Wasting assets

Revenues have tumbled, profits have been squeezed and some owners are keen to sell. Fund management is set for a wave of mergers.

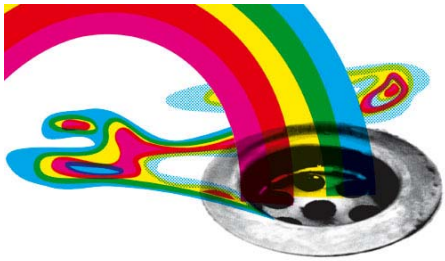
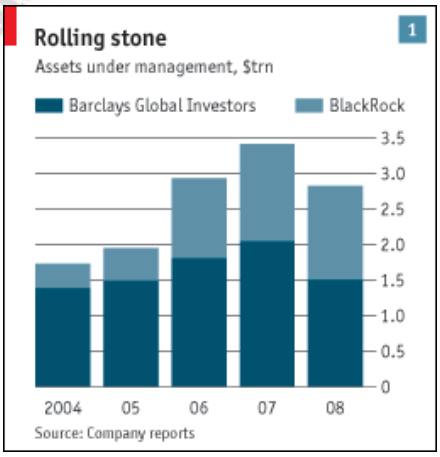


Illustration by Otto Dettmer

Blackrock is on a roll. With the purchase of Barclays Global Investors (BGI), finalised on June 16th, a firm founded a mere 21 years ago has become the biggest asset manager in the world. The deal unites BlackRock's expertise in fixed income with BGI's renown in index tracking, notably through its retail arm, iShares.

The $13 billion purchase is the banner deal of the latest wave of restructuring in fund management. For much of the past 25 years the industry prospered as rising asset prices drove up its fees. But it took a terrible hit in 2008 as falling stockmarkets, an exodus of clients and scandals (in particular, the Bernie Madoff affair) combined to ruin its reputation. Around a third of assets and 40% of revenues have disappeared, according to Denis Bastin of Oliver Wyman, a consulting firm. Bob Doll, BlackRock's vice-chairman, has estimated that as many as half the world's asset managers are breaking even at best.

BGI is among the more successful ones. It is being sold mainly because its parent bank, which turned down funds from the British government, wants to bolster its capital base. Barclays is not the only bank retreating from fund management (though it is retaining a 19.9% stake in the renamed BlackRock Global Investors). In France, Crédit Agricole and Société Générale are combining their operations. Having acquired a stake in BlackRock when it took over Merrill Lynch last autumn, Bank of America has put Columbia Management, its asset-management arm, up for sale.



Good day at BlackRock

As the industry's revenues fall, buying another group's assets is appealing because it spreads costs across a wider base. BlackRock and Barclays are trumpeting the enhanced scale of their business (see chart 1). It will be the largest manager in a host of categories from equities to fixed income, as well as in total. In iShares it has the biggest name in exchange-traded funds

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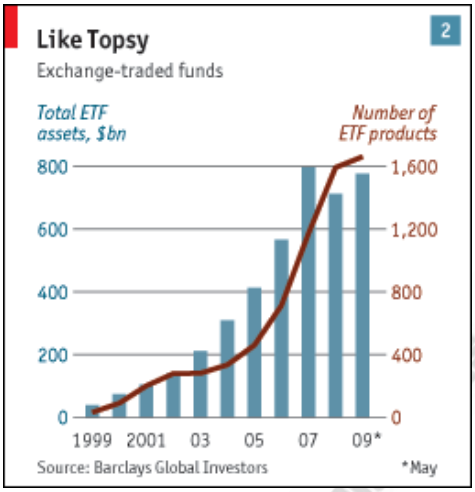
(ETFs), a fast-growing sector of quoted entities that mimic benchmarks such as the S&P 500 (see chart 2).

But not every bank has a fund-management arm as attractive as BGI. Having established a strong record in index tracking and in computer-driven stock-picking, it did not depend on its parent bank to bring in customers. In contrast, many banks acquired asset managers in an attempt to become financial "supermarkets", in which depositors would be sold products from other parts of the group. This approach, also called bancassurance, is standard in continental Europe, where most mutual funds are distributed through banks.



The model has its flaws. It is hardly plausible that any one bank would have the best products in every asset class. So customers are unlikely to be getting the best deal if they are sold a suite of a bank's products, something that has been noticed by the regulators. Hence there has been a move towards "open architecture", in which banks act more as distributors than manufacturers and sell products from across the industry.

Indeed, one reason why Barclays says it is selling BGI is that independent fund-managers have been gaining market share at the expense of bank-owned outfits. It estimates that independents' share of the assets run by the 50 largest managers rose from 36% in 1998 to 59% by last year. Barclays also says that some clients will not deal with asset-management firms that are part of investment banks, because of regulatory restrictions or concerns about conflicts of interest.

Whatever the reasons, banks are now reconsidering the advantages of owning a fund manager. "Over the last decade, the major acquirers of asset managers were commercial banks, investment banks and insurance companies," says Todd Ruppert of T. Rowe Price, a big independent fund manager. "In the next few years, they will be the major sellers."

The problem for any potential purchaser is whether the assets will stay put. If customers have bought funds merely on their bank's recommendation, they may not stay loyal for long. "If you buy a bank's asset manager, what are you buying?" says Massimo Tosato of Schroders. "The funds under management remain substantially under the control of the bank's branches."

Even when the seller is not a bank, mergers and acquisitions (M&A) in fund management are fraught with problems. "Clients don't like M&A, consultants don't like M&A and it seldom works because of investment culture and process," says Peter Harrison of RWC Partners, a London fund-management group.

Martin Gilbert of Aberdeen Asset Management is one of the industry's consolidators, having recently bought part of the business of Credit Suisse Asset Management. He says there has

never been a better time to pursue opportunities, although he adds that the best deals involve buying assets to manage, rather than whole companies. “That way, you don’t have the trouble of trying to integrate two cultures,” he says. Fund managers are independent souls who don’t like being dictated to by head office.

Private solutions

Purchases by private-equity groups may be the answer. Many of them have cash raised in the boom years of 2006 and 2007; fund managers have cashflows (from fees) that can be used to finance debt. Fund-management groups also have little need for extra capital as they grow. Private-equity groups are already involved: Hellman & Friedman, a San Francisco group, owns Gartmore; and TA Associates, based in Boston, backed the management buy-out of Jupiter from Commerzbank.

Better still, banks wanting to sell their fund-management arms can lend private-equity firms the money to buy them. (Barclays originally arranged such a deal for a sale of iShares, although that has been abandoned in favour of selling the lion’s share of BGI.) That is good news for the private-equity firms, which are finding it hard to get debt finance elsewhere. But owning fund-management groups is not without pitfalls, because they have no tangible assets against which debt can be secured. Their value lies in the fund managers themselves—and they are very mobile.

What is making the industry ripe for restructuring is its operational gearing. Managers earn fees, based on a proportion of assets under management. As share prices fall, margins decline and revenues may fail to cover fixed costs. Even without the huge falls in asset prices, reckons David Hunt, a consultant at McKinsey, the fundamental economics of the asset-management business have deteriorated. The revenue generated per dollar of assets may be about to decline by around a third.

In part, that is because of a change in asset mix. More money is being invested in bonds, at the expense of equities; the fees on fixed-income management are generally lower. And more is being invested in “passive” or index-tracking strategies rather than higher-charging “active” strategies intended to beat the benchmark.

In addition, fund managers can lack bargaining power. The industry is divided between those who aim for the retail market and those who look after money for institutions—pension funds, charities and foundations. It is possible for managers to have a fairly direct relationship with institutional clients, but fees are generally low. It is worth keeping prices down to attract a big pension fund and hence a critical mass of assets to manage.

On the retail side, finding customers is harder. Just relying on strong performance is not enough. Few savers, with the exception of those in America, have the confidence to go out and construct a portfolio on their own. Even in America, most mutual funds are bought through brokers. Mr Hunt points out that this market has just been consolidated. The share of the four biggest firms (today, Bank of America/Merrill, Smith Barney/Morgan Stanley, Wachovia/Wells Fargo and UBS) has climbed to 60% from somewhere in the low 40s before the financial crisis. Fund managers that want to crack the retail market will have to keep those distributors sweet.

So it is quite possible for fund managers to have a fantastic product, but no way to sell it. Sometimes they are competing with the in-house products of banks, which continue to dominate distribution in Europe. Even when they can sell their funds, the process usually involves paying a commission, or “retrocession”, to the distributor. This retrocession is taken out of the annual fee, pushing such fees higher and reducing clients’ returns. In some cases, the better the product sells, the higher the fees and worse the clients may end up doing.

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To aggravate matters, fund managers can find that intermediaries churn funds as they seek to generate income from their clients, causing assets to disappear as fast as they arrive. In Europe and Asia, net inflows are driven by fund launches. That often involves getting clients to invest in fashionable sectors at the top of the market (think back to the dotcom boom). In the three years to the end of 2008, 10,000 funds were created in Europe alone. The result tends to be unsatisfactory for both investors and managers.

The scale conundrum

The proliferation of funds in Europe points to another problem: the paradox of scale. In many industries, as companies get bigger, they cut costs and thus prices to customers. A few giants dominate by virtue of low costs, leaving room for niche players, and all the middle-sized companies get squeezed out. This is not so in fund management. In much of the industry scale seems to be self-limiting. No one is anywhere near big enough to dominate it. Even the combined BlackRock/BGI will have only 3-5% of the global sum of assets under management.

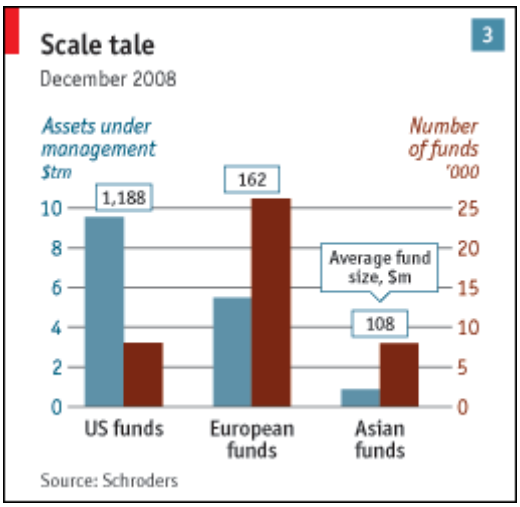
Some economies of scale exist. Back-office expenses such as technology and compliance do not rise one-for-one with assets under management. In index tracking, the bigger you get, the lower your costs, and the more closely you follow the index. In addition, bigger fund-management groups can spend more on advertising and attract even more money.

Nevertheless, it does seem that firms often become leading lights of the industry only to be brought down to size. The typical life-cycle of a firm is that it creates a successful performance record, attracts lots of assets, enjoys rapid growth of profits and then reaches a plateau as performance starts to tail off and star managers drift elsewhere. To make matters even more difficult, the markets, like circus clowns, always seem to have a custard pie at the ready. Just when a fund manager seems to be riding high, like Janus in 2000 or Legg Mason in 2005, a period of dismal performance comes along that makes a mess of its reputation. Assets under management disappear and the patient building process has to start all over again.

Nigel Wightman of Titanium Asset Management points out that in active management (ie, trying to beat an index) investment is not really scalable. Often, there is a natural limit to the size of equity portfolios: if they become too big they start to resemble expensive index funds. “Once you get very large, the cost of implementing decisions starts to whittle away your advantage,” says Mr Wightman. If a small fund manager wants to buy $1m-worth of a stock, it probably won’t move the price; if a big one wants $1 billion-worth, it surely will. And getting out of a big position may take even longer than getting in.

To add to the costs, many asset-management companies tend to offer a complete range of funds, covering everything from Asian equities to Treasury bonds. In theory, this allows them to meet all of a client’s needs; it also means they are almost certain to have some funds that are performing well, just by the law of averages. But they end up with a long tail of lossmaking funds.

Last December there were more than 26,000 European mutual funds, compared with just over 8,000 in America. But the American industry had almost €3 trillion ($4.2 trillion) more in assets. As a result, the average fund in Europe is less than one-seventh of the size of its American counterpart. In Asia, the average fund is smaller still (see chart 3).



Small funds are not ideal for anyone. Lipper, an information group, reckons that the median European fund has €25m of assets, barely enough to be economic to run. It also means higher average costs for clients. Funds with less than €20m of assets tend to have expense ratios of more than 2%. Those with more than €500m have ratios of around 1.5%.

Model behaviour

As well as the bancassurance groups, several other templates for running fund-management groups exist. At one end are the monolithic brands like Fidelity. The company has immense name recognition, giving it an advantage in mutual funds and in selling to investors in 401k (American personal pension) plans. Breaking through in the institutional business has been a harder slog, which is one reason why Fidelity has established a separate business, Pyramis, in this area. BlackRock is another example of a firm operating with one brand name and one integrated platform.

A second potential approach is the family of firms, exemplified by Allianz, a German insurer, and the Bank of New York Mellon. Such companies use a host of brand names: Allianz owns PIMCO, a bond manager; Bank of New York Mellon has Dreyfus, an equity mutual-fund group. The individual firms benefit from cost savings in areas such as technology and from the marketing clout that comes from being part of a bigger group. The parent benefits from a diversified stream of earnings. At any given moment, it is likely that at least one of its fund managers will be performing well. Nevertheless, there are still some questions over this model. Will the parent company really allow the fund managers complete investment freedom? And will all the subsidiaries get a fair crack of the marketing whip or will those that charge the most be favoured?

The third template is the boutique—a firm that specialises in a niche area such as emerging markets. Boutiques will always exist. It does not take much capital to start a fund manager and investors are usually willing to follow outperformers when they switch companies. “If you are small and focused and can deliver a good product, you will survive,” says Martin Huber of McKinsey. Nevertheless, boutiques are perennially exposed to the risk of a couple of years of underperformance, or simply a sharp fall in prices in their chosen sector, which can cause assets under management to fall below critical mass. They also have a succession problem: if the founders want to retire, they can find it difficult to realise the value of the business.

The biggest area of expansion for boutique managers over the past decade has, of course, been in hedge funds. The number of these funds tripled to more than 10,000 between 1998 and 2007. Fee income turned some hedge-fund managers into billionaires.

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Illustration by Otto Dettmer

But poor performance in 2008, when the average hedge fund lost 19%, has led to a mass exit of clients and managers. Assets under management have fallen by a third and performance fees have fallen sharply. Clients may have committed money to the sector rather blindly. When it comes to choosing (and paying) asset managers, “there needs to be more focus on the issue of what is skill and what is market return,” says Paul Trickett of Watson Wyatt, a firm of consultants. Institutional clients such as CalPERS, a huge pension fund for California’s public employees, are taking the lead, negotiating lower fees and stiffer performance targets.

Active fund managers thus face a squeeze from all sides. Not only have their revenues from alternative asset classes such as hedge funds been declining, they also face the prospect of losing retail clients to ETFs. It will also take time to recover from the bear market. Andy Maguire of Boston Consulting Group thinks it is hard to see assets under management regaining the levels of 2007 until 2013 at the earliest.

Improving profits may thus require cutting costs, and that means fewer jobs. A report by Watson Wyatt found that expenditure on staff accounts for more than half the total. The consultancy estimates that British asset managers are looking to reduce costs by around 20% and employment by 10%.

That is easier today than it would have been two years ago. A component of star fund managers’ pay usually varies with performance and this will decline. An executive quoted in the Watson Wyatt report remarked: “There will be no pay rise this year and the bonus is that you still have a job.” In less lean times companies would worry about losing talented fund managers, but anyone thinking of leaving is unlikely to get a better offer elsewhere. And these days there is much less allure for managers in decamping to start their own hedge funds.

Lower costs would be good for clients, too. “Reducing total expense ratios by 30 to 50 basis points can have a major impact on net customer returns over 20 years,” says Mr Tosato of Schroders.

Having faced difficult times in the markets, managers now face the challenge of getting their own business in shape. That is not something they will necessarily be good at. “Fund-management groups often have too many portfolio managers and too few business managers,” says McKinsey’s Mr Huber. That is why a lot of firms will be looking to see if the deal between BlackRock and BGI can be made to work. If it can, many more will follow.

WASTING assets. **The Economist**, New York, June 18, 2009. Disponível em: <www.economist.com>. Acesso em: 25 jun. 2009.

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