July 2019

Mutual fund outlook:

The time to act is now

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Introduction

US mutual fund firms face substantial challenges, including fee pressures, shrinking distribution platforms, intense competition for talent, and more. To compete in the coming years, firms will have to capitalize on emerging opportunities to offer new products and fee structures, leverage technology to cut costs and boost performance, and find innovative ways to deliver value to investors.

Many of the factors reshaping the global fund landscape are having a larger impact on US firms. Fee compression is greater, the transition from active to passive management is moving faster, and the flow of funds is lower. All of this translates to increasing pressure on US mutual fund firms.

Mutual fund firms must act today if they are to remain competitive and relevant tomorrow. The industry has evolved to be much more technology driven from the front to the back office. Firms have a choice: They can invest in technology and recruit/train tech-savvy talent, or they can outsource certain functions to gain access to the most current technologies and talent.

The industry has ridden the wave of market appreciation over the last several years. Operating margins have returned to levels seen before the global financial crisis, and asset growth has been strong. Still, fees are declining rapidly and cost pressures are rising. It is increasingly a buyer's market, with investors and regulators demanding lower fees and more transparency. For the US mutual fund industry, the time to act is now.

To succeed in this challenging environment, US mutual fund firms should focus on their strategic positioning, provide value for money, implement integrated data-driven technology platforms, and develop strong talent programs as the industry moves toward 2025.[1]

Peter Finnerty
US Mutual Fund Leader

"Change is the only constant. The pace of change in the US mutual fund industry continues to accelerate, creating new challenges and opportunities for managers.

What we expect to see by 2025

PwC has developed a point of view on nine trends, as highlighted in this report, which we expect to see by 2025

[1] This paper is focused on the US mutual fund industry, and many of the concepts here are also explored in "Asset & Wealth Management Revolution: Pressure on profitability" (PwC, October 2018), which focuses on the global asset management industry. See https://www.pwc.com/gx/en/asset-management/asset-management-insights/assets/pwc-awm-revolution-pressure-on-profitability.pdf

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The changing landscape

Where are revenue and expenses going?

The US mutual fund industry has been lulled into a false sense of security over the past decade. Assets under management (AUM) has grown substantially in the wake of the global financial crisis, making it relatively easy for many US mutual fund firms to sustain profits. However, a slowing of AUM growth and an industry-wide move to lower fees, driven in part by a surge in the popularity of low-cost passive products, are shrinking fund firms' revenues. In addition, investors are demanding more value for their dollars and regulators are demanding more transparency. The industry is at a critical juncture.

Between 2011 and 2018, US mutual fund AUM[2] grew by a robust 79%.[3] Between 2018 and 2025, PwC predicts that AUM will grow by 5.6% annually,[4] compared to the AUM growth rate between 2011 and 2018 of 8.7%.[5] Managers can no longer rely on AUM growth and market appreciation to sustain profits in the way that was possible in recent years.

In this challenging environment, managers must find new ways to stay competitive. US mutual fund firms should evolve their business models and strategies, invest more heavily in technology, gain access to high-quality data, and adapt to the changing workforce.

Distribution platforms are beginning to shrink and shelf space is declining. Increasingly, managers have had to rationalize funds. Competition continues to increase and is leading to more consolidation. To compete in this environment, firms will have to decide how to achieve scale through organic growth or acquisitions, or pursue a niche strategy.

Perhaps the biggest opportunity for mutual fund firms is to transform their technology infrastructure and explore outsourcing to increase efficiency and agility, reduce costs, and deliver a better client experience. Finally, all firms, regardless of size, will have to recruit and retain employees with the skill sets needed to operate in an increasingly technology-focused industry—and upskill their existing workforce.

#1

US mutual fund assets under management (AUM) are expected to grow by

5.6% annually

between 2018 and 2025, reaching $26.8 trillion, compared to

8.7% AUM growth

between 2011 and 2018.[6]

[2] Throughout the paper, we include ETFs and exclude money market funds when referencing US mutual fund firms and assets
[3] PwC analysis based on data from ICI
[4] Ibid
[5] Ibid
[6] Ibid

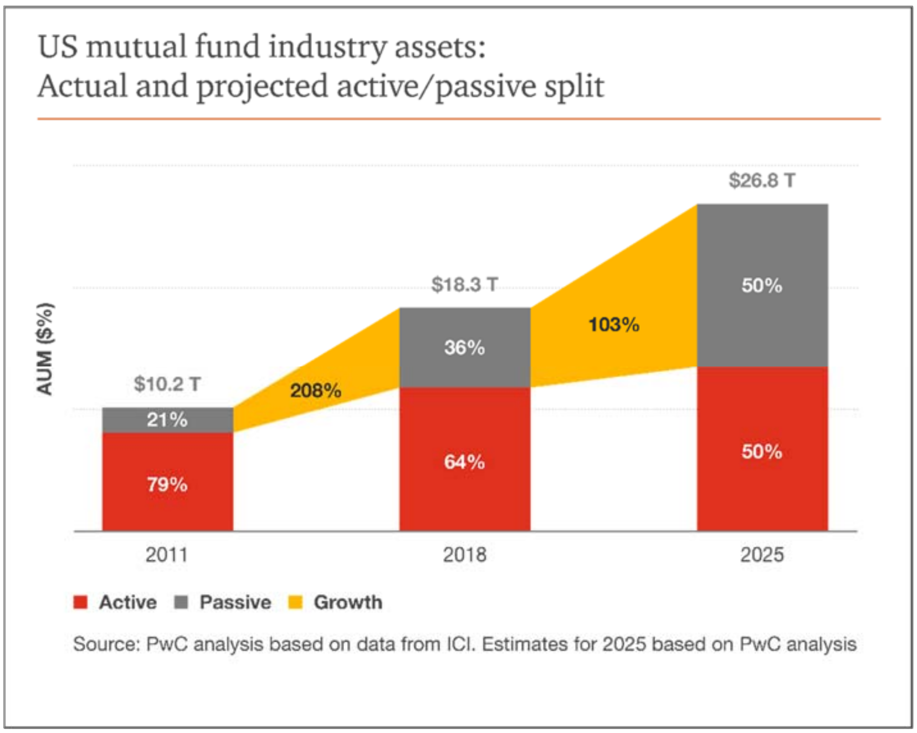
The shift toward passive management

Investors have been moving into low-fee passive products, putting more downward pressure on fees and dampening the revenue outlook for US mutual fund managers. Many mutual fund firms still employ active management, but passive management is gaining ground rapidly—far faster than earlier anticipated—buoyed by record equity market performance.[7] Institutional investors continue to surge into passive strategies, due in part to the transparency and low fees these products offer and the inability for many asset managers to consistently outperform their respective benchmarks.

Passive funds accounted for 36% of total US mutual fund/ETF industry assets in 2018. PwC predicts that the total could surge to 50% by 2025 (see Figure 1).[9] With passive products AUM on a par with active funds by 2025, profits will be squeezed.[10]

The rising demand for passive products has already intensified competition among all asset managers—those who pursue active and passive, alternative, and traditional long-only strategies (see Figure 1). To stay competitive, active managers are evaluating performance-based fee models (such as outcome-based fees, volume discounts, “early bird discounts”). Some managers are promising zero or minimal fees on select funds to acquire new clients. They are also cross-selling other alpha-focused products and ancillary services. These fee models are helping to reshape the passive landscape.

Figure 1: US mutual fund industry continues shift toward passive investment



#2

Passive funds could account for **50%** of total US mutual fund industry AUM by 2025, up from **36%** in 2018.[8]

[7] Lenova, Olga. “Corporate Governance In The Age Of Passive Investing,” February 14, 2019, Mondaq Business Briefing, accessed on Factiva April 15 2019 and PwC analysis based on data from ICI and Simfund
[8] Ibid
[9] PwC analysis based on data from ICI and Simfund
[10] Ibid

Declining US mutual fund expense ratios

Based on PwC analysis, we believe total expense ratios (TERs) for both active and passive funds will continue declining through 2025, consistent with the previous seven years (see Figure 2).[11] By 2025, we expect combined active and passive fund expense ratios to decline by approximately 22% from their already low levels in 2018.[12] Price remains a key differentiating factor (along with performance) among market cap-weighted passive products, driving fees—and TERs—ever lower.[13]

The shift to low-fee passive investments combined with falling TERs has led to a shift in the relationship between revenues and AUM. The numbers are telling: While US mutual fund AUM is projected to grow by 46% between 2018 and 2025, total industry revenue is projected to increase by between 10% and 15% over the same period (not taking inflation into account).[15]

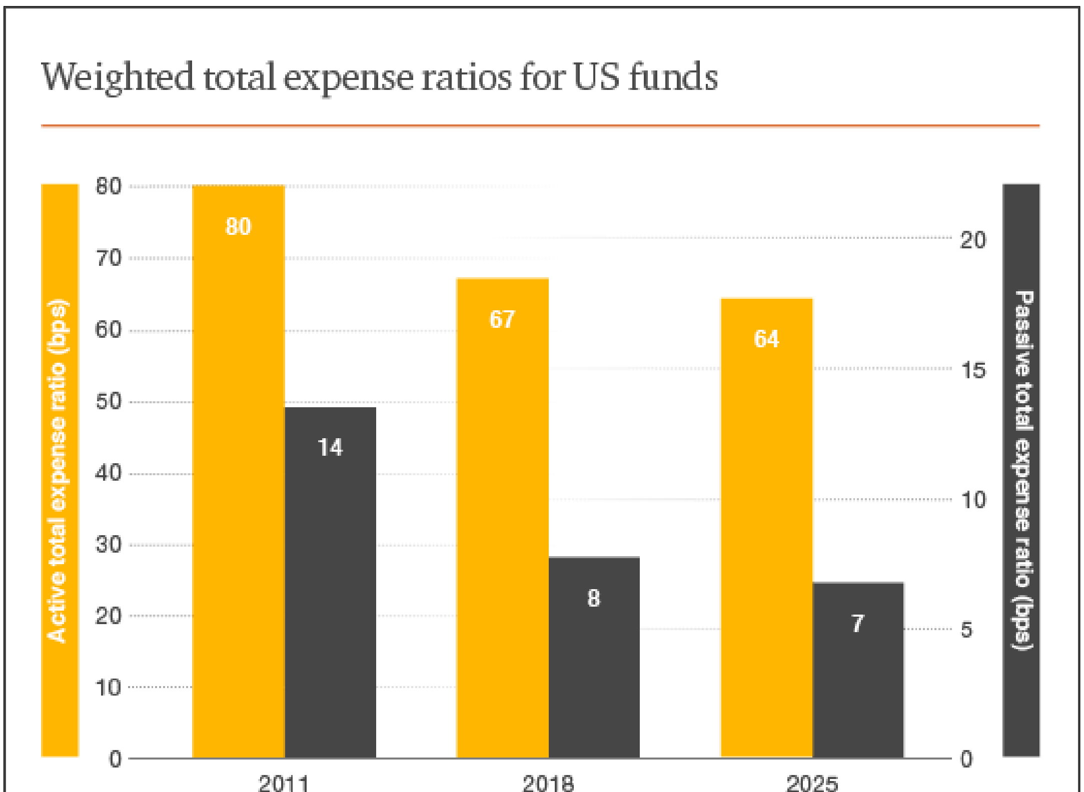
Due to the low fees for passive investment products, scale is essential to profitability in this space, giving larger, more established players an edge. Some active managers are trying to stay competitive by implementing outcome-based fee structures, multiple asset class solutions, and periodically disclosed active ETFs. The passive "race to zero" has long been a topic of discussion within the mutual fund industry, and the finish line is apparently closer than ever. Some may argue we've already reached it.

Given the tremendous pressure on management fees and TERs, the revenue outlook for US mutual fund firms as we head toward 2025 is not promising, particularly for active managers.[16] Mutual fund managers will have to work harder to maintain profits and stay competitive.

#3

By 2025, we expect combined active and passive fund expense ratios to decline by approximately 22%.[14]

Figure 2: Active and passive total expense ratios continue to fall



Source: PwC analysis based on data from ICI. Estimates for 2025 based on PwC analysis

[11] PwC analysis based on data from ICI and Lipper
[12] Ibid
[13] PwC, "Asset and Wealth Management Revolution: Pressure on Profitability," October 2018
[14] Ibid
[15] PwC analysis based on data from ICI and Lipper
[16] PwC, "Asset and Wealth Management Revolution: Pressure on Profitability," October 2018

3

Responding to the changing landscape

A four-part agenda for building a future-fit operating model

Strategic positioning	Mutual fund managers will need to decide how they plan to play in this space—what products to offer, what markets and distribution channels to use, and whether they are a scale or niche player.
Technology transformation	Transformation and automation are key for mutual fund managers to increase efficiency, lower costs, and provide a better client experience.
Value for money	As calls intensify for the AWM industry to provide better value for money, managers will need to continue to focus on aligning their products and services with investor needs.
Battle for talent	Individuals want opportunities to focus on digital technology, diversity and inclusion in the workplace, and work-life balance. Asset managers will need to compete with technology-focused firms for new talent while enhancing the technology skills of existing talent.

Some mutual fund firms have compensated for the disparity between AUM growth and profitability by streamlining operations and achieving other efficiencies. However, many managers have not made cost-cutting a priority until recently, relying instead on AUM growth to stay profitable, even as the industry growth rates have declined.

What will happen in the next downturn? Without finding ways to cut costs and operate more efficiently, managers will struggle to maintain profitability in the coming years.

Managers should be adapting more rapidly today to prepare for possible declines in both AUM and revenue growth.

We propose a four-part agenda for building a future-fit operating model (see Figure 3). The agenda focuses on **strategic positioning**, **transforming through technology**, **value for money,** and **winning the battle for talent**. These are the four foundations of target operating models outlined in PwC's Asset & Wealth Management Revolution.

Beth Savino
US ETF Practice Leader

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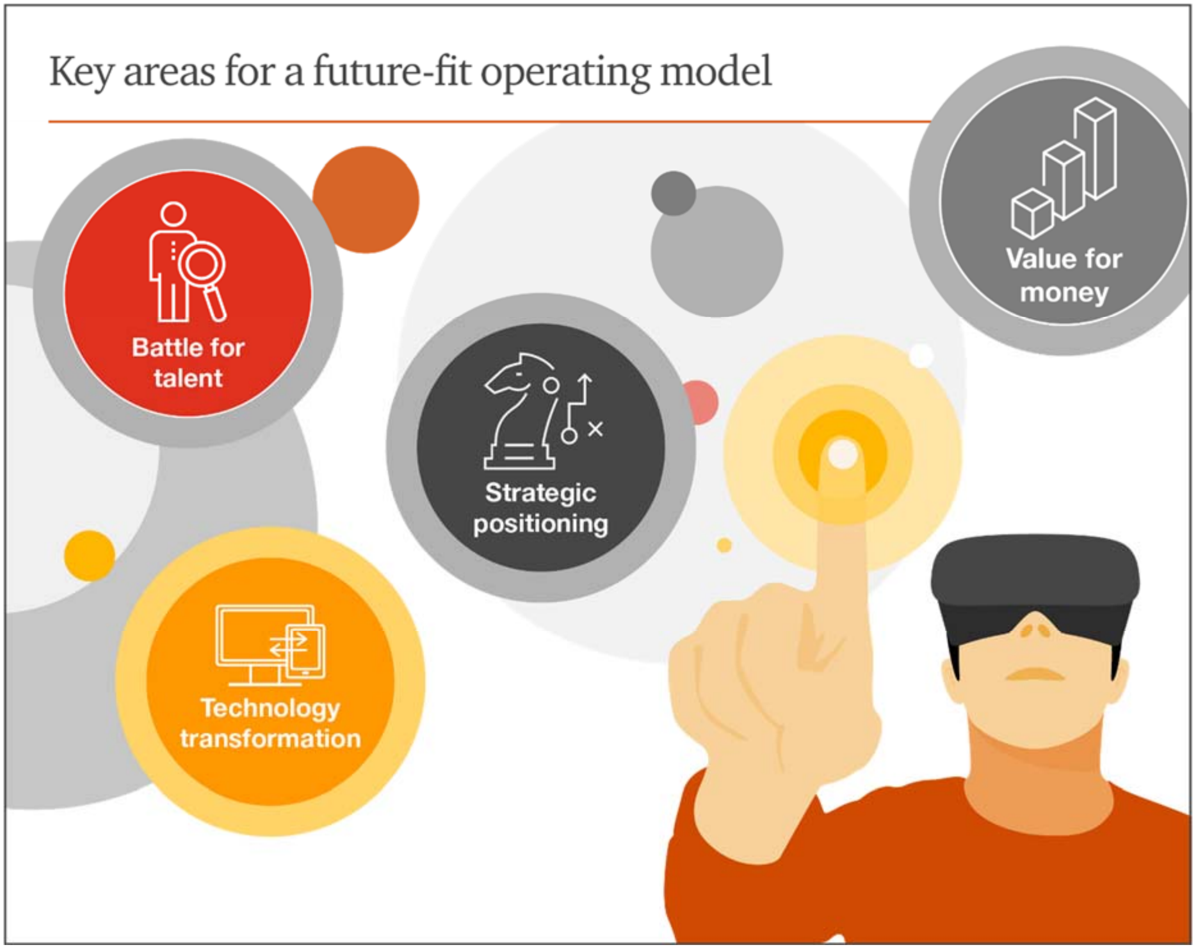
The rising demand for passive has intensified. New fee models are reshaping the industry. Managers need to act now to address the transformation underway.

Figure 3: Our four-part agenda for building a future-fit operating model



Strategic positioning

To thrive or even survive in a low-fee environment, mutual fund firms will need to decide how to play in this space: what products to offer, which markets and distribution channels to use, and whether to seek to grow organically or through acquisitions, or to pursue a niche strategy focused on a core area of expertise. Those without a clear strategic position are more likely to falter.

To stay competitive in the coming years, US mutual fund firms will have to develop and evolve their capabilities. Among other things, many will have to evaluate their sourcing strategies and decide which functions are core and should be retained in-house and which would be better outsourced. By outsourcing certain functions, firms can focus on their core competencies, achieve scale, enhance labor specialization, and deliver more value to clients.

#4

Fund accounting outsourcing is expected to increase to approximately **63%** in 2025 from approximately **38%** in 2018.[17]

[17] PwC analysis, based on Simfund data and Form ADV. Analysis performed based on Assets Under Management (AUM).

In many cases, it's faster, simpler, and cheaper to outsource some or all of a function, depending on whether the activities involved are considered strategic. Outsourcing can alleviate the burden of keeping technology up to date. For instance, it may be more cost-effective for third-party fund administrators to invest in the latest technologies, as they have greater scale than fund firms currently performing services internally. (See Figure 4 for areas mutual fund managers should evaluate as they consider insourcing, co-sourcing or outsourcing.)

#5

Mutual fund tax outsourcing is expected to increase to approximately **70%** in 2025 from **50%** in 2018.[18]

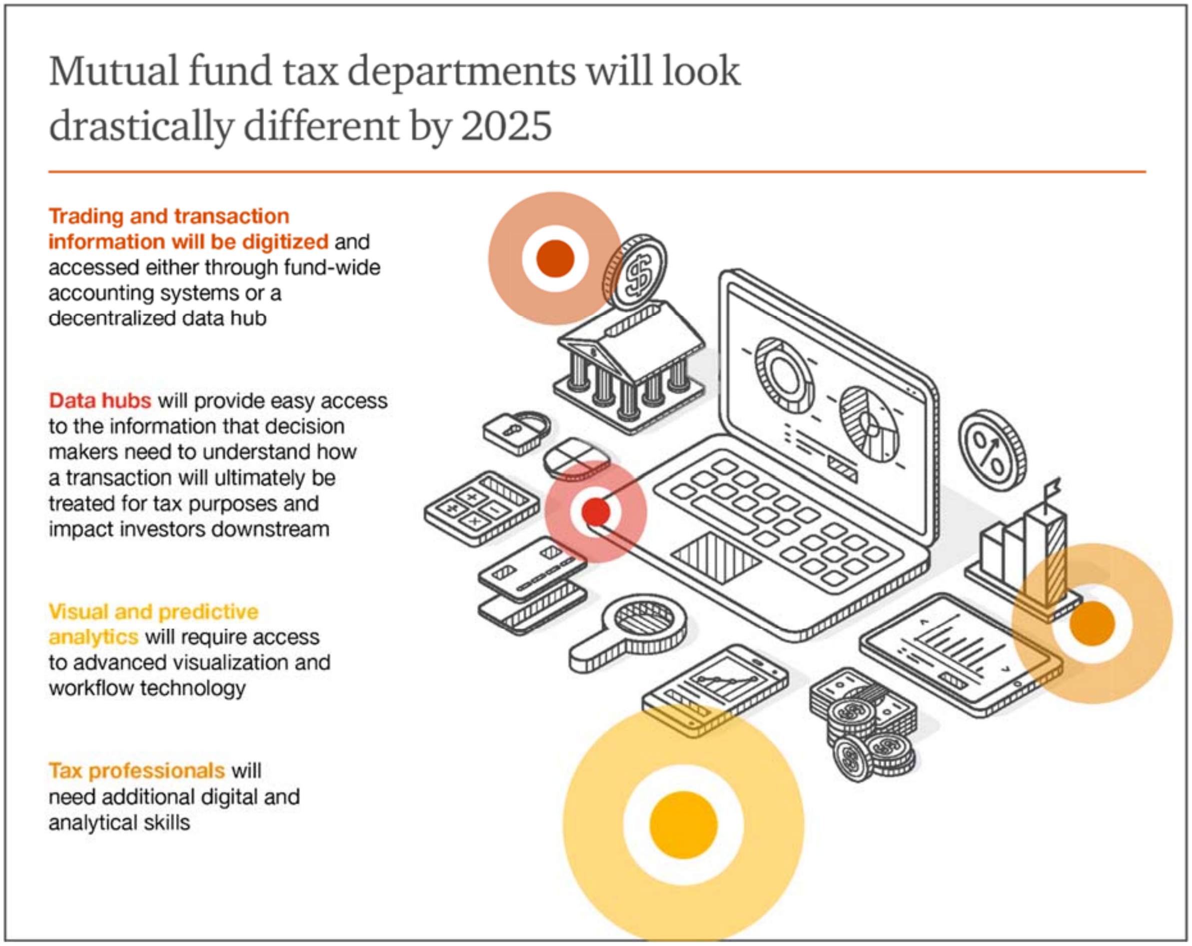
Figure 4: In many cases, it's faster, simpler, and cheaper to outsource some or all of a function

[18] As estimated by PwC

Outsourcing fund accounting is one strategy that's gaining traction, as US mutual fund firms turn to service providers to perform lower-value business processes in the "drive-to-zero" cost approach. Fund administrators today are increasingly investing in technology to assist US mutual fund firms in meeting the data and information demands of regulators and investors.

Many firms also outsource the tax function, and we expect this trend to continue as technology further enables automation. That, in turn, can help firms standardize processes, better leverage data, and bring down costs—all of which allows managers to focus on strengthening their core competencies. (See Figure 5.)

Figure 5: Many firms are outsourcing the tax function, a trend we expect will continue



Tracey Keevan
US Mutual Fund Tax Technology Leader

> "Firms have reevaluated their tax function operating models. Automation has bred new life into the tax function. The skills needed now go way beyond those of the traditional tax professional.

Rationalize products

As distribution platforms shrink and the remaining shelf space comes at a premium, many managers are starting to eliminate underperforming and costly funds. We predict that half of US mutual fund products currently offered in

the market will be closed or merged by 2025.[19]

The closure of these funds may be partially offset by new products. As firms look for cost-effective ways to grow, we expect to see more ETFs coming to market along with smart-beta; periodically disclosed active ETFs; quant; environmental, social and governance (ESG); and outcome-oriented funds. As a result, we foresee a 14% net decline in the overall number of fund products by 2025.[20]

#6

We expect to see a net reduction of **14%** in mutual funds and ETFs by 2025.[21]

Scale or niche? Decide which

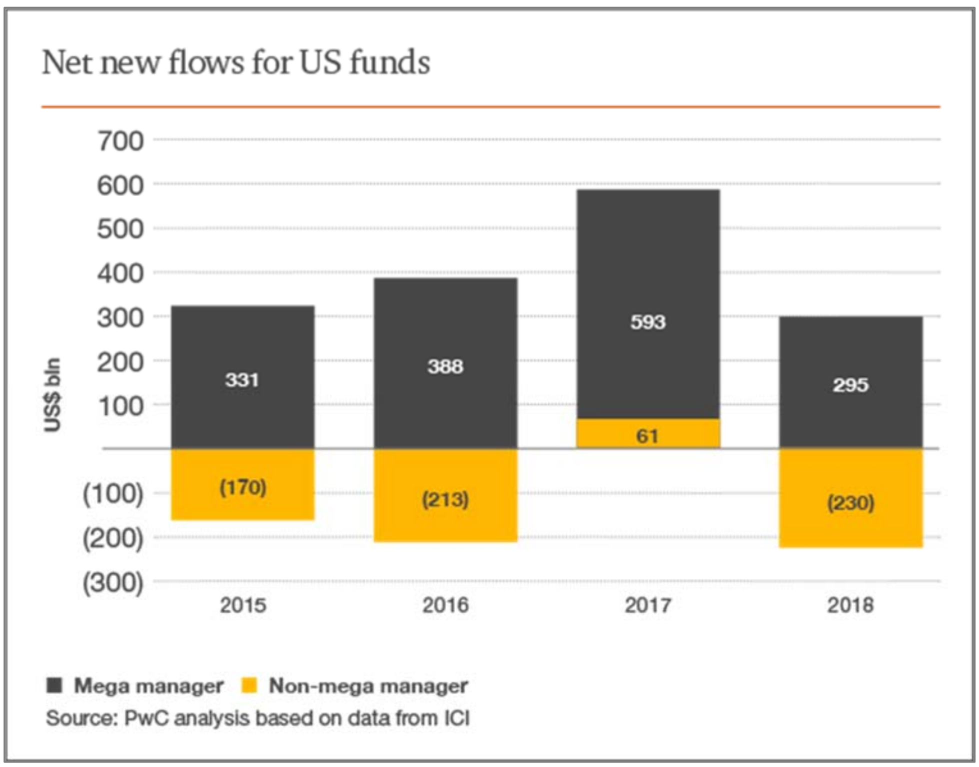
The big players have gotten bigger. From 2015 to 2018, the five largest US mutual fund managers—the so-called "mega managers"—attracted $1.6 trillion in net US mutual fund inflows.[22] The remaining managers saw net outflows of $552 billion during the same period (see Figure 6).[23]

We expect this trend to continue through 2025, with mega managers growing organically by 4.8% annually while the smallest managers continue to fight to gain market share.[24] The top five US ETF issuers have more than a 90% market share, which presents even greater challenges for other ETF sponsors.[25]

#7

By 2025, we expect mega managers will account for **64%** of US mutual fund AUM, compared to **55%** at the end of 2018.[26]

Figure 6: Mega managers continue to grow, while remaining managers have seen net outflows



[19] PwC analysis based on data from ICI and Strategic Insight Simfund
[20] Ibid
[21] Ibid
[22] Ibid
[23] PwC analysis, based on data from Strategic Insight Simfund
[24] PwC analysis based on data from ICI and Strategic Insight Simfund
[25] Ibid
[26] Ibid

Smaller firms may be able to find a profitable niche by specializing in particular areas of expertise, specific markets, channels, and/or products, or through an M&A transaction. Those that wish to operate on a niche scale should look to develop specific insights in their target areas and reallocate resources.

US mutual fund firms that are neither niche nor mega managers are finding it increasingly difficult to maintain profitability. These firms will have to decide whether to scale or pursue a niche strategy.

Turning to M&A to stay competitive

We have seen an increase in M&A activity in recent years and expect this trend to continue. Consolidation will continue to impact all industry players through 2025 as managers strive to enhance scale, acquire expertise in new asset classes, and gain access to new distribution channels or markets. In the coming years, M&A could provide solutions for a variety of firm types, including:

- Independent firms without a clear succession plan.
- Firms looking to build out multi-asset capabilities.
- Managers with heavy concentration risk, such as a flagship investor, flagship fund, key distribution partner or channel, single product focus, or geographical concentration.
- Firms for which being public no longer makes sense.
- Firms that want to focus on investment management and not deal with regulatory, distribution, and other challenges associated with managing an asset manager.

#8

Managers anticipate that they will be able to reduce their overall costs by

2%-4% annually

through business-led technology innovation, helping to offset pressure on margins.[28]

Technology transformation

Transforming technology infrastructure will be critical to the success of US mutual fund firms in the coming years. Firms that leverage technology and high-quality data effectively can reduce costs, bolster risk analysis, make better investment decisions—and potentially deliver higher returns to investors and profit margins.

Up to now, complex, uncoordinated systems have kept information technology (IT) costs high and hindered data analysis. Firms need to replace their siloed, inefficient IT systems that span the entire value chain, multiple asset classes, and geographic regions. Doing so will enable firms to perform richer, more timely data analysis.

Technology is already being used to cut costs and improve efficiency in the middle and back offices (see Figure 7). Now firms are applying it to the front office. Artificial intelligence (AI) in particular will be vital to improving front office operations, enabling real-time optimization of sales, marketing, client interactions, and predictive modeling with near instant processing of data.

By 2025, we expect the front, middle, and back office to be replaced by a single, “integrated platform” that has been transformed by technology. Blockchain, AI, and robotic process automation (RPA), for example, are expected to be able to handle most data maintenance and reporting requirements from counterparty exposure reporting to fund administration. Generally, employing digital technologies across the organization will enable firms to minimize the cost of their low-value activities and maximize the impact of their high-value activities to gain competitive advantage.

#9

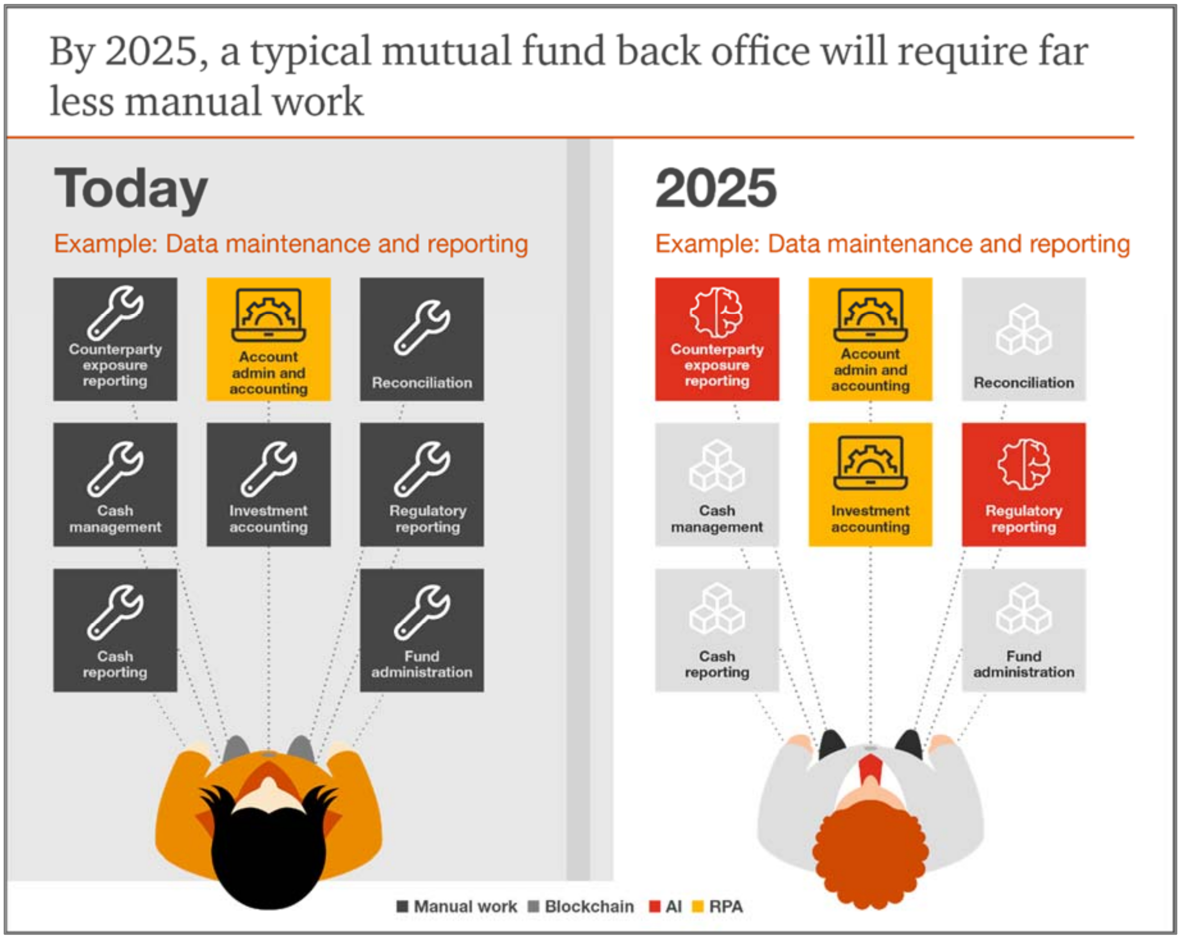
The US mutual fund industry is expected to undergo significant consolidation with up to

20% of the firms

currently in existence either being acquired or eliminated between now and 2025. [27]

[27] PwC, “Asset and Wealth Management Revolution: Pressure on Profitability,” October 2018
[28] PwC conversations with various clients

Figure 7: Automation will continue to drive changes in the back office

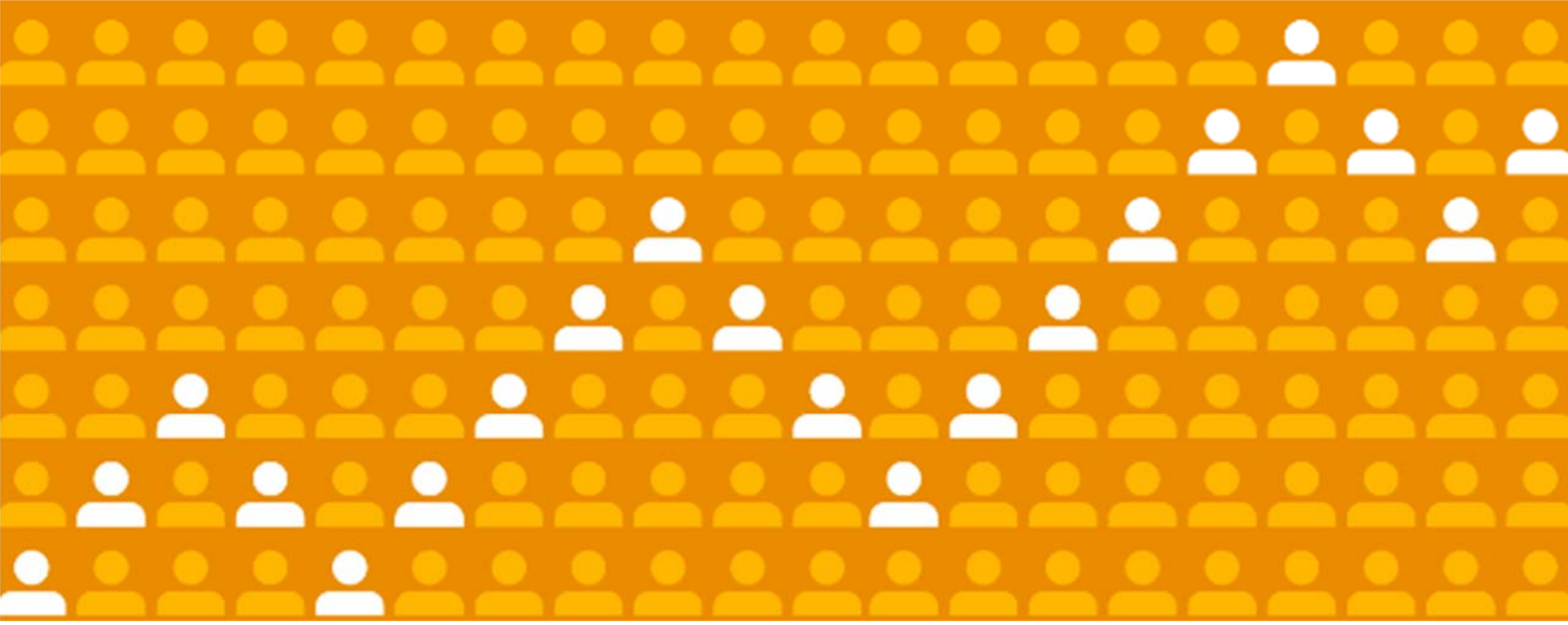


How will US mutual fund firms get there?

Firms looking to create an "integrated platform" have two options. One is to build or buy the core technology capabilities and keep them in-house, the other to adopt a multi-platform, cloud-based solution with managers outsourcing some operations to service providers.

Both approaches have their benefits, but they also come with significant drawbacks. The in-house approach enables firms to retain complete control over their technology, but it can be costly to deploy and maintain. Multi-platform, cloud-based solutions with some outsourcing may result in certain efficiencies, however, it may take time to realize these savings. And there are other challenges involved, including selecting vendors and building stakeholder consensus, as well as governance, monitoring, and maintenance.

Regardless of the approach a firm chooses, having access to the right high-quality data will be essential. Firms should ensure that they develop reliable, consistent, quality data—to feed into their systems and to support sound analysis and decision making.



Value for money

As pricing pressure intensifies, firms should look for creative ways to price their products to satisfy investor demand for value. Aligning fees with performance may help, but managers must work to understand what else constitutes "value" in the minds of investors. Market leaders have already introduced performance-linked or fulcrum fee structures. Currently, fulcrum fees account for just a minor portion of US registered funds. However, we expect new fee models will continue to develop in the coming years.[29]

Today's investors have access to more data and tools to help them analyze and compare fees and performance, yet standard asset management fee models have remained static. In the coming years, the asset and wealth management industry will need to lower costs, manage fee pressure, and learn to deliver more for less.

Product innovation will prioritize outcome-oriented products

As investors demand more transparency, product innovation is key as clients increasingly focus on what they are receiving relative to what they are paying. Many managers have adopted strategies to differentiate themselves. These strategies include moving toward smart beta and offering focused periodically disclosed active ETFs, concentrated active products, alternatives (such as real estate, private equity, hedge funds), and collective investment funds. There is also an increasing trend toward outcome/solution-focused product innovation. This represents a significant change from the past, when investors simply picked stocks or a single mutual fund and assembled a portfolio based on a set of individual fund choices. Client expectations have changed, and firms must adjust accordingly—or face the risk of simply being left behind by the competition.

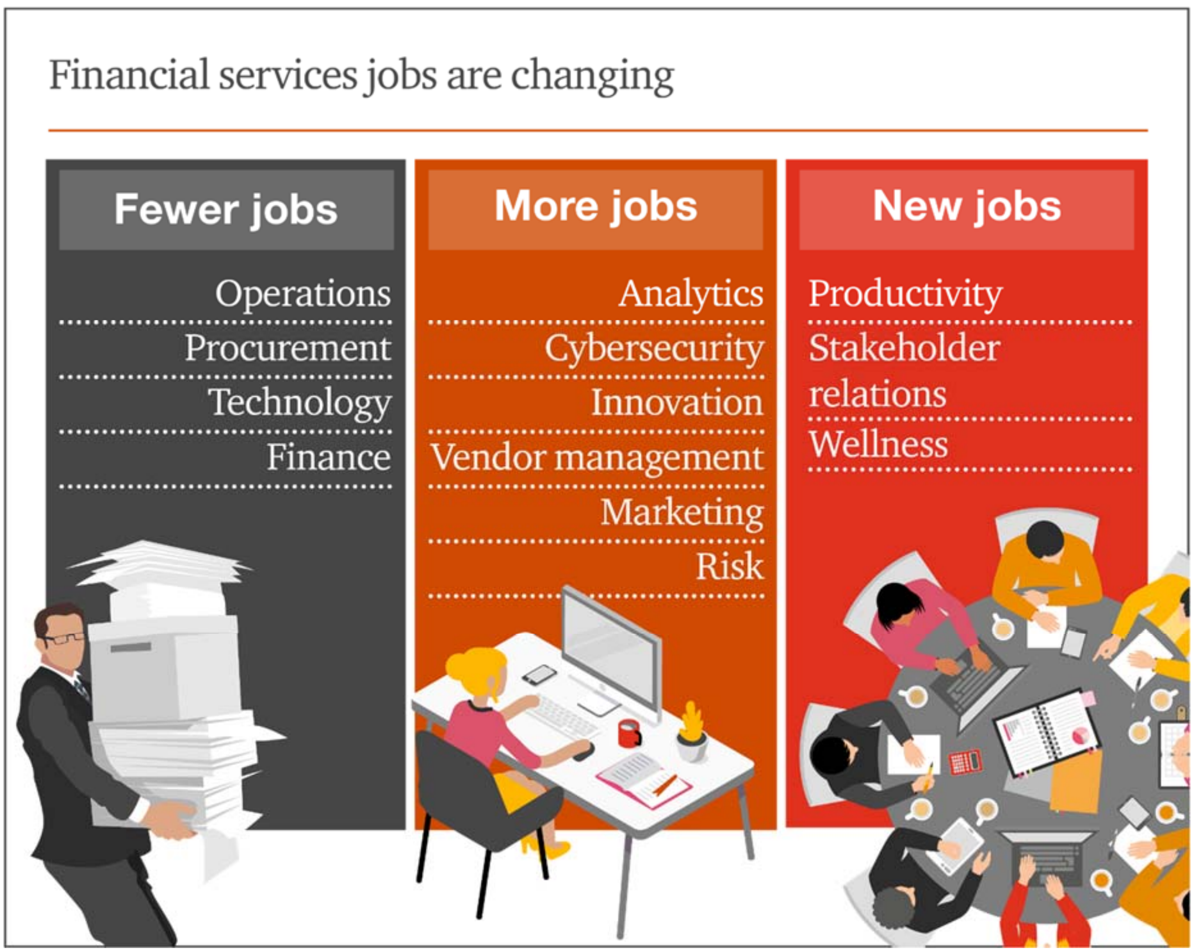
[29] PwC, "Asset and Wealth Management Revolution: Pressure on Profitability," October 2018

The battle for talent

The US mutual fund workforce is evolving and shrinking as we move toward 2025. Rapid developments in technology have changed the employee profile and the number of jobs needed. Robotics and AI now handle repeatable, transactional tasks that were once performed manually. Functions such as finance and operations are being disrupted, while areas such as analytics, cybersecurity, and vendor management are seeing growing demand. New roles are emerging as well, in areas ranging from ethics to stockholder relations (as shown in Figure 8).

In addition to hiring tech-savvy talent, managers should focus on training the current workforce for a digital world.[30] An effective change management strategy is essential to this effort. Transforming a business can be deeply unsettling for employees, and firms must be sure that the workforce is on board with the changes ahead.

Figure 8: Expect to see new jobs emerge as other positions are automated

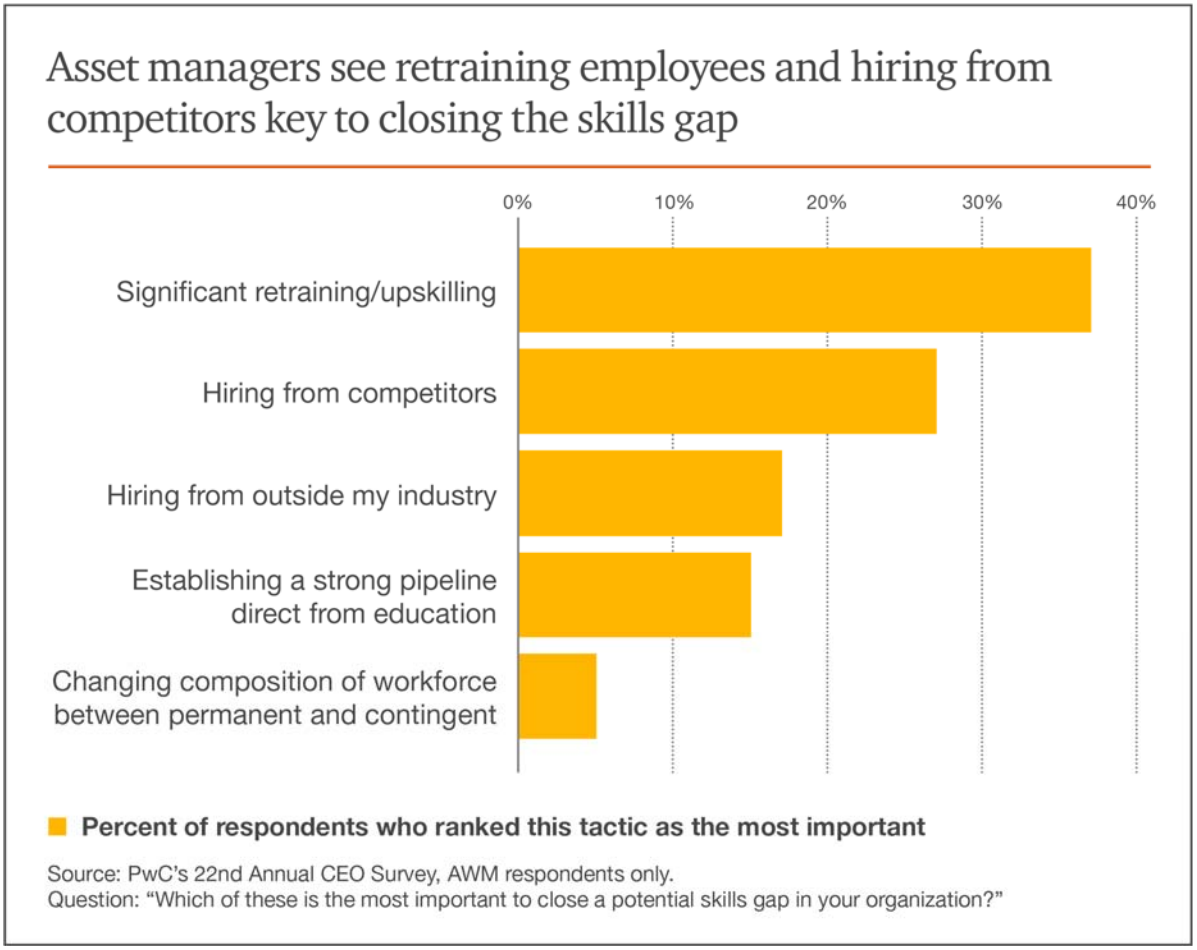


[30] For more on training a digital workforce, see *The productivity agenda: Moving beyond cost reduction in financial services* available at: https://www.pwc.com/gx/en/industries/financial-services/publications/productivity-agenda.html.

While managers have begun to recruit more tech-savvy employees, they are competing for talent with tech-focused firms. There is a growing concern in the industry over the ability to recruit and retain employees with the skills needed to succeed. In PwC's 22nd Annual CEO Survey, 55% of asset management CEOs said that it has become more difficult to hire workers in their industry.[31]

In a seller's market for talent, potential employees are dictating where they want to work, and many are looking for employers that align with their values and priorities, such as work-life balance and diversity and inclusion in the workplace. Firms are adopting a variety of strategies to bolster the workforce, such as upskilling employees and hiring from competitors (see Figure 9).

Figure 9: We expect asset managers to focus on retraining employees and hiring from competitors



[31] Source: PwC's 22nd Annual CEO Survey, AWM respondents only. Question: "In general, has it become more difficult or less difficult to hire workers in your industry, or is it unchanged?"

4

Conclusion

The pace of change in the US mutual fund industry is rapid, and that has created both challenges and opportunities for firms to adapt quickly to remain relevant. Firms must focus on four key areas if they are to succeed in this fast-changing environment.

1. Strategic positioning: Every firm needs to determine its strategic position for the future. Niche players should have high-conviction strategies and focus on their unique strengths. Scale players should leverage their ability to be a complete solution provider and focus on outcome-oriented products. Managers in the middle need to decide which direction to pursue—scale or niche—and adopt a stance that sets them firmly on that course.

2. Technology transformation: For a firm to be efficient and competitive, it needs to adopt an "integrated platform" that manages all activities—investments, distribution, reporting, operations, and regulatory compliance. Successful firms will be those that gain better insights by using artificial intelligence, robotic process automation, data, and analytics.

3. Value for money: Managers must react to the industry's changing price structures. New fee models continue to be developed, and investors are searching for firms that can provide superior returns, excellent client service, and competitive prices. The ability to deliver an innovative, technology-enabled, and seamless client experience will continue to create value for both investors and managers.

4. Battle for talent: Despite pressures on profitability, investments in top talent are essential to ensure the ability to transform firms and drive success. As technology becomes more central to fund managers, talent needs will change. Mutual fund firms are competing with large technology companies and startups for skilled workers. Data science is becoming a more crucial skill, and teams that can successfully develop and integrate cloud-based technologies are fundamental for the future. Firms that build diverse and inclusive workspaces will reap the rewards.

Tom Holly
US Asset & Wealth
Management Leader

"Mutual fund firms must act today to remain competitive and relevant in the future. We are at a crossroads, and industry dynamics will wait for no manager to catch up.

5

Methodology

In developing this report, we gathered historical data from well established, industry-standard sources, including the Investment Company Institute (ICI), Simfund, and Lipper, along with PwC's proprietary resources. We also drew on insights from PwC partners and subject matter experts.

Our forecasts of AUM and the active/passive split are based on historical data, including product types and strategies. This information was supplemented with economic and flow data that was fed into a proprietary model.

We forecast the fees for more than 100 series using multiple econometric approaches. In performing our analyses, we relied on multivariate approaches as well as time series forecasting. Ultimately, we proceeded with a decomposition of the time series components (trend, seasonality, and residuals) and forecast them out to 2025. For this purpose, multiple models were tested, from the random walk with drift to the ETS family and ARIMA models. The model we selected is exponential smoothing (specifically, the cubic smooth spline), due to its outperformance and flexibility.

Fund closures were forecast using historical ICI data supplemented with the growth projections, economic projections, and asset concentration data in our AUM model.

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