UBS

Longer Term Investments

Retirement planning

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- Asset gatherers (wealth and asset managers) and life insurers stand to benefit from several positive medium-to-long-term trends, namely increasing longevity and an aging society. These trends lead to increasing savings gaps, with a growing middle class in emerging markets and a rising number of high net worth individuals within the entrepreneur segment being the most promising.
- Structural asset growth, upside potential on higher trading volumes, ongoing consolidation efforts and relatively high capital requirements are additional drivers that should allow asset gatherers and life insurers to achieve good, above market average long-term profitability levels and earnings growth.
- This theme, although not free from challenges, also provides some degree of inflation protection, as revenue streams depend on nominal asset prices.

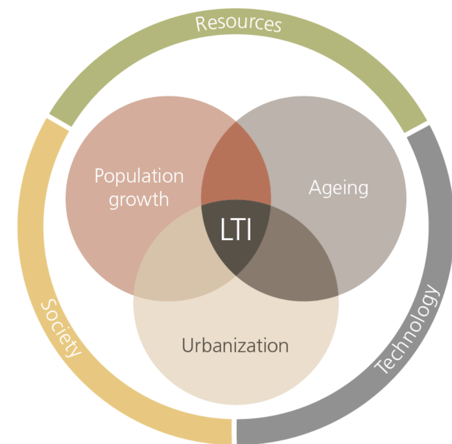
Introduction to the Longer Term Investments (LTI) series

– **The Longer Term Investments (LTI)** series contains thematic investment ideas based on long term structural developments.

– Secular trends such as population growth, ageing, and increased urbanization create a variety of longer term investment opportunities.

– These investment opportunities are influenced by the interplay of technological advancement, resource scarcity, and the societal changes.

– Investors willing to invest over multiple business cycles can benefit from potential mispricings created by the typically shorter term focus of stock markets.



Our view

Changing demographics leading to greater longevity and an aging society should result in the need for more retirement planning. We believe this in turn provides opportunities for those companies with the right answers. We think companies with asset accumulation solutions, as well as products that match income needs to longevity, should benefit from these long-term trends:

1. **Increasing longevity:** People are living longer across the world. This means that *many more* people are reaching older ages, a trend that will likely extend into the future. (see Fig. 1).
2. **Aging society:** With baby boomers reaching retirement age, the ratio of pension-age to working-age people is rising (see Fig. 2).
3. **Widening savings gap:** With strained public finances, retirees will need to rely increasingly on their own savings for retirement. However, the difference between what is saved and what is needed to finance old age remains a concern, specially for entrepreneurs (see "Entrepreneurs: Everything is about planning").
4. **Growing middle class in emerging markets:** Not only is the number of high net worth individuals (HNWIs) increasing, there is also an increasingly wealthy middle class in emerging markets with a growing need for asset gatherers' products and solutions.

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We believe that asset gatherers (wealth and asset managers) and life insurers should benefit from these structural demographic trends, which could lead to outperformance compared to the broader equity market.

Introduction: The beneficiaries – asset gatherers and life insurers

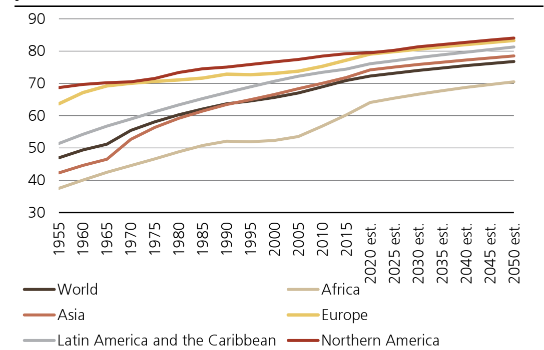
Asset gatherers (asset and wealth managers) and life insurers should benefit from four key trends related to retirement planning: **increasing longevity**, an **aging society**, an **increasing savings gap** and a **growing middle class in emerging markets,** together with rising numbers of high net worth individuals (HNWIs). These asset gatherers and life insurers have the right products for asset accumulation and risk protection. In this note, we describe the factors that support this investment theme, discuss important drivers of retirement planning in detail, highlight risk factors.

In addition to the four key drivers, we identify further reasons why asset gatherers and life insurers should benefit from retirement planning:

1. **Structural asset growth:** Asset growth is a function of world GDP growth and is thus expected to rise. Historically, global growth in assets under management (AuM) has been 1.4x of nominal GDP growth.
2. **Potentially higher trading volumes:** A rise from current historically low market volumes is expected.
3. **Hedged long-run inflation risks:** The asset gatherers' business model provides a good inflationary hedge, as the nominal value of AuM is influenced by the inflation rate. A possible pick-up in inflation and the need to protect the purchasing power of savings in the long run should also increase the need for investment advice and suitable investment vehicles.
4. **Ongoing consolidation:** The fragmented wealth management industry is likely to undergo further consolidation, resulting in take-over premiums for individual companies.
5. **Relatively light capital requirements:** The business model of asset gatherers (wealth and assets managers) generates plenty of cash and consumes much less capital than other types of financial services, like retail and commercial banks. As such, they have a relative advantage from a capital perspective versus other financial services companies, in particular banks.
6. **High barriers to entry:** Investments in IT infrastructure, onshore advisor networks and legal departments limit new market participants and provide some degree of protection.

Fig. 1: Increasing longevity

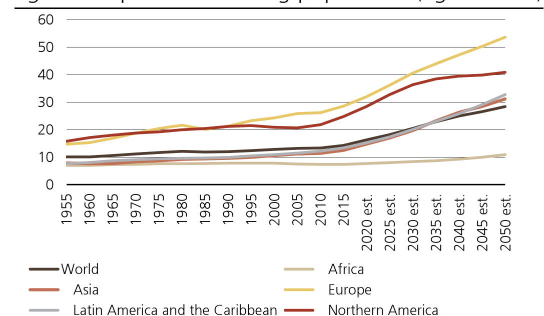
Life expectancy at birth (both sexes combined, in years)



Source: United Nations, Department of Economic and Social Affairs, Population Division (2018); World Population Prospects: The 2018 Revision, UBS, as of September 2019

Fig. 2: The aging society

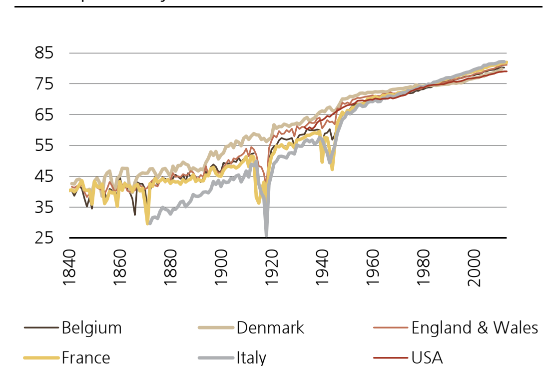
Old-age dependency ratio: ratio of population aged 65+ per 100 working population (ages 20-64)



Source: United Nations, Department of Economic and Social Affairs, Population Division (2018); World Population Prospects: The 2018 Revision, UBS, as of September 2019

Fig. 3: Rising longevity puts retirement planning in focus

Life expectancy at birth for selected countries



Source: Human Mortality Database. University of California, Berkeley (USA), and Max Planck Institute for Demographic Research (Germany). Available at www.mortality.org or www.humanmortality.de (data downloaded on 20 August 2019), UBS

7. **Profitability, earnings and performance:** We believe the superior profitability and earnings growth prospects, underpinned by the long-term drivers outlined above, will continue to support performance.
8. **Entrepreneurs, a growing segment:** The entrepreneurs' segment presents an attractive opportunity for wealth managers, as these individuals are a growing part of the UHWNI segment.

However, we see several challenges to the theme. A cooling of Asian economies, low interest rates and the challenges to sound risk management this entails, a changing regulatory environment, tax treaties, and the evolution of offshore businesses, as well as overall margin compression, could pose significant risks to our long-term theme. We elaborate on these risks later in the report.

KEY DRIVERS

Increasing longevity

All over the world, people are living longer. This trend accentuates the need for careful retirement planning and substantial retirement savings.

The retirement income challenge
How can we ensure that accumulated savings can be converted into a lifelong stream of income that fulfils the needs of a retiree? This is especially relevant considering that life expectancy has risen continuously over the last century (see Fig. 3).

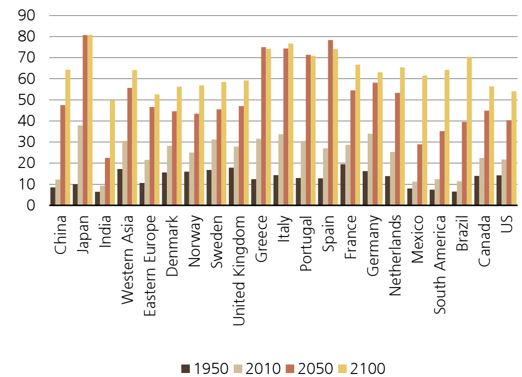
In a recent paper, the IMF estimated the average shortfall in savings, once retired, as 8-13 years for the world's largest economies; the shortfall is greatest for Japan at 15–20 years. In 2010, Allianz conducted a survey of US adults aged 44–75. Some 61% of respondents said they feared outliving their assets more than death. This number rose to 82% among people in their late 40s who are married and have dependents. To our mind, these results present a good opportunity for companies that can assuage the needs and fears related to retirement.

The aging society

As baby boomers reach retirement age, the ratio of retirees to working-age people is increasing dramatically, a trend that is expected to continue.

Dependency ratios are increasing across the globe
The dependency ratio shows the number of people aged 65 and over per 100 persons of working age. Dependency ratios have risen sharply over the last 50 years and the next 50 years will see more of the same. In Japan, for example, the dependency ratio is close to 40%, which means for 100 persons of working age, there

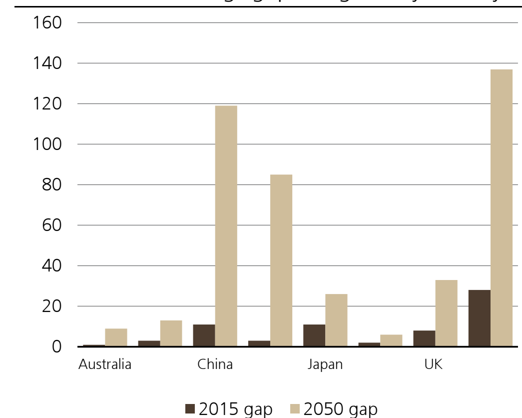
Fig. 4: The aging society
Old-age dependency ratio (number of people aged 65 and over per 100 persons of age 20–64)



Source: United Nations, Department of Economic and Social Affairs, Population Division (2018); World Population Prospects: The 2018 Revision, UBS, as of September 2019

Box 1: Pay-as-you-go social security systems
In a pay-as-you-go (PAYGO) model, available funds finance present expenditures for services, rather than pre-financing or borrowing. With respect to retirement systems, this model funds current pensions for retirees with money paid in by working-age people. Thus, it is an unfunded system. Normally, all contributions would be paid out in the same period as they are received and no reserves would be accumulated.

Fig. 5: Total retirement savings gap, by country (in USD trillions)
The retirement savings gap will grow by 5% a year



Source: World Economic Forum, UBS, as of February 2017

are 40 people aged above 65. This is expected to shoot up to 80% by 2050 (see Fig. 4).

Public retirement systems are under pressure
The rise in the dependency ratio, together with strained public finances, creates the need for individuals to save for themselves rather than rely on governments to provide for them. As the dependency ratio rises, the "pay-as-you-go" models (see Box 1), will suffer further, and most models in their current forms will struggle to survive. As such, individuals will have to consider other sources of income for retirement.

Public retirement systems are weak
Weak government balance sheets in Europe, Japan and the US, generally burdened by high levels of debt, will likely accelerate the trends described above, especially if governments offer incentives for people to save more on their own.

Widening savings gap

With public finances under strain, retirees will have to rely more on their own savings. But the difference between what is and what should be saved to finance old age (the savings gap), particularly given rising longevity, remains a concern.

According to the World Economic Forum, the retirement saving gap is expected to grow annually at 5% to reach USD 400 trillion by 2050, from US 70 trillion in 2015, for the eight largest pension markets in the world (see Fig. 5). Aviva calculates that individuals in Europe, depending on the country, would have to increase their savings by between EUR 4,000 and EUR 13,000 a year to fully close their savings gaps (see Fig. 6). The insurer revealed in its analysis that this is a problem especially for those nearing retirement, as they have less time to close the gap. While alternatives to saving more include retiring later to fund fewer years in retirement, or lowering expectations of retirement income, it is clear that in many cases people would still need to increase total savings to some extent.

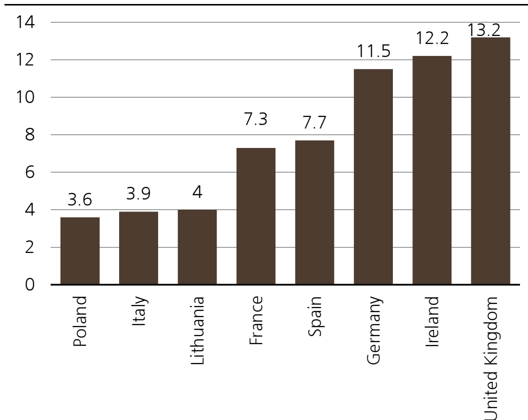
Growing middle class in emerging markets and rising number of HNWIs

Not only is the number of high net worth individuals (HNWIs) rising, but the wealthy middle class is swelling, particularly in Asia.

Rising middle class in Asia
Definitions differ on what the middle class is and how the size of the middle class should be measured. Should an income threshold define the middle class, i.e. a particular level above the poverty line, or should consumption or some other metric be used?

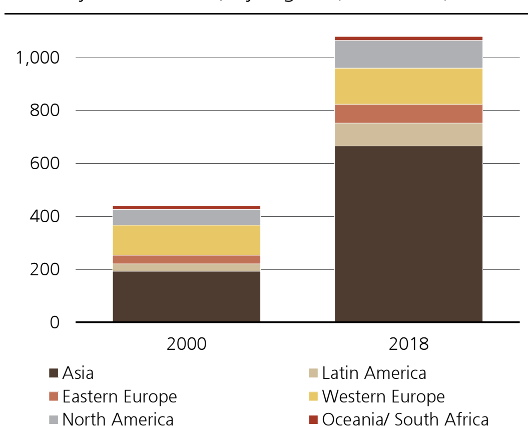
In any case, the middle class in Asia (see Fig. 7) is swelling, and

Fig. 6: Savings gap for individuals
Average annual savings gap per person for individuals retiring in 2017–57 (EUR thousand per annum)



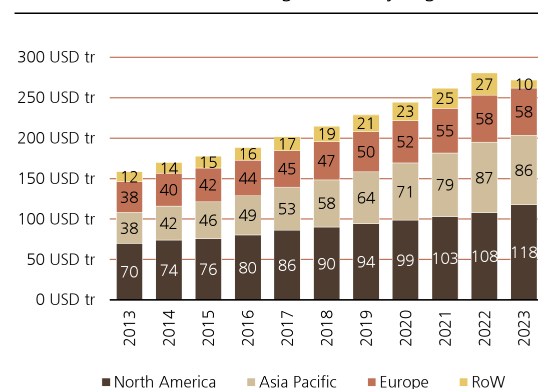
Source: Allianz Global Wealth report 2018, Allianz, UBS, as of September 2019

Fig. 7: Asian middle class is growing sharply
Wealthy middle class, by region (in millions)



Source: Allianz Global Wealth Report 2018, Allianz, UBS, as of September 2019

Fig. 8: Asia's share of global wealth increasing
USD trillions (fixed exchange rate), by region



Source: The Boston Consulting Group: Global Wealth 2018 report, UBS, as of September 2019

growing faster than the region's population overall. Moreover, the aggregate income of this class is growing faster still.

However, wealth accumulation becomes an option only when income rises above a certain threshold. On this point, Allianz has examined social classes, i.e. by dividing societies into "wealth classes." One result is that "income middle class" and "wealth middle class" are not the same, and that their financial needs differ. By either measure, the rising middle class in Asia has growing demand for financial products. Asia's share of the worldwide middle class, measured by the number of individuals, rose to around 60% in 2017 from about 20% in 2000, according to Allianz's Global Wealth report. Assets under management (AuM) globally have steadily increased, particularly so in Asian countries, despite the financial and debt crises in the global economy at the beginning of the decade. As Fig. 8 shows, the current AuM is around USD 229trn, and the Boston Consulting Group expects this to grow at roughly 7% CAGR for the next three years, with Asia exhibiting the largest growth rate. Strong growth there has meant that about 30% of global wealth is now centered in Asia, while Europe and the US have declined in importance. Though Europe and the US together are still home to about two thirds of global wealth, growth remains lower in these regions mainly because of below global average economic growth and high levels of debt.

HNWIs are quickly rising, driven by Asia

According to the 2018 World Wealth Report by Capgemini, the number of HNWIs (typically defined as persons having investable financial assets in excess of USD one million) worldwide has been expanding rapidly (see Fig. 9). Despite a slight tapering in 2018, growth has remained impressive over the past decade with a CAGR of 7%. A closer look shows that the Asia-Pacific (APAC) region is where the sharpest increase is taking place. The number of HNWIs in the APAC region rose 13% in 2017 to 6.2 million individuals, representing the region with the greatest concentration of HNWIs in the world.

It is therefore important to select companies that have a large presence in emerging markets, and in particular the Asia-Pacific region, in our view.

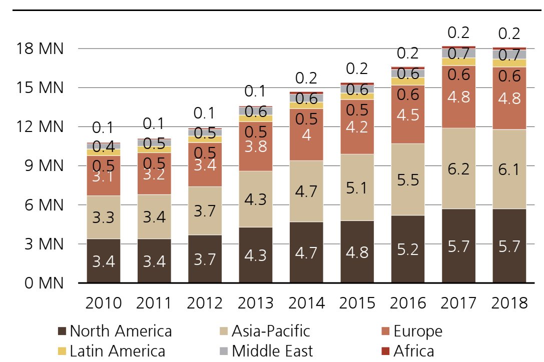
Entrepreneurs present an attractive opportunity

The entrepreneurs' segment is one of the fastest growing segments amongst affluents and HNWIs, The pool of entrepreneurs' wealth accounts for around USD 20 trillion in the top 20 economies, with the largest pools of entrepreneurial wealth being in the US, France, Italy and Japan (see Fig. 10).

Entrepreneurs usually have a high concentration of wealth in their own companies. In order to spread risks, we think entrepreneurs should increase diversification across asset classes and geographies.

Fig. 9: HNWI population, 2010–17

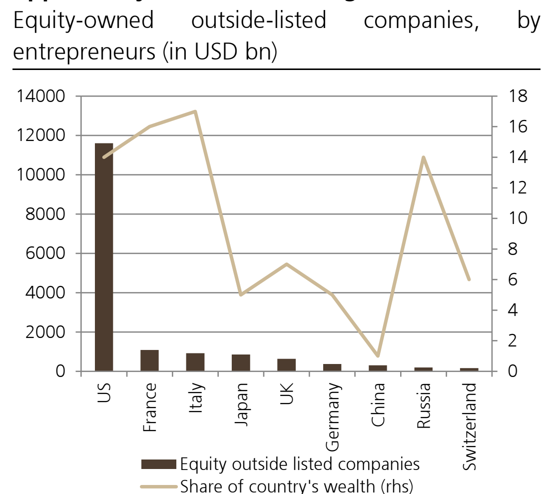
Number of HNWIs in millions, by region



Source: "World Wealth Report 2018. Capgemini", UBS, as of September 2019

Fig. 10: Entrepreneurs offer a significant opportunity for wealth managers

Equity-owned outside-listed companies, by entrepreneurs (in USD bn)



Note: Global Wealth 2018, BCG, UBS, as of September 2019. RHS= Right Hand Side

Additional drivers

Beyond the four key drivers described above, we see additional trends and factors that should support our long-term positive view on asset gatherers and life insurers.

Structural asset growth

Global AuM growth has averaged 1.4x global nominal GDP growth over the past 10 years (see Fig. 11) and the outperformance of AuM over GDP is likely to continue as the structural trend of wealth growth (fueled by economic growth, inflation, market movements and central bank money) endures. Therefore, despite slow growth in some regions, a diversified basket of wealth management companies should, in our view, be able to offer both superior growth in AuM compared to the economic evolution as well as higher profitability versus the market.

Upside potential for trading volumes

Normalized fees may be underestimated given the current historically low trading volumes. Equity market performance and equity trade volumes (see Fig. 12) were highly correlated between 1993 and mid-2008. However, the correlation has unraveled since then, which we attribute mainly to increased investor risk aversion due to the global financial crisis and cooling economic prospects. Also, we think that this divergence could have partly resulted from the rising number of exchange traded funds. Therefore, once investor risk appetite "normalizes" or reverts to its historical average, volumes traded are expected to pick up and the revenue of wealth managers will likely increase and boost sector profits, in our view.

Hedged long-run inflation risks

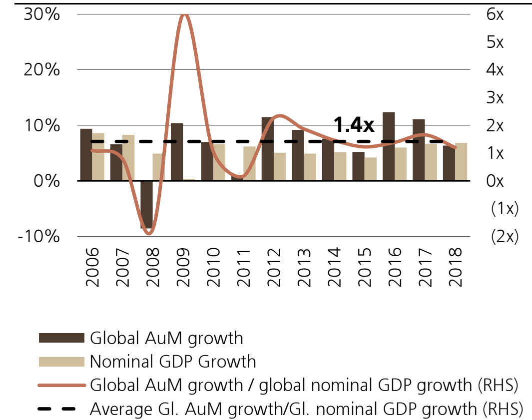
The asset gathering business model provides a hedge if inflation picks up: the large amounts of AuM offer a decent leverage given the companies' limited fixed assets and equity base. Major central banks have grown their balance sheets in response to the global economic slowdown, resulting in a great deal of money being printed (see Fig. 13); this could lead to higher inflation in future once the economic recovery gains traction and money begins to circulate faster. We think that investing in asset gatherers, whose assets (in terms of nominal value) is directly influenced by the inflation rate, provides a good inflationary hedge: in a reflationary environment, we would expect the asset gatherer industry to outperform equities overall. Also, a rise in inflation would increase the need to protect the purchasing power of savings in the long run. This would heighten the need for investment advice and suitable investment vehicles.

Ongoing consolidation

The wealth management industry is highly fragmented – the top

Fig. 11: Assets under management (AuM) growth is higher than nominal GDP growth

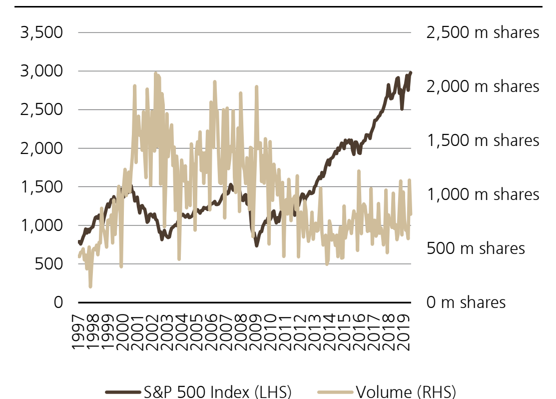
Ratio of global AuM to global nominal GDP growth



Note: Nominal GDP data is based on USD figures and is in PPP terms. "Gl." = Global, "RHS" = right hand side. Source: The Boston Consulting Group: Global Wealth Report 2018, Oxford Economics for nominal GDP figures, UBS, as of September 2019

Fig. 12: Volume traded is low compared to past two decades

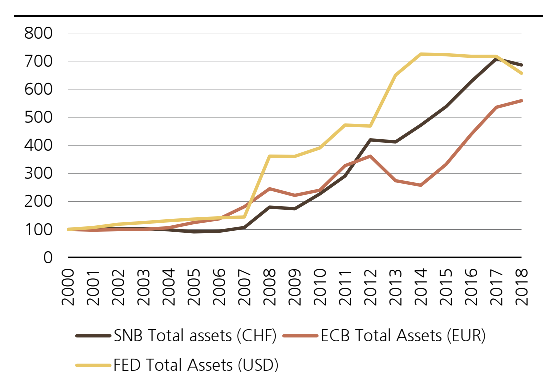
Divergent trends between S&P 500 performance and volume traded since 1997



Note: "LHS" = left hand side, "RHS" = right hand side. Source: Bloomberg, UBS, as of September 2019

Fig. 13: Central bank total asset expansion

Index basis 31 Dec 2000 = 100



Source: Bloomberg, UBS, as of September 2019

10 global wealth managers accounted for just 11% of the wealth managed for HNWIs in 2018. As a result, we expect industry consolidation to continue as global players grab market share from small banks, which to some extent still rely on the offshore banking model. Industry consolidation may, in turn, result in a rise in the valuation of the wealth management sector.

Relatively light capital requirements
While the financial sector is subject to tight regulatory requirements, the asset and wealth management industry is relatively unaffected by the new Basel III finalized capital requirements. Furthermore, managing third-party assets is fairly cash generative and is a capital-light business from a regulatory perspective.

We do not see new capital regulations forcing a new business model on asset and wealth managers, even if laws become tighter, requiring higher capital standards or more rigorous stress tests, which could affect profitability margins in various ways. We believe tax treaties and regulatory costs are ongoing issues faced by the industry, which we discuss below.

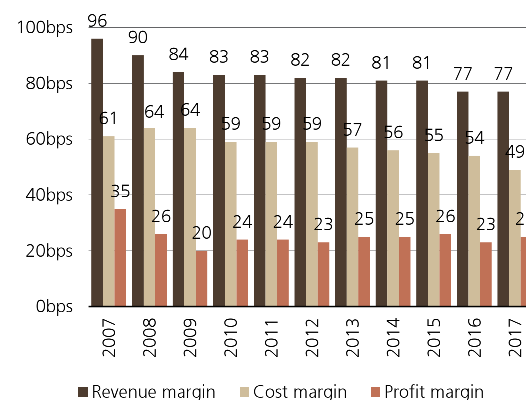
High barriers to entry
Investments in IT infrastructure, onshore advisor networks and legal departments limit new market participants that have sub-scale assets under management. This provides a high barrier to entry.

The risks

We will now discuss the main challenges that the asset gathering and life insurance industries are facing.

Low interest rates and risk management
Key risks for life insurers are risk management and market exposure, particularly given the current low interest rate environment. Not only for savings, but also for risk and protection products, overall investment returns are a key ingredient in their attractiveness. As such, volatility and market disruption may result in material losses. While some products offload a significant portion of this risk to policyholders, life insurers will continue to have some market exposure, not least via guarantees or embedded return assumptions in certain products. As for market risk, we see the current low interest rate environment in many countries as a major concern. The low interest rate environment puts a big strain on life insurers' back-book profitability, where guarantees tend to be static, while investment returns are falling. Moreover, the shape of the yield curve could impact the rate of surrenders of policies, rendering strict asset-liability matching (ALM) approaches ineffective. While longevity is also a major risk for insurers, we believe current low interest rates pose an even larger threat. This is especially true for

Fig. 14: Revenue, cost and profit margins of Western European wealth managers
2007–17, in bps



Note: Revenue margin is also commonly referred to as gross margin. Source: McKinsey European Private Banking Survey 2018, UBS, as of September 2019

European life insurers, as they have written policies with high guarantees in the past, and face material spread compression risk from the current low yield environment.

Cooling of Asian economies
Given our view that the middle class and HNWI numbers will be growing primarily in Asia-Pacific nations, weak economic outcomes in these countries could hurt our investment case. Therefore, while we will monitor the risks for a substantial and extended slowdown in Asia, our economic base case view supports our theme, especially for the asset gathering industry.

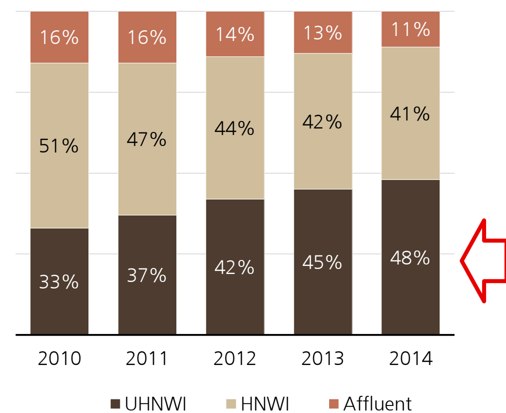
Changing regulatory environment
Insurers: Major regulatory and political changes have been impacting the retirement savings market directly or indirectly. These have not always been positive for market participants. Hungary, for example, was one of several Eastern European countries that introduced a multi-pillar pension system in the late 1990s. However, during 2010–11, the government effectively forced mandatory private pension savings to be moved to the state. The reason was to lower government debt, but it also strongly affected the retirement savings market. Poland followed a similar course in 2014. Both of these changes had a profound impact on the then-active private pension providers. Another example of changing regulation is the introduction of new solvency rules in Europe, called Solvency II (see Box 2). With respect to the pension market, it introduced new capital requirements for products with longevity risks and guarantees.

Asset gatherers: Given their fiduciary nature and minor own risk taking, the asset and wealth management business consumes much less capital than other types of financial services, such as retail and commercial banks. For now, we do not envisage the requirements rising sharply, leading to a change in the business model. Even so, increased regulatory complexity and changes in the tax treaties would favor accelerated M&As within the sector, most likely pushing overall valuation multiples higher.

Margin compression
According to a study by McKinsey of Western European wealth managers, profit margins declined by 10bps over 10 years, from 35bps in 2007 to 25bps in 2017 (see Fig. 14). While we think that the trend toward margin compression is a major issue that the industry will have to overcome, we offer two caveats:
First, wealth and asset managers deliberately focus on ultra-high net worth individuals as clients. Fig. 15 shows the increasing share of this client category within Credit Suisse's AuM. While we do not have precise recent data split for the most recent years, the company said in December 2016 that roughly 50% of its AUM was related to UHNWIs. Although gross margins are weak in this segment because clients have more bargaining power, transactions generally are larger and the cost base doesn't

Box 2: Solvency II
Solvency II is EU Commission legislation that fundamentally transforms the way insurers are regulated, in particular with respect to capital requirements. It requires companies to back various risks with capital, such as insurance risks, but also asset and operational risks. The key objectives of the new regime are improved consumer protection, modernized supervision, deepened EU market integration, and increased international competitiveness of EU insurers.

Fig. 15: UHNWIs' increased proportion of AuM
AuM segment split, 2010–14



Note: While we do not have precise recent data split, at the December 2016 investor day Credit Suisse confirmed that roughly 50% of its AUM was related to UHNWIs. Source: Credit Suisse, UBS.

experience a similar rise. This bodes well for wealth managers' net margins.

Second, the decline in banks' revenue margins was not initially accompanied by stronger cost control, as a review of the numbers makes clear. But banks are now fully aware of the challenges and, while they still face higher compliance and risk requirements, as well as higher IT spending to compete with fintech, they have become much better at containing costs. Overall, this more disciplined approach has resulted in lower cost margins and stable profit margins in recent years.

Link to sustainable investing

We believe our retirement planning theme is strongly aligned to the United Nations' Sustainable Development Goal (SDG) 8, which is "Decent Work and Economic Growth." It is particularly in line with target 8.1 that aims to sustain per capita economic growth in accordance with national circumstances, and to achieve an annual GDP growth of at least 7% in the least developed countries. Successful asset gatherers and life insurers will leverage on long-term trends such as increasing longevity, population aging and increasing saving gap to achieve this goal while investing their assets responsibly. To ensure sustainability, adjustments to national social frameworks are needed, in particular changes to the pension age and to mandatory saving schemes. Investing sustainably means investing in companies that can help to steer the society's developments in a more sustainable direction within the area of their influence (e.g. by encouraging savings from a young age, discovering innovative ways of saving, doing a "good job" by accumulating and not losing their clients' money, or conducting a systematic management of environmental and social risks in the insurance business).

Entrepreneurs: Everything is about planning

Entrepreneurs and small business owners need to consider what will happen after they retire. According to a study by Aegon, only a third of small business owners save habitually for their retirement.

Why should I not bank everything on selling my business?

Usually, businesses are sold using a valuation multiple based on earnings or the operating profit, this multiple is based on listed company data and then discounted to account for the size or the risk of a non-listed business. Imagine you had tried to sell your business in the middle of the global financial crisis. Between 2007 and 2008, the earnings multiple in Europe fell by more than 35%, as the financial markets collapsed. Moreover, the mergers and acquisitions market dropped by some 45% in volume and value in 2008 as buyers put on hold their acquisition plans due to the gloomy macroeconomic outlook. Also, it takes time to sell a business, which means owners might have to delay retirement. As a consequence, entrepreneurs should carefully consider a systematic approach to retirement planning.

What strategy to adopt?

Entrepreneurs should plan their retirement strategy in cooperation with their wealth planner. We have identified some key aspects to consider:

- **Diversify your investments**: As business owners, you should pay attention to the concentration risk of your portfolio. Diversification can give entrepreneurs a higher liquidity and new sources of return. Entrepreneurs can reduce the exposure to their own business through portfolio diversification by investing in different assets, sectors and countries.

- **Identify new opportunities**: Concentration risk can cause business owners to forgo opportunities. To avoid over-investment in a single company, market or currency, entrepreneurs can diversify by investing across broader equities or assets classes, look at other parts of the worlds, or use hedging strategies.

- **Alternatives to selling part of your business**: As an entrepreneur, you may be reluctant to sell all or part of your business. Doing so could reduce your control over the company, which can be particularly unattractive if your business is young and growing fast. Also, a sale can generate a large tax bill.

- **Build a liquidity buffer:** We recommend that business owners hold three to five years' worth of lifestyle expenditure in liquid assets. Instead of holding everything in cash, entrepreneurs can consider agency or multilateral development bank (MDB) debt, which pays a higher yield than US Treasuries and has a higher credit rating than US government debt.

- **Revisit your portfolio with your wealth manager:** Think about it as a living document as its value fluctuates over time. A well-diversified portfolio will reduce your reliance on a specific asset, country or currency. If you seek assets that tend to rise in value when your business struggles, understanding what drives your business is essential. If, for example, your firm’s fortunes are closely tied to the economic cycle, investing more in companies less vulnerable to a slowing economy or those that might even benefit from a slowdown could make sense.

For more details, please see "*How to diversify as a business owner,*" published on 2 July 2019.

Conclusion

Although not free from challenges, we believe asset gatherers (wealth and asset managers) and life insurers will continue to benefit from several positive medium-to-long-term trends. These include increasing longevity and an aging society, which lead to widening savings gaps, along with a growing middle class in emerging markets and a rising number of high and ultra-high net worth individuals. Structural asset growth, upside potential for higher trading volumes, consolidation efforts and relatively low capital requirements are additional supportive drivers. They also provide some degree of inflation protection as revenue streams depend on nominal asset prices.

In summary, these drivers should positively influence our theme in two ways: 1) they should result in above market average earnings growth; and 2) offer re-rating potential for financial companies with retirement savings exposure. Investors have the opportunity to benefit from the retirement savings trend over the next few years, in our view.

Appendix

Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
A	actual i.e. 2010A	COM	Common shares
E	expected i.e. 2011E	Shares o/s	Shares outstanding
UP	Underperform: The stock is expected to underperform the sector benchmark	CIO	UBS WM Chief Investment Office

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