



MS 15/2.2: Annex 8

Market Study

Asset Management Market Study

Interim Report: Annex 8 – Profitability Analysis

November 2016

Annex 8: Profitability

Introduction

Why have we conducted a profitability analysis of asset management firms?

1. There are two main reasons we have undertaken a profitability assessment. First, we wanted to understand the business models of asset management firms in the UK market. Understanding firms' business models helps us to understand firm incentives and how firms compete. In doing so, we looked at the relationship between revenues, costs, and profits across different asset management firms. We examined how the relationship is affected by the size of the firm, its client base, investment strategy, the asset classes in which the firm specialises and the extent to which these relationships change over time.
2. Second, we wanted to understand what profitability implies about how competition is working in the asset management sector. The rationale of profitability assessment lies in economic theory; in a perfectly competitive market, prices should reflect an efficient level of costs plus a reasonable profit, when considered for a sustained period of time. In less competitive markets, prices are likely to significantly exceed efficiently incurred costs, and hence high profits are likely to be observed over time.¹ Our profitability analysis looks at firms' profit margins over time and their return on capital employed. Where margins are high and sustained across our sample, or where returns are consistently in excess of the cost of capital across a large share of the firms in the market, it could be an indication of limitations in the competitive process.
3. This annex provides a summary and explanation of our analysis. The structure is as follows:
 - **Data:** we provide an overview of the scope of our sample, which firms were selected and why. We also discuss some of the issues with the data we received and the conditions and limitations this places on our analysis.
 - **Firm revenues:** we provide an overview of firms' revenue sources which we then use to assess firm profitability.
 - **Firm costs:** we provide a breakdown of firms' cost base.
 - **Trends in revenues, costs and operating profits:** we wanted to understand how firms' operating profits changed over time. This is important because asset management firms operate in markets that are cyclical. Looking at profitability at a single point in time could provide a misleading impression of firm profitability, particularly if the profits made when markets are buoyant are needed to compensate the firm when markets fall. In our analysis we have defined operating profit as firms' total revenue less all operating cost. We define operating cost as the cost of providing all asset management services, including internal arm's length transfer prices, but excluding interest and tax payments.
 - **Return on capital employed:** we consider the operating profit generated by the capital invested in the firm. Beginning with accounting measures of capital we

¹Lower profits may be observed in less competitive markets where firms are not incentivised to maximise their efficiency.

make a series of adjustments to account for non-accounting economic capital. We benchmark these returns against estimates of the weighted average cost of capital. This is important because it provides an indication of the return the market requires from a firm given a certain level of risk. Returns consistently above the cost of capital across a large share of the firms in a market is one indicator that competition might not be working effectively.

- **How profitability is affected by scale:** we consider the effect scale has on firms' financial performance. We have assessed whether firms earn more for each £ they have under management. We also consider the impact of scale on average price.
- **How profitability is affected by customer group, investment strategy and asset class:** we consider the differential levels of profitability between institutional and retail clients; between active and passive management; and between asset classes to determine the extent to which any one group of clients or securities drives profit at a firm or industry level.

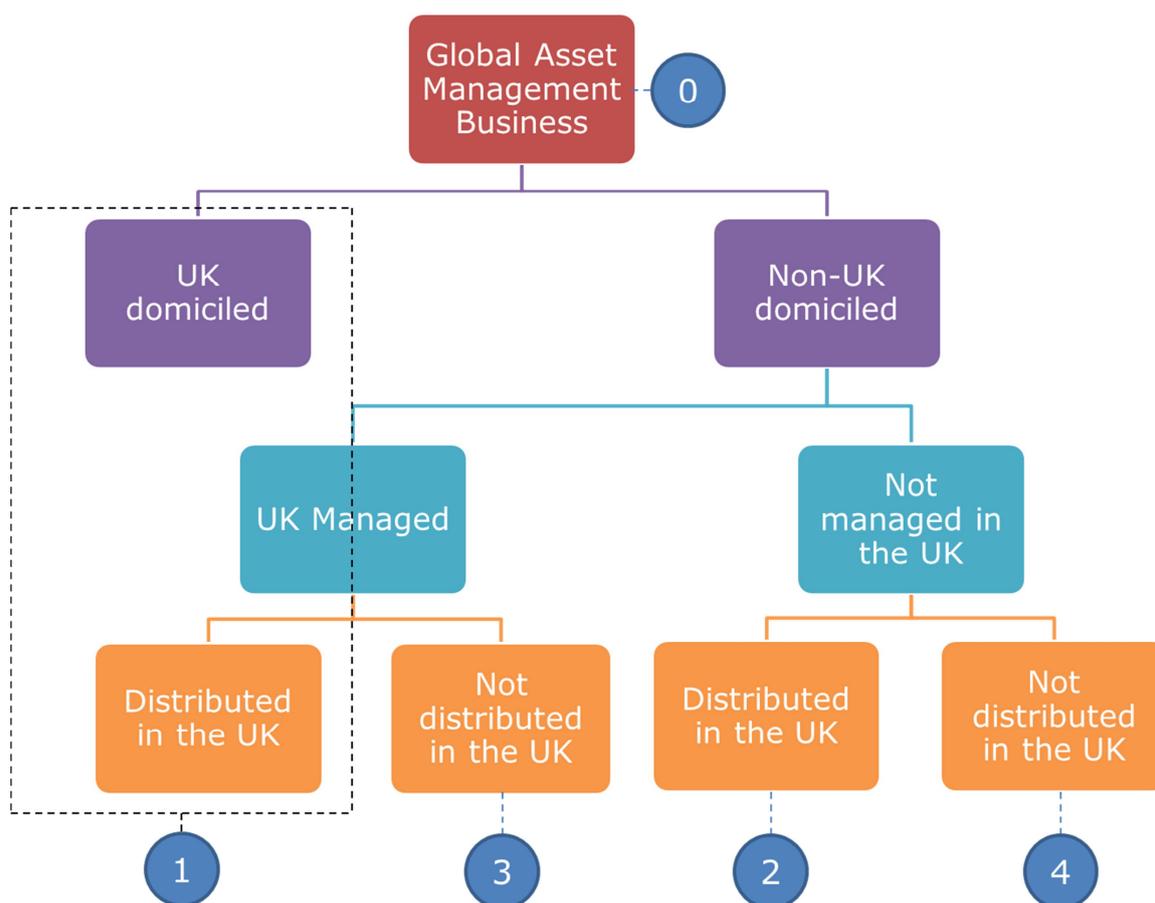
What data is our profitability analysis based on?

4. Our financial analysis is based on a sample of asset managers selected to be representative of the market whilst minimising the burden on industry. Firms were selected primarily due to scale. Large firms represent a larger proportion of the market and are more likely to cover a wide range of market segments, for example servicing a wide range of different client types or managing products across multiple asset classes. Consideration was also given to the mix of firms selected, for example, we selected a number of passive product providers to ensure our sample contained a mix of different investment strategies. In addition to these larger firms, a number of smaller firms were also included in order to gauge profitability at all levels of the industry.
5. Our sample comes from 16 asset management firms from 2010 to 2014 and 14 firms for 2015. In 2015 assets under management (AUM) in our sample totalled £4.4 trillion generating revenue of £13 billion and operating profits (profit before interest and tax) of £5 billion. For the firms in our sample, assets under management in the UK come to around £3tn which covers just over half of the market within the scope of this review.²
6. The scope of our data request was on firms' asset management business only. Our sample does not include the provision of ancillary services such as custody banking or other related services such as the provision of sales platforms. For firms whose asset management division use services provided by their corporate group we asked for details of their transfer prices.
7. In the draft data request circulated to the firms in our sample we requested revenue and cost information at a fund level for a 10 year period. We also asked for the data to be split by combinations of client type, asset class and investment strategy, for example the cost of all active equity products sold to retail consumers; and for details of where the fund was domiciled, managed and the region in which it was sold.
8. In meetings with firms they told us that this data could not be provided due to the way in which financial data was stored and the level of granularity firms' management accounting systems worked on. In particular, cost allocation was

² City UK's estimate of total assets managed in the UK in 2014 was £6.8 trillion. The Investment Association members manage £5.7tn (2015), other AUM is attributed to private equity funds, hedge funds and other vehicles which are largely outside the scope of our study.

viewed by some firms as too arbitrary and difficult to be worth focusing on in management information, with revenue and AUM KPIs being more commonly used.

9. We had expected firms' management accounts to be able to provide this level of granularity, estimating the profitability of each fund and closing or merging funds which were unprofitable to the company. We found that asset managers typically do not manage their business in this way. Firms' management of financial performance appears to focus more on ensuring AUM and hence revenue is maximised, rather than on fund level cost management. The result is that management accounts tend to focus less on profitability of funds and more on the overall performance of subsets of the business, for example by asset class or by geographic region.
10. We therefore reduced the detail of our request. We asked for a split of the data by client type, by investment strategy and by asset class but not for the combinations of these splits. We also removed our request that financials be provided on a fund by fund basis. Instead we asked for financials for the firm as a whole with each of the three subset splits described above. We then asked for this data to be broken down into four segments:
 - Segment 0: The entire global asset management business.
 - Segment 1: All business relating to funds domiciled in the UK or which are in any way managed or distributed in the UK.
 - Segment 2: All business relating to funds domiciled and managed in other jurisdictions which are in any way distributed in the UK.
 - Segment 3: All business relating to funds domiciled and distributed in other jurisdictions which are in any way managed in the UK.
 - Segment 4: All business related to funds domiciled, managed and distributed in jurisdictions other than the UK.



11. Note that for some firms' business their entire business (segment 0) is synonymous with some smaller subset (for example segment 1). Additionally some firms have only been able to supply their UK or European business segments for segment 0. The intention was to focus primarily on segments 1 and 3, which more closely match areas in which the FCA has greater powers and responsibilities. However, given the difficulty most firms have experienced with cost allocation our results are primarily based on segment 0 to minimise the level of cost allocation inherent in our data. Even at this level we have found that some of the data requested could not be provided even on a best endeavour basis.
12. Lastly, when speaking to firms we found that IT legacy issues prevented most firms providing data for a 10 year period and that there remained some issues of comparability in the data even when the time period was reduced. We felt that 6 years of data balanced the burden on firms with the minimum time period necessary to look at firms' profitability and understand trends. Our concern is that this data period may obscure large losses during the market downturn. This is addressed in the trend analysis below. In addition it limits the extent to which we can analyse the cyclicity in asset managers' business cycles.
13. We are also conscious that the sample does not encompass the whole market and that the limited number of data points (no fund by fund data, limited sample of firms and shortened time period) make some methods of analysis more challenging. As a result our analysis has been conducted in the round, looking at operating profit margins, return on capital and trend analysis to establish the extent and persistence of profitability in this market.

A note on presentation

14. Though the bulk of our analysis has been completed on a firm by firm basis we will typically show averages to reflect financial performance across the industry and to protect confidential firm information. Where results are notably different between different firms we also note ranges and levels of variance in the sample data.
15. Averages for percentage variables such as margin (operating profit divided by revenue) are typically calculated by using the sum of input variables for all firms (in our example the sum of all firms' revenue and the sum of firms' operating profit) then calculating the percentage variable (in our example operating profit margin). We refer to this as asset weighted or money weighted average.

How do asset management firms generate revenue?

16. Asset managers generate revenue by levying fees proportional to the value of the assets being managed, with charges typically expressed as a percentage of assets under management. Depending on the structure of the asset manager and the services being provided, these fees can have a number of different names. In our data set we asked for a split of revenue between "investment management fees", which we defined as the revenue earned from managing assets of segregated mandates and "asset management charge" defined as the revenue earned by managing assets in pooled funds. These two categories account for the majority of revenue. Thirteen firms in our sample earned more than 80% of their revenue from these fees.³
17. However investment management fees do not have a consistent definition between firms. A firm may charge an investment management fee to pay for the cost of allocating assets, with the cost of all other services, for example fund administration, being paid for directly out of the fund to the third party providing the service. Alternatively the asset manager could provide these services and increase the investment management fee to cover the additional cost. Lastly the asset manager could contract with a third party to provide the service, charge a higher investment management fee and pay the third party contractor with the additional revenue earned.
18. For example, a firm may charge an arrangement fee that another firm would have included in its asset management charge. Similarly the cost of fund administration may have been levied by one firm directly (and thus is included in our revenue figures⁴) but charged directly to funds by all other companies. As a result our data set includes a large number of small revenue sources which are unique to the firm and arise based on how fees are structured and reported. These revenue sources make up around 4% of total revenue on average. These small revenue sources work on the same business model as asset management fees and reflect firms' charging and reporting structure.
19. The other main source of revenue for asset managers is performance fees. Here the asset manager agrees on a fee payment contingent on some measure of the

³ The remaining firms earn a significant amount of their revenue directly from "investment management fees" and "asset management charge" categories. However in two cases firms also earn revenue from internal transfer prices for services provided to other parts of their corporate group, with the third firm earning a higher than average proportion of its income from performance fees. This means the proportion attributable to management fees falls.

⁴ For firms that are outsourcing third party services including the cost in the income statement or charging funds directly should have very little impact on our analysis of operating profit (though margins may be slightly elevated for those firms which include these charges in their income statement). For firms that supply these services themselves we might expect profitability to be higher as a greater proportion of the value chain is captured by the asset manager. However asset managers typically do not offer many ancillary services directly, those that do more typically offer them through their corporate group making it likely that these are transfer prices and therefore reasonably comparable between different firms.

underlying performance of the fund either before (gross) or after (net) other fees such as the asset management charge have been taken into account. The extent to which firms rely on this revenue stream varies across our sample. Only three firms derive more than 5% of their revenue over our sample from performance fees, though two of these firms generate above 14% of their revenue from performance fees.

20. Eleven of the firms in our sample reported their performance fee income as having been earned from net performance fees with revenue averaging £463 million per year. We note that eight firms are still making income from gross performance. For the majority of firms this income makes up less than 2% of total income. However for at least one firm the proportion is around 8% of income across the 6 years of our sample. Total revenue varies depending on the scale of the firm but income from gross performance fees still averages around £54m per year.

What are the main costs asset management firms incur?

21. For the majority of firms in our sample, costs are primarily related to staff expenses. Across all firms, for the 6 year period of our sample, staff costs make up 56% of firms' total cost, though the proportion of staff cost can vary between around a third to two thirds of total cost.
22. Frontline staff wage cost (the sum of staff involved in investment management, research or distribution) makes up around 15% of costs across our sample.
23. Bonus payments make up around a quarter of total costs. However this data covers bonuses paid to all staff. If bonuses are paid in proportion to wages then the cost of frontline staff plus bonuses makes up 25% of staff cost on average across our sample (44% of the total wage bill).
24. Non-staff costs tend to make up a smaller proportion of costs and can be split into two main types of cost, logistics costs and payments to other entities. Logistics costs are typically made up of office, IT infrastructure and non-staff marketing costs but also include a variety of additional cost categories added to our data set by firms (typically more granular splits of the three main cost types). Logistics costs make up around a third of non-staff cost (about 15% of total cost). The largest two additional cost categories are payments to third parties⁵ and payments to platforms⁶ which together form 18% of total cost (40% of non-staff cost). Firms' submissions also include transfer payments within their own groups for additional services required to manage funds.

Frontline staff cost

25. Firms have told us that revenue and AUM are key indicators of performance. Below we consider the impact of AUM on profitability and find that both absolute profitability and profit margin seem correlated with AUM, meaning that firms with more assets under management tend to make larger GBP profits and tend to have higher profit margins.
26. In chapter 4 we discuss the factors that influence decision making for both institutional and retail investors. We have found that for both groups, past performance is a factor in their decision making process, with funds that experience

⁵ This can cover a range of different payments, for example it could include payments to a third party service provider by a firm that charges for these services through the AMC, as discussed above. It could also include the cost of back office support where the provision of this service to the asset manager has been outsourced to a third party.

⁶ This will include commission payments, which, following RDR, can only continue to be paid to platforms where they are rebated back to the investor.

better past performance being associated with higher net flows (see Annexes 4 and 6 for full details).

27. A firm's track record and its relationships with clients are established and maintained by its frontline staff and this poses a potential risk to the asset management firm. To the extent that a fund's track record or institutional relationships are tied to certain key individuals there is a potential risk that AUM can follow the individual if they move to another asset manager or set up their own firm. In order to retain frontline staff the firms' owners would need to engage in some form of profit sharing.
28. We see similar patterns of remuneration in other human capital intensive firms such as accountancy and law firms. In these firms, profits, defined as the revenue remaining after the firm's cost of doing business is deducted, are shared between these business critical staff and the shareholders. The distinction between these two groups is often due to a firm's legal structure or its approach to tax planning.
29. It can be difficult to determine the actual economic "wage" in these circumstances. The distinction between "owner" and "employee" is not clear in an economic sense. For those frontline staff designated "employees", remuneration is also somewhat arbitrarily split between salary, bonus and share options creating further distortions caused by consideration of tax and financial regulations.

Disposable Revenue

We define operating profit as:

- revenue – staff costs – non staff costs = operating profit

where;

- staff cost = "frontline staff cost" + "non frontline staff cost"

We also consider the profit that can be shared between frontline staff.

- Revenue - "non frontline staff cost" – non staff costs = disposable revenue

We define frontline staff roles as investment managers, analysts & researchers, distribution (sales and relationship management) and senior staff. Our data set provides details of the wage costs of these groups. However, whilst the data set also contains the cost of bonus payments these costs apply to all staff. Our analysis is concerned with the proportion of these costs that should be regarded as profits being shared rather than the cost to the firm's owner. We consider a number of different scenarios and estimates of this "frontline staff cost":

- Scenario 1: Wages are a logistic cost and profit is shared between frontline staff and firms' owners entirely through firms' bonus schemes. We estimate frontline staff cost to be 50%⁷ of the total bonus pot (frontline cost 1). All other costs are treated as non frontline staff costs (non frontline staff costs 1) including the wage cost of those in frontline staff roles.
- Scenario 2: Profit is shared between frontline staff and firms' owners via their total remuneration package. We estimate frontline staff cost as all

⁷ 50% is calculated by looking at the percentage of total staff wages made up of frontline staff wages. This gives a range of 37-67% averaged across all periods and all firms in our sample. The arithmetic average would be 55% however we use the money weighted average of 48% in line with our use of money weighted averages in our analysis. Note if we exclude firms that did not provide capital estimates our money weighted average would rise to 55%.

wages plus a proportion of the total bonus pot proportional to wages (frontline cost 2). The remaining bonus pot is treated as non frontline staff costs (non frontline staff costs 2).

- Scenario 3: Profit is shared between frontline staff and firms’ owners via their total remuneration package. We estimate frontline staff cost as all wages plus the entire bonus pot (frontline cost 3). Any remaining staff wages are treated as non frontline staff costs (non frontline staff costs 3).

Using these scenarios we estimate three measures of disposable revenue:

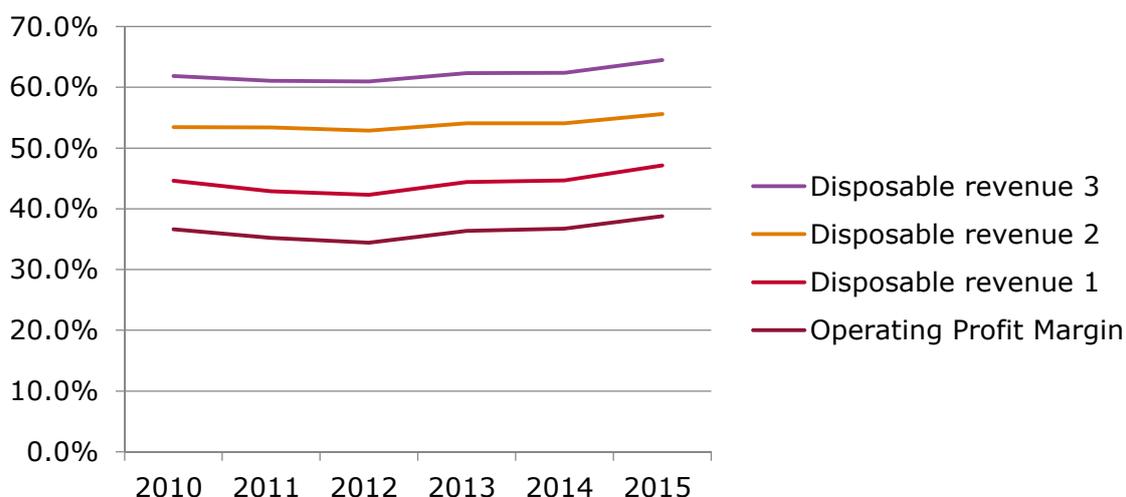
- Revenue – non frontline staff costs 1 – non staff costs = disposable revenue 1
- Revenue – non frontline staff costs 2 – non staff costs = disposable revenue 2
- Revenue – non frontline staff costs 3 – non staff costs = disposable revenue 3

An alternative method would be to start with operating profit and add back frontline cost in each scenario:

- Operating profit + frontline cost 1 = disposable revenue 1
- Operating profit + frontline cost 2 = disposable revenue 2
- Operating profit + frontline cost 3 = disposable revenue 3

30. However, it is possible to observe the total disposable revenue that is earned after the firm’s logistics costs have been covered and which is then shared between key staff and shareholders (see summary box above). To estimate this figure we look at staff and non-staff costs but exclude costs associated with frontline staff. Due to the difficulties outlined above in estimating the proportion of employee remuneration associated with profit sharing, we focus on estimating a possible range of frontline cost estimates which can be added back to operating profit to give an indication of the disposable revenue that is being shared by firms’ owners and its frontline staff.

Figure 1: Estimated disposable revenue margins compared to operational profitability



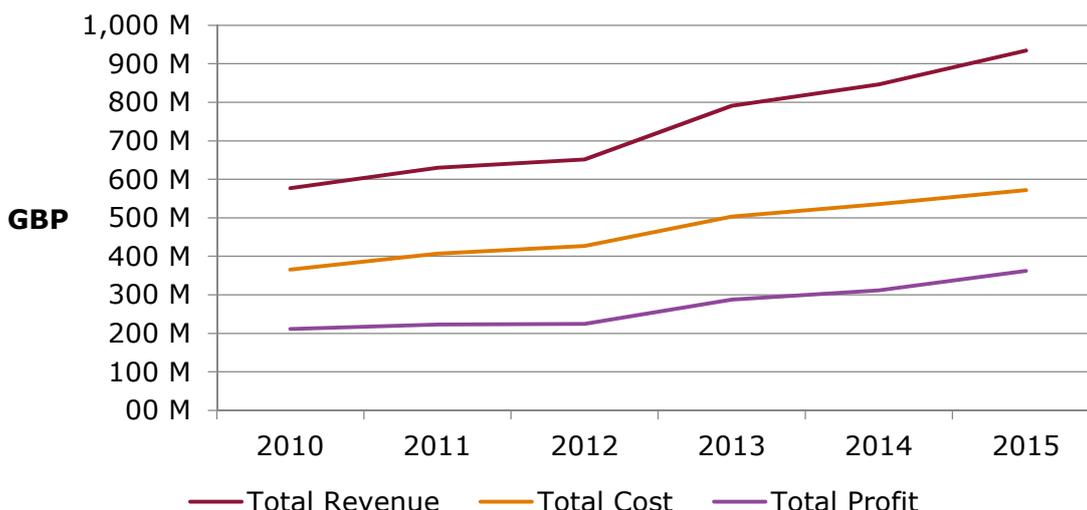
31. Regardless of the estimate used it is clear that the logistical cost of managing assets (organising funds, conveying decisions, back office functions etc.) is small in comparison to the cost of the expertise involved. Our range of estimates suggests that the profit margin of asset management may be in lie in a range of 30%-70%

depending on the method of estimation, with these economic profits split between the firms’ owners and experts, considerably higher than operating profit.

Trend analysis (revenues, costs and operating profits)

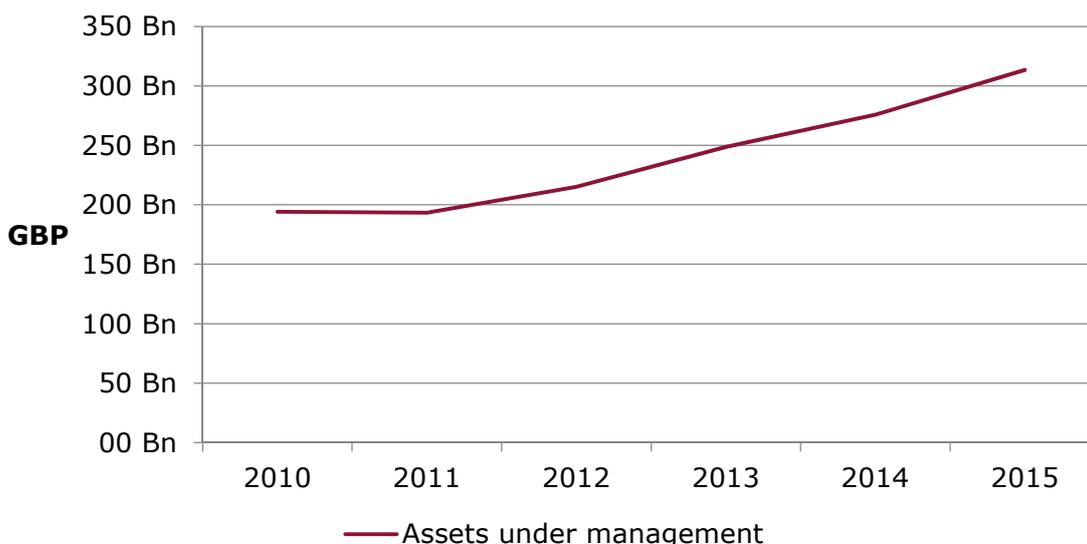
- 32. Revenue, cost and profit have all risen over time for almost all firms in our sample. Figure 2 shows that average revenue and profit for the sample as a whole has risen year on year since 2010.

Figure 2: Average of total revenue, cost and operational profit



- 33. This rise in revenue, cost and profit is strongly correlated with rising levels of assets under management. Figure 3 below shows that AUM was static between 2010 and 2011 but has grown year on year thereafter.

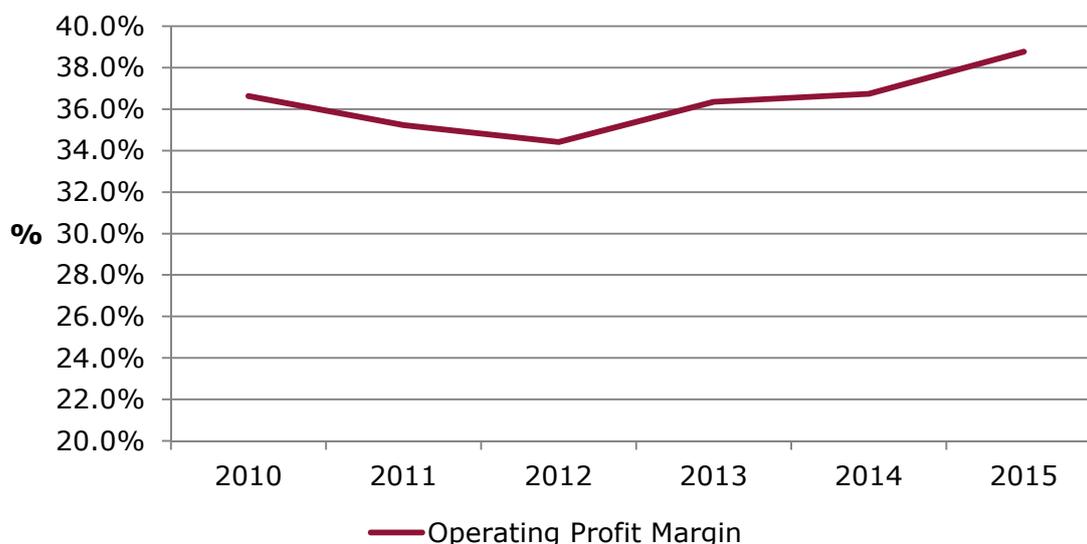
Figure 3: Average assets under management



- 34. The link between revenue and AUM is consistent with the ad valorem charging structure (a percentage charge for assets under management) used by asset managers. However we find that cost is also correlated with assets under management. Revenue typically grows at a greater rate than cost when AUM rises.

The result is that average operating profitability in our sample is also growing over time in line with AUM and AUM and operating profit are correlated. Whilst this trend is representative of most firms in our sample, not every firm in every period experiences an increase in profit as a result of rising AUM. Whilst revenue typically rises as a result of higher AUM, cost increases can be stepped leading to slightly lower profit until AUM and revenue catch up to the adjusted scale of the asset manager.

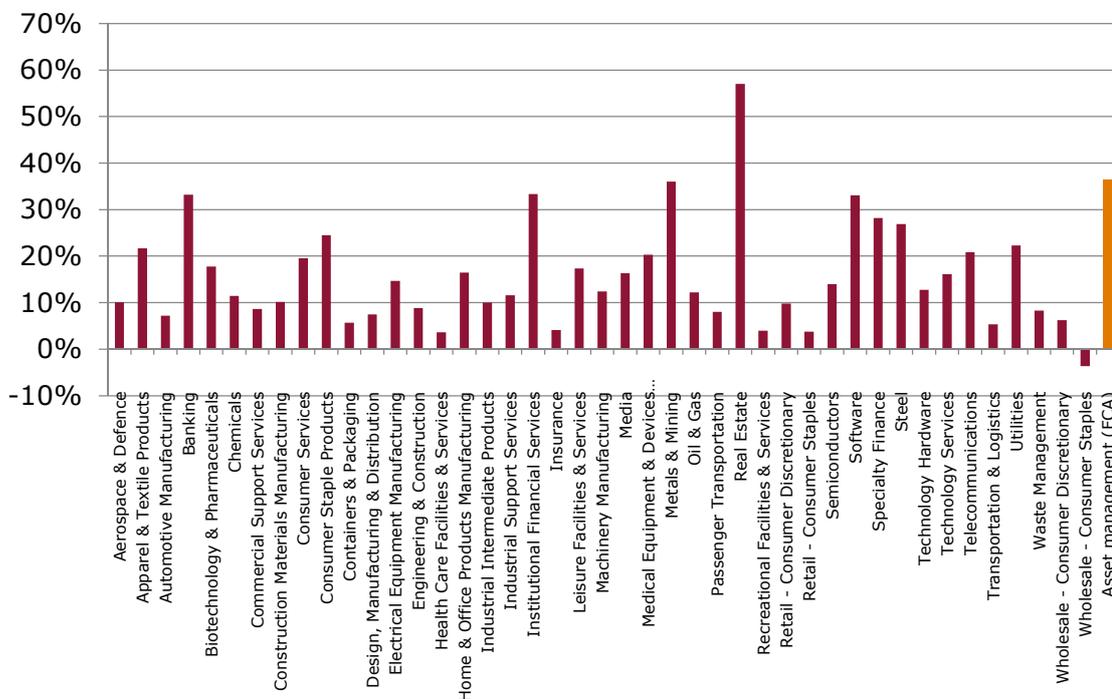
Figure 4: Operating profit margin



35. Average operating margin across our sample is 34-39% between 2010 and 2015. Trends in operating margin are more variable between firms. For about half of the firms in our sample operating margin is largely flat from 2010-2015, varying by only a few percentage points. For the remaining firms operating margin tends to grow over time for the majority as AUM increases.
36. Eleven of our sixteen firms' operating margins do not drop below 20% for the entire period and three further firms with operating margin below 20% in 2010 have margins above 20% by the end of the period. Operating margin is more typically in the 20-40% range for most firms in our sample.
37. Profit margins are usually an indicator of efficiency, with profitability analysis typically considering profit in the context of the return on capital employed using firms' cost of capital as a benchmark. In the case of asset managers we anticipated that estimating the economic capital employed would be challenging due to the high level of intangible assets employed by asset managers, increasing the margin for error and reducing the weight that could be placed on our results. To compensate for this we compare our analysis of margins against historical averages in other industries in order to provide an additional gauge of relative profitability.
38. Relative to other industry groups, operating margins for asset managers in our sample appear to be high. A survey of operating margins of firms in the FTSE All share (including asset management firms) showed average margin to be around 16% with only one industry group achieving margins above the average margin found in our data. A comparison of industry groups with similar business structures (high human capital, relatively low physical or financial capital) found margins in the 4%-33% range. By comparison half of firms in our sample had an average operating

margin above 30%. Three quarters of firms had an average operating margin above 20%.

Figure 5: 10 year operating margins by industry % (H2 2006 - H1 2016)



Source: Bloomberg and FCA data

39. Some firms have suggested that their business is cyclical; that as markets increase in value AUM will grow and as markets fall AUM will decrease. Whilst this may be true for certain specialist asset managers, invested in one set of markets, it seems less likely to be the case for firms that are diversified globally across many markets. Fluctuations in their AUM seem less likely to be driven by local macroeconomic conditions. Though our sample is not long enough to draw robust conclusions on cyclicity we note that while we have found a link between AUM and revenue, we have found a similar link between AUM and cost and that for the majority of firms in our sample margin remains above 20% for the entirety of our data sample. It seems likely that in the event of a downturn asset managers will be able to trim costs to at least 2010 levels in order to maintain profitability, limiting the impact any cyclicity has on the business.
40. Whilst asset managers may experience periods of lower profit due to market exposure our data set does not cover the last period of financial downturn. However if we take into account the total level of profitability over the 6 years of our sample, any future downturn would need to be sustained and prolonged for firms to become unprofitable overall in the near future.⁸

What impact does the size of the firm have on profitability?

41. We have analysed the impact that scale, at the firm level, has on profitability. This is important because we wanted to understand whether firms become more profitable as they grow and whether their consumers share any benefits from falling costs.

⁸ A firm earning no revenue but still incurring the average yearly costs in our sample would take approximately four and a half years to incur losses equal to the average total profits earned across 6 years of our sample.

42. Our analysis indicates that asset management firms earn greater absolute profit as AUM grows. As AUM increases both revenue and cost increase. However our analysis shows that costs increase less quickly than revenue and hence profit is highly correlated with AUM, as shown in figures 6 and 7 below. The charts below are presented without scales to preserve confidentiality of individual firms.

Figure 6: Revenue and cost plotted against AUM for each firm in each year

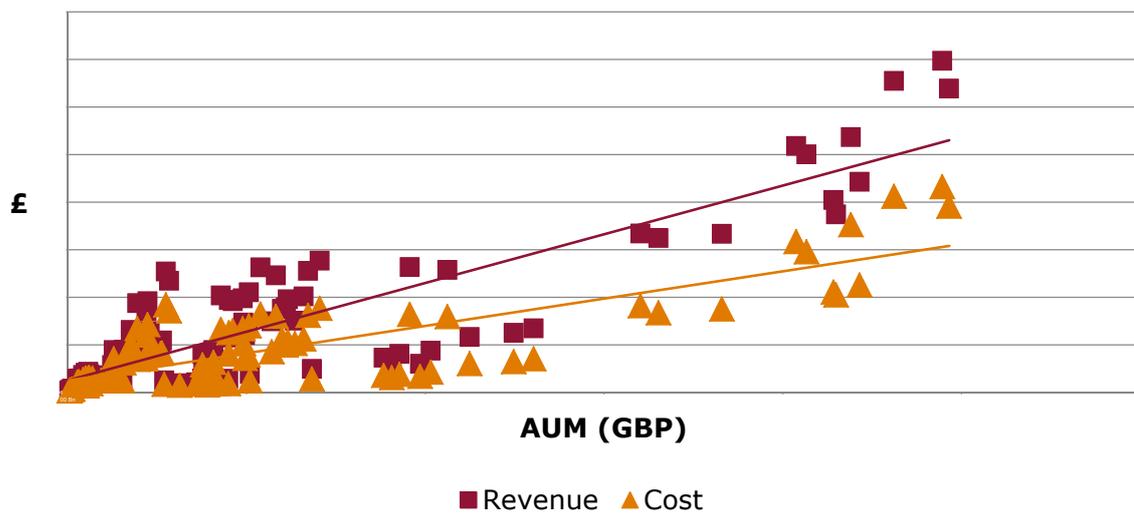
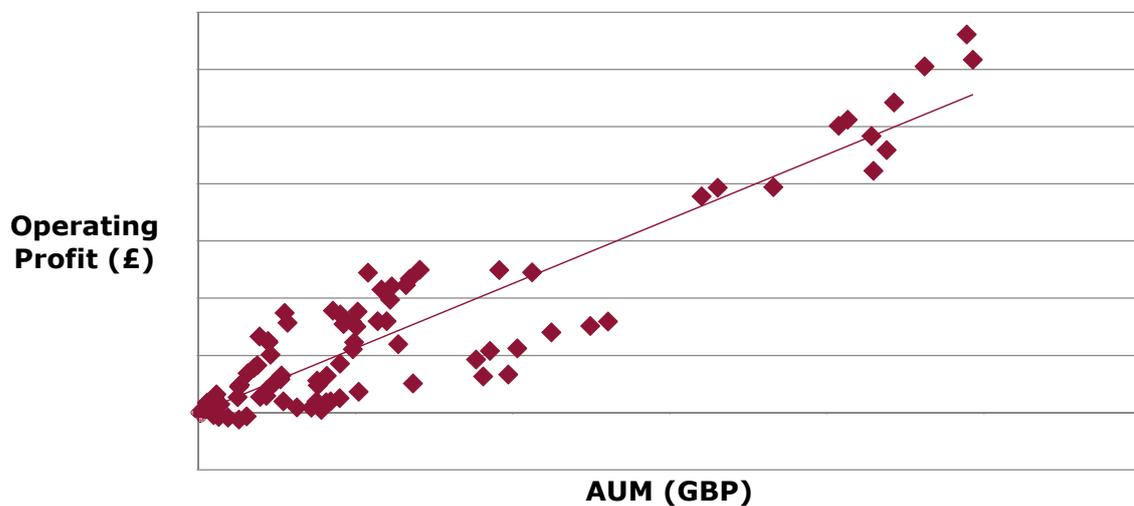
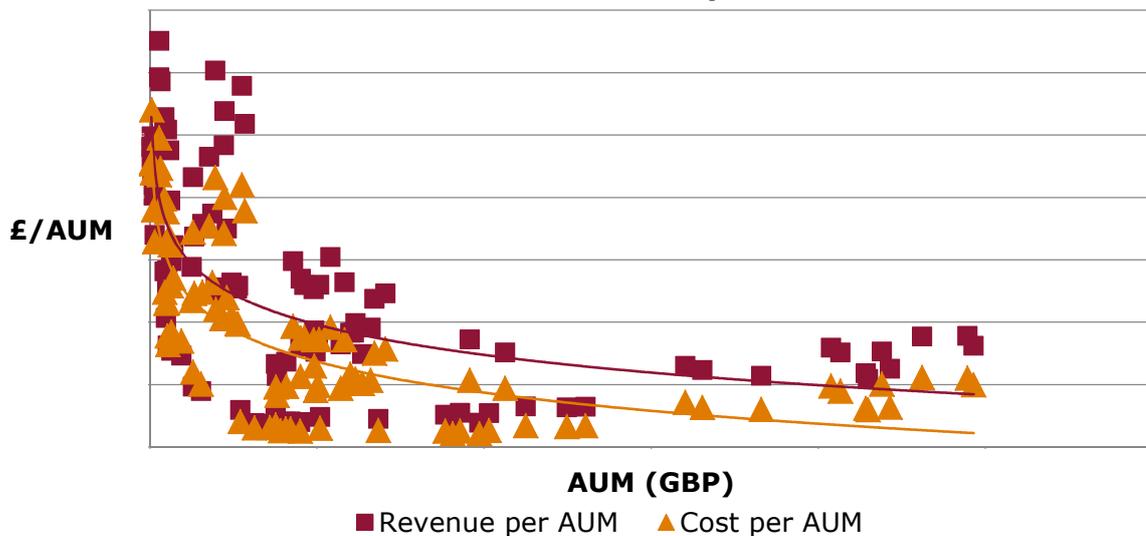


Figure 7: Profit plotted against AUM for each firm in each year



43. Our analysis also looks at the cost per £ of assets under management. We find that cost per £ AUM fall as AUM increases suggesting economies of scale between firms of different sizes. Though we also note that there appear to decreasing economies of scale as AUM grows suggesting a potential lower limit to the cost of managing assets.

Figure 8: Revenue/AUM and cost/AUM plotted against AUM for each firm in each year



44. Our analysis also finds that revenue per £ AUM, which is effectively a measure of price, tends to decrease as a firm's total AUM increases in size. Whilst average revenue per £ of AUM is falling, it decreases at a slightly slower rate than average cost per £ AUM. This is in line with our finding that higher AUM tends to be correlated with a higher operating margin.
45. In chapter 6, our analysis of pooled equity funds suggests that once a fund's AUM exceeds £100m, price is not significantly affected by AUM. However this analysis does not take into account segregated mandates, which are included in our profitability data. Segregated mandates are typically larger than most pooled funds and tend to attract lower prices. This may explain why we see falling revenue per £ AUM in our profitability data which is based on a weighted average of mandates and funds across all asset classes
46. The granularity of our profitability data does not allow us to look at the profitability of pooled funds and mandates directly. However we are able to look at the profitability data split between retail and institutional subsets. We expect the institutional section to contain a high proportion of segregated mandates and for the retail subset to be primarily pooled funds.
47. We find that revenue per £ AUM is higher for retail than the institutional subset (excluding pensions). This reinforces our view that falling revenue per £ AUM at the firm level is primarily driven by firms' larger institutional clients. It also suggests that the economies of scale from greater assets under management may not be shared equally between different customer segments.

What return do firms make on the capital employed?

48. As discussed above estimating the economic capital employed is challenging due to the high level of intangible assets employed by asset managers. Our analysis of returns forms one aspect of our assessment of profitability, together with our review of firms' margins relative to other industries and our trend analysis.
49. We have analysed what returns firms make on the capital employed in their business. Calculating the return on capital employed (ROCE) – which is operating profit divided by the employed capital – is a key part of our financial analysis and our

investigation into the competitive conditions in the asset management sector. Some asset managers earning a high return on capital employed could be consistent with competition in the asset management industry being effective, as more efficient companies secure more profit in the market than others, although we would not expect this to persist over a sustained period. Note that, as discussed, the effect of higher skilled staff may be more muted when looking at operating profit since they may be able to bargain for a higher share of disposable revenue. Since this is accounted for as a cost, operating profit may appear lower. However these higher economic profits earned by firms could reflect a scarce availability of skill amongst asset managers. Nonetheless, consistently high returns on capital employed combined with persistently high operating margins, across most firms in the sector could imply that competition is not working effectively.

50. The key challenge in estimating ROCE accurately in this industry is that determining the economic value of the capital employed is difficult for several reasons:
- Asset managers can carry different levels of capital due to different regulatory requirements
 - Our data may be concerned with the asset management arm of a larger corporate group or with one region within a larger corporate group
 - Asset management typically requires relatively small amounts of financial capital (equity and debt) but a large amount of human capital that is not present on the balance sheet.
51. In addition, as discussed above, the returns earned by asset managers are after paying salaries to investment and frontline staff, who may be sharing in the economic profit of the firm. The ROCE is therefore likely to understate the profitability associated with managing investments.

Unadjusted ROCE

52. Firms were asked to provide estimates of their long term capital which we defined as the total book value of equity plus long term debt. Of the 16 asset managers in our sample 13 were able to provide data on long term capital.
53. We calculated an unadjusted ROCE by dividing operating profit by this long term capital estimate. Firms' unadjusted ROCE typically averaged between 20%-45% with 10 firms of the 13 available in our sample in this category over the length of our sample. Extreme results above this range seem to be due to the issues identified above relating to the difficulty of estimating long term capital in corporate structures that span multiple business lines or geographic regions.
54. ROCE is typically benchmarked relative to an estimate of the cost of capital. When estimating the WACC⁹ we have considered a range of values for each variable based on different assumptions. The main line of our analysis uses an estimate of 7.6% which represents a combination of market parameters intended to best represent a hypothetical UK asset manager. We have tested the sensitivity of our WACC estimates to different market parameters. However we find that our estimate of the cost of capital, which falls between 5.5-8.5%, is relatively insensitive to changing assumptions. We therefore find that unadjusted returns are significantly above our estimate of cost of capital.

⁹ The weighted average cost of capital (WACC) used in our analysis is estimated for a hypothetical UK asset manager over the period 2010-2015. Market parameters (risk free rate, equity risk premium) are based on the UK market. Beta estimates are taken from firms within our sample for the relevant period.

55. Some firms also submitted their own estimates of cost of capital which are typically in the 11-15% range. However these figures are typically used as hurdle rates for the return on seed capital invested in new funds. The risk on these projects would be far higher than for asset managers as a whole and so are inappropriate as benchmarks in our analysis.

Adjustments to capital base

56. Before comparing ROCE and WACC we consider a number of options to correct for the presence of economic capital such as the ability and expertise inherent in the investment managers and other frontline staff. Since human capital of this sort cannot be capitalised on the balance sheet we asked for data that allows us to estimate a range of values for economic capital.
57. In order to adjust the capital, first we considered firms' own measures of goodwill and intangible assets in the firms' accounts. Though these are subject to some of the same accounting issues of estimates of capital they may represent an underestimate of economic capital. We find that the capital uplift applied when the book value of goodwill and intangible assets are included as part of the capital base averages to 1.4 times long term capital. Some firms' accounts do not report either goodwill or intangible assets (a multiple of 1) but estimates range as high as 2.6.
58. However these are accounting measures of intangible assets and have been applied inconsistently across our data. One method of measuring the economic value of the capital employed by asset managers is to look at the value placed on firms' assets when they are acquired as part of a merger. By looking at the value of acquisition relative to the value of the acquired firm it is possible to produce a multiple that allows us to scale the capital estimates provided by firms to give a value for economic capital inherent in the firms employees where, as discussed above, much of the firms expertise and client relationships reside.
59. We therefore considered the multiple of book value to sale price of acquisitions made by these 16 firms over the last 6 years. In addition two of the firms in our sample had been revalued during this period which gave us further data on firms' current estimates of their economic capital. Looking at this data produced a range of multiples, with firms on average paying 2.8-3.1 times more for firms than their accounting value. The money weighted average for our entire sample was 3.2, though this included a number of partial purchases of firms. The money weighted average focusing on whole firm acquisition or company revaluation came to 3.0.
60. It could be argued that asset managers pay a price equal to an acquired firm's discounted cash flow, and that if capital has been correctly uplifted to represent economic capital then the discount rate used to estimate company values will be the same as the expected return on capital.
61. However it is likely that our capital uplift is an overestimate and represents the upper bound for the capital employed for asset management firms. This is because; firstly we have applied our uplift to firms' long term capital rather than simply to their equity base which inflates both firms' debt as well as their equity. Since our uplift was calculated based on the multiple of book value (equity) to economic value this is likely leading to capital estimates that are too high and ROCE figures that are too low.
62. In addition, our approach is based on a valuation of assets based on discounted future cash flow but does not distinguish between sources of profitability. We know from our analysis that margin tends to rise as an entity increases in size suggesting

that there could be returns to scale that will make cash flows higher post-merger than for the target firm as a standalone entity.

63. The acquiring firm also takes into account the merged firm's ability to raise its prices above the competitive level as a result of the transaction. In our assessment of profitability this should be stripped out, but this is not possible with the data available. The result is that a capital uplift multiple of around 3 likely includes a higher valuation of capital than would be the case if the merged entity could only price at the competitive pricing level and hence overestimates the economic value of the underlying assets if they were generating normal economic profit. The result is that the economic value of assets is higher than it should be.
64. Taking all of these factors into consideration we use a capital uplift of 2.6 times long term capital in the main line of our analysis.

Adjustments to returns

65. As set out above, the average operating margin, for the asset management firms in our sample, ranges from 34-39% between 2010-2015. Operating margin ranged from 20-40% for the majority of firms in the sample. As explained above, however, the reported operating margin can be seen as a lower bound for firm profitability as this is after paying salaries and bonuses to frontline staff. As it can be argued that the economic profits from managing investments are shared between the firm's owners and experts we have added back some staff costs to create an upper bound of profitability of managing investments. Again we use the most conservative of our estimates of disposable revenue. We add back only the proportion of bonuses we believe relates to frontline staff (see the disposable revenue summary box on page 7). Using these estimates we consider an operating profit margin range of between 30-60% to be reasonable.

Adjusted ROCE range

66. Having made these adjustments, we find that the majority of firms earn a ROCE of between 10-25% over the period of our sample, with a money weighted average ROCE of 12.8%.
67. This is above our estimate of the cost of capital for firms in the asset management industry. Some asset managers periodically earning high profits could be consistent with competition existing in the asset management industry as the high profits earned by these managers could reflect a scarce availability of skill among asset managers.
68. In the main line of our analysis, all of the firms in our sample of 13 make returns above our estimate of the cost of capital over a sustained period of time. Where we have used upper bound estimates of the capital multiplier or a higher weighted average cost of capital we find that one firm out of 13 does drop below the cost of capital by less than 1 percentage point.
69. Our data set covers six years and begins at the start of the recovery of the industry after the financial crisis. It is possible that financial performance will decline for asset managers in the future due to macroeconomic cyclicality, though as discussed above the effect of national macro conditions on a global firm with a highly diversified product offering may be relatively muted.
70. What is clear from our analysis is that even in the relatively lean times just after the financial crisis, asset managers were generally not experiencing sustained periods of

loss that need to be compensated for during better times. Even if market conditions, and hence AUM, do decline it is not clear that profitable asset managers would become unprofitable or that returns would decline below 2010 levels.

71. Whilst we recognise that our analysis relies on a number of assumptions and uses data provided on a best endeavour basis it is clear that the weight of evidence suggests that profitability is high relative to market benchmarks. We therefore conclude that the results of our analysis are consistent with competition not working as effectively as it could.

Segmental Analysis

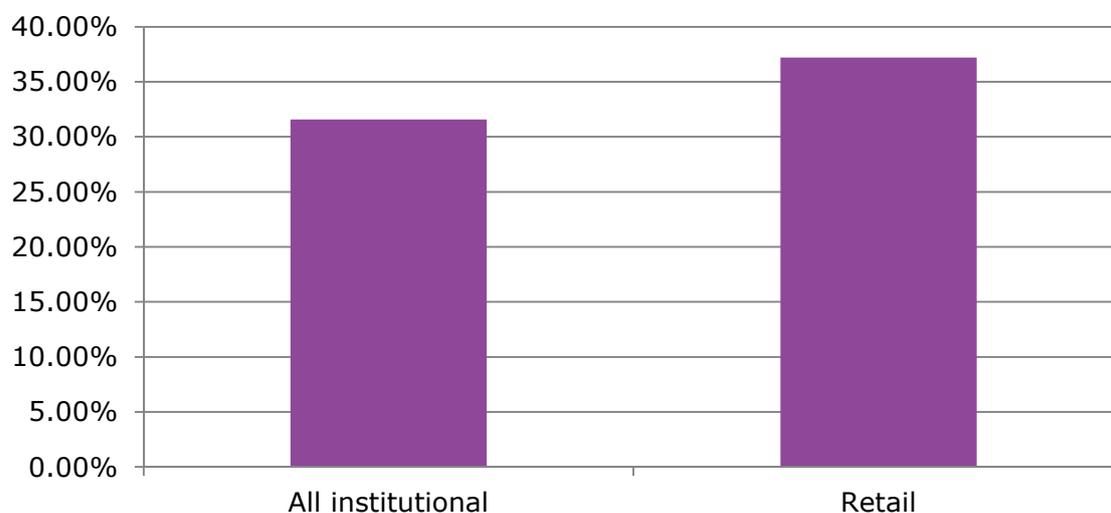
72. Our segmental analysis is based on data provided by 15 firms, with one firm from our detailed data set unable to provide any segmental data even on a best endeavour basis. We asked firms to subdivide the data in three ways:
- By client type:
 - Institutional clients managing a defined benefit pension scheme
 - Institutional clients managing a defined contribution pension scheme
 - All other institutional clients
 - All retail clients
 - All clients not falling into one of the four categories above
 - By investment strategy
 - All actively managed funds
 - All passively managed funds
 - All other funds (such as smart beta strategies)
 - By asset class
 - Equity
 - Fixed income
 - Money markets
 - Property
 - Mixed Investments
 - Alternative Investments
 - All asset classes not falling into one of the six categories above
73. In each segmental data set (client type, investment strategy and asset class) the categories were chosen to be mutually exclusive and collectively exhaustive.
74. Cost allocation proved to be more difficult for firms than anticipated. The majority of firms' internal organisation tends to work along the lines of stratification that we were interested in for our analysis. A significant number of firms have used AUM or even revenue to make the required allocations. Whilst there are some costs for which revenue may well drive cost, for example bonus payments, this creates some circularity in our segmental analysis.
75. The problem is exacerbated when cost allocation is required to derive the financial performance of a business segment as further cost allocation between subsections of the business is required. As a result the following analysis looks at subsets of the whole business to limit the amount of cost allocation on which the analysis relies.

- 76. Despite these limitations, these results still provide an indication of the areas of the market that are more or less profitable and the extent to which different consumer groups drive individual firms’ business models.
- 77. Our analysis concentrates on operating profit margin to allow for comparison between groups. However, we also factor in the size of relative groups and the impact any one group has on absolute profitability, since we accept the point made by several firms that a lower margin on a larger contract can be preferable to high margins for small amounts of business.

Segmental Analysis: Client type

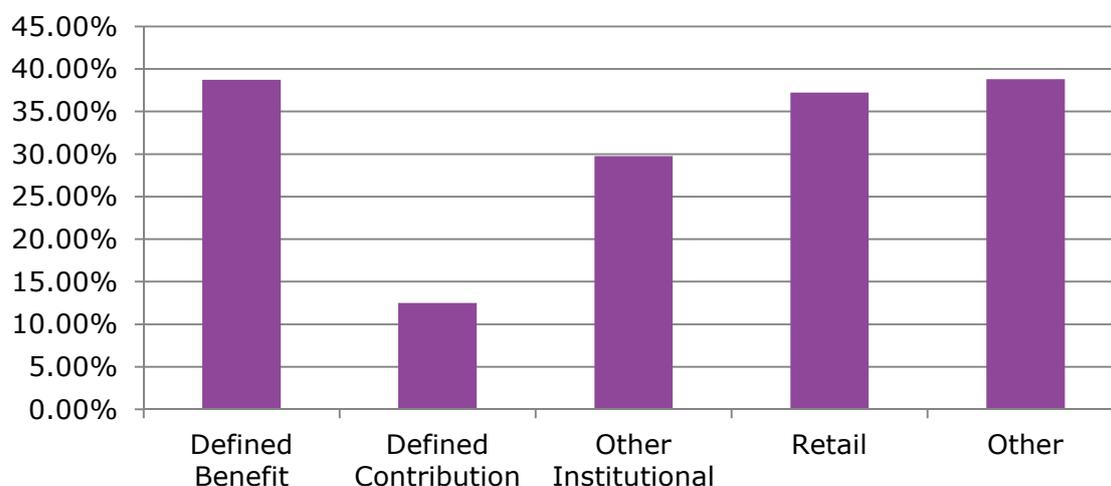
- 78. Firms’ submissions suggest that the profit margin on retail products is higher than on institutional products by around 6 percentage points.

Figure 9: Operating margin 2010 - 2015



- 79. However this masks considerable disparity between different institutional clients.

Figure 10: Operational margin by client type 2010-2015 (firms allocation)



- 80. When splitting out institutional clients we find that for defined benefit pension schemes, firms earn a margin slightly above retail clients across our sample. Defined

benefit pension scheme clients make up 26% of our sample by AUM, retail clients 22%¹⁰ (though this percentage is likely to be low due to some firms identifying retail customers sold through platforms as institutional clients). Despite margins and AUM being of a similar size, however, we note that revenue and cost associated with retail clients is around three times the size of defined benefit clients. This is in line with representations made by the industry that retail clients pay more because they cost more to service. However, it can be seen that they represent firms’ more profitable lines of business, despite far higher cost per £ to service assets under management, when compared to institutional clients.

81. As a cross check of firms submissions we reran this analysis using AUM as a consistent cost driver. We found that costs for defined benefit and defined contribution pension clients were roughly proportional with their AUM and hence margins moved very little. However we found that allocating cost on basis of AUM caused a very high proportion of costs to be allocated to Other Institutional clients (by far the largest client type segment - 44% of our sample by AUM) whereas the retail clients attract a relatively lower proportion of cost.

Figure 11a: Operational margin by client type 2010-2015 (all allocation by AUM)

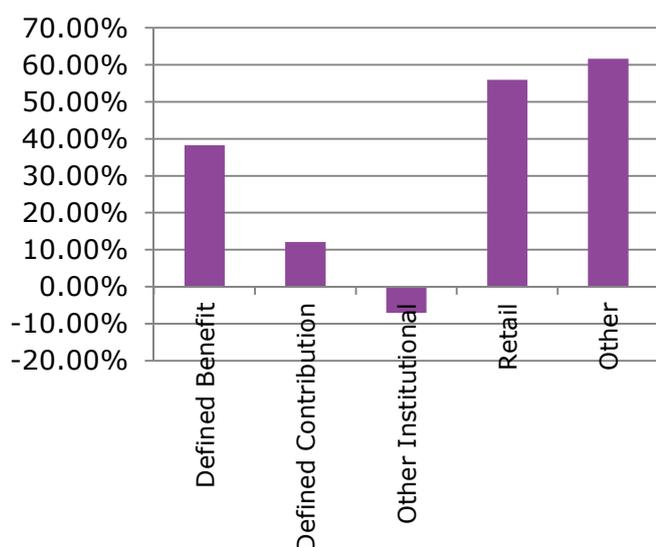


Figure 11b: Operating margin 2010 - 2015 (all allocation by AUM)



83. We recognise firms’ arguments that AUM is not a perfect allocation methodology but it has been used as the best available cross check of the effects of using an operating cost driver. Firms’ submissions note that operating cost allocation is complex and not critical to managing the profitability of the firm. This has been borne out in the data. We have discussed above the link between AUM and revenue. When combined with comparatively high and relatively static margins, detailed cost allocation may not be required to ensure the firm is profitable. Provided AUM and revenue remain high the firm will continue to remain profitable. The firms’ incentive in this case will be to focus on AUM, revenue and their underlying drivers (for example historic fund performance) as key performance indicators.
84. Whilst this is true from a management accounting perspective, revenue based cost allocation will have tended to smooth the difference in margin between client groups. AUM provides one estimate of the extent to which costs could shift if a more operational driver is used.

¹⁰ The “Other” client type section, despite high margins, accounts for less than 3% of assets under management across our sample.

85. We conclude that whilst costs are higher for retail customers the data is consistent with proportionally high revenue leading to higher margins. However, it seems clear from firms' data submissions that in the majority of cases firms tend not think about their profit margins in this way.

Segmental Analysis: Investment Strategy

86. Our segmental analysis uses firms' submissions, however, for firms that had a large proportion of passive funds we asked for further detail around their allocation method of staff cost, and data regarding FTE numbers between these segments of the business. For these firms we have incorporated this additional data into our results.
87. Margins are similar on average between active and passive products, being close to industry averages as a whole. However our analysis does not show any trends that are consistent across the market with different approaches producing different results.
88. We find that money weighted average margins are higher for passive products than active products by around six percentage points. However this result is primarily driven by a single firm's results. When this outlier is excluded the money weighted average between active and passive, across all firms and all financial periods, is nearly identical.
89. We also considered the arithmetic average profit margin across all firms and time periods and find that on this basis active products have a higher average margin than passive products.
90. The difference in these averages is driven by significant variation in performance between active and passive funds between firms. Analysis at the firm level shows that absolute profit and profit per £ of AUM is higher for active compared to passive strategies.
91. We also found that for the ten firms in our sample that engage in both active and passive management, seven make higher margins on their active products than their passive products. For some of these firms the passive component of their portfolio is smaller than the active segment. This might reflect a lack of efficiency savings on the passive side of the business or greater experience in the firm in dealing with active products.

Segmental Analysis: Asset Class

92. Equity, fixed income and mixed products make up 80% of assets across our sample set. Operating margins are above average for equity and below average for fixed income and multi-asset products. Results vary as with the market but this pattern is repeated at the firm level for two thirds of the firms in our sample.
93. We note that whilst a smaller proportion of overall AUM is held in money market products (12%) the money weighted operating margin is higher. However our data is skewed by a large provider and the results tend to suggest that the high margin in this area is based on scale.¹¹

¹¹ A trimmed arithmetic mean suggests an operating margin closer to 15% across all providers with a high level of variance between firms.

Figure 12: Operating margin by asset class

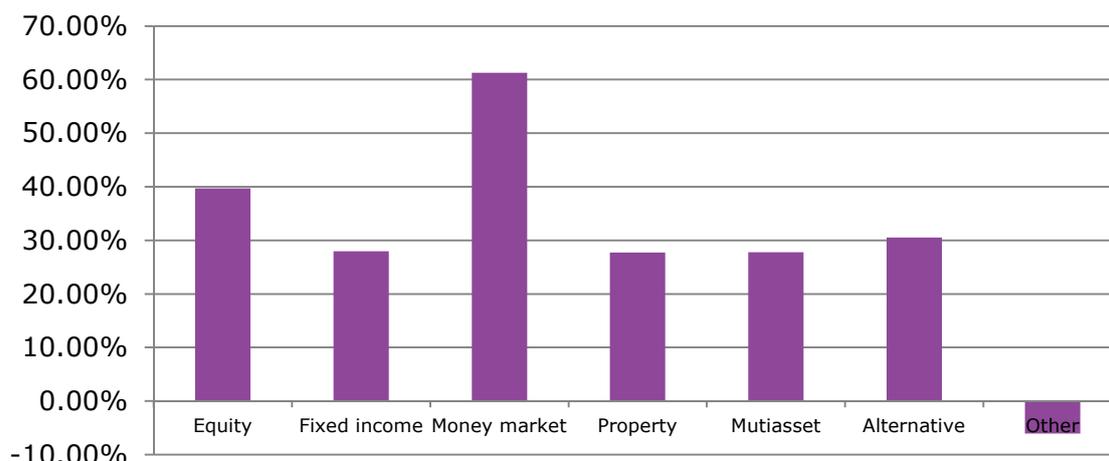
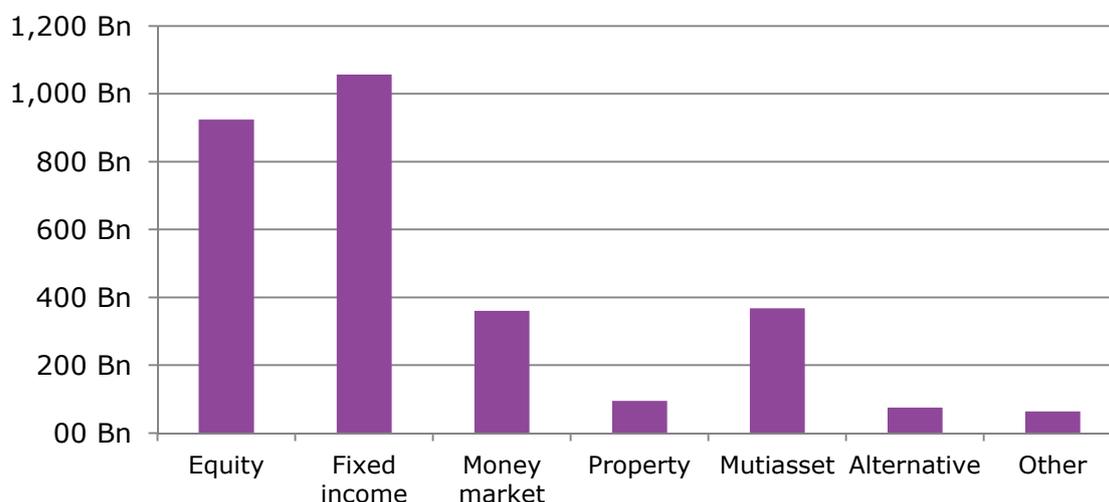


Figure 13: Average AUM by asset class



Sensitivity

94. As discussed above we recognise that the firms in our sample have portfolios made up of funds domiciled, managed and sold in different geographic regions depending on firms' business strategy and corporate structure. Our intention was to isolate only that part of the business that related to the areas in which the FCA has greater powers and responsibilities (segments 1 and 3 in the business segment diagram above).
95. However the difficulty encountered by firms in allocating revenue, cost and capital to different business segments, even at the highest level of the data, meant that the availability and quality of data was much lower for segments 1 and 3 across our data set. We therefore used unallocated figures (segment zero in the business segment diagram above) in the main line of our analysis but have tested our results using subsets of the data designed to more closely match the areas in which the FCA has greater powers and responsibilities. Where our analysis can be replicated, we do not find our results to be materially affected by these sensitivity tests, though we note that margins appear to be higher in our sensitivity tests.

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