being employed. More recently evidence suggests that the German, Italian and Spanish markets are moving rapidly towards embracing the sub-advisory model.

In Germany at least two of the big distributors have already outsourced asset management mandates with many of the *landesbanks* exploring the option. While in Spain both of the main players have opted for the sub-advisory route for particular asset classes and styles.

FUTURE GROWTH

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Alex Fletcher, Goldman Sachs Asset Management

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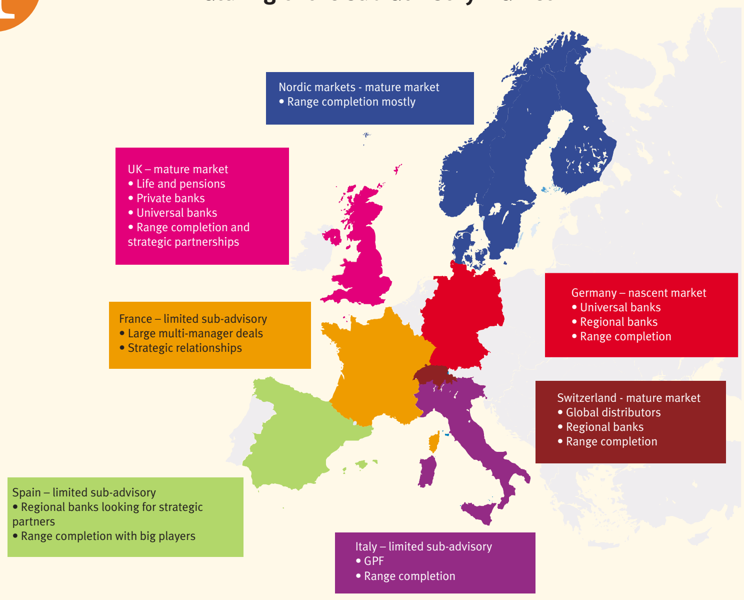
Maturing of the sub-advisory market



Source: Goldman Sachs Asset Management

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● **Insurers** – insurers in many markets are looking for ways to become more financially efficient and as a result are looking at cutting fixed costs and improving investment returns.

● **Universal banks** – while a European bank's clients could reasonably expect their bank to be able to manage European equities or bonds, they may feel it acceptable, even beneficial, for their bank to outsource Japanese smaller companies, US equities or non-traditional asset classes.

● **Regional banks** – to compete for assets regional banks are seizing the opportunity to bring in asset management experts from outside their own domestic arena. Often this results in a strategic alliance where the whole asset management function – all asset classes – is outsourced to one sub-advisor.

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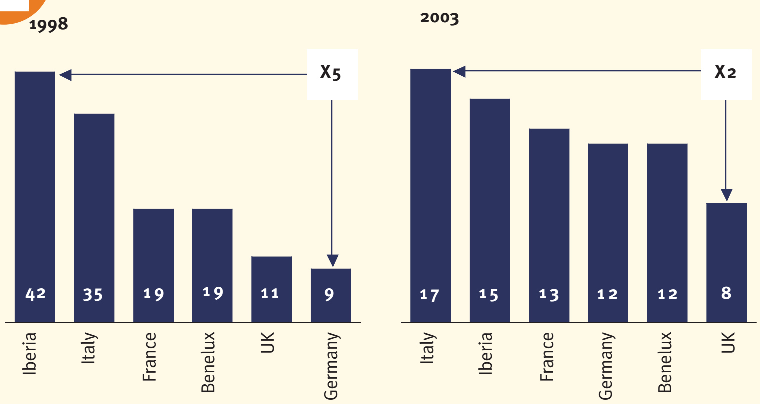
European profitability levels (basis points)



Source: McKinsey European Asset Management surveys 1999 and 2004

PARTNERSHIPS

The role of strategic partnerships is one of the key elements of sub-advisory in Europe. In picking a sub-adviser an institution has two main options:

● Pick the best-of-breed in a specific asset class.

● Find a strategic partner who can manage multiple products.

Cerulli estimates that in Europe 43 per cent of sub-advised mutual fund assets result from strategic relationships. Under such arrangements, the sponsor selects a limited number of manufacturers to provide all sub-advisory services, and new mandates are generally not open to competition.

As more distributors take the strategic route of focusing on asset gathering, expectations are that the use of strategic sub-advisory partners will increase, with one or two partners being brought in to manage the majority of assets, and perhaps single asset class specialists used to manage one product.

PROFITABILITY

Across Europe we are seeing a convergence in the profitability levels of individual countries. Whereas in 1998 the most profitable market – Spain and Portugal – was almost five times more profitable for asset managers than the least profitable – the UK, in 2003 the most profitable market was now only twice as profitable as the least.

As markets mature and country profitability levels converge further, distributors, with fixed and increasing sales and marketing costs, are likely to look to outsource asset management in order to maintain profitability and competitiveness.

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