The CBM Group, Inc.

505 Park Avenue
New York, NY 10022
Phone 646 282 0050
Fax 646 282 0044
www.thecbmgroup.com

THE RETIREMENT CHALLENGE AND WEALTH MANAGEMENT OPPORTUNITIES

January 2006

A "lifecycle view" of financial services businesses

CBM Group research, which covers a variety of developed and emerging economies, some 25 major countries, has identified a "lifecycle model" of financial services businesses:

- As economies become wealthier (measured in GDP/ capita) , the demand for financial services grows: there is increasing "*monetization*" of the economy, i.e. financial assets / GDP increase.
- Traditional commercial banking activities - deposits and loans - thrive in the *early* phases of economic growth (e.g. grow at a significantly faster rate than the economy)
- As economies become richer and more sophisticated, the capital markets and the investment businesses grow and bank *disintermediation* occurs.

Growth in investment products such as mutual funds and insurance correlates with growth of GDP/Capita.

.

So does pension fund growth, but to date only a handful of countries have well-established funded pensions: US, UK, Netherlands, Sweden, Switzerland, Chile, Singapore, etc. Several other countries, notably Latin American countries and Hong Kong have also adopted funded pension schemes. Several other countries are about to do so.

Overall, *professionally managed assets* (the aggregate of mutual funds, life insurance and pension funds) grow predictably with GDP/ capita and tend to stimulate the development of capital markets. The introduction of funded pension plans in a country is typically a key driver of a stock market boom.

The "consumer wallet" lifecycle : countries are at different stages of evolution.

The "consumer wallet", defined as overall *household financial assets* - based on central banks' flow of funds data - varies greatly by country and by region: from 250% -300% of gross domestic product (GDP) in the US and UK to less than 100% GDP for emerging economies.

The size of the consumer wallet depends primarily on the presence of funded retirement plans and other attractive long-term savings/ investment vehicles which support the accumulation of financial wealth over time.

The consumer wallet grows slowly

We have observed the evolution of the consumer wallet in several countries over long periods and noted it generally grows slowly in *real terms* (around 3-5% a year, in "real terms", i.e. inflation-adjusted), although usually a little faster than GDP growth. This is to be expected, since wallet growth results from net new household savings flows and their compounding, at the real rate of return for the consumer wallet.

In countries without funded pensions, this real rate of return typically remains very low, or even negative, due to "leakages of wealth", such as inflation, taxes, financial institutions' fees (asset management and distribution), and to excessively conservative asset allocation. Bank deposits, which typically have poor real net rates of return continue to represent the bulk of household financial assets in some countries.

To accumulate financial wealth, "*saving smart*" - e.g. saving regularly, for the long term, accepting more risk, minimizing tax impact and reducing "leakages of wealth" - is much more effective than "*saving hard*" i.e. saving a high proportion of disposable income.

Smarter saving, as well as the incentives provided by various governments for long-term investments have contributed to a steady evolution of the wallet mix away from bank deposits and towards "professionally managed assets" - mutual funds, pension funds and insurance products. Yet, this evolution has been occurring at different speeds, mostly slow, due to differences in institutional framework and cultural consumer preferences. The overall pace of this evolution needs to accelerate, worldwide, due to the challenge posed by retirement in aging societies.

The retirement crisis: single biggest change driver.

Traditional, “first pillar”, typically “pay-as-you-go” “social security” schemes (i.e. pensions financed through contributions by current workers) are under pressure everywhere, especially in Continental Europe. Some countries’ social security systems are already technically bankrupt, and others will go bankrupt as the worldwide population ages in the next few decades.

Yet, these systems will remain the only basis for mass market retirement for a long time, since governments must protect the average citizen (majority of votes for politicians !!) , but they will be progressively modified - by reducing benefits, increasing contributions and lengthening contribution periods - to evolve to a “guaranteed minimum income” approach.

At the same time, governments everywhere are encouraging “supplementary” pensions and the creation of long-term retirement-oriented investment schemes.

Driven by the need to reduce long-term liabilities, employers are progressively switching from “defined benefit” pensions in favor of “defined contribution” retirement products, such as the 401K plans in the US.

Retirement savings fuel wealth management businesses

We estimate that, assuming full funding, a country (with an age structure similar to Europe or America today) needs about 300% of GDP “earmarked” for retirement in its “consumer wallet”.
No country is there yet. If the retirement challenge is to be met by the time the baby boomers reach retirement age (around 2030), annual growth rates of over 15-20% in *real terms* for pension assets are required, in most countries, for the foreseeable future.

The highest potential for growth, in most countries, will be in the area of “third pillar” (i.e. individually-driven) defined contribution, where the consumer is responsible both for the savings flow as well as for the choice of investments, and “second-pillar” (i.e.

employer-driven) defined contribution products or a hybrid such as the 401 K pension plans in the US. By the way, government-sponsored efforts, such as Latin America's compulsory funded pension plans (AFP's) and Singapore's Central Provident Fund (CPF) are interesting solutions and have been successful at gathering assets, but expensive administration costs and under-diversified investments (e.g. real estate in Singapore) have tended to deliver lower returns than expected.

In terms of market segment attractiveness, *high-income*, *low-wealth consumers* in all countries will be the best targets for retirement products. These consumers are likely to derive limited benefits from government/employer retirement scheme and will need the most help to maintain their standards of living after retirement. Theuy have the current earning power to save significant amounts and are therefore attractive customers for the financial services industry.

* * *

To sum up, "wealth management" - asset management and investment product distribution businesses - especially related to the retirement theme, will be very buoyant businesses in all countries for a long time to come. We anticipate sustained strong growth in assets-under-management for pension funds and retirement-oriented insurance products in most countries. The "retirement savings industry" offers giant opportunities to financial institutions:

- For asset management firms these businesses offer the greatest future growth potential.
- For insurance companies, retirement businesses are vital: as populations age, people will worry less about protecting their families in case of death and much more about "outliving" their savings.
- For banks, they are equally vital, since bank deposits and bank loans are declining business as economies develop.

These businesses will be most attractive for *scale-advantaged global companies* who can transfer "best practices" and success models across a multitude of countries.

The institutions that can develop innovative asset amangement and distribution approaches will likely win the competitive battle.