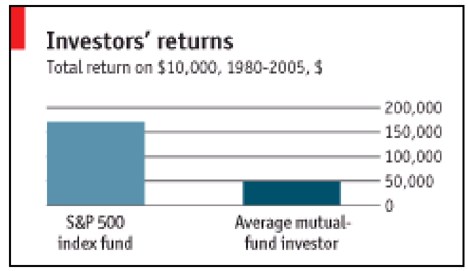
OPINION
LEADERS

Fund management

Trillion-dollar baby

Feb 28th 2008
From The Economist print edition

Investors pay too much to have their money managed



LOOKING after other people's money is a fine business. The asset-management industry long ago managed to secure a deal whereby its fee income rose in line with the markets; it can earn ever more money by doing nothing. The industry oversees some $64 trillion of assets and, at a conservative estimate, its costs in fees, dealing charges, custody and so on are around 1.5-2% a year—so investors are shelling out $1 trillion a year to the custodians of their cash.

As our special report in this issue shows, the industry puts a big chunk of this straight into its back pocket. A survey by Boston Consulting Group found that operating margins of fund-management firms were more than 40%. People like Steve Schwarzman of Blackstone and Ken Griffin of Citadel have become billionaires thanks to the way their private-equity groups and hedge funds look after other people's money.

You would have thought such a business would be an easy target for new entrants; competition would reduce margins and force fees down. But, by and large, this has not happened. A cheap alternative to traditional fund management arose more than 30 years ago, in the form of index-trackers, portfolios that mimic a benchmark such as the S&P 500. Trackers have gained a respectable market share but are much more popular with astute pension funds and insurance companies than with the general public.

Even pension funds entrust money to index-trackers with one hand and to high-charging private-equity and hedge-fund managers with the other. They appear to believe both that markets are so efficient that it is hard for fund managers to beat them; and also that markets are so inefficient that it is still possible to beat them after paying hedge-fund managers 2% a year, plus a fifth of all positive returns.

This dichotomy stems from the conviction that some special fund managers have skill, or “alpha” in the jargon. The fund-management industry has exploited this by persuading investors to judge it on past performance, rather than price. And you can always find some managers that have outperformed; in a range of 20 funds, at least four or five will probably have beaten the market. The industry has been able to advertise those funds and keep quiet about the rest.

You can see why investors want more than an “average” return when they learn that some managers have made 20% a year. And the records of some of these managers may indeed be due to skill, rather than luck. The problem lies in the difficulty of spotting such skilful managers before they have beaten the market, not after—when their run is over.

Consumers have often been their own worst enemies. If they are to save at all, they typically take a lot of persuading. Marketing costs eat into investors' returns. Salesmen have to be paid, and their commission creates an incentive to push higher-charging funds. If consumers were only willing to look more carefully at these costs, they could save themselves a lot of money.

Fooled by randomness

There is hope, however. A relatively new form of tracking vehicle, called exchange-traded funds (ETFs), has grown its assets even faster than hedge funds have this decade. Furthermore, as academics have studied the patterns of fund managers' returns, they have discovered that excess returns, which the managers attribute to their own skill, may well stem from things like a greater exposure to smaller stocks. You can design ETFs to mimic these factors cheaply. Even the returns of hedge funds can be copied.

Yet change will come slowly. It is hard for the average investor to see through the statistical fog; easy to be "fooled by randomness", in the phrase of Nassim Nicholas Taleb, a writer and former trader. But small investors really ought to worry about cost. Figures from John Bogle, founder of the fund giant Vanguard, show that an S&P 500 index-fund returned 12.3% a year between 1980 and 2005, whereas the average mutual-fund investor, because of costs and poor timing, earned just 7.3%. That makes an enormous difference to wealth: $10,000 invested in the index fund grew to $170,800; a typical mutual-fund investor saw his money grow to just $48,200.

In a free market, regulators should not aim to control fees or even ban the advertising of past returns. But they should make sure that the full costs of fund management are clear. And when governments set up their own savings schemes—in pensions, say—they should make sure that costs are controlled. Let hedge-fund managers earn their yachts the hard way.

RESEARCH TOOLS
SURVEYS

Money for old hope

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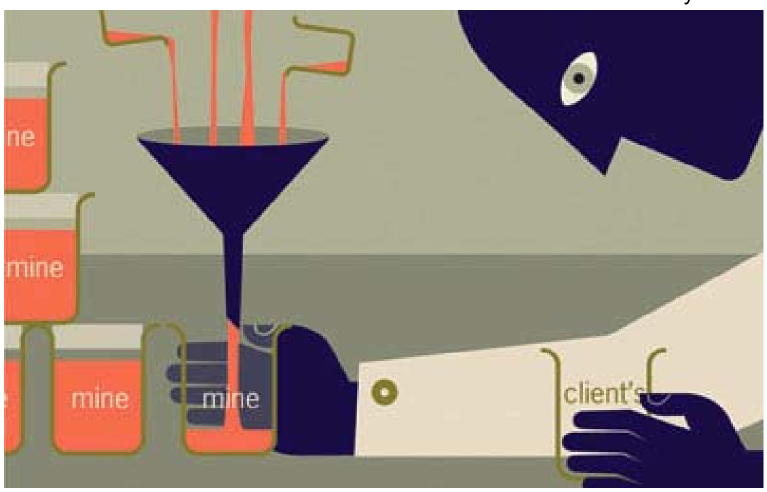
Andy Baker



The fund-management industry has done very well—but mainly for itself, says Philip Coggan (interviewed here)

IMAGINE a business in which other people hand you their money to look after and pay you handsomely for doing so. Even better, your fees go up every year, even if you are hopeless at the job. It sounds perfect.

That business exists. It is called fund management. Charley Ellis, a veteran observer, explains that fees in the industry tend to grow at around 15% a year because markets rise by an average of 8% and savings grow by 5-6%. This growth is being maintained despite the industry's vast size. According to a report by Watson Wyatt, a consultancy, the value of all professionally managed assets at the end of 2006 was $64 trillion (see chart 1).

Under the normal rules of capitalism, any industry that can produce double-digit annual growth should soon be swamped by eager competitors until returns are driven down. But in fund management that does not seem to be happening. The average profit margin of the fund managers that took part in a survey by Boston Consulting Group was a staggering 42%. In part, this is because most fund managers do not compete on price. Instead, they persuade their clients to select their funds on the basis of past performance, even though there is little evidence to show that this is a good predictor of future success. Nor can investors be sure that the intermediaries who sell the funds—brokers, advisers and bankers—will steer them in the right direction. These middlemen often get a cut of the fund managers' fees, so they have little interest in recommending low-cost alternatives.

Hence the clients get engaged in a costly game of chasing the best performers, even though by definition they are bound, on average, to lose it: after costs, the average manager inevitably underperforms the market. Figures from John Bogle of Vanguard, an American fund-management group, neatly illustrate the point. Over the 25 years from 1980 to 2005, the S&P 500 index returned an average of 12.3% a year. Over the same period, the average equity mutual fund returned 10% and the average mutual-fund investor (thanks to his regrettable tendency to buy the hottest funds at the top of the market) earned just 7.3%, five percentage points below the index.

But whereas the clients have not always done particularly well out of the industry, the providers have prospered. In recent years the growth of private equity and hedge funds has led to more widespread use of performance fees, creating a new class of billionaires. The balance between the industry and its clients will not be redressed until investors learn that higher fees do not guarantee higher returns. "There's a huge amount left to do in order to provide a reasonable proposition to the client," admits Alan Brown, chief investment officer of Schroders, a British fund-management firm.

Even so, fund management is undergoing a revolution of sorts. "The industry is in the process of more change than I've seen in the 30-plus years that I've been in the business," says Mr Brown. In part, this reflects the lessons of the 2000-02 equity bear market. Pension funds had been heavily exposed to equities in the 1990s, which allowed the sponsoring companies to take contribution holidays. But when share prices fell, pension funds went into the red, raising doubts over whether equities were the right match for the long-term liability of paying out retirement benefits. Some pension funds switched to bonds; others demanded products that delivered positive returns, regardless of the performance of the equity index. That opened the door to hedge funds, private equity and a whole school of investing known as alternative assets.

The market for retail investors is also changing. These days most fund managers do not deal directly with such clients, but sell their funds to third parties such as brokers, advisers, private banks and pooled portfolios called funds-of-funds. This saves fund managers a lot of marketing expenditure, but it also leaves them at the mercy of the middlemen. They can no longer rely on the inertia of clients who stay with a firm for most of their lives; instead, holdings are churned as the intermediaries seek to generate the highest possible returns and justify their fees.

Call me unpredictable

One of the industry's biggest problems is the markets themselves. Not only do whole asset classes go through dismal periods, but investing styles too go in and out of fashion. A technology manager with a shining reputation in 1999 may have found that by 2002, 90% of his fund value had vanished. Even Bill Miller, the star manager at Legg Mason who beat the S&P 500 index 15 years in a row, has just suffered two years of poor returns. The latest event to ruin fund managers' performance numbers has been the credit crunch.

A second problem is that, in fund management, size is not necessarily an advantage. True, it can bring an improvement in margins; managing $2 billion does not cost twice as much as managing $1 billion. It also gives managers the marketing clout to build a brand name. Yet size can also be the enemy of investment performance. If a fund becomes too large, trading moves prices against the manager, or the fund starts to resemble the overall market. And star managers may be driven away by bureaucracy or lack of freedom.

So far, fund managers have been remarkably successful in maintaining their high fees, even in the face of lower investment returns in recent years. For more than three decades they have been fighting the challenge from "passive" rivals, which simply track the market through an index such as the S&P 500 or the FTSE 100. But now there are passive versions of other fund-management styles too, even high-charging hedge funds. Asset managers, for so long the Bloomingdales and Harrods of finance, are facing competition from the sector's Wal-Mart in the form of exchange-traded funds (ETFs), a flexible vehicle that gives investors exposure to almost any asset class at low cost.

The top 20 2

Asset managers, December 2006

Manager	Total assets $trn
UBS (Switzerland)	2.45
Barclays Global Investors (Britain)	1.81
State Street Global (United States)	1.75
AXA (France)	1.74
Allianz (Germany)	1.71
Fidelity Investments (United States)	1.64
Capital Group (United States)	1.40
Deutsche Group AG (Germany)	1.27
Vanguard Group (United States)	1.17
BlackRock Group (United States)	1.12
Credit Suisse (Switzerland)	1.09
JPMorgan Chase (United States)	1.01
Mellon Financial* (United States)	1.00
Legg Mason (United States)	0.96
BNP Paribas (France)	0.82
ING (Netherlands)	0.79
Natixis (France)	0.77
AIG Global Investment (United States)	0.73
Crédit Agricole (France)	0.70
Aviva (Britain)	0.70

Source: *Pensions & Investments*/Watson Wyatt *Now Bank of NY Mellon

Yet the industry is also being presented with two great long-term opportunities. In the developed world, populations are ageing and the burden of retirement provision is increasingly falling on the individual. In some countries the state pension offers little more than a subsistence income, and companies are increasingly retreating from the expensive final-salary pension promises that they made in the 1970s and 1980s. This gives the asset-management industry an opportunity to step into the breach.

In the developing world, meanwhile, rapid economic growth is creating an immense amount of new wealth. Energy billionaires in Russia and sovereign-wealth funds in China and the Middle East may turn to the asset-management industry to guide their investment decisions.

Although those two huge opportunities are likely to ensure that the industry will survive and prosper, the future of individual companies is far more difficult to predict. Only ten years ago the British pension-fund industry was dominated by four big names; Mercury, Phillips & Drew, Gartmore and Schroders. But competition has blown that cosy oligopoly apart: the first two names on that list no longer exist as separate companies.

Individual managers are having to make a series of choices. Do they emphasise their skill ("alpha" in the jargon) or head down the passive ("beta") route? Do they stick to traditional asset classes, such as equities and bonds, or branch out into alternative areas such as hedge funds and commodities? Do they stay small, aiming for boutique status and putting the emphasis on performance? Or do they aim big, covering as many areas as possible, and protect themselves against the vicissitudes of the markets? Even more drastically, do they give up the business of investing altogether and concentrate on the relationship with individual clients, selling them other people's investment products? That, in effect, is what Merrill Lynch did, selling its fund-management business to BlackRock. Citigroup made a similar deal with Legg Mason.

In response, a host of different models is emerging, from tiny specialists with a few hundred million dollars of assets to retail giants such as Fidelity or hybrids such as the Bank of New York Mellon, which has more than $1 trillion of assets spread among a collection of boutique managers. This special report will explain how fund managers make these choices and what is best for the most important people: the individuals who entrust their savings to the fund-management industry.

RESEARCH TOOLS
SURVEYS

Better than beta?

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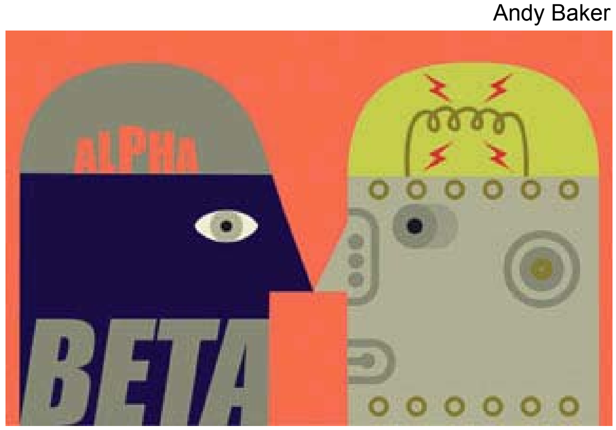


Managers' superior skills are becoming harder to prove

WHAT exactly are fund managers selling? At heart, they are offering exclusivity. In the complex world of financial markets, the client wants the best brains to look after his money. Picking the right fund manager is like shopping at Saks Fifth Avenue or having your shoes made by Manolo Blahnik. But unlike a posh retailer, a fund manager cannot guarantee to provide a superior service year after year. Indeed, he cannot even be sure of offering a positive real return. All too often, clients hand over their money to managers that have performed well in the past, hoping that this superior record was down to skill rather than luck and that it can be replicated in the future.

Historically, fund managers' appeal has been due to two things: risk reduction through diversification, and an ability to pick the right assets. Think back to the 19th century. Victorian investors faced specific risk because they usually held only a handful of securities in their portfolios. To avoid this risk, they often sought the help of their accountants or solicitors. Those professionals soon found themselves with a lucrative sideline in investment advice. Investment trusts (which still exist today) were set up because it was more efficient to bundle together clients' assets into pooled portfolios. Mutual funds were built on similar principles; by agglomerating the assets of a whole range of clients, it was possible vastly to reduce specific risk.

But since the development of index-tracking funds in the 1970s, the business of diversification has become commoditised. Clients can get access to a broad portfolio, such as the shares in the S&P 500 index, for fees of a fraction of a percentage point of the assets a year. Indeed, the widespread use of indices has dramatically changed the fund-management business.

Originally, indices were devised (often by newspapers) as a means of assessing the stockmarket's mood. Then it occurred to investors that they could use the indices as a means of judging whether their fund manager was doing a good job. As they became more sophisticated, they realised that fund managers would be able to beat the index, in the long run, by taking more risks, and started to move to risk-adjusted performance measures that combined returns with volatility. These led to the development of alpha, a measure of a fund manager's skill, defined as the ability to produce superior risk-adjusted returns.

It's all Greek

In recent years there has been a move to separate the effect of alpha from that of beta, which is the portion of an investor's return that comes straight from the market. Thus, if the S&P 500 index rises 8% and an American equity-fund manager delivers a 10% return, the investor gets eight percentage points of beta and two of alpha. Arguably, the client should pay top dollar only for the two additional points, not the eight he could have received even from a low-cost index-tracking fund.

But alpha is quite hard to define. As Andrew Lo of the Massachusetts Institute of Technology points out, to primitive people, everyday technology like cars and televisions can seem like magic. Alpha is a bit like that: it is the part of investment returns that we do not understand.

Investors' attempts to isolate alpha from beta have taken several forms. One is the “core-satellite” approach: the bulk of the money is placed in index-tracking funds and the rest allocated to managers with a proven record of outperforming the market. Often the index-tracking money is invested mainly in developed markets and the satellite money goes to areas such as emerging markets, where an active manager is more likely to be able to outperform the index.

Consultants argue that in the past clients devoted too much of their “risk budget” to equities, in the belief that they would beat bonds over time (the so-called equity-risk premium). Instead, they should have concentrated more on alpha because the returns earned from it are more likely to be uncorrelated than market returns, offering a better combination of risk and reward.

Another approach to finding alpha is to give managers more latitude to stray from the index; in the jargon, to be “benchmark-agnostic”. The idea is that managers should pick the best shares regardless of their weighting in the index. This should produce better returns in the long run, even if it sometimes causes them to lag the index in the short run.

As John Brennan of Vanguard (which, as it happens, is one of the largest index-tracking managers) says, “if you're going to have an active fund, make it take active bets.” As well as its well-known mutual funds (including one $122 billion behemoth that tracks the S&P 500 index), Vanguard offers a range of actively managed funds which it contracts out to other managers. “When we hire someone with an active mandate, we want them to take risk,” Mr Brennan continues. “Me-too stuff will get you nowhere.”

In a way, this change has been good for the fund-management industry, in that it has given individual fund managers more creative freedom. No longer are they forced to buy shares in a company they dislike simply because it has a 5% weight in the index. There has been a fashion in the mutual-fund industry for “focus funds” that own only 20-30 stocks rather than the hundreds needed to track the market. As Jim Connor of Morse, a consultancy, puts it, “the industry has gone from a manufactured model to more like the music industry where it looks for talent that can produce hits.”

But betting on alpha really puts the onus on the fund manager to do better than the market. That explains the increasingly widespread use of performance fees. The idea is that the manager should receive only a modest base fee to help cover his fixed costs, but should take a bigger share of the gains when he succeeds in delivering alpha.

Unfortunately for clients, the alpha delivered by the average fund manager is negative. That is because the performance of the average investor mirrors that of a broadly based index, before allowing for costs. Since costs are often sizeable, the average fund manager is doomed to underperformance.

Even when a fund manager can beat the index, his problems are not over. Just as beta has been commoditised, so, in a way, has alpha as academics have started to break down its components. Most stockmarket indices are dominated by larger companies, which means that active managers' best chance of outperforming lies in buying the shares of smaller businesses. Another tried-and-trusted route to outperformance is to take a "value" approach: buying the shares of companies that look cheap on some valuation measure, such as the ratio of the share price to profits. The rationale is that investors can become overpessimistic about the prospects of struggling companies.

The increased sophistication of indices means that investors can get access to factors like value and small-cap stocks at low cost; they have become betas. So fund managers who outperform with the benefit of these factors are not really demonstrating alpha at all.

Indeed, there are now very few markets that investors cannot access cheaply, thanks to the explosive growth of a vehicle known as exchange-traded funds (ETFs). These are quoted stockmarket vehicles that hold baskets of shares designed to track a benchmark. The first one was launched in 1993. By 2000, ETFs had just $74 billion in assets. But by June last year there were more than 1,000 products with just over $700 billion in assets, estimates Morgan Stanley, an investment bank. By 2011, the bank forecasts, the sector will have $2 trillion under its belt.

Exchange-traded Lego

What makes ETFs so attractive is their flexibility. Funds have been established to cover almost any asset class, from Asian property to oil. That has given retail investors an easy way of getting exposure to assets they might previously have been able to access only in a more costly, or roundabout, fashion. Those who foresaw gold's surge to a record high, for example, have been able to buy an ETF that tracks the metal's price instead of paying a mark-up for gold coins or buying shares in a mining company and taking a bet on the management's competence.

Paradoxically, the biggest advantage of ETFs—their cheapness—also turns out to be the biggest barrier to their acceptance by retail investors. The low fees leave no margin to pay commission to intermediaries, who therefore have little incentive to sell them. ETFs have been a success in the American market, which is more attuned to fee-based rather than commission-based financial advice; in other markets it is up to small investors to discover the benefits of ETFs for themselves.

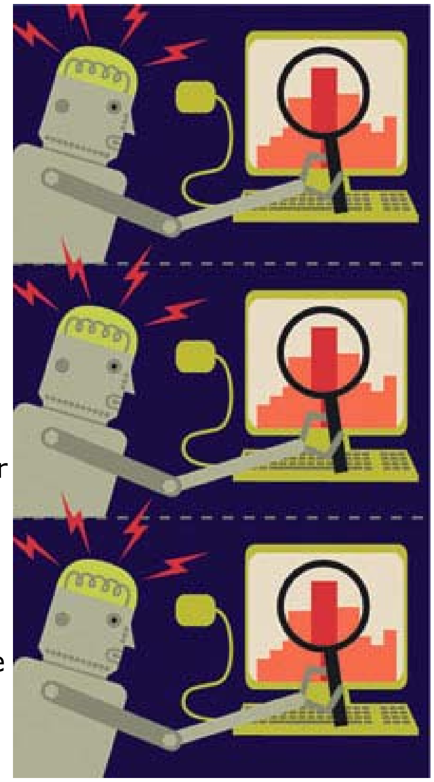
But ETFs have also been bought by institutional investors such as pension funds and even by those modern-day masters of the universe, hedge-fund managers. One reason is that an ETF represents a quick and easy way for investors to take a view on an asset class. Say a hedge-fund manager believes that the Japanese market is set to surge. If he were to assemble a portfolio of stocks, he would have to do a lot of research and might choose the wrong ones. Instead, he can simply buy an ETF linked to a broadly based benchmark such as the MSCI Japan index.

So ETFs could be viewed as a set of Lego bricks from which an investor can assemble a do-it-yourself portfolio. They can also be used to replicate the style biases that, some would argue, have often been mistaken for fund-manager alpha.

Andy Baker

One example is WisdomTree, an American company set up with the help of Michael Steinhardt, a hedge-fund legend, and with the intellectual backing of Jeremy Siegel, a noted academic. It runs ETFs that are weighted on the basis of the cash dividend paid, rather than the market value of the company concerned. The total expenses of its domestic funds amount to a quarter to a third of a percentage point, a small fraction of the costs of a traditional mutual fund. And yet over the ten years to March 30th 2007 its approach would have returned 11.2% a year in the American market, around two-and-a-half percentage points more than the broadly based Wilshire 5000 index. Other companies have come up with similar ideas. Research Affiliates has an index that uses four "fundamental measures" relating to sales, profits, dividends and asset, or book, value.

These ideas have their critics. Some argue that such "active ETFs" are contaminating the purity of the sector's appeal and increasing the costs paid by the investor (because the components of the index have to be changed more frequently). Others would say there is nothing new about the techniques; they are merely value investing in a new guise. Even if that is so, they still pose a considerable threat to traditional fund-management houses. The value school is one of the most respected approaches to investing. If its returns can be matched by funds that mechanically use a few ratios, why pay the fees demanded by active fund managers?



Even hedge funds are seeing their territory invaded. Its managers are the high priests of alpha. Clients have so much faith in their skills that they are willing to pay 2% annually (as well as a 20% performance fee) for the privilege of having their money managed by them. One particular hedge fund was recently able to charge 5% a year and 44% of performance.

But how much of what hedge funds are delivering is really alpha rather than beta? Research suggests that the correlation between hedge-fund returns and the S&P 500 index is already high and getting higher. Worse still, hedge funds are becoming more strongly correlated with each other. Although the hedge-fund industry is very diverse, there have been times in recent years when nearly all the sectors have fallen in unison. This suggests that all of them may be exposed to some common underlying factor.

Grow your own hedge

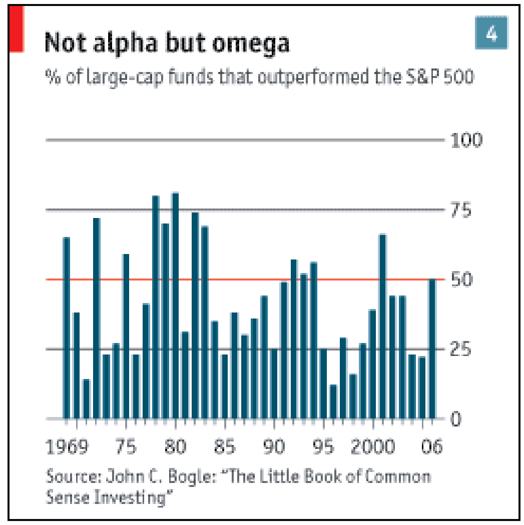
Bill Fung and Narayan Naik at the London Business School have analysed the performance of the hedge-fund industry over a decade and identified seven or eight factors that seem to be responsible for the bulk of its returns. All these factors, the two academics claim, can be replicated at low cost in the market, capturing most of the benefits. So it is possible to set up a fund that offers returns akin to those in the hedge-fund industry but is able to charge much lower fees.

Investment banks have (slightly surprisingly, given their close links with the hedge-fund industry) piled in, producing funds that clone individual hedge-fund strategies. Naturally, many hedge-fund managers are scathing about the banks' efforts. A cloned portfolio is necessarily backward-looking, they say, so investors will be buying what hedge funds used to own, not what they are about to buy. Furthermore, clones will capture the entire beta but none of the alpha of the industry—and it is the alpha that makes hedge funds worth buying. Messrs Fung and Naik accept that hedge-fund managers display skill, but would argue that most of the time this alpha is absorbed by their fees.

Returning to Professor Lo's definition of alpha as the portion of investment returns that we do not understand, it seems possible that as more and more analysis is undertaken, this portion will become smaller and smaller. The "magic" may turn out to be sleight of hand, or it may be random. Some fund managers will always outperform the market, but there is little hope of identifying them in advance.

Cloning represents a particular threat to the quantitative school of fund management. The quants, as they are known, use computer models to identify patterns and relationships in the markets that have been profitable in the past. They are often staffed by the brightest academic minds in mathematics and physics. Quants generally have no interest in visiting a company, sampling its products or meeting its management. Whereas traditional fund managers look at the fundamentals, such as the quality of a company's business model or the nature of its competitors, the quants try to take the subjectivity out of fund management by concentrating on the numbers alone.

Some quants have a long-term perspective, but many take advantage of the liquidity of modern financial markets to trade very frequently indeed; companies such as AQR, D.E. Shaw, Highbridge and Renaissance often form a substantial portion of daily trading on the New York Stock Exchange. They may aim to conduct their trades in a matter of milliseconds as they try to exploit fleeting anomalies. Some funds put their computer servers very close to stock exchanges for a minuscule reduction in the time it takes for data to be transmitted down the wires.



Quants have been remarkably successful over the past decade, but in August last year something went badly wrong: within the space of a week many of their models ceased to work. The quants thought they had built diversified portfolios by selecting stocks on the basis of a host of different criteria that had previously had low correlations with each other, but suddenly a lot of the factors started to move in the same direction. Some funds put in a dreadful performance; for example, Goldman Sachs's Global Alpha fund lost 38% on the year.

The problem seemed to be that if you set computers to analyse the same set of data, they are likely to come up with similar investment strategies. As positions became crowded, returns started to fall, prompting the quants to use more borrowed money to improve them. When the credit crunch hit, one fund was forced into cutting its positions, bringing down the prices of stocks held by all its rivals and setting off a downward spiral.

Reinventing quants

This does not mean the end of quant investing. “To believe the quant game is over you'd have to think reasonably priced, reasonable growth stocks will underperform,” says Gus Sauter of Vanguard, which runs quant-based funds. But it does mean that in future quant managers may have to reconsider how much leverage to build into their funds, and will have to try even harder to find factors that their rivals are not exploiting. Mike O'Brien of Barclays Global Investors (BGI) says the sector needs to move away from “data mining” and adopt a scientific approach, using quant techniques to provide a sound basis for original investment thinking. Instead of letting the data generate the ideas, BGI now tries to turn the process on its head, coming up with ideas first and then testing them on the data.

But the quant funds may face a challenge from the clones, which use computers to identify a series of factors that produce attractive investment returns. On the face of it, that does not look very different from what the quant funds do. Quant managers may come up with a lot more factors than the clones, but in practice just a few of them account for most of the returns. And the more mechanical and replicable the process of investment gets, the harder it becomes to justify high fees.

RESEARCH TOOLS
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Plenty of alternatives

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But hedge funds and private equity have their limits

THE stockmarket is a hard taskmaster. Beating the indices on a regular basis is difficult, and low-fee rivals are competing ever more vigorously. But the fund-management industry has found a new wonder weapon: alternative assets. What makes these special, the industry claims, is that they are not correlated with the stockmarket. They are also difficult to understand, so they require greater skills to manage—which have to be properly rewarded.

That explains why, even as ETFs are driving fees on big stockmarket funds down to a few basis points a year, the managers of the main alternative-asset categories—hedge funds and private equity—are able to charge two percentage points a year, with a performance fee on top. And clients are queuing up to pay them.

Why are they so enthusiastic? The reason goes back to mistakes made in the 1990s. The long bull market encouraged the belief that share prices could move only upwards, and investors who did not have a big allocation to equities looked foolish. Corporate-pension sponsors were able to put 80-90% of their portfolios into shares and then stop making contributions to the fund, on the assumption that juicy returns would continue.

The 2000-02 bear market revealed what an unwise bet that had been. To compound the problems of pension funds as their assets fell with the stockmarket, their liabilities rose because of the drop in bond yields, which made it much more expensive to purchase the income needed to pay pensioners. So the pension funds (and their advisers) decided to broaden their bets and reduce their risks.

One big change was to put more emphasis on alpha, the skill of the manager (see article). But funds also started to widen their range of assets, in the hope of earning a more stable return. The models for this were the university endowments of Yale and Harvard, which started moving into alternative assets in the 1970s and 1980s and have enjoyed considerable success with them. Morse's Mr Connor sees this as an extension of his music analogy: "The industry has expanded from having a limited number of genres into a wide range, from hip hop to garage, thrash metal and the rest."

However, the move has not been without controversy. It seems plausible that emerging-market debt, property and commodities are genuine alternatives to the traditional staples of developed-market equities and government bonds. But are private equity and hedge funds really in the same category?

Private equity and its close cousin, venture capital (which concentrates on start-ups), invest in businesses that are not quoted on the stockmarket. The idea is that companies will be able to produce better returns if they are protected from the glare of constant public scrutiny and if the managers are given suitable incentives. This usually means offering them share options and loading the company up with debt, forcing managers to pay meticulous attention to their cashflow. These takeovers, also known as leveraged buy-outs, have become a big influence on stockmarkets. But is private equity really an alternative source of return? After all, most of the factors that affect quoted companies—the health of the economy, interest rates—affect private companies as well.

This is also true of hedge funds. These private pools of capital may be run in a different way from traditional funds—for example, they can go short (bet on falling prices) and use borrowed money to enhance returns. But hedge funds still mostly invest in the same types of assets—equities and bonds—as traditional fund managers.

Most hedge funds are alternative only in the way they are managed, rather than where they invest. Because of their methods, they claim to produce "absolute return"—in other words, a nominal gain regardless of market conditions. By contrast, traditional fund managers might think they have done well if they lose 17% when the index has dropped by 20%.

The short answer

Hedge funds can pull off this trick thanks to their greater flexibility, in particular their ability to go short. The worst year for the industry was 2002, when the Hedge Fund Research Index lost just 1.5% (although these indices may flatter, thanks to survivorship bias). Enthusiasts would also argue that if you believe in managers' skill, you should give them as much freedom as possible. Most companies have a tiny weighting in the index. A traditional manager who takes a dislike to a stock can only give it a zero weighting, which will make virtually no difference to performance. But a hedge-fund manager can make a much bigger bet by selling the stock short.

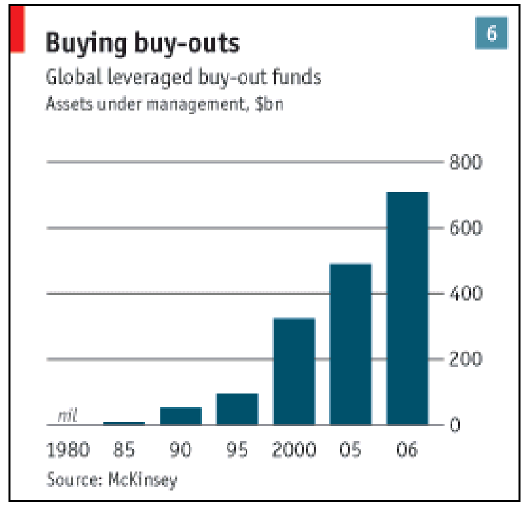
It sounds good in theory, but in practice shorting is very difficult. A long position that goes wrong becomes a smaller part of the portfolio; a short position becomes larger. And where hedge-fund managers use borrowed money, bad bets can be disastrous, as shown by the closure of Amaranth, an energy-trading fund, in 2006 and two Bear Stearns credit funds in 2007.

Even if some hedge-fund managers have special skills, can the industry continue to deliver exceptional returns as it gets bigger? Its assets increased from $39 billion in 1990 to $1.9 trillion by the end of last year (see chart 5). Allowing for the use of borrowed money, McKinsey estimates that total assets under management may be $6 trillion. If the skill of hedge-fund managers consists of exploiting market anomalies, there must surely be fewer anomalies to go around now. The result may be high fees for hedge-fund managers but modest returns for clients, or worse. "Hedge funds are rapidly deteriorating in quality. There is a nasty accident waiting to happen," says Jeremy Grantham of GMO, a fund-management group.

The same arguments can be applied to private equity. If lots of people are competing to do private deals, that is likely to force up the price of deals and cut the level of future returns. According to McKinsey, the amount of private-equity capital increased by 120% between 2000 and the end of 2006 (see chart 6); including venture capital, the sector's total assets add up to over $1 trillion. "So much money has flowed into private equity, venture capital and hedge funds that it has swamped the available talent," says Mr Grantham.

McKinsey reckons that 62% of American private-equity assets in 2006 were in the hands of the top 20 firms. This is not surprising: the top 25% of funds seem consistently to beat the rest. If anything, it is surprising there has not been more consolidation, given the lacklustre performance of the rest of the industry. The average investor in private equity has not seen particularly attractive returns compared with those available in the public market.

And those returns may be about to deteriorate. The most recent leveraged-buy-out boom ended with many firms collapsing in the early 1990s recession. Mr Grantham fears history may repeat itself. "Private equity has a long tradition of adding value, but there is one issue they have all missed," he says. "Not a single firm has in its spreadsheet the expectation that profit margins have to come down."



The move into both hedge funds and private equity involves a paradox. For an asset class to be a true diversifier, it needs to be small; but if it is small, then few investors can be exposed to it. When lots of capital flows into an asset class, it starts to behave like other markets. The recent problems in the British commercial-property market are a good example. Retail investors flocked into the sector as a diversifier from equities, and in the ten years to 2006 it performed brilliantly. But property is an illiquid asset. When prices started to fall last year, investors rushed to redeem their holdings. But it was impossible for the funds to realise on their properties in such short order, so many of them have been forced to suspend dealings in their shares and units. The asset class was simply not liquid enough to be a real diversifier for so many investors.

That has not stopped investors from looking for diversified returns elsewhere. In the second half of 2007 the truly hot areas were "frontier markets", or what might be called the "emerging emerging markets". The hope is that countries such as Kazakhstan and Vietnam will eventually achieve the same sort of growth rates as India and China.

Fund managers are also offering even more esoteric bets, known as "exotic beta". Assets in this class include weather derivatives, distressed power stations and even footballers' contracts. The attraction is twofold. First, these asset classes are so remote from the forces that drive the S&P 500 index that any correlation is unlikely. Second, prices in this market may be set inefficiently, offering scope for astute fund managers to make money. At least that is what exotic-beta fund managers tell their clients to justify their fees.

RESEARCH TOOLS
SURVEYS

In the spotlight

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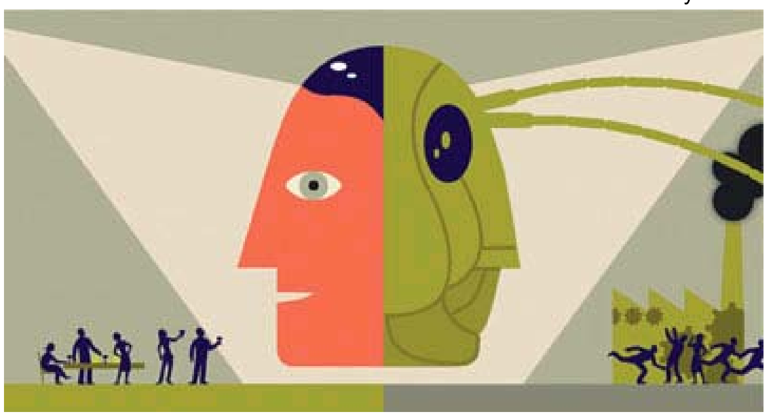
From The Economist print edition

Andy Baker



Fund managers are having to polish their image

WHEN industries become rich and powerful, they inevitably attract attention—and criticism. Fund managers are often reluctant to embrace the spotlight, but are now being forced to do so. Whether it is private-equity groups accused of firing lowly workers, hedge funds under attack for destabilising the financial system or institutions being berated for holding shares in "unethical" companies, the public scrutiny is unrelenting.

Henry Kravis, one of the doyens of the private-equity industry, has found himself the subject of a film, "The War on Greed", as well as of a protest outside his ritzy Manhattan apartment. In Britain a trade union paraded a camel outside a church attended by Damon Buffini, another private-equity titan, to remind him of the biblical story about the entry restrictions to heaven imposed on rich men.

Such attention has forced the industry to consider whether earning the highest possible returns should be its sole concern. Fund managers have taken to trumpeting the benefits they bring to the economy (by directing capital to where it will be most useful and helping to create employment) and to society at large (by making it easier for individuals to plan for their old age).

Perhaps the unwelcome publicity was inevitable once fund managers started to become rich and appear in the gossip columns. Only 30 years ago fund management was a bit of a backwater, just the thing for those who were not quite bright enough to get into investment banking. "At the very first meeting I went to, a rival told me I had joined the most boring industry in the world," recalls Patrick Disney of SEI, a firm that advises on selecting the best fund managers.

But thanks to the rise of private equity and hedge funds, these days fund management is a fast route to billionaire status. Buoyant markets and generous performance fees mean that managers who get it right become very rich very quickly. A survey by *Alpha* magazine found that the top 25 hedge-fund managers between them took home $14 billion in 2006. And many of them like to splash their money around, with Steve Cohen of SAC Capital Advisers becoming a prominent art collector and Daniel Loeb of Third Point reportedly paying $45m for a Manhattan apartment.

Fund managers have become the latest group of rich people to incur public displeasure, reinforced by a feeling that they do not perform a socially useful function but merely speculate with other people's money. Some of the criticism is deserved.

Private equity owes some of its success to anomalies in the tax system. For example, when it buys a company it often loads it up with debt and claims tax relief on the interest paid. In an ideal system the tax treatment of debt and equity should be the same. Private-equity executives have also benefited by having a large part of their earnings classed as capital gains, which in most countries are subject to a less severe tax regime than income.

Hedge-fund managers have benefited from light regulation that has given them advantages over their traditional fund-management rivals—such as being allowed to keep the details of their holdings secret, for example, or being able to benefit from falling, as well as rising, prices.

As yet, governments have made little coherent attempt to crack down on these tax and regulatory privileges, mainly because capital is so mobile these days and countries such as Britain and America do not want to drive away rich residents or antagonise the financial community. That may change if an economic downturn prompts voters to demand action.

What about the workers?

Perhaps the most potent attack was launched by Franz Müntefering, a prominent German Social Democrat politician who in 2005 described the hedge-fund industry as "locusts". He gave voice to the widely held view that both hedge funds and private-equity firms were interested only in short-term profits and catered exclusively to the needs of shareholders rather than employees, customers or the wider community.

This view was taken up by trade unions in Britain, particularly in the early months of 2007 when a new private-equity-funded takeover deal seemed to be announced every week. Calls for the government to change the rules, particularly on tax privileges, resulted in a botched reform of the British capital-gains-tax regime that penalised small businesses far more than private-equity bosses.

The private-equity industry, surprised by the intensity of the criticism, duly supported the creation of voluntary codes committing firms to greater transparency. In Britain at least, the hedge-fund sector took similar steps. Both industries can afford a high-powered lobbying machine. Private-equity firms cited academic studies that appeared to show that, far from destroying jobs, the industry was a net creator of them.

The industry also argued that its model was superior to that of the traditional public company because the interests of managers and investors were more closely aligned, high debt required managers to focus on cash generation, keeping them honest, and managers found it easier to take tough long-term decisions away from the glare of media attention. The debate was still continuing when, in the middle of the year, the credit crunch hit home and the private-equity funds suddenly found it far more difficult to raise money. That seems to have shifted attention to a different type of investor, the sovereign-wealth funds. These funds, particularly those set up by governments in Asia and the Middle East, were prominent among those helping to bail out the American banking sector in the aftermath of the credit crunch.

Hedge funds have also slipped out of the limelight somewhat since last summer. But although unlike private-equity groups they rarely launch takeovers on their own, they can still wield a lot of influence. They frequently lobby for executives to realise value for shareholders by returning cash, selling off unprofitable subsidiaries or agreeing to bids from larger groups. Such "activist" hedge funds usually try to recruit other institutions to their cause. They then organise a shareholder vote, campaign in the media or attempt to enlist outside bidders to get the company's board to change tack.

One of the best-known activists is the Children's Investment Fund (TCI), a European hedge fund. It successfully blocked Deutsche Börse's attempt to take over the London Stock Exchange and then, with a stake of just 1%, set the scene for ABN AMRO, a Dutch bank, to become the target of a bidding war between Barclays and the Royal Bank of Scotland. More recently, hedge funds attempted (unsuccessfully) to control the terms of the rescue of Northern Rock, a struggling British bank.

Such activism has not made them popular, either with the public or with company boards. In the days of autocratic chief executives, fund managers, like small children, were expected to be seen and not heard. Even today, rules at many American companies make it difficult for investors to unseat the management. If investors do not like the way a company is being run, they are expected to shut up and sell the shares. European companies can also be sniffy when investors speak up. And in Japan they hardly ever do.

Gradually, however, activists are becoming more widely accepted. “Even in France and Germany, governments are gradually coming to the conclusion that activism is an acceptable instrument of corporate governance,” says Michael Treichel of Audley Capital, an activist fund. Besides, now that markets are global, it is very hard to keep the activists out without driving away the international capital most companies want to attract.

However, hedge funds are not the only activist shareholders. Other fund managers, often reflecting the views of their pension-fund clients, have pushed for companies to pass ethical and corporate-governance tests, such as decent treatment of workers in the developing world or the separation of the jobs of chairman and chief executive. This could leave companies open to attack on both sides. Even as activist funds might be asking them to cut costs and lay off employees, ethical investors could be urging them to think about their workers.

To make things more difficult, the ethical camp is itself split. Old-school ethical investors, often guided by religious principles, did not want their money to be used in businesses they disapproved of, from alcohol and arms manufacturing to gambling and tobacco. In recent years, thanks to the Middle East's increasing wealth, there has been rapid growth in financial products compliant with *sharia* law, aimed at Islamic investors.

Do the right thing, but which?

Another ethical trend, supported by those of a leftish (in America, liberal) persuasion, has been for socially responsible investing (SRI), although the term has been interpreted in a variety of ways. “Social responsibility is in the eye of the beholder,” says Ed Bernard of T. Rowe Price, an American fund-management group. But in general, socially responsible investors try to avoid companies that exploit workers (for example, by using child labour in poor countries), cause pollution, add to global warming or operate in countries with dubious human-rights records.

A third school adds some hard-headed calculations to elements of both the ethical and the social-responsibility approaches. Believers in sustainable investing think that picking out the best companies on non-financial criteria will ultimately lead to higher returns. David Blood used to work in the money machine that is Goldman Sachs. Together with Al Gore, a former American vice-president, he set up Generation Investment Management, a firm that specialises in sustainable investment. Firms that treat workers or the environment badly, he says, will eventually face lawsuits or a backlash from consumers or regulators, so a narrow focus on the balance sheet does not make sense in the longer term.

Cynics claim this preoccupation with corporate governance encourages a “box-ticking” mentality; companies will simply meet the minimum standards and cheer up the annual report with some feelgood pictures of racially diverse groups of workers, fetching children or leafy glades. Bozena Jankowska, head of sustainability research at RCM (part of Allianz Global Investors), agrees that “questionnaires are a waste of time” and adds that it is important to talk to companies face to face: “If they are not telling the truth about social responsibility and sustainability, they are probably not telling the truth about the rest of the business either.”

Some see socially responsible or sustainable investing as a backward step that will tie down fund managers just as they are escaping the shackles of the index. “The world is moving towards unconstrained investing, but SRI is moving in the opposite direction,” says Mr Connor of Morse. Still, as long as some clients care as much about where their money is invested as about how much they earn, SRI is not going to go away.

All things to all men

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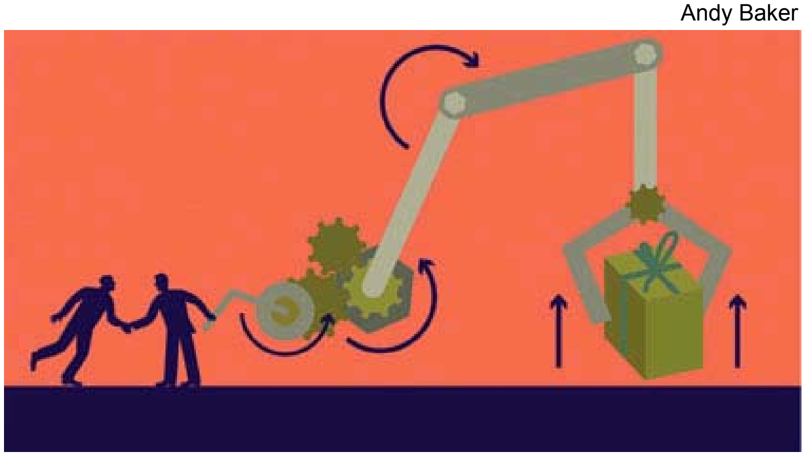
Andy Baker



The industry is becoming more diversified

ASK management consultants to review any sector, and the chances are they will forecast that a few big groups will come to dominate it, with a few niche businesses at the tail end.

The remarkable thing about the fund-management industry is how little it has consolidated. Much of that is due to the random influence of markets. A struggling fund-management group can have its fortunes transformed by hiring one star manager or perhaps having a lucky year. Henderson, a British fund-management group, is exactly the kind of mid-sized business that the management consultants would have expected to disappear, but in recent years it has been very successful in selling international funds to American investors.

In most industries, companies can hope to thrive by following the Wal-Mart model. Economies of scale will allow them to become more efficient, reduce prices and attract more customers. But in the fund-management industry that strategy works only in index-tracking, or passive management. This is a commodity business. Some technical expertise is needed to ensure that the benchmark is tracked accurately, but the business is mainly about price. Large companies are able to spread their fixed costs, allowing them to charge lower fees. Sure enough, two giants, Barclays Global Investors and State Street, dominate the industry.

When it comes to active management, there is a big debate over whether size is a help or a hindrance. The "small is beautiful" school points out that some of the best hedge funds were started by two men and a spreadsheet. "Total assets under management is a relatively poor explanatory variable of success," says David Hunt of McKinsey. "Scale in many styles works against performance."

Sandy Nairn has worked at both Templeton and Scottish Widows Investment Partnership (part of the Lloyds TSB banking group). He now runs his own boutique business, Edinburgh Partners, with just £3 billion ($6 billion) under management. "Often in firms, there are three key people who make all the difference," he says. "There is a limited number of very good people so the bigger the firm, the smaller the proportion of top talent." Mr Nairn adds that "the bigger you are, the more sales-oriented you become because you are tapping into the mass market. Fund managers become less important than the marketing and compliance people."

Mr Nairn may be biased, but he raises a fundamental dilemma for the industry. Charles Ellis, an industry veteran, describes it as the difference between professional-led and business-led companies. In the first sort, the fund managers are in charge. The second kind are in danger of becoming too preoccupied with short-term profit, increasing the proportion of assets under management and running the risk of damaging the culture and long-term reputation of the firm. For example, marketing people may persuade firms to launch funds in hot areas (such as technology in 1999-2000) even when investors think the top of the market may be in sight.

"When I started in the industry in 1972," says Ed Haldeman of Putnam, a Boston-based fund-management group, "all asset-management companies were led by investment people. Being good at investment didn't necessarily make them good at leading the firm. Eventually, the business and marketing people came to lead. The risk was that they ran the company on the basis of what was best in the short term. Now we are trying to find a balance between the two."

What are the problems of scale in the fund-management industry? The first is the culture it can create. Most people agree that you have to be clever to be a successful fund manager, and also a bit of a contrarian: there is no point in buying what everyone else is buying. The danger in a large company is that individual managers will be second-guessed by strategy committees or risk managers or simply intimidated into going along with the rest of their colleagues. "Fund management requires talent, just like being a concert pianist. Industrialising the process really doesn't work," says Nigel Blanshard of Culross, a hedge-fund group.

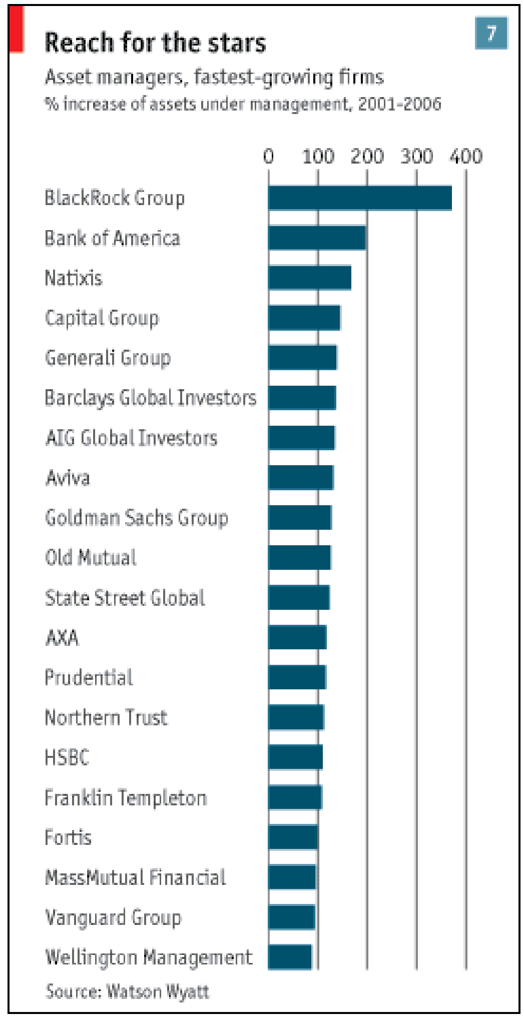
Not everybody sees control systems as a disadvantage. Rogue fund managers have ruined the reputations of plenty of businesses, and clearly there is a need for some sort of oversight. But even if a manager is given his head and becomes a star, the company may not reap the success it expects. It is all too easy for a star manager to be lured away by a rival and take his clients with him.

A lot of fund managers, particularly those that deal with institutional clients, emphasise the "process"—the systematic approach they take to beating the markets. In some firms, such as Capital International, this is driven by teams of analysts rather than by fund managers; the hope is that even if the star is run over by a bus, the firm will still perform well.

But scale affects other aspects of the business too. For example, if a fund has hundreds of billions of dollars of assets under management, it may not find it worth its while buying stakes in smaller companies. If it does, it risks becoming the dominant shareholder. Robert Harris of Majedie, a specialist British equity manager, illustrates the maths. "How much of a company with a £2 billion market value does a fund manager need to hold to have a 2% position across his portfolios?" he asks rhetorically. "If the manager has £5 billion of assets, it needs to own just 5% of that company. If it has £20 billion of assets, it needs to own 20%." It may be possible to assemble that kind of stake, but it will not be easy to sell it quickly.

Another problem for large fund managers is that the act of buying and selling can move prices against them. The big groups do their best to reduce this problem by setting up specialist trading desks, splitting their orders among brokers and keeping their plans to themselves, but it is hard to escape the issue entirely. "If you start to move share prices when you have assets over a certain size, that must affect performance," says Mr Nairn. Some managers close their funds or discourage new investors if they think that further growth may affect their performance. For managers motivated by performance fees, this will usually make financial sense, because the loss of performance fees would outweigh the extra fees from managing more assets.

But a deliberate strategy of staying small also has its problems. If the business specialises in just one product area, a couple of bad years in that speciality can be fatal. Similarly, the business may remain sound only for as long as the founders are willing to stay on; if they get bored or complacent, it may not survive. “It's a one-generation business,” admits Mr Nairn. “But everyone pretends it's a two-generation business so they can sell out.”



Convergence and divergence

So an odd combination of trends is at work. The clients are moving away from investing in a limited number of asset classes to a much broader range. In response, the specialists in the fund-management industry are venturing into new areas; for example, hedge funds are going into private equity and vice versa. Client strategies are diverging whereas fund-management firms' strategies are converging on a broadly based model.

For the firms, this means diversification. For example, in the hedge-fund industry, managers who used to concentrate on one particular product line, such as arbitrage, in recent years have added other strings to their bow and become multi-strategy firms. Others have taken the diversification several steps further, adding long-only funds or moving into other operations, such as private equity, direct lending or market-making. That should provide them with better protection against a freak bad year. It should also allow them to keep those of their clients who are now haring off in different directions, looking for returns from asset classes such as commodities and private equity.

Traditional firms have set up their own hedge-fund operations or established hybrid funds that offer a watered-down version of hedge-fund strategies. “Big firms were never going to miss out on hedge funds. They weren't going to let their staff be lured away or miss out on the fees,” says Rob Fairbairn of the BlackRock Group. Investment banks, too, have taken control of, or stakes in, hedge-funds groups; it was through this route that Vikram Pandit became chief executive of Citigroup.

In a few years' time there may no longer be such a thing as a hedge-fund group, only groups that offer a range of ways of managing money. Clients will be able to choose from their menu of long-only or long-short, rather like diners in a restaurant can order their eggs scrambled or sunny side up.

By diversifying, fund managers also hope to avoid some of the old traps of scale. Firms pride themselves on being a "collection of boutiques". Sometimes the groups try to create these boutiques internally; more often they go out and buy them. That allows the founders of smaller fund-management groups to cash in on some of the value they have created and to take advantage of the larger group's marketing clout.

Yet when boutiques become part of a larger business, they risk losing the spark that made them successful in the first place. Horacio Valeiras now works for Nicholas-Applegate, a small and midcap manager that is part of Allianz Global Investors. He was reluctant to join a larger group after an unhappy experience when a previous employer was taken over by Morgan Stanley. "We wanted to maintain our philosophy and control our own destiny," he recalls. He talked to Allianz in Germany and they convinced him they would allow him autonomy. "I confess they have given me more freedom than I expected," he says.

So the integration of boutiques needs careful handling. "It is possible for a fund-management company to have a large number of funds and run them well," says Ed Haldeman of Putnam. "But we believe it needs distinct teams as opposed to being all controlled from the top." Having such teams, or internal boutiques, means the individual fund manager can feel responsible for his own operation. Incentives can be set at the level of the individual unit. "The worry in big groups is that some guy in another part of the group has lost your bonus," says Jonathan Little of Bank of New York Mellon.

Boutique-style giants

Mr Little's group now has $1.1 trillion of assets under its wing, with 13 brand names including Dreyfus (an American mutual-fund arm), Newton (a London-based equity manager with a thematic approach) and EACM (an American fund-of-hedge-funds manager). Ronald O'Hanley, the group's chief executive, says this diversity is an advantage. "We have three global bond products, so depending on the clients' attitude towards, say, credit, we can steer them in the direction of the appropriate fund manager," he says.

Another group that is unashamedly aiming for scale is BlackRock. At the end of its latest financial year the company had some $1.4 trillion of assets, thanks to the purchase of the old Merrill Lynch Investment Management (MLIM) business and of Quellos, a hedge-fund group. According to Mr Fairbairn of the group's London office, the "merger between MLIM and BlackRock was driven by a real opportunity to build strength across equities, fixed-income and alternative assets to get a greater share of the wallet."

BlackRock also has ambitions to expand outside the fund-management area. It is one of the pioneers of "fiduciary mandates" where the manager takes total charge of a pension fund, dealing with issues like asset allocation and administration as well as stock selection. The company also has a business called BlackRock Solutions that allows it to model portfolios and assess risk; the system is sold to both clients and competitors. In the thick of the credit crunch, the company was called in by the state of Florida to advise on the handling of a money-market fund with exposure to subprime-related securities.

In these examples, fund managers are moving into business areas previously occupied by actuaries and consultants. Fund managers are trying to exploit their size without running into the diseconomies of scale peculiar to the industry. Such diversification brings potential conflicts of interest; for instance, firms might favour their hedge-fund clients, who pay higher fees, over their traditional clients. Nevertheless, the business opportunities are too attractive for fund managers to pass up.

Besides, nobody wants to be seen as a big monolithic group that might produce mediocre results. Until recently, that was a danger facing Fidelity, arguably the best brand name in global fund management; at the start of this decade, its funds were perceived as too large and unwieldy to generate exciting returns and it developed a reputation for chasing asset growth. However, Fidelity has recently turned its investment performance around.

In 2005 it installed Harry Lange as the new manager at Magellan, which for many years had been Fidelity's flagship fund. Mr Lange made some daring but successful bets in 2007, as a result of which, for the first time since 1997, Magellan has just been opened to new money. Insiders point to the extra money that the company's chairman and key shareholder, Ned Johnson, has devoted to research over the past couple of years. But the company has also seen some reorganisation under Rodger Lawson, whom Mr Johnson recently installed as president, in an attempt to sharpen its focus and to ensure that the business is run efficiently.

We make, you sell

Feb 28th 2008
From The Economist print edition

Sometimes it's better to concentrate on one thing

IF FUND management is such an attractive business, why would large banks such as Citigroup and Merrill Lynch want to give it up? After all, with both groups facing write-offs related to the credit crunch, the steady revenue from asset management would have been a comfortable cushion.

But there is one big problem with being a fund manager: you have to beat the market. If you don't, intermediaries such as brokers and private banks will not select your funds. And regulators, at least in America and Britain, will get upset if they think you are stuffing your poorly performing funds down your clients' throats.

This has prompted a move in the Anglo-Saxon markets to separate the jobs of “manufacturing” (managing portfolios) and “distribution” (selling them to clients). In continental Europe and Asia fund management is still dominated by the big banks and insurance companies. In Italy, for example, 92% of assets are gathered directly by salesmen tied to, or employed by, the fund-management group; in Britain the proportion is just 14%.

Manufacturing may sound like the more attractive part of the business. Provided the company gets its performance right, its profits will go up exponentially: it costs little more to manage $2 billion than $1 billion. But firms that act as distributors still earn fees from fund management, by charging investors for the oversight of their portfolios or by taking commission on the funds they sell. At the same time they cut out much of the cost.

There are three main kinds of distribution. The first is simply to sell products managed by your own firm. The second is “open architecture”. This allows the client access to almost any fund manager on the market, or at least to all the managers who are willing to allow their funds to be offered on such a platform. For various reasons, some are not. For example, they may want to control the type of clients that own their funds, or limit the size of funds under management to avoid their performance being diluted. Or they may object to handing over part of the annual management fee to the distributor. “Some of the really interesting boutiques don't want to be on platforms and give away half their fees,” says Alan Bartlett of WestLB Mellon AM, a firm that specialises in identifying skilled fund managers.

Decisions, decisions

Another problem of open architecture is the so-called paradox of choice. Retail investors can feel overwhelmed by the thousands of funds on offer, so they are inclined to choose names they recognise. This favours funds that spend a lot on marketing and advertising. As a result, clients may not choose the best (and almost certainly not the cheapest) funds. But there is nobody to steer them in the right direction, because giving clients individual advice is too difficult and too expensive.

The third sort of distribution is “guided architecture”. In this model, a distributor offers the funds of a restricted number of firms that it has pre-selected as being suitable for clients. This narrows down the choice for investors and offers a degree of stability to the fund managers involved.

The effect of the manufacturing-distribution split is that the retail market is becoming almost as institutionalised as the pension-fund market. Just as a pension-fund manager's ability to get business usually depends on winning over a handful of consultants, attracting money from the “high net worth” market (ie, the rich) depends on a manager's ability to convince an elite group of private banks. That gives the managers plenty of scope to bandy about terms like alpha and beta in their presentations. “At least this means we can talk at the level we're accustomed to,” says one manager.

This opens up opportunities for boutique-style firms. “Groups like Citigroup and Merrill Lynch have got out of asset management and moved to open architecture; we, as an independent asset manager, are just what they are looking for,” says Jim Kennedy of T. Rowe Price. Outsourcing distribution allows fund managers to specialise in their area of expertise.

But there is a price to pay. Depending on outside distributors means the fund manager loses direct contact with the client. One industry veteran recalls how his firm used to maintain a department to deal with the letters from investors; now the correspondence has slowed to a trickle. The result may be less hassle but also a reduction in customer loyalty. There is a lot more “churn” (turnover of customer accounts) than there used to be. “These people [the distributors] have to do something to justify their fees,” laments one fund manager, and that something usually means switching to a new fund as soon as one appears to falter.

The recent decline in the fortunes of New Star, a British fund-management group, illustrates the danger. New Star was founded by John Duffield, formerly of Jupiter Asset Management, with the explicit aim of recruiting well-known individual fund managers. Its funds were popular with both retail investors and distributors such as financial advisers and private banks. But in 2007 performance faltered as the company became overexposed to the British property market. In the second half of the year fickle investors left in droves, withdrawing almost £2 billion from the group's funds. The company cut its dividend in the expectation of further withdrawals this year. In response, its shares fell by nearly a third. If you live by short-term performance, you can die by it too.

Jam today, jam tomorrow

Feb 28th 2008
From The Economist print edition

Why the industry will still be thriving in ten years' time

Andy Baker

THE fund-management industry may have its problems, but it also has two enticing opportunities ahead of it. You could call them the two Es—the emerging and the elderly.

Twenty-five years ago, developed countries in Europe and America started to drop the capital controls they had had in place ever since the second world war. Rational investors took the opportunity to diversify their portfolios. The fund-management industry profited richly as it took a slice of the capital flowing freely between nations.

Now the capital markets are truly global. One of HSBC Global Investment Funds' most successful products in recent years was the sale of a BRICs (Brazil, Russia, India and China) fund through the Italian post office. Here was a London-based manager selling the shares of Russian oil firms and Brazilian coffee companies to Italian pensioners, neatly demonstrating that finance has become borderless.

Not that globalisation is a new phenomenon. Before the first world war, British investors were funding the development of Argentina's railways and French ones were buying Tsarist bonds issued by the Russian government. But now the capital is coming back the other way, most obviously in the form of the sovereign-wealth funds that have been every bank's favourite sugar daddy over the past 12 months. The deals that hit the headlines are the direct investments, but sovereign-wealth funds are also likely to spread their portfolios more widely. That will not only diversify their risk but may also avoid a lot of political hassle. The fund-management industry will benefit from the opportunity to offer a range of investments to the new centres of financial power.

And it is not just the sovereign funds that will be accumulating assets. As individuals in emerging markets become wealthier, they will start to build up their own savings. Foreign fund-management groups will compete for the chance to tap into this fast-growing pool of capital.

Just as in the West, the market will probably split into three. Institutions are already looking abroad for international equity exposure. Rich individuals will also be potential targets as they look for more sophisticated products such as hedge funds. The mass market will be harder to break into. In some countries, such as China, the best route will be to link up with a domestic partner.

McKinsey reckons that the best opportunity for growth is not, in fact, in any of the emerging markets but in Japan, which already has personal financial assets totalling $13 trillion, against China's $2 trillion. In the past a lot of that money has been locked up in low-yielding deposits. Less than 3% of household assets are in mutual funds, against nearly 20% in America.

Fund managers are even more excited about the Middle East, with plenty of wealth being generated by high oil prices and looking for a home. Some of this is going into local stockmarkets which are now enjoying another boom, not long after the previous one fizzled out in 2006. But some of it is also being grabbed by American and British fund managers. As one of them says, “the great thing about these accounts is that if you win one, it can easily be worth $500m.” Flights from Heathrow to Dubai are packed with managers chasing the Arab dollar.

The region is also developing its own fund-management community. Investcorp was founded in 1982 and sells a range of alternative investments to local investors, from hedge funds through private equity to real estate. Assets under management are growing fast, reaching $15 billion earlier this year, and the group now has a significant presence in the fund-of-hedge-funds market.

Between them, the growth of Asian and Middle Eastern markets may represent as great an opportunity for the fund-management industry as the rise of corporate-pension plans in the 1970s and 1980s or the love affair between baby-boomers and mutual funds in the 1980s and 1990s. But there is also much to do for the industry nearer home.

An age-old problem

In the core European Union countries, the old-age dependency rate (the number of people above retirement age as a proportion of the working-age population) is set to rise from 21% today to 50% in 2050, according to Elizabeth Corley of Allianz Global Investors. Responsibility for funding retirement income is increasingly switching from the state and the corporate sector to the individual.

But a lot of people have no interest in, or understanding of, the pensions market. They underestimate the amount of capital they will need to live on in retirement. And they can be overwhelmed by the task of deciding what to do with their pension savings. “It is asking a lot of uninformed individuals to handle the responsibility for asset allocation for their retirement,” says Jeff Knight of Putnam, a Boston-based fund-management group.

Andy Baker

The “cafeteria” model of pension provision, in which employees are invited to choose from a vast range of funds, leads investors to worry about the wrong things. “People are focusing too much on which funds to choose and not enough on the total amount of their contributions and whether that will provide a decent return,” says Alan Brown of Schroders.

The privatisation of the Swedish social-security system provides a useful case study. Swedes were encouraged to pick their own funds, with 456 to choose from at the launch in 2000, according to a 2004 paper by two academics at the University of Chicago, Henrik Cronqvist and Richard Thaler. But despite the large choice, most participants put their money into funds with an alluring recent record. The favourite fund at launch, specialising in technology and health care, had risen 534% in the five preceding years. Over the next three years, however, it lost 70% of its value. Oddly, once having made their choice, participants slumped into inertia; fewer than 4% changed their portfolio each year.

Chastened perhaps by their experience, over 90% of Swedes now choose the default option (the one that scheme members are assigned to if they do not want to make their own choice). Similar figures have been observed in America and Britain. This suggests that particular care needs to be taken in designing the default fund so that it offers a broadly based mix of assets.

There are three possible ways of achieving this, each of which would have different implications for the fund-management industry. The first is to use index funds to get exposure to the main assets of equities and government bonds. That would be the cheapest option and would provide plenty of business for passive specialists such as Barclays Global Investors and Vanguard, but the rest of the industry would not get a look-in.

The second route would be for one fund manager to run the entire fund; that would be a great business opportunity for one of the big groups, such as Fidelity or BlackRock. The third option would be for a fund-of-funds group to select the portfolio, choosing funds that specialise in areas like emerging markets, property and so on. This would be good for the boutiques, which might otherwise be shut out of the pension-fund industry.

But offering the right pension funds is only one of the industry's preoccupations. It will also need to cater for the fact that as Western populations age, they are likely to stop building up assets and start running them down—or, as the management consultants like to put it, from the accumulation phase into the decumulation phase. Investors will no longer be looking for capital gains but for income.

The trouble is that fund managers do not provide clients with the information they need to make sensible plans. People thinking about their retirement are not really interested in whether their portfolio has beaten the S&P 500 index or outperformed its peers in the global-equity-funds sector. What they want to know is how much income they can expect and how much spending power it will command.

People in traditional defined-benefit pension schemes have a rough idea of the answer. Provided they stick with their employer, they know what proportion of their final salary they will draw in retirement, so they can prepare for it. But those who are relying on a defined-contribution, or money-purchase, scheme are completely in the dark. They can be given illustrations of the sort of income that different rates of return will produce, but there is no guarantee that those returns will be achieved, and the effect of inflation can be hard to understand.

The sort of product that most people want is probably something that requires them to pay in a given sum a month for the rest of their working lives in return for a given annual income, or some proportion of their final salary, for the whole of their post-retirement lives. Anyone who could offer them something along those lines would crack the market.

Yet fund-management companies find it very difficult to make that kind of promise. The only investment that can offer a guaranteed inflation-linked return is index-linked government bonds, which offer very low real yields. Add in a fund manager's fees, and the client would have to save a huge amount to get the income he wants. That explains the prevalence of the current system: the client saves less and the funds invest in equities in the hope of earning good returns, but they do not offer a guarantee.

Why don't fund managers take advantage of the fact that equities nearly always outperform bonds and cash in the long term? They could offer their own guarantee and rely on the stockmarket to do its bit. After all, this is what final-salary pension schemes have traditionally done. The problem is that regulators would not allow managers to make such an unfunded commitment because things might just go wrong. Instead, they would ask the funds to put up an enormous amount of capital to back such a guarantee.

This has put the onus on fund managers to come up with products that deal with some of people's retirement worries, but without offering guarantees. Among the most popular are lifestyle funds, which switch investments from equities to bonds as retirement approaches. The idea is to prevent disaster in the form of a stockmarket crash hitting the fund just before retirement. Similarly, so-called target retirement funds allow investors to choose the year of their planned retirement so that the manager can adjust the asset allocation accordingly.

Then there are variable annuities, which tend to be offered by insurance companies. In return for a fee, these allow investors to lock in the value of the fund (and the expected income) on a regular basis; this gives investors the security they crave but still allows them to benefit from a rise in the market. But ultimately the guarantee is only as strong as the insurer's hedging strategy and balance sheet.

Other options include guaranteed funds that offer investors, say, 90% of the rise in an equity market over the following five years, but with the promise that capital will be returned if the market falls. These products appeal to first-time investors who want to get some exposure to stockmarkets but are nervous about the risks. Lastly, there are products that seek to use most people's biggest pool of savings, their homes, allowing them to convert capital into income.

These outcome-oriented products, as they have become known, are likely to increase in popularity. McKinsey reckons that between 1994 and 2005 such products grew at 28% a year, compared with 13% for the conventional mutual-fund industry; and that by 2010 perhaps 25-30% of the earnings of leading asset-management firms will come from products not yet on offer today.

Guaranteed uncertainty

Indeed, one of the few sure predictions that can be made about the fund-management industry is that in ten years' time it will have changed drastically. Leaving aside the havoc that turbulent markets can wreak, some managers will have taken advantage of the rise of the developing world and the ageing of Western populations, and some will have failed miserably. Some will have built a franchise in the complex world of alternative assets and some will have suffered embarrassing losses. Fund management will still be a great business in aggregate, but there will have been plenty of scope for individual firms to make a complete hash of it.

But whatever happens to the industry, it would do its reputation a power of good if over the next ten years its activities were adjusted to benefit its clients a little more and its managers rather less.

Sources and acknowledgments

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