INDEFI

October 31, 2022

PERSPECTIVES

RETURN OF THE LIVING DEAD

These are scary times for global capital markets and subsequently for asset managers as well. With the recent rise in interest rates, investment firms are facing renewed forms of competition from traditional saving instruments (bank deposits, life insurance, structured products) that they thought were locked up in the "secret dungeon of history".

As these recessionary forces take shape across Europe, asset managers need to determine if they are true monsters rearing their ugly heads once again, or if it's a temporary guise that's muddying the path toward growth.

Saving products that threaten to "steal everyone's candy"

In all of the key European markets 2022 has been a challenging year for fund flows. This is not just a reflection of poor product performance but also a result of a wide-scale reallocation of wealth to competing products:

- Banking deposits were artificially boosted in 2020 across the EU with a pandemic-induced injection of liquidity. While some of this excess cash found its way into managed products in 2021, 2022 data show a clear reversion to the mean. The contrast is even starker for Southern European countries, where international managers registered huge success over the past 10 years. For instance, retail-oriented issuance of BTPs have doubled in 2020-22 compared to the 2016-19 period.
- Structured products are coming back once again to the fore. 2022 issuance has picked up by 25-33% in key geographies as the higher level of interest rates expands the opportunity set beyond coupon-generating autocallable structures.

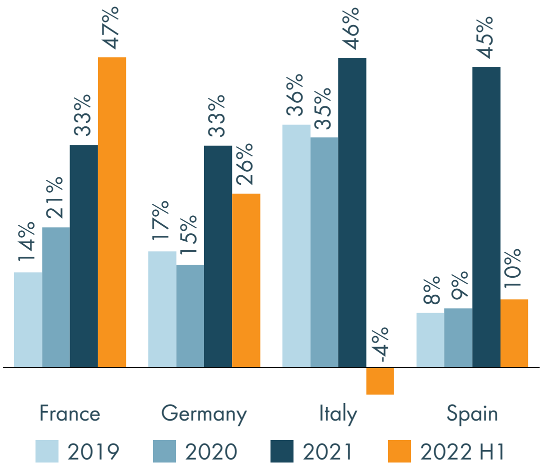
It's not 2008 again

While all of this could give managers a good scare, it is unlikely that history repeats itself and that money gets sucked away from their reach as it did during the GFC years. Three structural factors play are at play here:

- Macroeconomics: Risk-free rates may no longer be negative in nominal terms, but they remain so in real terms. This will naturally lead a wide array of clients to maintain exposure to return-generating inflation-protecting asset classes.
- Long term outlook: A growing share of European savings needs to be channeled towards funding pensions as most countries pivot away from state-sponsored to privately funded defined contribution (DC) systems[1]. This means that client and advisor focus will move from short term yield and nominal protection objectives to long term real returns and capital appreciation.

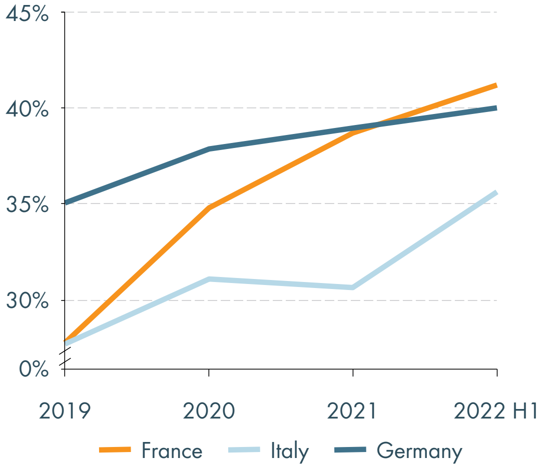
1. Refer to our review: "The €10tn question, how to succeed in the European DC pension market?" Indefi, June 2021.

Investments in funds as a % of total retail net flows (2019-2022 H1)



Sources: ECB, Bundesbank, Banque de France, ANIA, Gobierno de Espana.

Unit-linked as a % of total life insurance gross premia (2019-2022 H1)



Sources: GDV, Bundesbank, Banque de France, ANIA.

- Industry structure: Banks, insurance companies as well as the delivery of wealth management services have fundamentally changed over the past decade.
  - Unlike during the GFC, financial institutions are well capitalized and flush with cash. The pressure to repatriate funds on balance sheet via aggressive deposit offers should remain subdued.
  - Life insurance companies have operated a significant shift in their business model under the double blow of melting interest rates and Solvency II. After almost 10 years of constant and regular efforts pivoting their model towards the promotion of unit-linked (UL) products, it would be counterproductive for them and harmful to profitability to revert to the old ways.
  - The structure of wealth management markets has changed, with independent channels (often supported by private equity money) growing to the detriment of traditional incumbents (banks, insurance).

A call for action: Ghostbusters!

Who are you going to call? Rather than getting spooked in this new environment, there are clear steps that asset managers can take to strengthen their business prospects:

- Build a better-balanced geographical business portfolio: international managers have often eschewed the largest markets (DACH, France) to focus on what they perceive as low-hanging fruit (Southern Europe). However, both short-term and long-term wealth market dynamics will prove more promising in the former than in the latter and should prompt managers to reassess their resource allocation to retail markets.
- Prioritize growing channels for asset management products: in every European market, both the nature and level of penetration of funds and the use of competing products vary by channel. As headwinds rise, asset managers should magnify their potential by following a clear roadmap and reallocating resources accordingly. Tomorrow's winners include GFIs, DC / UL insurance, independent wealth as well as their digital avatars (retire/wealthtechs...)
- Decide where to compete in terms of capabilities and adapt the product offering accordingly. Here, asset managers should decide to take on the "ghosts" and/or prioritize a differentiated positioning:
  - Competing head-on will rely on renewed fixed income offers (money market, fixed maturity investment grade and high yield funds, floating-rate strategies...) and enhanced structured product capabilities (capital-protected vehicles, iCPPIs, etc.);
  - Differentiating will rely on bringing to market an array of solutions and services that cater to client bases and distribution channels that will not satisfy themselves with a near-term spike in rates. In this area, the long-term trends that characterize the European wealth opportunity remain as relevant as ever: delivering resilient and diversified private market exposure, designing ESG-customized solutions in line with regulatory changes, supporting clients with enhanced digital and tech capabilities.

As traditional saving instruments come to the fore once again, it is critical for asset managers across Europe to become even more laser-focused in their resource allocation, client coverage efforts and product development initiatives.

Indefi is a leading strategy advisor for the global investment management business. Established in 2007, Indefi helps asset managers shape their business strategies and build a sustainable competitive advantage. The firm's expertise spans public and private markets, including infrastructure, private credit and equity, and real estate. A pioneer in advising asset managers on ESG development and integration strategies, Indefi is a PRI signatory. For more information, please visit www.indefi.com.