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How to help close the gap between assets under management and profits.

BY ALAN GEMES AND
ANDREAS LENZHOFER

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Four Strategies for Wealth Managers

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After a tumultuous period of plummeting asset prices and downward-spiraling revenue, and the near collapse of some of the world's leading firms during the financial crisis, the global wealth management industry is regaining some of the ground it lost. More specifically, assets under management (AUM) are now rising in markets around the world. In North America, for example, AUM have passed their pre-crisis levels after four years of steady growth. In China, Latin America, and other emerging markets, they have risen far beyond their mid-2000s levels. Only Europe is lagging, and even there, AUM have increased significantly since the nadir of 2008. Yet the industry is still struggling, because the gains in assets have not translated into healthy top- and bottom-line growth.

According to a global study conducted by Booz & Company using quantitative market analysis and in-depth interviews with more than 150 wealth management executives, senior financial advisors, and regulators, AUM are rising for three distinct reasons. First, emerging-market economies have been expanding. Second, equity markets worldwide have rebounded, drawing greater inflows of assets from investors. Finally, the number of high-net-worth individuals (HNWIs)—those with more than US$1 million in investable assets—continues to grow two to three times faster than the gross domestic product in most markets.

Despite these gains, however, pretax profit margins for wealth managers fell in all regions of the world from 2007 through 2012: from 37 percent to 16 percent in Europe, from 29 percent to 21 percent in North America, and from 30 percent to 12 percent in Asia. The explanation? New global regulations (including greater scrutiny of undeclared offshore assets), changing customer behavior, the rapid advance of digitization, and a fluid competitive landscape have permanently altered the rules of the game and raised the cost of doing business. Few wealth managers have adapted to this new reality, but they must do so quickly if they are to survive, let alone capitalize on the continued economic recovery expected in 2014 and 2015. Before delving into the solutions, it's helpful to look at each of these issues in more detail.

An Industry in Transition

The financial industry currently faces an unprecedented degree of regulation, covering a wide range of issues: capital, liquidity, proprietary trading, derivatives, corporate governance, and the transparency of offshore assets and income. If there is any good news on the regulatory front, it's that predicted new global rules are finally taking shape, ending years of uncertainty about how to prepare. Also, these regulations will likely raise the industry's barriers to entry, which may ultimately help wealth managers preserve margins. We see the major regulatory challenges for wealth managers falling into two main categories: taxation and transparency, and client protection and suitability.

More specifically, new rules on international compliance and transparency have radically changed the

Illustration by Lars Leetaru

Better Segmentation Leads to Better Insights and New Markets

Populations in industrialized countries are aging, defined-benefit pensions are disappearing, and investment returns have been challenged by a long period of volatility and low interest rates. These changes have affected the needs of wealth management clients, creating an opportunity for wealth management firms that adopt a more granular approach to segmenting their customers. Specifically, what would help is a means of segmenting customers by "forms of wealth" and demographics.

Although these themes and challenges are applicable to developed countries around the world, they are particularly pronounced in the United Kingdom. Booz & Company recently conducted an analysis of wealth in the U.K. designed to yield a deeper understanding of numerous wealth subsegments (*see "Affluent but Forgotten: The Demographic Opportunity for Wealth Management in the U.K.," by Victor Koss, Jorge Camarate, and Guy Weissman, Booz & Company, Oct. 2013*).

In all, U.K. households held the equivalent of US$12.1 trillion in total gross wealth (meaning all investments, cash, property, and any other assets) and $6.8 trillion of liquid wealth (excluding property and mortgages) in the U.K. in 2012. Current segmentation strategies among wealth managers, banks, independent financial advisors, and insurers target a portion of that liquid wealth. But the Booz & Company research shows that some $3.2 billion—or nearly half—is available to wealth managers with better customer insights and product offerings that are more tailored to the needs of the market.

Some of the best opportunities for wealth managers lie in the affluent segment, comprising people who have between $162,000 and $1.6 million in liquid assets, who together own 27 percent of liquid wealth in the U.K. (Approximately 12 percent of U.K. households are classified as affluent.) Today's efforts to appeal to this affluent group are limited by an approach to segmenting customers that focuses on how much income and wealth people accrue, rather than the different needs demanded by different forms of wealth. Thus, banks can fail to provide the kinds of services many affluent people need.

For example, real estate (including primary residences) is the largest asset class and is increasingly becoming the pension of the affluent. There is a clear opportunity for wealth managers to think creatively and design products and services that appeal to people with significant real estate holdings. For instance, wealth managers should give customers a consolidated view of their income and assets, including property. They could also offer products to monetize some of their clients' illiquid investments—such as reverse mortgages—to fill income gaps, especially during retirement.

Another important segmentation factor is age. The needs and behaviors of affluent households in the 35-to-44 and 65-to-74 age bands, for example, are fundamentally different. The younger group is about to enter its peak earning years and has relatively less accumulated wealth. These clients need a better financial education to ground them in sturdy, lifelong investment habits. The latter group needs ways to generate steady income from portfolios, cash-flow planning, and hedges against inflation risk.

Wealth managers that develop better segmentation strategies, gain deeper customer insights, and tailor their products and services accordingly will gain a competitive edge in the U.K.—and ultimately in other markets as well.

Victor Koss
victor.koss@booz.com
is a partner with Booz & Company based in London.

Jorge Camarate
jorge.camarate@booz.com
is a principal with Booz & Company based in London.

Guy Weissman
guy.weissman@booz.com
is an associate with Booz & Company based in London.

climate for tax havens. One of the most significant changes so far is the U.S. government's new Foreign Account Tax Compliance Act, which requires banks in other countries to disclose the accounts of U.S. citizens. Similarly, most interviewees in the recent Booz & Company study assume that the Organisation for Economic Co-operation and Development will ultimately push for full tax transparency among its member states. In light of these developments, players will need to reevaluate their offshore strategies, withdrawing from some markets and focusing only where they have a clear value proposition, growth prospects, and proper compliance capabilities.

Besides taxation and transparency issues, new regulations designed to reduce conflicts of interest and improve customer "suitability" are changing traditional distribution, compensation, and pricing models across the wealth management industry. In the past, financial players paid banks handsome distribution fees known as retrocessions for distributing their products to clients. But recent laws aimed at eliminating conflicts of interest spell the end of these business practices. Most of those surveyed expect that these bans will reduce costs for clients—and profits for banks. That effect has already become apparent in the U.K., where retrocessions were banned in 2013.

On the issue of "suitability," meaning the matching of investment risk to client risk tolerance, national and international regulators have pushed client protection initiatives to improve disclosure, eliminate conflicts of interest, and document client meetings. Suitability rules like these introduce new sales and marketing risks for wealth managers—it is one more thing they must get right—along with increasing their cost burden.

The industry must also placate customers whose daily experiences on sites such as Google and Amazon, and on devices such as smartphones and tablets, are influencing their expectations for wealth management. Customers want plentiful, transparent information at their fingertips, as well as the freedom to conduct research and make decisions wherever and whenever it's convenient.

As more and more high-net-worth individuals are motivated to use technology and emerging channels to manage their wealth, the industry is moving toward a 24/7, multichannel, digital environment dictated by customers, especially for standard products and services.

These global regulatory trends and evolving customer behaviors, particularly those involving technology, are reshuffling the competitive landscape in a number of ways. One way is through acquisitions and spin-offs. The costly operating environment is hurting wealth managers of all sizes, but large players are weathering the storm better than small players, which increasingly lack the necessary scale to keep their businesses viable, particularly with respect to IT costs. Since 2007, small banks have experienced slower AUM growth, greater increases in cost-to-income ratios, and a faster decline in profit margins than large and medium-sized organizations. This has driven a wave of acquisitions and consolidation, which is expected to continue.

At the same time, many international universal banks are looking to shed overseas wealth management operations that are marginal or unprofitable. Not long ago these banks invested heavily in the Middle East, for example. But in the past three years, many have partly or fully withdrawn from these activities, often selling their operations to local players.

Even as industry consolidation continues apace, however, we are seeing a rise in independent wealth managers that are unaffiliated with large banks. Because of the reputational damage that many large institutions suffered during the financial crisis, many HNWIs, especially in North America and Europe, are now more inclined to do business with independents. These include multifamily offices—or commercial enterprises that handle financial issues for wealthy families—which can leverage open banking platforms and can offer an array of products and services that were once available only from larger institutions.

In addition, new digital providers are targeting the wealth management market from several angles. Investment advisors can provide real-time customized advice and innovative tools to help clients set goals, monitor performance, and rebalance their investments. Portfolio review providers go one step beyond, offering financial management portals that track not only the performance of investment portfolios but also the performance of specific wealth advisors. And investment communities offer a platform on which people can share and discuss investment ideas.

These new digital entrants pose a unique challenge to established wealth managers. Digital providers offer their services free (or sometimes at very low rates), meaning

Customers want the freedom to conduct research and make decisions wherever and whenever it's convenient.

their long-term profitability—and viability—is uncertain. Nevertheless, they are forcing incumbents to make significant technology investments to keep pace.

Over time, a more serious threat to today's wealth management firms will be established online brokers that begin complementing their transactional expertise—such as basic stock trading and low commissions—with higher-end wealth management services. For example, the Charles Schwab Corporation is rolling out 80 advisory service branches in 2014, and its compound annual revenue from such services grew 30 percent between 2009 and 2012.

Four Response Priorities

We believe that wealth managers can keep pace with the industry's changing dynamics and capitalize on the recovery in 2014 and 2015 by

The Rising Mass Affluent

Retail banks in the United States are increasingly pinning their hopes on the "mass affluent" demographic to provide growth opportunities. Mass affluent customers—those with investable assets of US$250,000 to $1 million—are typically six to 10 times as profitable as mass-market customers. In fact, they generate approximately two-thirds of total customer profits for retail banks, even though they make up only 20 to 30 percent of banks' customer base, according to the Economist Intelligence Unit.

But shifting these customers from low-margin deposit products to higher-margin investment products is a challenge. Today, just 5 to 7 percent of mass affluent clients at retail banks use wealth management services. According to results from a Booz & Company study of 1,100 mass affluent retail bank customers in the U.S. conducted in March 2013, most of these customers don't believe the banks are capable of providing the investment products and services their households need (*see "Wealthy, Young, and Ambitious: How Banks Can Profitably Serve the Rising Mass Affluent," by Paul Hyde, Ashish Jain, and Suzanne Lyman, Booz & Company, Oct. 2013*). Instead, they believe traditional brokerage firms are the solution.

However, the Booz & Company survey identified one particularly promising subgroup for retail banks. We call them the rising mass affluent (RMA) because they are relatively young, ages 30 to 49, and are increasingly assuming leadership positions in business and government. They often have young families and know they need financial planning, but they typically have not yet built a relationship with an advisor. This makes them more receptive to the idea of getting investment services from their bank. In the survey, 51 percent of the RMA group said they would consider using their primary bank for their household investment needs, whereas only 37 percent of the older mass affluent group said the same.

Many banks have struggled with RMA customers because they do not neatly fall into the traditional retail, wealth, or business models. Rather, their needs straddle multiple areas of the bank that don't traditionally work together. Each individual bank will have a different approach to targeting the RMA, but all banks should have a few common capabilities.

- **Distinctive client value proposition and targeting.** Banks should develop their differentiated value proposition and customer experience in a way that targets the RMA's investment needs and preferences.
- **Integrated delivery.** Banks should create a team model in which the client is a joint responsibility among people in multiple roles, including the personal banker and financial advisor.
- **Customer-oriented analytics.** Banks should establish systems to collect insights from the transactions and behavior of RMA customers. They should then use that data to identify and target customized products and services that differentiate the bank.
- **Digital offerings.** Banks should create a digital, integrated, real-time wealth management experience using online mobile channels. Digital offerings were a top priority for 61 percent of the RMA survey respondents.

Capturing a greater share of the mass affluent business will be an uphill battle for banks, but a good starting point is targeting the rising mass affluent. The RMA are young, with plenty of time for their assets to grow. If banks can make inroads with this group today and manage investments for the long term, they can prosper as they help the RMA graduate to higher levels of wealth.

Ashish Jain
ashish.jain@booz.com
is a partner with Booz & Company based in Chicago.

Paul Hyde
info@strategy-business.com
was a senior partner at Booz & Company in 2013, when this article was researched and written.

focusing on four priorities.

1. Apply a capabilities lens. First, wealth managers need to clearly define which markets they intend to play in, whether onshore, offshore, or both. Wealth managers are understandably drawn to markets that promise superior underlying growth, but the expense and patience required to compete in some of these markets can make profits elusive.

Going forward, wealth managers need to apply a capabilities lens, to identify the markets where they can provide a clearly differentiated set of products and services that leverage the things they are demonstrably good at. Even the biggest wealth managers can no longer be all things to all people. This will inevitably require some difficult trade-offs in terms of markets to play in, client segments to target, and business models to adopt.

2. Rethink the value proposition. New regulations on client suitability and compensation, as well as customer demands for tailored solutions and digital access to financial information, are forcing banks to rethink how they go to market. They must improve the way they bundle products and services to appeal to different customer segments, while also helping the wealth manager control costs.

The industry needs new pricing models. Customers expect to know exactly what they are paying for, and regulators want customers to be able to compare prices across the industry. Transparency is key. This will fundamentally change how private banking services are priced; pricing models may include standard fees for basic products and services, all-inclusive fees for advanced packages, and volume/transaction fees that are clearly linked to specific thresholds.

3. Go digital. The requirement to digitize the business model varies by region to a surprising degree. In the United States, digitization is a top priority for virtually all wealth managers. But in other parts of the world, digitization is a priority only for large players. Some small players even argue that a traditional approach—offering direct, hands-on service from a wealth manager, with no digital component—is a differentiator and part of their value proposition. That argument is misguided. Digitization is critical if wealth managers are to better understand customer needs, generate customer-centric holistic advice, and deliver a superior customer experience.

Building a digital agenda entails several components. Wealth managers must create a 360-degree view of clients' assets and behavioral profiles, and offer high-speed, always-on access to their portfolio, along with "self-serve" research and advice. Managers also need to improve the quality of their advice, by using "big data" analytics to tailor it to the needs of individual clients. Establishing a social media presence allows them to gauge customer sentiment and better communicate with clients. And digitization can help streamline and automate back-office operations (and thus reduce costs).

4. Adopt a *Fit for Growth approach.** To date, wealth managers have not been able to lower their costs fast enough to overcome the escalating cost of doing business. Instead, they need a strategic, ongoing approach to fixing their cost base and positioning themselves for growth. Taking a *Fit for Growth* approach starts by articulating a clear cost agenda from the front line to the back office. It continues with building lean and resilient processes, systems, operations, and organization structures. And it culminates in the permanent ability to redirect resources away from "bad" costs and toward "good" costs—namely, those that reinforce differentiating capabilities.

Despite the trials of the last few years and the challenges that lie ahead, wealth management remains an attractive growth industry over the long term, with a return on equity superior to that of any other financial-services segment. The growth in the number of HNWIs, along with strong economic activity in the world's most robust emerging markets, bodes well for the industry—and for the wealth managers that can learn to compete in this new environment. +

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Alan Gemes
alan.gemes@booz.com
is a senior partner with Booz & Company based in London. He specializes in transformation strategies for financial institutions and works with wealth managers and private banks across Europe on strategy, adapting to the digital world, and transforming operating models.

Andreas Lenzhofer
andreas.lenzhofer@booz.com
is a partner with Booz & Company based in Zurich, and the leader of the firm's global wealth management study. He has more than 15 years of experience in consulting with leading wealth managers across Europe. He specializes in strategic transformation programs along the wealth management value chain.

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