Canadian asset management industry opportunities & risks report

October 2017

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Canada's 150th anniversary has given companies cause to reflect on their roles in our country's ongoing evolution and their individual legacies. That includes those within Canada's asset management industry who are no stranger to navigating consumer trends, technological disruptors, and regulatory shifts in pursuit of growth. KPMG surveyed some of the leading Canadian asset management professionals to gauge their outlook for the industry.

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(67 percent) of respondents are Investment Managers

75%

have over $1 billion in assets under management (AUM) (42 percent > $20B)

85%

cite Canada as their investor domicile (6 percent US)

88%

are headquartered in Ontario

45%

have a retail investor base, 30 percent institutional, and 18 percent high net worth individuals

67%

indicate they offer mutual/pooled funds

These are the organizations at the heart of KPMG's second *Canadian asset management industry opportunities and risks* report. We have also drawn on our network of financial industry experts to add their insight to the results of our national survey of Canadian asset management stakeholders on the opportunities and risks facing both their individual organization and the asset management industry as a whole in the years to come.

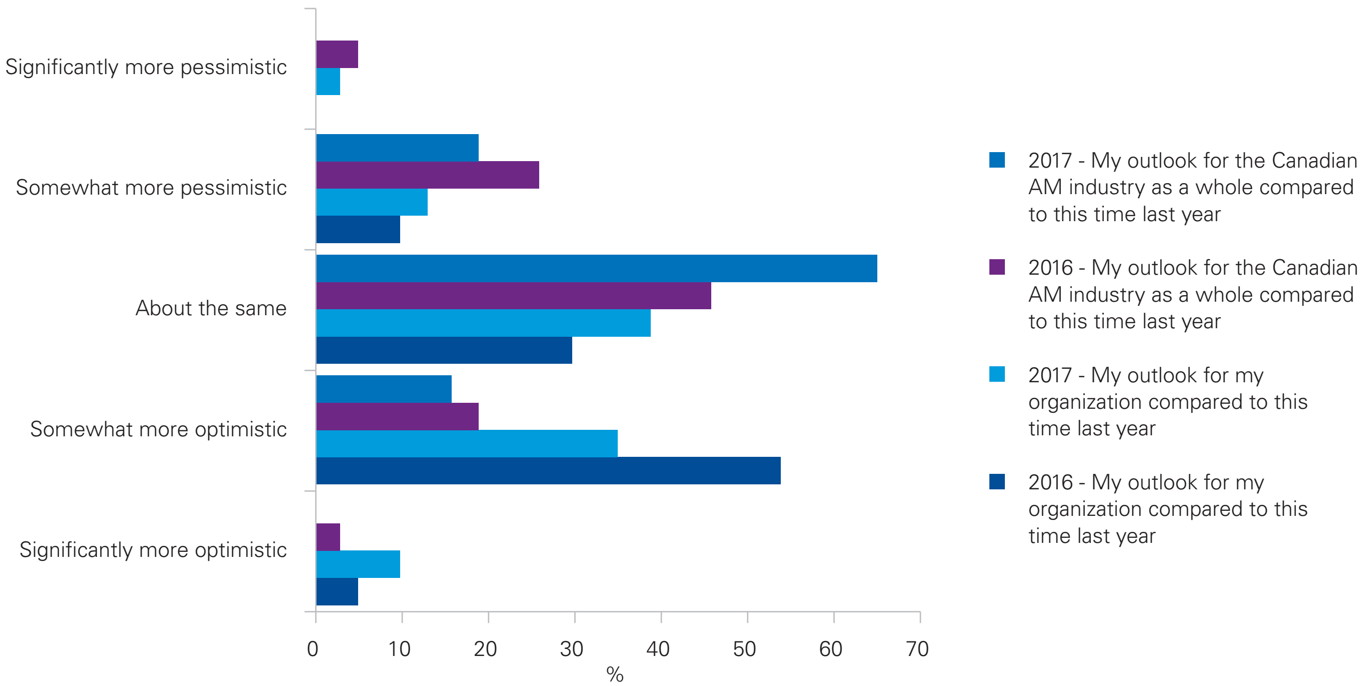
These findings reflect over 90 online survey responses from industry leaders over the span of two years, 2016 and 2017. Overall, respondents reveal moderate optimism for their respective organizations in the years ahead and a cautiously positive outlook for their field as a whole (see graph on next page). Moreover, they identify what is keeping Canadian asset managers and their organizations awake at night, including the impacts of rising competition and consolidation, complex regulations, pricing challenges, and cyber-security.

Nevertheless, many are also moving beyond Canada's sesquicentennial with a sense of optimism. As we examine in this report, asset management leaders are aware of the obstacles ahead, but are navigating the opportunities presented by new technologies, evolving distribution channels, and potential collaborations.

What's making asset managers anxious and driving them forward for 2018 (and beyond)? Read ahead for what they are telling KPMG...

For the purposes of this report, responses for "organizations" refer to respondents' views on their individual companies whereas those for "asset management industry" refer to their views on the asset management space as a whole.

How does your outlook compare with this time last year?



Opportunities

Top five organizational opportunities

2017		3 to 5 years outlook	
70%	Focusing on distribution channel and their client needs	**55%**	Accessing new investor base either within and/or outside existing market
55%	Enhanced operational processes and use of technology	**55%**	Focusing on distribution channel and their client needs
52%	Launching new product types/services (managed accounts, sub-advisory, new fund strategies, insurance-related products, and/or alternatives)	**48%**	Launching new product types/services (managed accounts, sub-advisory, new fund strategies, insurance-related products, and/or alternatives)
52%	Increased penetration of existing client base (retail, institutional, fund of fund, and/or private wealth platform)	**48%**	Enhanced operational processes and use of technology
52%	Accessing new investor base either within and/or outside existing market	**45%**	Mergers and acquisitions to enhance market position

Top five opportunities for the Canadian asset management industry

2017		3 to 5 years outlook	
58%	Increased penetration of existing client base (retail, institutional, fund of fund, and/or private wealth platform)	52%	Enhanced operational processes and use of technology
48%	Focusing on distribution channel and their client needs	48%	Data analytics to enhance product design, marketing, and pricing
45%	Mergers and acquisitions to enhance market position	48%	Mergers and acquisitions to enhance market position
42%	Data analytics to enhance product design, marketing, and pricing	42%	Launching new product types/services (managed accounts, sub-advisory, new fund strategies, insurance-related products, and/or alternatives)
42%	Demand for solutions and specialties (outcome-oriented investing and multi-assets)	36%	Focusing on distribution channel and their client needs

Retirement accounts

One way to measure the depth of a relationship is the presence of a retirement account. In 2016, 67 percent of retail wealth management relationships included a retirement account (up from 62 percent in 2013).[1] Although 27 percent of overall AUM resides in retirement accounts, relationships that include retirement accounts represent two-thirds of assets under management in the wealth management industry.[2]

[1] "The state of retail wealth management 2016". Price Metrix Part of McKinsey & Company

[2] Ibid.

Existing opportunities

Over half of 2017's respondents (58 percent) believe that existing client bases pose the greatest source of opportunity for the industry over the next year, 18 percent more than those who responded similarly in our 2016 survey. Along those same lines, nearly half (48 percent) believe focusing on distribution channels and clients' needs also has promising, short-term potential (up 8 percent from 2016).

Priorities change when reflecting on their own organizations. Looking within, a majority (70 percent) say their organizations will benefit most from focusing on their distribution channel and client needs (up 24 percent), while over half (55 percent) say the best opportunities lie in enhancing operational processes through technology. Nevertheless, over half (52 percent) share the perspective that increasing their penetration of existing customer bases is an opportune strategy over the next twelve months.

There are certainly benefits to fostering deeper relationships with existing clientele. To that end, PriceMetrix's 2016 global survey suggests that clients who hold more products exhibit higher levels of satisfaction with their advisors and are more inclined to stay with them over the long term. Advisors are keyed into this strategy, as the number of accounts per household has risen to a record average of 2.8, while single account households dropped to a record low of 41 percent. The fact that both statistics have improved steadily over time further suggests that clients are either relying on their advisors to solve increasingly complex needs or that they are consolidating their financial needs with fewer providers to ensure they are getting portfolio level rather than product level advice. Both are good indicators of growing loyalties.

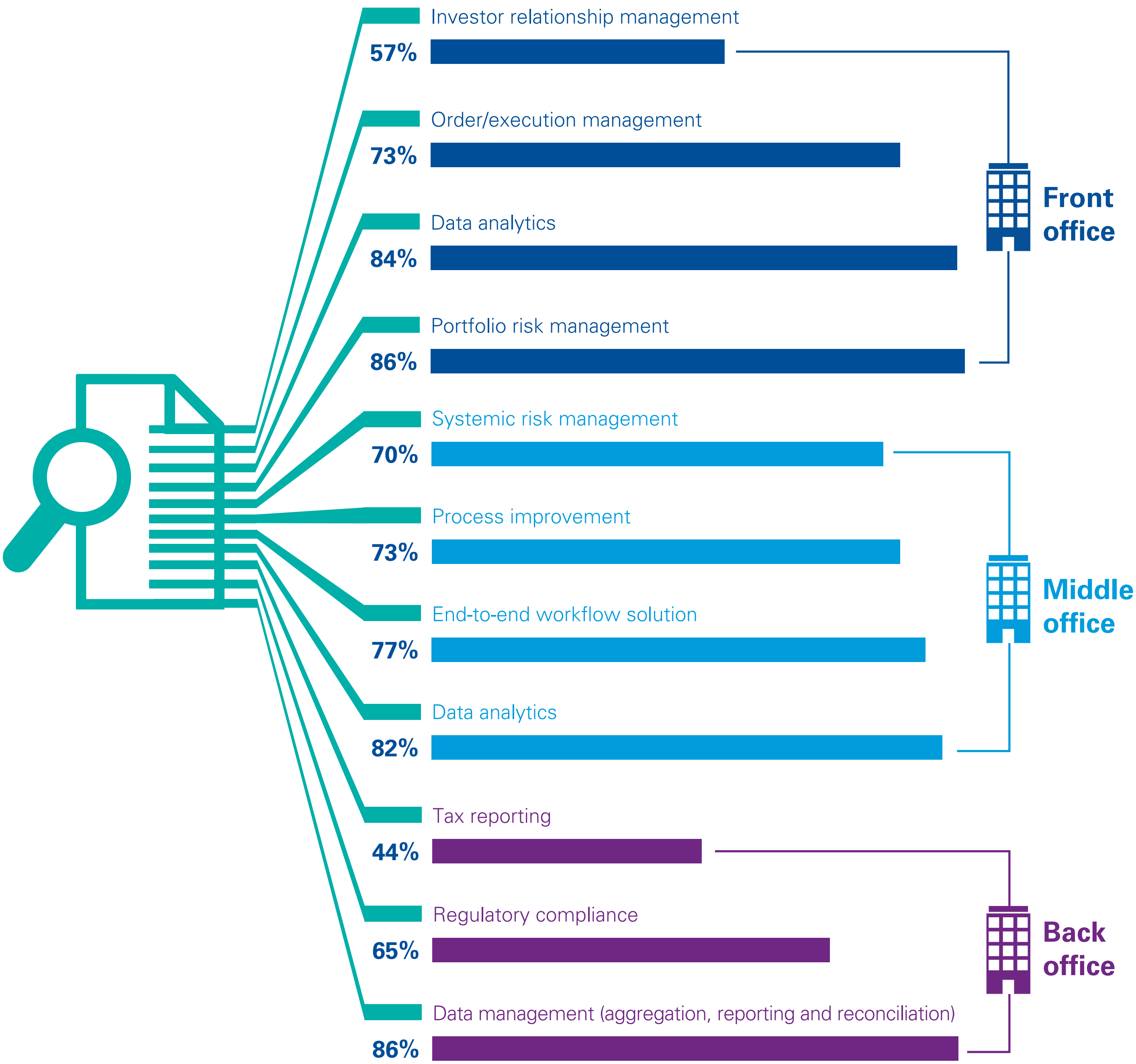
"Moving forward, the challenge for wealth management firms will be to continue that momentum by rewarding advisors for cultivating deeper relationships, while remaining mindful of the increased scrutiny on advisor conduct and sales practices," says Genevieve Leong, Partner, Risk Consulting, KPMG in Canada.

Still, while the focus on nurturing current clients is strong in the year ahead, responses to our 2017 study suggest that both organizations and the industry as a whole will benefit more from adopting new technologies, stronger data analytics capabilities, and pursuing partnerships over a longer, three to five-year span.

New tech, new possibilities

Disruptive technologies and business models may be causing stress across all industries, but according to a majority of our asset management respondents, those same factors are also opening doors to new opportunities.

Over the next 5 years, how important will the role of technology be in the following areas? Percent of respondents that rated important and very important.



Source: 2016 KPMG/AIMA/MFA Global Hedge Fund Survey

> "We see organizations ranking technology lower over a three to five-year span, and that's because they understand that the time to realize the potential of technology is now. They're incentivized to get on board now and move on these innovations, or get left behind."

James Loewen
National Asset Management Leader, KPMG in Canada

Over half (55 percent) believe that enhanced operational processes and the use of technology will be a top opportunity for their organization over the next twelve months, and slightly less (48 percent) say the same over a three to five-year time period. By and large, 2017's numbers are in line with 2016's numbers, suggesting that technology remains a key consideration.

The fact that this organizational focus on technology slips slightly over a longer timeline is not surprising. Many organizations recognize that the window for adopting new technologies is closing and that waiting to catch up may place them behind the competition.

Technology is also perceived to be a benefit for the asset management industry as a whole. One-in-four respondents (27 percent) say technology will enable enhanced operational processes for all Canadian asset managers within the year (down 26 percent from 2016) and almost double (52 percent) saying the same for the next three to five years (up 4 percent).

"I'm pretty sure that – by the time I'm out of this business – it will be completely unrecognizable from where it is today," said one fund manager with more than 25 years of experience.

That outlook is shared on a global scale. In KPMG's 2016 study, *Transformative Change – How innovation and technology are shaping an industry*, 38 percent of respondents indicated that technology will have a significant impact on the industry.

As for what role technology will play, a majority of respondents to that same study (90 percent) said it will be used to improve controls and compliance, and 88 percent said it will help achieve efficiency objectives by streamlining transaction processing and improving processes.

"In the new age of operational effectiveness, as well as the ever-changing regulatory landscape, firms are finding it necessary to use technology to both improve margins, as well as help manage the compliance processes more efficiently and effectively in order to improve overall controls and better manage risk." says Peter Hayes, Audit Partner and National Director of Alternative Investments Practice, KPMG in Canada.

However, that's not all fund managers hope to achieve from their technological investments. More than half aim to leverage their IT capabilities to better meet investor expectations in areas such as transparency and reporting, while nearly the same amount expect technology to help improve their overall competitiveness or drive cost reductions. Furthermore, over two-fifths say they hope to reduce complexity through technology enablement.

Reflecting on these attitudes towards technology, KPMG US Director Adam Hirsh notes, "Although technology will drive efficiencies, a big oversight firms make is to focus on the cost and efficiency side of the technological equation without putting enough consideration towards the growth opportunities."

Even in situations where technology is assisting asset management organizations to eliminate redundant tasks in the back or middle office, he adds, "Fund managers should be asking how they can reallocate those resources to improve the front office and drive better results."

Data and analytics

Asset management leaders see a much greater potential for data and analytics (D&A) this year and beyond than they did in 2016. In 2017, 36 percent say D&A capabilities will provide their organization the means to enhance their product designs, marketing, and pricing (up 16 percent from 2016); while 42 percent say D&A tools and expertise will be equally beneficial to the industry as a whole (up 24 percent).

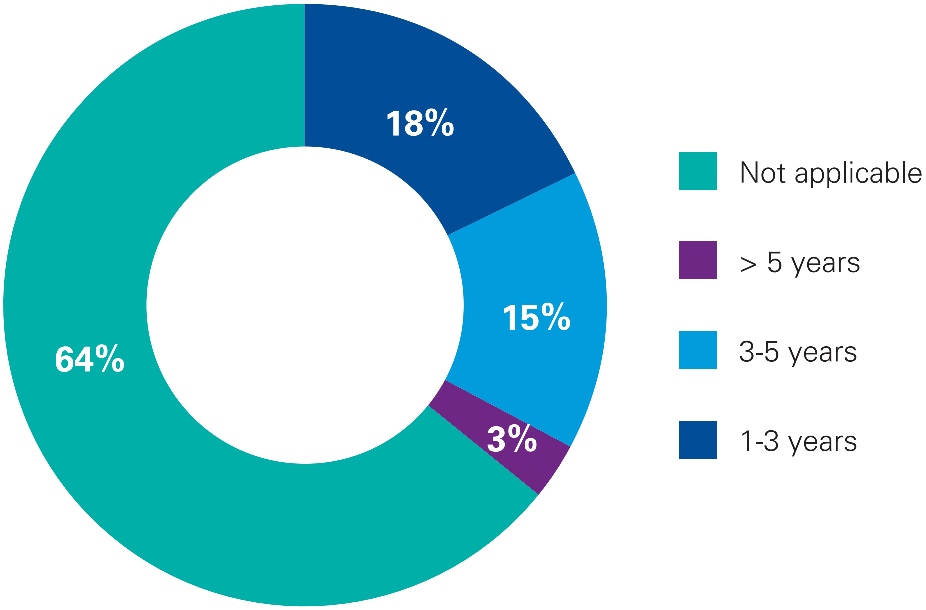
"The larger funds likely see more scope for driving efficiencies and tend to have larger budgets devoted to technology, which often means that they can capture a competitive edge through targeted technology investments. However, smaller funds tend to lack the legacy systems and processes that often impede technology implementations at larger firms, so while the scope for competitive advantage may be narrower, the value of technology is certainly broad."

Peter Hayes

Audit Partner and National Director of Alternative Investments Practice, KPMG in Canada.

The adoption of D&A is expected to continue as stronger expertise, applications, and D&A tools come to market, making it easier (and more affordable) for organizations to identify new opportunities among existing client bases, optimize consumer channels, or gain the predictive edge over their competition.

What is your time frame for deploying the use of these technologies?



Blockchain and DLT

Nearly half of KPMG's 2017 survey respondents don't believe blockchain and distributed ledger technology (DLT) are currently disrupting the status quo for investment managers and their value chains. Over one-third, however, are yet unsure of their impacts.

Interestingly, 58 percent reveal they are not investing in and/or exploring partnerships to integrate blockchain and DLT into their business strategies, while only 21 percent of respondents say they are, and a similar amount is undecided.

As for where industry leaders believe blockchain and DLT will offer the most potential, 72 percent "most definitely" or "somewhat" agree they will have an impact on middle office and clearing services. Two-thirds also say the same for blockchain and DLT's influence on the distribution of investment fund products and accessing accurate and trustworthy transaction data.

Courting new business

Over half of respondents believe accessing new investors and/or increasing penetration of existing channels will be key to the continued growth of their organizations.

With expectations of slower market growth for investment funds, asset managers will be challenged to assume a greater share of channels and client segments currently served through new product offerings and/or better services. New strategies will also be required, such as focusing on large pockets of the market where fund penetration remains relatively low, including discretionary brokerage and private wealth; and vertical integration, such as developing existing and new proprietary distribution channels going directly to the consumer.

Accessing new investors is perceived to be an opportunity over the longer, three to five-year timeframe as well – both for individual organizations (as noted by 55 percent of respondents) and the industry (30 percent).

"Investment managers with strong multi-asset and portfolio construction expertise capabilities can capitalize growing investor demand for outcome-oriented solutions across customer retail and institutional customer segment."

Joseph Micallef
National Tax Leader, Financial Services, KPMG in Canada.

Renewed focus

There is significant opportunity to be had in focusing on distribution channels and client needs in the year ahead. That's according to 70 percent of survey respondents who rank this tactic as the most opportune course of action for their organization over the next year (and the 55 percent who say that opportunity will continue to pay off over the next three to five years). Fewer, however, believe this focus will be advantageous for the industry over the next year (48 percent) and over a three to five-year outlook (36 percent). Nevertheless, it is important to note that these perceptions are all higher than in 2016's survey.

Carving out a favourable niche within distribution channels is not anticipated to be easy. For many, it will require a heightened commitment to branding, communications, and advisor practice support. Moving forward, distribution partners will seek solutions aligned to their positioning and their investors' needs, as well as assistance in decreasing administrative and compliance costs and overall complexity.

Rationalizing shelf space

New regulations are likely to spur a rationalization of shelf space – especially as the industry adapts to the stricter compliance requirements presented by the Best Interest Standard, which is anticipated to come to Canada over the next few years. Therefore, those with a large number of products may need to radically reduce the size of their shelf in order to make it much more manageable to remain in compliance. On one hand, this will increase competition for shelf space; while on the other, it will present asset managers with an opportunity to gain the market edge by fine-tuning their product selection to ensure they are offering the right products at the value proposition, and are supporting the distribution channel to make them successful.

Risks

Top five organizational risks

2017		3 to 5 years outlook	
64%	Intensified competition and consolidation	58%	Increasing complexity of regulation and the cost of compliance
58%	Increasing complexity of regulation and the cost of compliance	58%	Cyber-security risks
52%	Cyber-security risks	55%	Intensified competition and consolidation
39%	Push for a lower management fee environment	42%	Cost challenges and squeezed profit margins
39%	Product differentiation	42%	Push for a lower management fee environment

Top five risks for the Canadian asset management industry

2017

64%	Push for a lower management fee environment
64%	Cost challenges and squeezed profit margins
61%	Intensified competition and consolidation
52%	Increasing complexity of regulation and the cost of compliance
48%	Product differentiation

3 to 5 years outlook

70%	Push for a lower management fee environment
55%	Intensified competition and consolidation
55%	Cost challenges and squeezed profit margin
52%	Increasing complexity of regulation and the cost of compliance
33%	Failure to adapt to changing customer preferences

Crowding markets

Competition and industry consolidation are a growing concern among Canada's asset management players. In 2017, these two factors rose to the highest level of the organizations' risks and the third highest perceived threats for the Canadian asset management industry.

Although anxieties around competition dip over the next three to five years, it's no secret that new entrants, advancing technologies, and competitive products are putting pressure on the industry to adapt or risk falling behind.

"Although consolidation and strategic partnerships allow investment firms to offer a more diverse range of products and strategies to investors, access to new distribution channels, facilitating success planning and the ability to retain top talent, there is a concern from smaller players in the industry that they will be unable to compete effectively against larger players", says Brian Seidler, Managing Director, Deal Advisory, KPMG US.

Pricing pressures and cost concerns

Over one-third of asset managers believe the push for a lower management fee environment will pose the most significant risk for their organizations, while over two-thirds say it will be the number one challenge for the industry both now and into the future.

Concerns over pricing pressures are nothing new. In 2016, 38 percent of survey respondents echoed similar concerns for their organizations, and 59 percent for the industry. However, the fact that respondents feel equally concerned over cost challenges and squeezed profit margins, and that pricing concerns are higher for many in 2017, indicates that those anxieties are only increasing.

These pricing pressures are owed to a number of factors, not the least of which is the push for greater disclosure around fees required by new regulations and an increasing awareness of management fees among consumers. Furthermore, efforts are being made by regulators to unbundle fees and remove embedded commissions from retail mutual funds, thereby forcing advisors to charge directly for their own services. Based on international experience, these factors will place further downward pressure on pricing if, and when, they come to pass.

Lastly, market forces are also playing a role in driving prices down. There has been a rapid gain in share of passively managed funds, exchange-traded funds, and other lower fee fund series. As these types of funds continue to gain traction in the marketplace, this trend will create further downward pressure on higher fee funds to lower their fees. This trend has already motivated a number of fund managers to announce multiple fee reductions over the last 12 to 18 months – a strategy that is likely to persist now and over the next three to five years.

Enhanced oversight

All eyes are on Canada's regulatory landscape, both now and into the future. Fifty-eight percent of Canadian asset management leaders believe increasingly complex regulations and the cost of compliance will be the biggest risk facing their organizations moving forward and 52 percent believe the same issue will pose a risk to individual asset managers.

Those concerns are well-founded. CRM2, for example, has sounded the call for increased industry transparency and oversight, and new standards are holding wealth management professionals to greater scrutiny over their choice of products for customers. While these changes aim to better protect customers, the increased oversight may incentivize financial advisors to trim their product line in order to manage and evaluate their offerings more closely and remain in compliance.

Additionally, there has been a recent wave of regulations that will also impact the industry. These include a new set of fee structures, fee unbundling, and additional oversight rules. The full implications of these changes will take time to manifest, which explains why concerns over Canada's regulatory landscape top the list of perceived risks both now and in the coming years.

Compensating through technology

Firms are turning to technological investments in order to address pricing concerns. In KPMG's global survey, we discovered that more than half (54 percent) of those with AUMs of more than US$5 billion report spending more than US$5 million per year on technology over each of the past five years, while 86 percent of funds with AUMs of less than US$500 million report spending less than US$500,000 per annum on technology over the same timeframe.[3]

[3] "Transformative change – How innovation and technology are shaping an industry". KPMG Global, AIMA, MFA.

> "People are getting more cautious and savvy about cyber security and the risks around it. They are asking appropriate questions to the asset management companies that are looking after that data – they are asking companies "are you looking after the data appropriately and can you prove that to me?" If an organization has a breach, it's going to impact you. It's your brand, and it's your regulator who is going to be looking over your shoulder."

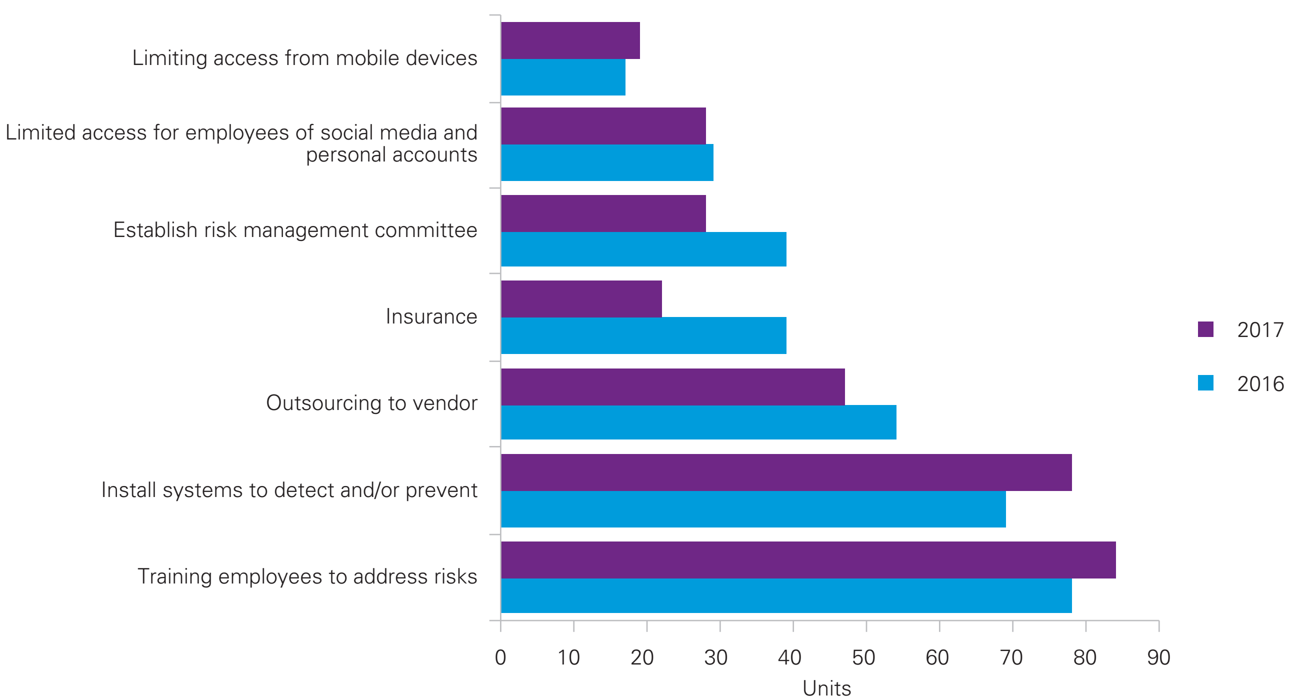
Yassir Bellout
Partner, Cyber Security Advisory, KPMG US.

Cyber threats

Concerns over data loss, identity fraud, and organizational hacks are growing. Over half (52 percent) rank it their second-most concern in the immediate future (up 8 percent from 2016), while even more (58 percent) believe it will remain on their radar in the years to come (up 22 percent).

Pressing the issue are mandatory reporting laws which require all organizations in Canada to report any and all cyber security breaches. And while many countries have already adapted to such laws, this will be new to Canadians who have yet to adapt to this level of transparency with their data.

Raising cyber-defenses will no doubt be a priority among any and all organizations, and strategies are likely to be similar across each. For those in the asset management industry, top strategies include employee training, installing systems to detect and/or prevent cyber events, outsourcing cyber security to a vendor, and a mix of preventative internal practices.



Product differentiation

The lines between mutual fund products are blurring. By the traditional model, ETFs and index funds historically occupied the "low cost, low sophistication" end of the product spectrum, while more common mutual funds – which added up to the lion's share of products – occupied the middle, and funds reserved for high net worth individuals sat in the "high end" of that range.

Now, however, low-cost solutions are continuing to grow in quantity and gain popularity, at the same time higher net worth options are coming down in price. Both are meeting in a middle range of products already crowded with more common mutual funds. As a result, it's becoming more and more difficult to differentiate products; especially for smaller players who are already struggling to secure shelf space. This concern is also more relevant now than it will likely be in three to five years, as reflected by 48 percent of Canadian asset managers believing product differentiation to be a top risk over the next year, while only 30 percent believe it to be one over the next three to five years. The risk is also acknowledged on an organizational level, although to a lesser extent (39 percent next year, 30 percent over three to five years).

Time to adapt

Although further down the list of perceived risks, Canadian asset managers are nonetheless concerned about their ability to adapt to the new technologies and systems shaping the industry. And indeed, as customer preferences continue to shift to online channels, DIY solutions, and personalized service, the industry will need to follow suit. This will demand new business models, challenging those in the industry to keep pace or move out of the way for those who can.

No concern on commission ban?

Despite the regulator's movement towards a ban on commissions, 70 percent of respondents believe this will not impact their ability to attract new customers (18 percent unsure/12 percent yes). On the same track, 64 percent say the regulator's ban will not increase their business development costs in the long run (21 percent unsure/15 percent yes).

> "Product differentiation is very important today because your typical, run-of-the-mill mutual fund isn't offering much more in terms of value than those lower-cost solutions, yet they are still charging significantly higher fees because they used to be the prime source of cash."

Charles Armstrong
Partner, KPMG in Canada

"The pace of change is incessant and the opportunities and challenges seem to be continuously shifting. But with the right long-term vision, a flexible strategy, and the right partners, wealth managers should be able to plot – and then execute – a sustainable digital strategy for the future," said Tom Brown, KPMG Global Head of Asset Management in *KPMG's 2017 publication, Realizing digital – Delivering wealth management in the digital era.*

	2013	2014	2015	2016
Fee-based revenue	40%	46%	49%	54%
Fee-based assets	28%	31%	33%	37%
Fee-based accounts per advisor	66	72	79	96

Source: PriceMetrix 2016 *State of retail wealth management report*

From a different angle, the vast majority of clients in retail wealth management do not have any fee-based accounts. The increased prevalence of hybrid relationships, where clients hold both fee and transactional accounts, is challenging the traditional economics of the wealth management industry. According to the results from the PriceMetrix report, this trend is disruptive to traditional pricing models and may be a catalyst for wealth management firms to consider "total client relationship" pricing.

	2013	2014	2015	2016
Fee-only households	8%	10%	11%	13%
Transaction-only households	74%	72%	69%	65%
Hybrid households (mix of fee and transaction)	18%	19%	20%	23%

Source: PriceMetrix 2016 *State of retail wealth management report*

These are daunting times for Canada's asset management leaders; albeit ones with great potential. Yet, as new rules, products, cyber threats, and market entrants continue to change the game, wealth management firms are determined to overcome these challenges by using technology, data and analytics, and enhanced services to strengthen existing relationships and build new business.

How firms approach growth in the coming years will rely on a number of factors. It will mean ensuring advisors have the tools to target the right clients as well as the resources and products to ensure their needs are fully served. It will also mean keeping pace with industry regulations, staying up to speed with evolving client expectations, and bridging generational gaps.

No doubt, as the industry evolves and the players begin to multiply, it will fall on firms to give advisors what they need to stay competitive and seize tomorrow's opportunities.

Fee percentage preferences

According to the *2016 State of Retail Wealth Management*, a report from PriceMetrix, Part of the McKinsey & Company, North American wealth management firms, advisors, and investors have shown a growing preference for accounts that charge fees as a percentage of assets managed, rather than per transaction (growth of 33 percent in fee-based accounts in 2016 accounting for 54 percent of the industry's overall revenue).

If you have questions about the contents of this report or would like support in navigating any of the opportunities and risks described herein, please contact us.

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