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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.

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