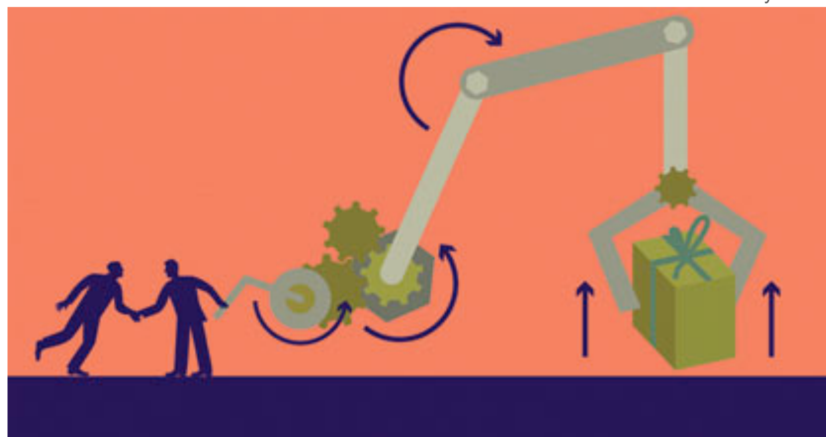
Economist.com SPECIAL REPORTS

All things to all men

Feb 28th 2008
From The Economist print edition

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.

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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.

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