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The Global Asset Management Industry: Competitive Structure, Conduct and Performance

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The Global Asset Management Industry:

Competitive Structure, Conduct and Performance

by

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Abstract

The asset management industry represents one of the most dynamic parts of the global financial services sector. Funds under institutional management are massive and growing rapidly, particularly as part of the resolution of pension pressures in various parts of the world. The industry is not, however, well understood from the perspective if industrial organization and international competition, which is the focus of this paper. It begins with a schematic of asset management in a national and global flow-of-funds context, identifying the types of asset-management functions that are performed and how they are linked into the financial system. It then assesses in some detail the three principal sectors of the asset management industry -- mutual funds, pension funds, and private-client assets, as well as foundations, endowments, central bank reserves and other large financial pools requiring institutional asset management services. Relevant comparisons are drawn between the United States, Europe, Japan and selected emerging-market countries. This is followed by a discussion of the competitive structure, conduct and performance of the asset management industry, and its impact on global capital markets.

The Global Asset Management Industry: Competitive Structure, Conduct and Performance

by

Ingo Walter
New York University[1]

The institutional asset-management industry is likely to be one of the largest and most dynamic parts of the global financial services sector in the years ahead. As of 1996, the global total of assets under management was estimated at close to $30 trillion, comprising some $8.2 trillion in pension fund assets, about $5.3 trillion in mutual fund assets, $6.4 trillion in fiduciary assets controlled by insurance companies, and perhaps $7.5 trillion in offshore private client assets.[2] Not only will this already massive industry experience an extraordinary rate of growth in comparison with other segments of the financial services sector, but cross-border volume—both regional and global—is likely to take an increasing share of that activity.

Within this high-growth context, asset management attracts competitors from an extraordinarily broad range of strategic groups—commercial and universal banks, investment banks, trust companies, insurance companies, private banks, captive and independent pension fund managers, mutual fund companies, and various types of specialist firms. This rich array of contenders, coming at the market from several very different starting-points, competitive resources and strategic objectives, is likely to

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[1]Draft of December 10, 1997. The research was supported by the European Capital Markets Institute (ECMI), London.

[2] Source: Financial Times, *Global Fund Management*, April 24 1997, and Chase Manhattan Bank.

render the market for institutional asset management a highly competitive one even under conditions of large size and rapid growth.

The underlying drivers of the market for institutional asset management are well understood. They include the following:

- A continued broad-based trend toward professional management of discretionary household assets in the form of mutual funds or unit trusts and other types of collective investment vehicles, a development that has perhaps run much of its course in some national financial systems but has only begun in others.

- The growing recognition that most government-sponsored pension systems, many of which were created wholly or partially on a pay-as-you-go (PAYG) basis, have become fundamentally untenable under demographic projections that appear virtually certain to materialize, and must be progressively replaced by asset pools that will throw-off the kinds of returns necessary to meet the needs of growing numbers of longer-living retirees.

- Partial displacement of traditional defined-benefit public- and private-sector pension programs backed by assets contributed by employers and working individuals—under the pressure of the evolving demographics, rising administrative costs, and shifts in risk-allocation by a variety of defined-contribution schemes.

- Reallocation or portfolios that have—for regulatory, tax or institutional reasons —been overweighted to domestic financial instruments (notably fixed-income securities) toward a greater role for equities and non-domestic asset classes, which not only promise higher returns but also may reduce the beneficiaries' exposure to risk due to portfolio diversification across both asset classes and economic and financial environments that are less than perfectly correlated in terms of total investment returns.

The growth implied by the first three of these factors, combined with the asset-allocation shifts implied by the fourth factor, will tend to drive the dynamics and competitive structure of the global institutional asset management industry in the years ahead.

This paper begins with a schematic of asset management in a flow-of-funds context, identifying the types of asset-management functions that are performed and how they are linked into the financial system. It then assesses in some detail the three principal sectors of the asset management industry—mutual funds, pension funds, and private clients, as well as foundations, endowments, central bank reserves and other large financial pools requiring institutional asset management services. Relevant comparisons are drawn between the United States, Europe, Japan and selected emerging-market countries. This is followed by a discussion of the competitive structure, conduct and performance of the asset management industry, and its impact on global capital markets.

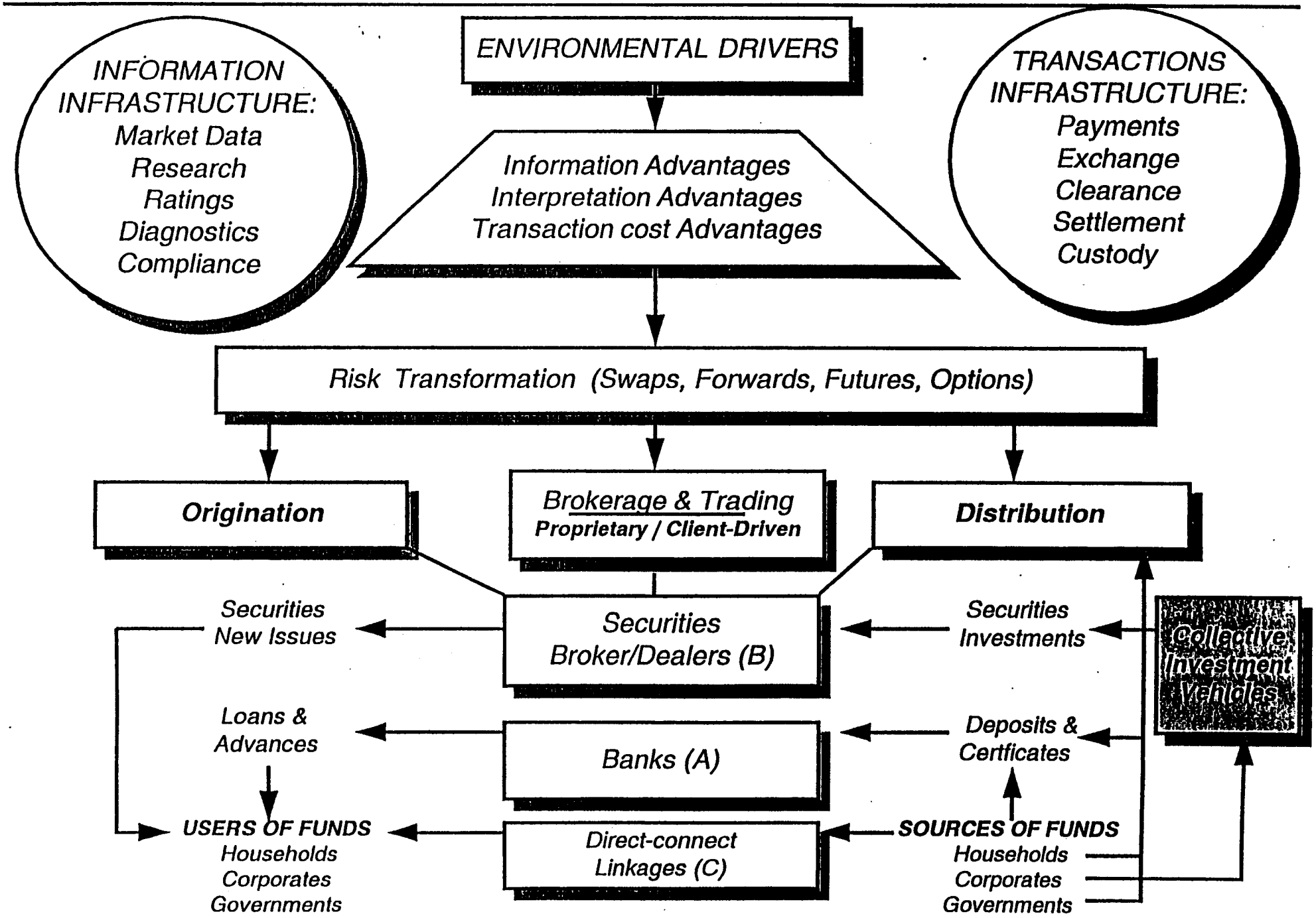
1. Asset Management in the Context of National and Global Funds-Flows

A convenient model that can be used to guide thinking on the positioning of the asset management industry in domestic and international flows of funds is summarized in Exhibit 1.[3] The diagram depicts the financial intermediation process among the different sectors of national and global financial systems in terms of: (1) The underlying environmental and regulatory determinants; (2) The financial infrastructure services that need to be provided—market information, financial research and its dissemination, financial rating services and portfolio diagnostics on the one hand, and trading, payments, securities clearance and settlement, and custody services on the

[3] For a more complete explanation of this model, see Roy C. Smith and Ingo Walter, *Global Banking* (New York: Oxford University Press, 1997), Chapter 7.

Exhibit 1

Role of Asset Management in Financial Intermediation



Source: Roy C. Smith and Ingo Walter, *Global Banking* (New York: Oxford University Press, 1997).

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other; as well as (3) The generic information, interpretation and transactions cost advantages or "competencies" needed to add value to, and profit from, the three primary inter-sectoral flow-of-funds linkages: (1) Savings institutions, commercial banks other traditional forms of intermediated finance; (2) Investment banking and securitized intermediation; and (3) Various financial direct-connect mechanisms between end-users—the ultimate users of capital and sources of funds in the system or those who act for them in a fiduciary capacity.

Ultimate *sources* of surplus funds tapped by financial intermediaries arise predominantly in the household sector (deferred consumption, or savings), together with the corporate sector (retained earnings, or business savings) and the government sector (budgetary surpluses and external reserve accumulation).

- Under the first or "classic" mode of financial intermediation (A), savings (or funds-sources) are held in the form of deposits or alternative types of claims issued by commercial banks, savings organizations, insurance companies or other forms of financial institutions entitled to finance themselves by placing their liabilities directly with the general public. Financial institutions then use these funds flows to purchase domestic and international assets issued by non-financial institution agents such as firms and governments.

- Under the second mode of funds flows (B), savings are allocated directly (or indirectly via so-called *collective investment vehicles*-CIVs) to the purchase of securities publicly issued and sold by various governmental and private-sector organizations in the domestic and international financial markets, using intermediaries to provide underwriting and distribution, or in the form of private placements. These CIVs comprise the asset management industry discussed in this paper.

- Under the third alternative (C), savings held in collective investment vehicles may be distributed directly to borrowers via (possibly automated) direct-sale mechanisms and private placements, or they may be internally deployed within the saving entity (e.g., retained earnings of nonfinancial corporations).

Ultimate *users* of funds comprise the same three segments of the economy—the household or consumer sector, the business sector and the government sector.

- Consumers may finance purchases by means of personal loans from banks or by loans secured by purchased assets (mortgages and hire-purchase or instalment loans). These may appear on the asset side of the balance sheets of credit institutions for the duration of the respective loan contracts, or they may be sold off into the financial market in the form of structured, asset-linked securities backed by various types of receivables.

- Corporations may borrow from banks in the form of unsecured or asset-backed straight or revolving credit facilities and/or they may sell debt obligations (e.g., commercial paper, receivables financing, and structured and unsecured fixed-income obligations of various types) or equities directly into the financial markets.

- Governments can likewise borrow from credit institutions (sovereign borrowing) or issue full faith and credit and revenue-backed securities directly into the market.

Borrowers such as corporates and governments also have the possibility of privately issuing and placing their obligations with institutional investors, thereby circumventing both credit institutions and the public debt and equity markets. And even consumer debt can be repackaged as structured asset-backed securities and sold to private investors.

In addition to the various sources of external finance, of course, internal financial flows within economic entities comprising the end-users of the financial system remains a basic alternative to external finance.

Savers and investors as end-sources of finance in the system may select their own portfolios of financial assets directly from among the publicly-issued debt and equity instruments on offer—i.e., through *retail distribution* of financial instruments by

banks or broker-dealers. This can provide a broad range of asset-allocation options other than standardized savings contracts provided by credit institutions. It also permits the larger investors to tailor portfolios more precisely to their objectives while still achieving acceptable liquidity through rapid execution of trades, aided by linkages with banks or other financial institutions that are part of the domestic payments mechanism.

Investors may, alternatively, choose to have their portfolios professionally managed, within various types of CIVs (mutual funds or unit trusts, pension funds, or asset pools managed by insurance companies) that comprise the asset management industry. Asset managers purchase securities in the form of new issues or in the secondary market (*institutional distribution*). They may also buy large blocks of privately-issued securities directly from issuers, although in doing so they may in some cases face a liquidity penalty—due to the absence or limited availability of a liquid secondary market—for which they are normally compensated in the form of a higher yield. On the other hand, directly-placed securities usually involve lower issuing costs and can be specifically "tailored" to more closely match both the asset-manager's and issuer's requirements than can publicly-issued securities.[4]

Value to ultimate savers and investors, inherent in the financial processes described here, accrues in the form of a combination of yield, safety and liquidity at acceptable information and transaction costs.

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[4] Institutional and regulatory developments, such as SEC Rule 144A in the United States, have added to the liquidity and depth of some direct-placement markets in recent years.

Finally, geographic linkages make it possible for savers and issuers to access markets in foreign and offshore markets, thereby potentially improving risk, liquidity and yield or reducing transactions costs.

Static and Dynamic Efficiency Aspects

Static efficiency in the operation of financial systems—as described the three alternative, stylized financial processes depicted in Exhibit 1—is represented as the all-in, weighted average spread (differential) between rates of return provided to one set of end-users (savers) and the all-in cost of funds to the other set of end-users (borrowers and issuers). This differential represents the overall cost of using a particular mode or type of financial intermediation process, and is reflected in the monetary value of resources employed in the process of financial intermediation. In particular, it reflects the direct costs of production (operating and administrative costs, cost of capital, net regulatory burdens, etc.), losses incurred in the financial process that are passed along in the form of wider spreads or increased fees and other charges, as well as liquidity premiums and any monopoly profits earned. Financial processes that are considered "statically inefficient" are usually characterized by high spreads attributable to high overhead costs, high losses, high levels of regulation including barriers to market-access, or excess intermediation profits.

Dynamic efficiency is characterized by the rate of financial product and process innovation through time. *Product innovations* usually involve creation of new financial instruments. *Process innovations* include contract design (e.g., cash settlement futures

contracts), methods of clearance, payments, custody, securities settlement and trading, and techniques for efficient margin calculation. Successful product and process innovation broadens the menu of financial services available to ultimate issuers, ultimate savers, or other agents along the various financial channels described in Exhibit 1. Probably the most powerful catalyst affecting the competitive dynamics of the financial services industry has been technological change. However, there may be costs associated with financial innovation as well. Examples include financial instruments and processes (1) that take substantial resources to develop but that ultimately fail to meet a need in the marketplace, (2) that are misrepresented to end-users, or (3) are inadequately managed with respect to the various market or credit risks involved.

It is against a background of continuous innovation and pressure for static and dynamic efficiency that financial markets and institutions have evolved and converged over time. Global financial markets for foreign exchange, debt instruments and to a lesser extent equities have developed various degrees of "seamlessness." Indeed, it is arguable that the most advanced of the world's financial markets are approaching a theoretical, "complete" optimum where there are sufficient financial instruments and markets to span the whole spectrum of risk and return outcomes.

As a consequence of these developments, borrowers in many national financial systems today face a range of alternatives for obtaining financing, and even households and small or medium-size companies which are basically limited to bank credit can subsequently have their loans securitized, and benefit from both access to

a much broader pool of funding sources as well as conversion of illiquid bank loans into liquid securities form. The gains from both types of activity will tend to be partially passed backward to the borrower. Similarly, today's modern financial systems tend to provide a wide range of opportunities and services to investors, which allow them to optimize their asset portfolios by taking advantage of the domestic and international diversification across the broad range of financial instruments being offered, as well as improvements in the securities market infrastructure services. Again, even the retail investor can access these investment alternatives and process-technology improvements by taking advantage of the broad array of mutual funds, unit trusts, pension funds and other collective investment vehicles being marketed to households—in many cases using imaginative, high-technology non-stationary distribution techniques backed by extensive macro-economic, financial-market and securities research.

Even as intense competition across financial intermediation channels has developed, similar competition has emerged among national financial systems, as well as between them and offshore financial markets. Again, the borrower not only has the choice between bank credits and securities issues in the domestic market, but also has the alternative of borrowing or issuing abroad if foreign or offshore financing alternatives are more attractive. Similarly, savers and their fiduciaries have the option of going abroad to place funds if the returns and portfolio alternatives on offer are considered superior to those available at home.

Asset Management in a Financial Intermediation Framework

In terms of Exhibit 1, it is clear that there are three more or less distinct sets of services provided to institutional asset managers by intermediaries and other participants in the domestic and global financial process.

First, are sales of securities, derivatives and various types of structured products to the asset managers themselves. Institutional asset managers make tough customers for the sales and trading desks of banks and securities firms. They expect high levels of service that include execution of block trades, after-market support of new issues, high-quality research, timely market information, and constant accessibility in order to assure continued order-flow. For them, buying and selling investment products is a cat-and-mouse game in which anything less than the best price can, in time, be severely punished in the performance rankings. And if still more efficient securities distribution than conventional institutional sales can be achieved by automating the process, it will eventually appear in the market.

Second, an array of financial infrastructure services are used by institutional investors that lie between buyers and sellers of securities, domestically as well as internationally. These are critical for the effective operation of securities markets (top right of Exhibit 1). Such infrastructure services involve domestic and international utilities for clearing and settling securities transactions via domestic and international central depositories, and links between them, which in turn are prerequisites for a "value-chain" of infrastructure services that also comprise over-the-counter and exchange-based trading systems, payments systems, credit services and securities

lending, as well as domestic and global securities safekeeping and enhanced custody services such as portfolio information processing and reporting, tax reclamation, and corporate events services such as proxy voting. Some of these transactions-infrastructure services are supplied by public-sector entities such as central banks, while others are provided by competing private-sector vendors on the basis of price and quality of what are usually highly technology-sensitive and scale-sensitive activities.[5]

Third, the asset management industry is a voracious user of the output of the financial market's information infrastructure (top left of Exhibit 1). Portfolio performance depends on prompt access to information and interpretation, some of which can be obtained from banks and securities firms exercising a sales function, but other sources of information are critical as well. This includes information vendors like Bloomberg, Dow Jones Telerate and Reuters as well as various sources of research. The information infrastructure also includes portfolio diagnostic services such as Lipper Analytics and Morningstar, Inc., which provide fund performance information and calibration to fiduciaries such as pension fund trustees and end-users like mutual fund investors.

The activities of asset managers themselves, serving both institutions and individuals, are grouped under *Collective Investment Vehicles* at the bottom right of

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[5] See for example Ian Giddy, Anthony Saunders and Ingo Walter, "Alternative Models of Clearance and Settlement: The Case of a Single European Capital Market," *Journal of Money, Credit and Banking*, November 1996.

Exhibit 1. With respect to institutions, major investors such as pension funds and insurance companies provide them with blocks of assets to manage against specific performance targets (usually stock or bond indexes, or the average performance of all fund managers), sometimes called "performance bogeys." Individual investors usually place assets under discretionary management via widely-marketed open-end mutual funds or unit trusts. Individuals with significant assets (high net worth clients) usually couple asset management with tax planning, estates and trusts, and similar services in a "private banking" relationship with a bank or an independent financial adviser. Closed-end mutual funds and special investment vehicles like limited partnerships may be marketed selectively to institutions and high net worth individuals, and sometimes mass-marketed to the general investor community.

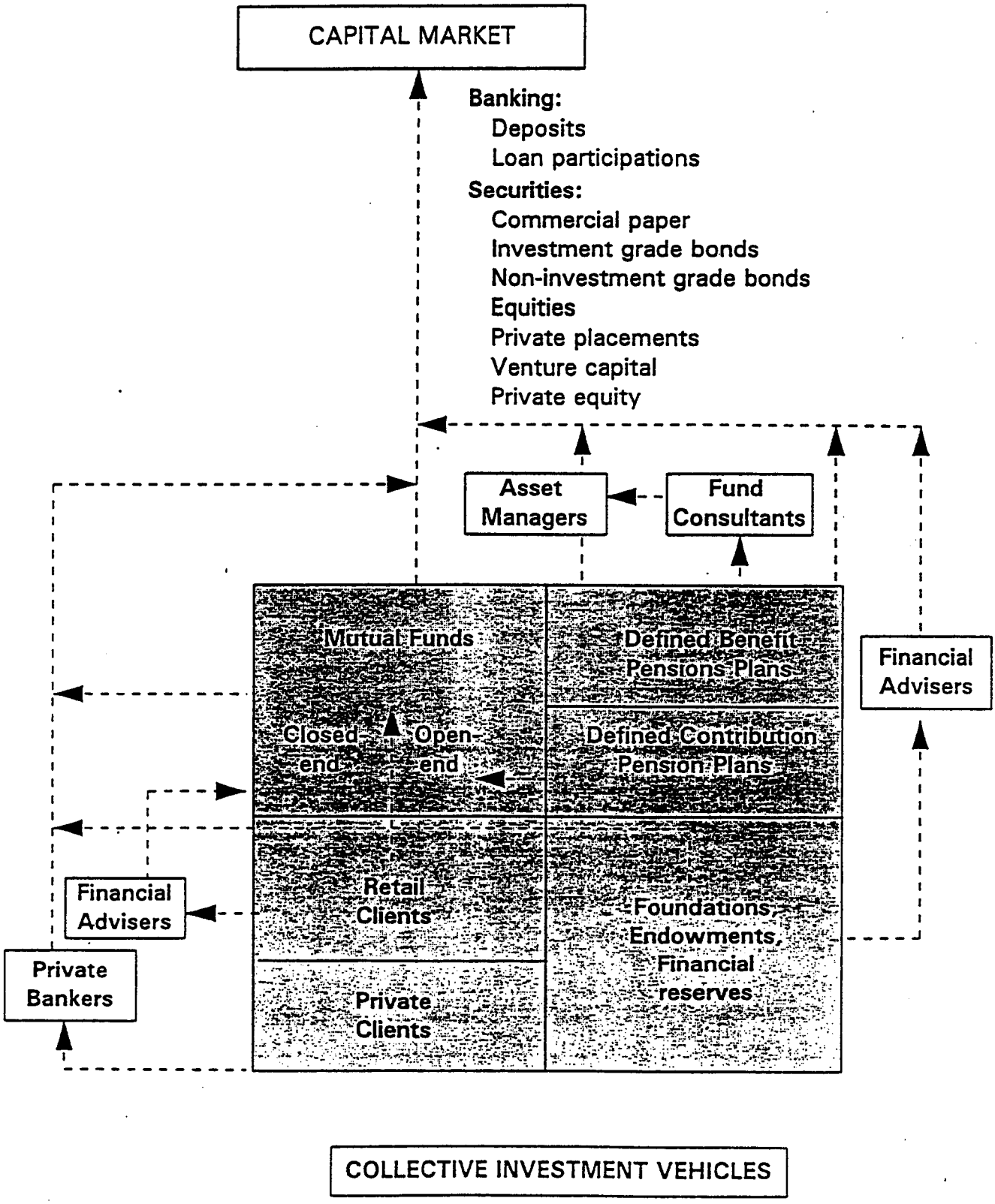
These various asset management services of collective investment vehicles are depicted in greater detail in Exhibit 2, as follows:

First, retail clients have the option of placing funds directly with financial institutions such as banks or by purchasing securities from retail sales forces of broker-dealers, possibly with the help of fee-based financial advisers. Alternatively, retail investors can have their funds professionally managed by buying shares in mutual funds or unit trusts (again possibly with the help of advisers), which in turn buy securities from the institutional sales desks of broker-dealers (and from time to time maintain balances with banks).

Second, private clients are broken-out as a separate segment of the asset management market in Exhibit 2, and are usually serviced by private bankers who

Exhibit 2

Organization of Asset Management



bundle asset management with various other services—such as tax planning, estates and trusts—placing assets directly into financial instruments, commingled managed asset-pools, or sometimes publicly-available mutual funds and unit trusts.

Third, foundations, endowments, and financial reserves held by nonfinancial companies, institutions and governments can rely on in-house investment expertise to purchase securities directly from the institutional sales desks of banks or securities broker-dealers, use financial advisers to help them build efficient portfolios, or place funds with open-end or closed-end mutual funds.

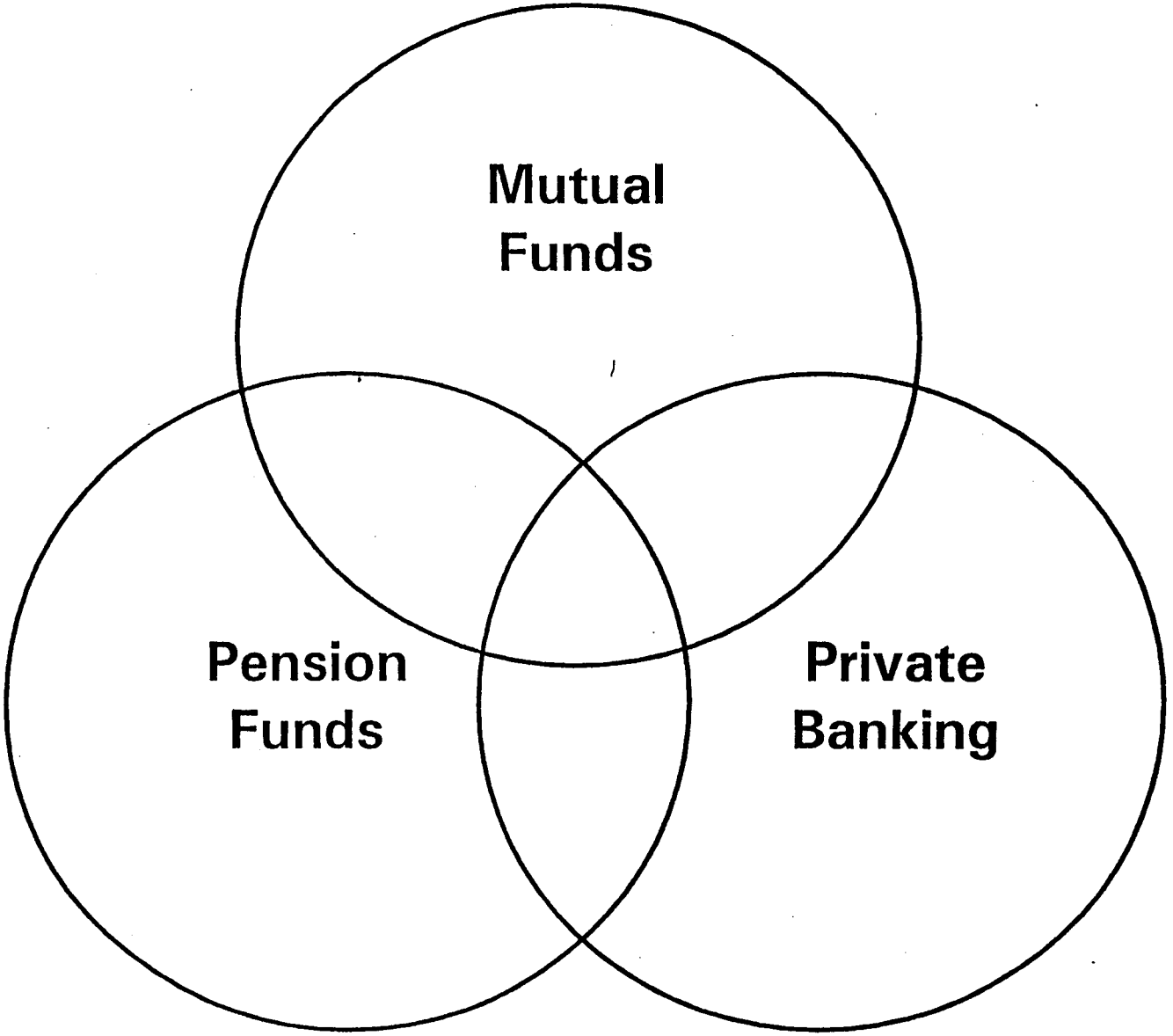
Fourth, pension funds take two principal forms, those guaranteeing a level of benefits and those aimed at building beneficiary assets from which a pension will be drawn (see below). Defined-benefit pension funds can buy securities directly in the market, or place funds with banks, trust companies or other types of asset managers, often aided by fund consultants who advise pension trustees on performance and asset-allocation styles.

Defined-contribution pension programs may operate in a similar way if they are managed in-house, creating proprietary asset pools, and in addition (or alternatively) provide participants with the option to purchase shares in publicly-available mutual funds.

The structure of the asset management industry can be depicted in terms such as Exhibit 3, with significant overlaps between the three types of asst pools to the point where they are sometimes difficult to distinguish. We have noted the linkage between defined-contribution pension funds and the mutual fund industry, and the

Exhibit 3

Interlinkages in Asset Management



association of the disproportionate growth in the former with the expansion of mutual fund assets under management. There is a similar but perhaps more limited linkage between private clients assets and mutual funds, on the one hand, and pension funds, on the other. This is particularly the case for the lower-bound of private client business, which is often commingled with mass-marketed mutual funds, and pension benefits awarded high-income executives, which in effect become part of the high net-worth portfolio.

The following three sections of this paper will consider the development of mutual funds, pension funds and private banking as the three principal types of asset management institutions dominating the global financial environment.

2. Mutual Funds

In the United States, as well as in Europe and Japan, the mutual fund industry has enjoyed rapid growth during the 1990s, although there are wide differences among national financial markets in the pace of development, in the character of the assets under management, and in the nature of mutual fund marketing and distribution.

The pattern of development in Europe has differed significantly from the United States, where at the end of 1996 there were more than 6,000 mutual funds in total and over 4,500 equity mutual funds available to the public—more than the number of stocks listed on the New York Stock Exchange—with average annual growth in excess of 22% between 1975 and 1996 and almost $4 trillion of assets under management in all funds at the end of 1997 (about 13% of household net financial wealth, more

than life insurance companies and about equal to the total assets of commercial banks). Only a part of mutual fund growth is attributable to new net investments in this sector of the financial system, of course, with the balance of the growth in assets under management attributable to reinvested earnings and capital gains. So the relative importance of equity funds and the performance of national stock markets is directly linked to observed differences in mutual fund growth patterns among countries and regions. Much of the growth is also attributable to the use of mutual funds for retirement savings, capturing roughly 17% of U.S. retirement assets in 1996 (see below).

Measured in relation to stock market capitalization at the end of 1996, mutual fund assets accounted for slightly over half of market cap in the United States, about 31% in the EU and about 9% in Japan.[6] Within Europe, mutual funds in France accounted for the largest percentage of market capitalization with 29%, followed by 17% in Germany, 12% in the United Kingdom and 11% in Switzerland.

Types of Funds

The term "mutual funds" in the U.S. encompasses both open-end and closed-end funds, the vast majority of which are actively managed. Closed-end funds are publicly traded with a stated net asset value comprising mainly listed shares, although they may be permitted to hold a certain percentage of unlisted shares as well. Market

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[6] According to the OECD, personal financial assets in Europe have grown at an average rate of about 11% in the decade ending 1996, compared to about 8% in the United States and Japan, with an disproportionately high growth rate of over 18% in the case of Italy during this period.

Exhibit 4

Types of Mutual Funds by Investment Objective

Aggressive growth funds seek maximum capital appreciation; current dividend income is not a significant factor. Some funds invest in out-of-the-mainstream stocks, such as those of struggling companies or stocks of companies in new or temporarily out-of-favor industries. Some may also use specialized investment techniques, such as option writing or short-term trading.

Balanced funds generally try to achieve moderate long-term growth of capital, moderate income from dividend and/or interest payments, and moderate stability in an investor's principal. Balanced funds invest in a mixture of stocks, bonds, and money market instruments.

Corporate bond funds purchase primarily bonds of corporations based in the United States; they may also invest in other fixed-income securities, such as U.S. Treasury bonds.

Flexible portfolio bonds seek a high level of interest income by investing in the debt securities of companies and countries worldwide, including those of issuers in the United States.

Global equity funds seek capital appreciation by investing in securities traded worldwide, including those of issuers in the United States.

Asset-backed funds seek a high level of interest income by investing primarily in mortgaged-backed and other asset-backed securities.

Growth-and-income stock funds invest mainly in the common stock of companies that offer potentially increasing value as well as consistent dividend payments. Such funds attempt to provide investors with long-term capital growth and a steady stream of income.

Growth funds invest in the common stock of companies that offer potentially rising share prices. These funds aim to provide capital appreciation, rather than steady income.

High yield bond funds seek a high level of interest income by investing at least two-thirds of their assets in lower rated corporate bonds (rated Baa or lower by Moody's and BBB or lower by Standard and Poor's).

Income bond funds seek a high level of income by investing in a mixture of corporate and government bonds.

Income equity funds seek a high level of income by investing mainly in stocks of companies with a consistent history of dividend payments.

Income mixed funds seek a high level of interest and/or dividend income by investing in income-producing securities, including equities and debt instruments.

International equity funds seek capital appreciation by investing in equity securities of companies located abroad (these securities at all times represent two thirds of the fund portfolios).

National municipal bond funds (long-term) seek dividend income by investing primarily in bonds issued by states and municipalities.

Precious metal funds seek capital appreciation by investing at least two-third of their fund assets in securities associated with gold, silver, and other precious metals.

State municipal bond funds (long-term) seek dividend income by investing primarily in bonds issued by states and by municipalities of one state.

Taxable money market mutual funds seek the highest income consistent with preserving investment principal. Examples of the securities these funds invest in include treasury bills, commercial paper of corporations, and large-denomination bank certificates of deposit.

Tax-exempt money market funds seek the highest level of tax-free dividend income consistent with preserving investment principal.

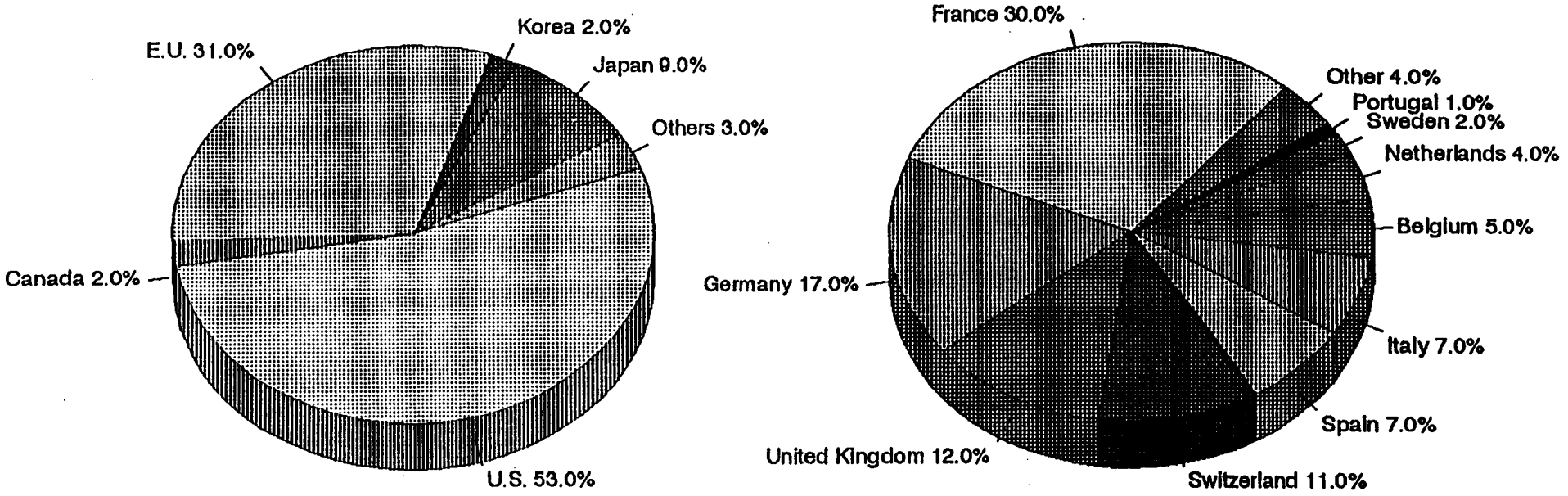
Government income funds seek income by investing in a variety of government securities.

Source: Investment Company Institute, Mutual Fund Factbook (Washington, D.C.: ICI, 1997).

Exhibit 5

Breakdown of Global and European Mutual Fund Markets, 1996

($5.3 Trillion)



Source: FEFSI

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prices of closed-end finds may reflect either a discount or premium to the stated net asset value in market trading. Open-end funds comprise pools of assets that are fully reflected on a daily net asset value basis in the subscription or redemption price of their (non-traded) shares. Mutual funds must pay-out at least 95% of gains in the form of dividends to shareholders, although pass-through of losses is not permitted.

Mutual funds come in all shapes and sizes. At least 21 different mutual fund investment objectives have been identified—see Exhibit 4. There are money market funds, tax-efficient funds, investment-grade bond funds, junk bond funds, balanced funds, global funds, country funds, growth funds, income funds, growth and income funds, sector funds, hedge funds, currency funds, funds with various types of derivatives overlays, and so on. Among open-end mutual funds there are also passive index or "tracker" funds, which attempt to replicate a particular index such as the U.S. Standard & Poors 500 or the German DAX. There are actively-managed closed-end funds, whose fixed number of shares may be traded separately in the market, possibly at a premium or discount to book value. There are closed end funds, including hedge funds, whose shares are not publicly traded at all. And there are a variety of fund-like structures, such as limited partnerships, used to pool financial investments of number of (usually sophisticated) investors for real estate participations, venture capital or other special-purpose investments. Exhibit 5 shows the distribution of global mutual fund assets, as well as the distribution of mutual fund assets within Europe.

In terms of asset allocation, mutual funds and unit trusts in Europe are roughly evenly split between money market funds, fixed-income funds and equity funds, but

this masks the wide inter-country differences shown in Exhibit 6. The French market has been dominated by money market funds, in part due to tax advantages, while the British market has virtually been monopolized by equity funds. At the same time, fixed-income funds take a disproportionate share of the market in other European countries, notably in Germany, reflecting both investor preferences and the limited state of development of national equity markets in the countries concerned.

In the United States, on the other hand, mutual funds were traditionally invested mainly in equities—in 1975, over 82% of the fund assets under management were equities and a mere 10% and 8% in bonds and money market instruments, respectively. By 1985 this picture had changed completely, with the equity component declining to 24% and money market funds capturing 49%, due both to relatively poor stock market performance in the 1970s and early 1980s, and to the substitution of money market mutual funds for bank savings products by households searching for higher yields at a time when banks continued to be limited by interest-rate regulation on deposits. By 1995 the U.S. pattern of mutual fund investments had shifted yet again, with equities accounting for 44% of the total, and money market and bond funds 28% each.[7]

Mutual Fund Distribution

There are also wide differences among countries in how mutual funds are

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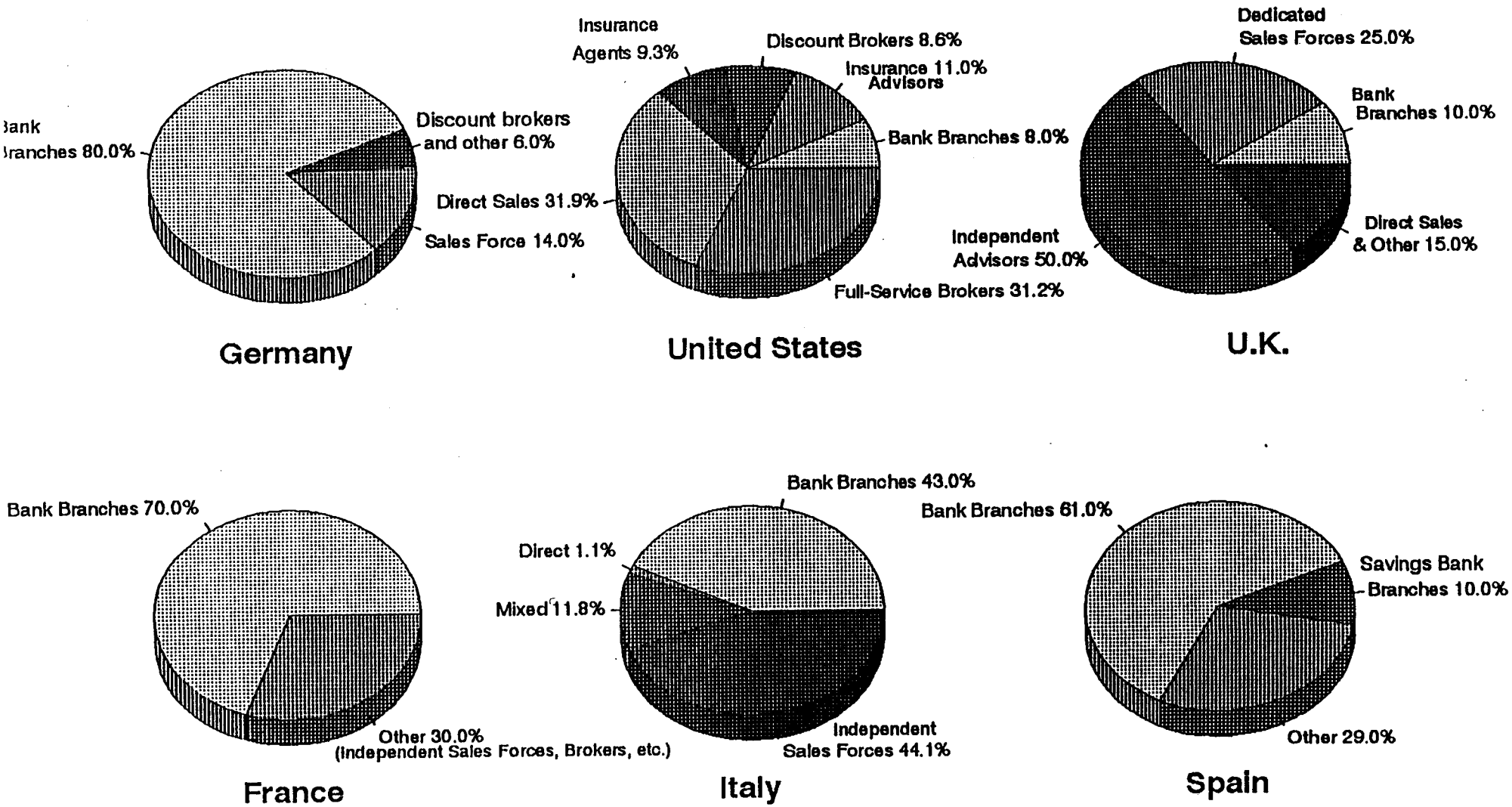
[7] Investment Company Institute, *Mutual Fund Fact Book* (Washington, Investment Company Institute, 1996).

Exhibit 6

Estimated Mutual Fund Market Share by Distribution Channel in Major Markets, 1996



Source: EFID, Banca Fideuram, Investment Company Institute, Securities Industry Association.

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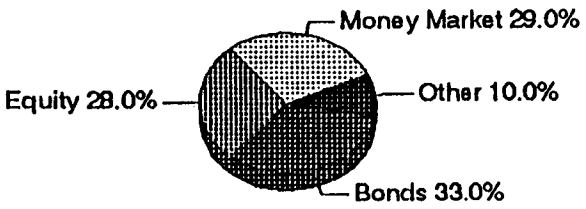
distributed, which in turn are linked to comparative mutual fund growth and structure. As shown in Exhibit 7, U.S. mutual fund distribution has been concentrated on full-service broker-dealers which maintain large retail sales forces capable of penetrating the household sector and which are compensated mainly on the basis of commissions earned and assets under management (AUM). In recent years, discount brokers have made substantial inroads in mutual fund distribution, compensating for reduced sales effort and limited investment advice by lower fees and expenses. Insurance agents account for 15% of U.S. mutual fund distribution, focusing on mutual funds with an insurance wrapper such as fixed and variable annuities and guaranteed investment contracts (GICs). Bank branches have played a limited role in the U.S. due to the legacy of regulatory constraints—accounting for the relatively small 13% distribution share through bank branches—although deregulation and cross-selling opportunities with retail commercial banking products is likely to boost the share of bank-based mutual fund sales in the future. The bewildering array of available mutual funds and asset managers has led to a growing market opportunity for independent advisers, whose share in mutual fund distribution reached 18% in 1996. According to a recent study, professional advisers in the United States had a major role in the selection of mutual funds by retail investors. Of total households sampled, 59% had consulted on fund purchases with a professional financial adviser. Of those, 13% simply directed the adviser to place purchase orders, 74% selected from among several funds recommended by the adviser, and 13% effectively delegated full discretion on fund

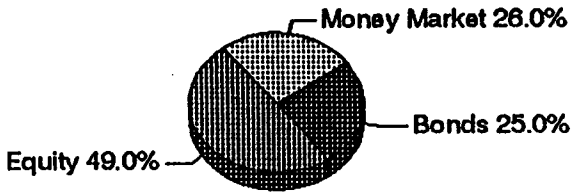
Exhibit 7

Comparative Domestic Mutual Fund Assets by Investment Type, 1997

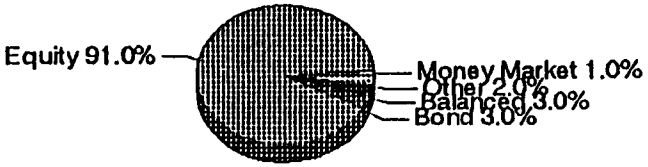
(US $Billions)



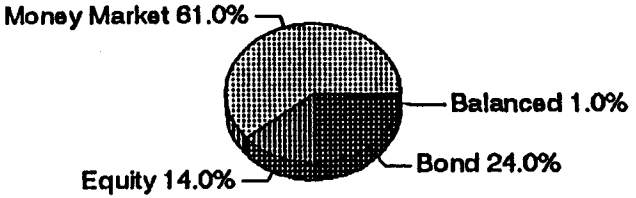
Europe
($1,700)



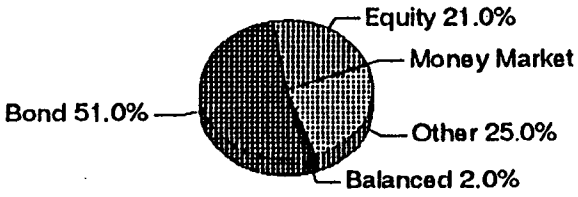
US
($3,500)



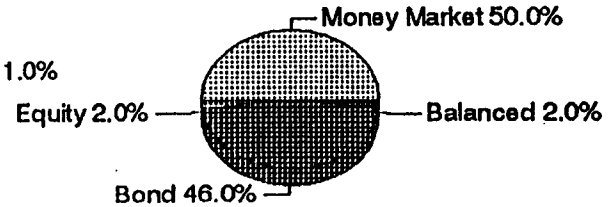
UK
($156)



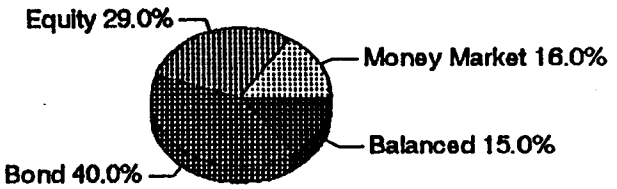
France
($365)



Germany
($213)



Spain
($90)



Italy
($88)

Source: EFID; Lipper Analytical Services International; Goldman Sachs.

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purchases to the adviser.[8]

A 1996 forecast suggests that U.S. mutual fund market shares by 2001 will be distributed 33% by full-service brokers, 11% by commercial banks and thrifts, 5% by insurance companies and insurance brokers, 9% by financial planners, and 43% by direct marketers and institutional fund managers. This forecast indicates some increases in market-share by the latter two distribution channels.[9]

In Europe, mutual fund distribution through bank branches dominate in countries such as Germany (80%), France (70%) and Spain (61%), with U.K. distribution concentrated among independent advisers and Italian distribution roughly split between bank branches and independent sales forces. The dominance of universal banks, savings banks and cooperative banks as financial intermediaries in most of the continental European countries explains the high concentration of mutual fund distribution via branch networks.[10] One major exception was Robeco, a Dutch fund management company, which was highly successful in penetrating the retail market, only to be taken over by Rabobank after a brief joint venture to market each other's products.

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[8] Investment Company Institute, Understanding Shareholders' Use of Information and Advisers (Washington, D.C.: Investment Company Institute, 1997).

[9] Bernstein Research, *The Future of Money Management in America – 1997 Edition* (New York: Sanford Bernstein, 1996).

[10]German mutual fund distribution is dominated by the major banks, with DWS (Deutsche Bank) controlling a 24% market share, DIT (Dresdner Bank) 14.1%, and ADIG (Commerzbank and the merged Bayerische Hypo and Bayerische Vereinsbank) 21.1%. However, foreign players such as Fidelity of the U.S. and Bank Julius Baer of Switzerland appear to be making significant inroads even as local competitors strive to improve investment performance, increase the range of products available, and enhance their non-European (particularly U.S.) funds marketed to German investors.

A development that has had a significant role in fund distribution in the United States is the mutual fund supermarket, such as the *OneSource* mutual fund supermarket established by Charles Schwab & Co. in 1992. This allows investors to choose between hundreds of funds by telephone, by mail or on-line over the Internet using Schwab-provided software. It includes discount brokerage-account management, integrated financial statements, basic research, and user-friendly approaches to personal portfolio planning. This service comes at a cost of some 25-35 basis points to the fund manager using distribution via Schwab. It substantially increases visibility and reduces distribution costs of smaller funds, and has been instrumental in prompting some of the major U.S. retail broker-dealers and banks to sell externally-managed funds alongside in-house funds. Meanwhile, direct marketers have been providing more investment advice, and full-service brokerage firms have moved down-market to attract less affluent clients even as discount services have moved up-market with innovative do-it-yourself asset management techniques. And many mutual funds are sold at net asset value to independent financial planners, who then levy their own charges on clients. It is likely that the same sort of innovation in distribution will also develop in continental Europe before long as well to challenge the general dominance of bank-based mutual fund distribution, probably facilitated by ease of access over the Internet.

A key question is how mutual funds will be distributed in the future European unified financial market. Distribution without advice will clearly be most efficient over the Internet or other on-line interfaces with the retail client. This means that

transactions services can be separated from *investment advice*, both functionally and in terms of pricing. Advice can be delivered only in part in disembodied form, with value-added depending partly on interpretive information on investments and partly on personal counseling that the client must be willing to pay for. With this advice increasingly likely to come from independent financial planners in many markets, traditional distributors of mutual funds are encroached-upon from both sides and have had to react in order to maintain market share.

In Europe, it is also probable that the major American mutual fund companies like Fidelity and Vanguard will try to penetrate the bank-based distribution channels that have traditionally prevailed in most countries, along with U.S. broker dealers like Merrill Lynch and Morgan Stanley Dean Witter Discover, discounters such as Charles Schwab, as well as Citicorp as the only U.S. bank with a European presence of sufficient mass to use as a platform for mutual fund distribution. U.K. fund managers and insurance companies will try to do the same thing on the continent, even as continental European banks and insurance companies strive to adapt their powerful distribution systems to more effective asset management and mutual-fund marketing, and to sharpen-up their product range and investment performance.

Sources of Mutual Funds Earnings

Operators of mutual funds have a number of different sources of earnings. First is the marketing of funds which carry a sales charge (front-load) and those which carry an exit fee (back-load) or an exit fee that depends on the holding period (digressive

back-load), sometimes called "contingent deferred sales charges." In the United States, the 1996 asset-weighted front-loads averaged 0.21% for directly-marketed funds, 1.88% for broker-sponsored funds, and 2.50% for independent load fund groups marketed through intermediaries. The first of these groups had zero deferred loads, the second averaged 1.87%, and the third 1.26%.

The second source of earnings is management fees, usually based on the amount of assets under management, that can range from as little as 15 basis points for some passive funds to 200 basis points or more for actively managed equity funds. U.S. directly-marketed funds in 1996 averaged expenses of 0.84% of assets, broker-sponsored funds 1.31%, and independent funds sold through intermediaries 1.24% of assets. In some cases, management fees are linked to performance (e.g., 30% of capital gains achieved above some designated benchmark), and in some cases they are linked to the marketing and advertising of the fund itself, such as the so-called 12(b)1 fees in the United States. In 1996 the all-in weighted mean expense ratio for U.S. domestic equity mutual funds ranged from 1.26% of assets for bare-bones management services and 2.26% of assets for "wrap" accounts which bundle portfolio advice with fund management services. Based on historical performance, these fees amounted to 7.6% and 13.6%, respectively, of five-year total returns and 10.3% and 18.5%, respectively, of 25-year total returns.[11] The pricing trends in the U.S. market have been for loads to decline and in some instances to be waived, for expense ratios

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[11] Michael L. Goldstein et al., *The Future of Money Management in America* (New York: Bernstein Research, 1997).

to be relatively flat, and for wrap accounts to increase somewhat in terms of market share. Indeed, mutual find charges and expenses in the U.S. mutual fund market have been remarkably resistant to erosion even in the face of intense competition from low-cost marketers like Vanguard, averaging 96 basis points for all equity funds. Explanations have included investor apathy and a high correlation between compensation of mutual fund trustees and expense ratios.[12]

Management fees in Europe for bond funds range from 1.59% in Spain to 0.49% in Germany, for stock funds from 2.06% in Spain to 0.75% in Germany, and for money market funds from 1.31% in Spain to 0.49% on the United Kingdom.[13]

Most observers have concluded that pressure on mutual fund loads and fees will intensify in most markets, as competition heats-up among the various contenders and as the options facing retail clients become increasingly transparent and easy to access—including cross-border sales of mutual fund services. The fact is that the present value of front-loads is high relative to expected earnings, while management fees and other fixed charges can cut heavily into mutual fund total returns. So mutual fund alternatives that are cheaper but not demonstrably inferior in performance will clearly be highly attractive to the investor.

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[12]Robert Baker, "Wanted: Shareholder Rights for Mutual Funds," *Business Week*, September 1, 1997.

[13] Davis International Banking Consultants, *Trends in European Asset Management* (New York: Smith Barney, 1996).

Mutual Fund Competition

Competition between mutual funds can be among the most intense anywhere in the financial system, heightened by the aforementioned analytical services which track performance of funds in terms of risk and return over different holding periods and assign ratings based on fund performance. These fund-rating services are important, because the vast majority of new investments tend to flow into highly-rated funds. For example, in the United States during the period 1993-96, about 85% of all new money was allocated to funds rated 4- or 5-star by Morningstar, Inc. These same highly-rated funds captured roughly three-quarters of all mutual fund assets at the end of 1996.[14] In addition, widely-read publications like *Business Week* and *Fortune* in the United States publish regular "scoreboards" among publicly-available mutual funds based on such ratings and, together with specialized investment publications and information distributed over the Internet, have made mutual funds one of the most transparent parts of the retail financial services sector. These developments are mirrored to varying degrees in Europe as well, notably in the United Kingdom.

Despite clear warnings that past performance is no assurance of future results, a rise in the performance rankings often brings in a flood of new investments and management-company revenues, with the individual asset manager compensated commensurately and sometimes moving on to manage larger and more prestigious funds. Conversely, serious performance slippage causes investors to withdraw funds,

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[14] Ibid.

taking with them a good part of the manager's bonus and maybe his or her job, given that the mutual fund company's revenues are vitally dependent on new investments and total assets under management. A gradual decline in the average sophistication of the investor in many markets—as mutual funds become increasingly mass-market retail-oriented and interlinked with pension schemes (see below)—performance ratings, name-recognition and "branding" appear to be progressively more important in defining competitive performance in the industry.

Historically, at least in the United States, there has been little evidence of increasing market- concentration in the mutual fund industry. There are 25,000 entities that run funds and/or give investment advice, of which some 6,000 have assets under management in excess of $25 million. The five-firm ratio has been between 32% and 34%, the top-5% ratio between 65% and 68%, and the top-10% ratio between 81% and 82% from 1990 to 1996.

Factors that seem to argue *for* greater industry concentration in the future are economies of scale and band-name concentration among progressively less sophisticated investors in taxable funds and mutual funds that are part of retirement accounts battling for attention among the enormous number of funds vying for their business.[15] Arguments *against* further concentration include shifts in performance track-records and the role of mutual fund supermarkets in distribution, which increase the relative marketing advantage of smaller funds.

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[15] A 1996 money management IQ test designed to calibrate basic investing skills was passed by less than 20% of respondents. Another survey indicated that only a small minority of mutual fund investors actually perused the prospectus, or even a summary of the prospectus, before they invested. See Michael L. Goldstein et al., *The Future of Money Management in America* (New York: Bernstein Research, 1997).

One factor that may promote continued *fragmentation* of the mutual fund industry is that size itself can lead to significant performance problems. For example, the largest actively-managed U.S. equity fund, the Fidelity Magellan Fund, had grown to about $56 billion at the beginning of 1997. Such enormous size makes it difficult to beat the market indexes, with even successful bets on small-company stocks making little difference in the bottom line. Moreover, Magellan's trades eventually became so large they were often telegraphed to the market and front-run by smaller, more nimble competitors, resulting in rougher prices even in large-cap stocks.

Magellan's size problem and its role as the flagship fund of the entire Fidelity Investments mutual funds group assured that, when it encountered performance problems in 1996, those problems were transmitted to the group as a whole. Propelled by Magellan's stellar long-term performance (it had produced total returns to shareholders of 7,445% from 1977 through 1996, or six times the capitalization growth of the U.S. equity market as a whole), the Fidelity group had become the top firm in the world mutual fund industry—with $477 billion in assets under management in almost 200 mutual funds at the end of 1996. The firm attracted more new investments (a 20% market share) than any other competitor in the five years to 1995 using a strategy of active asset management, aggressive and expensive marketing with heavy reliance on Magellan and other strong funds and their managers as star performers in the industry.

Given the disadvantages of Magellan's size, its fund manager was forced to take increasingly risky bets on the direction of the overall market. Problems arose at the end

of 1995, when Magellan's then manager, Jeffrey Vinik, bet that U.S. equity markets would fall and therefore shifted out of technology stocks into bonds, causing a total return for the year to drop to 11.69% against about twice that for the S&P 500 index, and pushing Magellan's ranking down to 602 out of 699 U.S. growth funds. Vinik was quickly replaced. But the damage was done. Investors deserted Fidelity, feeling betrayed by the "surprise" that a so-called "growth" fund had been allowed to shift to a no-growth assets, thereby upsetting their individual portfolios. Eight other top Magellan diversified fund managers, together accounting for $120 billion in assets, along with 12 of the 25 managers of Fidelity specialized funds, left the firm shortly thereafter in a hemorrhage of senior staff. The result was a significant net outflow of funds from Fidelity during 1996—notably into mutual fund companies such as Vanguard that promoted passive funds and low expenses, and a major decline in the Fidelity group's U.S. market share for new investments from 20% to less than 5%.[16]

In addition to performance, mutual fund companies and securities broker-dealers have aggressively added banking-type services such as checking and cash-management accounts, credit cards and overdraft lines. They provide user-friendly, integrated account statements and tax reporting. Client contact is based on easy access by telephone, mail and the Internet. Bank competitors in the mutual fund business have thus seen their retail competitive advantage increasingly reliant on a fragile combination of high-cost branch networks and deposit insurance. In response,

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[16] John Authers, "Victim of Its Own Success," *Financial Times*, January 22, 1997.

many began to reduce sales charges and fund expenses, introducing their own fund supermarkets to compete with those already established by firms like as Charles Schwab, and bundling banking and investment services under more attractive pricing schemes. In the United States at least, mutual funds operated by commercial banks and thrifts have not been among the best performers, this has further encouraged bank clients to segment their financial activities into banking and investment services. The 1,500 proprietary funds sold by banks in many cases have short track-records. Banks also have lacked asset management expertise, especially in areas such as foreign equities. And there have been continuing problems in the quality of investment advice available to clients through bank branches.[17]

Investment banks have likewise increased their mutual fund activity, presumably with the view that this part of the securities industry is more capable of supporting significant, sustained returns than is wholesale investment banking, such as debt and equity capital markets and corporate advisory services, where competition has become cutthroat, capital-intensive, and subject to a high degree of earnings instability. For example, Goldman Sachs—traditionally without much in the area of retail financial services and with virtually no in-house fund distribution—negotiated to sell its mutual funds through the Charles Schwab's *OneSource* mutual fund supermarket in an effort to build its family of 34 mutual funds with a total of $45 billion (out of a total assets under management of $100 billion), previously sold only though intermediaries such

[17] Edward C. Baig, "Bank Funds: Playing Catch-up," *Business Week*, March 24, 1997.

as brokers, financial advisers, insurance agents, banks or corporations. This arrangement was part of the firm's "commitment to building a world-class global asset management business."[18] For investment banks, better access to retail distribution can clearly help in competing for new securities issues.

Insurance companies have likewise considered the mutual fund business to be a strong candidate for strategic development, especially in the face of competition in their traditional annuities business and the cross-links that have emerged in some countries between the pension fund and mutual fund industries. Insurance-based groups such as AEGON of the Netherlands, Groupe AXA of France, BAT of the United Kingdom, Zurich Insurance of Switzerland, Prudential and Legal & General of the United Kingdom, as well as the Travelers Group of the United States have pushed into the mutual fund business using a variety of strategies for gaining access to the retail investor.

Finally, there are competitors in the mutual fund business that are not easy to classify. One is American Express, which at one time failed in its attempt to become a full-service financial services supermarket, but has since successfully focused on travel-related services and retail financial planning though its Investors Diversified Services (IDS), which focuses heavily on mutual funds.

There have been successful examples of direct fund distribution even in heavily bank-dominated European financial systems, such as Direct Anlage in Germany and

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[18] Letter to Goldman Sachs staff from Jon S. Corzine and Henry M. Paulsen, Jr. dated February 17, 1997.

Virgin Direct in the United Kingdom. Cortal Banque (affiliated with Banque Paribas) in France had a client-base of 150,000 and assets under management of $3 billion in 1995, built entirely though telephone sales and other direct media.[19] Examples of an effective cross-border mutual fund distribution include Fidelity Investments of the United States and Fleming Flagship of the United Kingdom, which by 1996 had 20 registered UCITS approved in 13 different European markets totaling $3 billion, with asset management centers in London, New York and Hong Kong and a distribution center in Luxembourg. Such cross-border incursions into idiosyncratic national markets requires high levels of product performance, excellence in service quality, and effective distribution techniques that are appropriate to the nation environment—either on a stand-alone basis or in joint ventures with local financial firms. This suggests that highly targeted approaches which provide specific client segments with products superior to those available from traditional vendors is probably the only viable way to develop a pan-European approach to retail asset management.

Competition in the mutual funds business thus covers a rich array of players, ranging from commercial banks and securities broker-dealers to specialized mutual fund companies, discount brokerages, insurance companies and nonfinancial firm. Such interpenetration of strategic groups, each approaching the business from a different direction, tends to make markets hyper-competitive. This is the likely future competitive structure of the mutual fund industry, particularly in large, integrated

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[19] Davis International Banking Consultants, *Trends in European Asset Management* (New York: Smith Barney, 1996).

markets such as the United States and—with currency unification—the European Union.

Mutual Fund Performance and the Importance of Reputation

Mutual fund business can be treacherous territory for the retail investor, a problem that has become more serious as mutual funds have been marketed to ever-wider circles of retail clients to capture both discretionary and pension assets.[20] How are the uninitiated supposed to pick high-performance fund managers?

Both equity and bond mutual funds have over time tended to underperform the market. In the U.S. over the ten-year 1987-1996 period, no more than 26% of equity mutual funds beat the S&P 500 Index during four different time intervals. Performance in other sectors has not been much better—see Exhibit 8 for a comparison of the performance of different types of U.S. funds with their respective indexes. Exhibit 9 shows the relative performance of publicly available growth and value funds against the S&P 500 stock index and the Vanguard Trust-Index 500 Portfolio after adjusting for management and related fees, but not for loads. In all, 197 funds under performed the index fund, and only 49 outperformed the index during the eleven-year period covered. Unless the retail investor knows something special about a particular fund manager, it would seem that a low-fee, passively managed index fund is likely to produce better results. Although consistent information is not available for Europe, it

[20] See the following section for a discussion of the role of mutual funds in defined-contribution pension programs.

Exhibit 8

Comparative U.S. Mutual Fund Performance Against Indexes

Type of fund	1-year total return	10-year avg. annual return
Aggressive growth stock	-3.31%	13.37%
Growth stock	-2.05%	12.75%
Growth and income stock	-1.47%	11.77%
S&P 500 Index	**1.31%**	**14.38%**
International foreign stock	-2.91%	15.72%
Morgan Stanley Foreign Stock Index	**7.78%**	**17.55%**
Government bond-general	-3.56%	8.29%
Government bond-Treasury	-4.10%	8.17%
Lehman Bros. Government Bond Index	**-3.37%**	**9.57%**
Municipal bond-national	-5.18%	8.43%
Lehman Bros. Municipal Bond Index	**-5.60%**	**9.43%**

Source: Fortune, April 1, 1995

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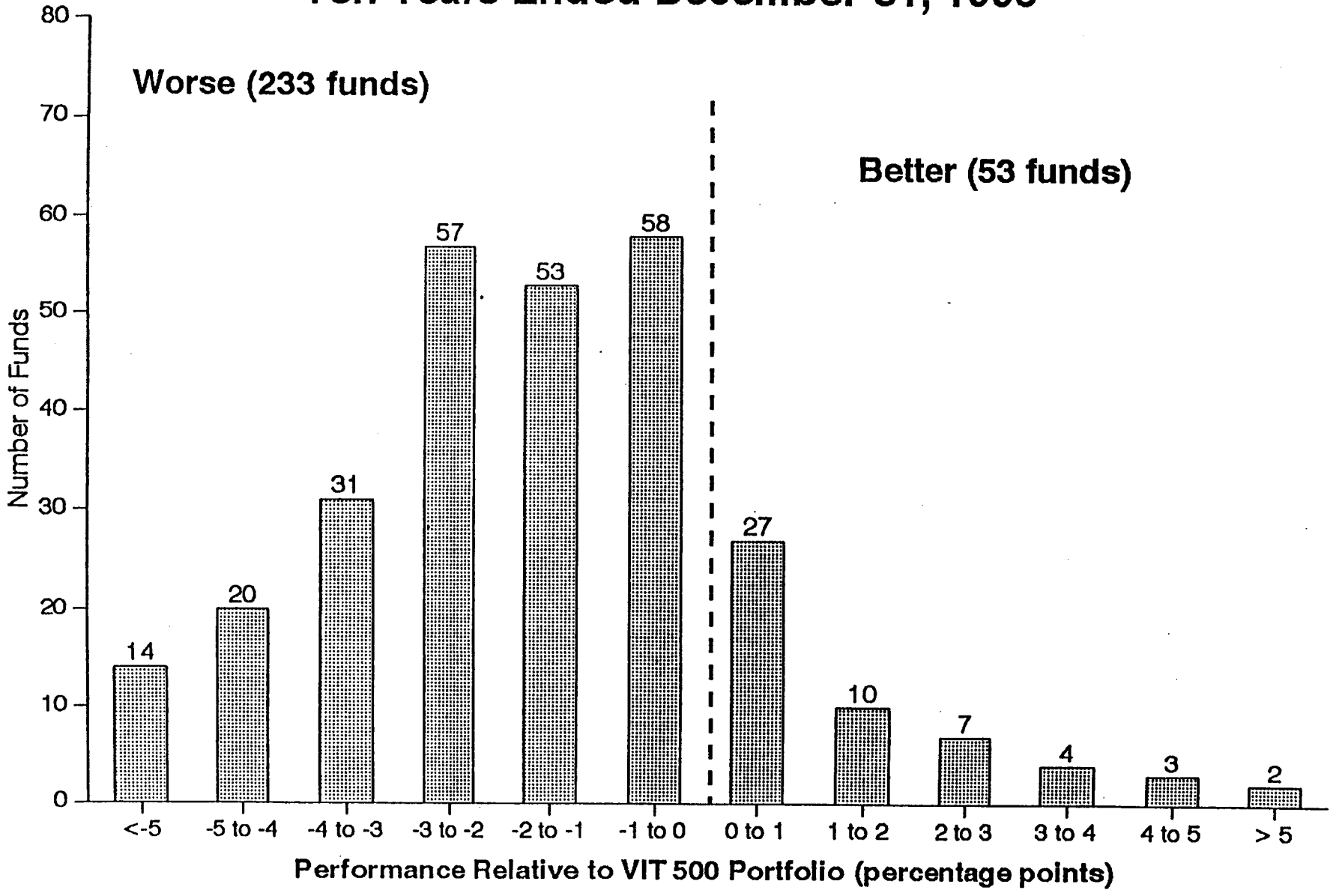
Exhibit 9

Growth and Value Funds Versus 500 Portfolio
Ten Years Ended December 31, 1996



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seems doubtful that portfolio managers performed much better in the comparatively less competitive and less transparent European retail investment environment.

Still, people tend to invest mainly in actively managed funds, despite the available evidence that they offer the investor lower risk-adjusted returns and on average underperform index funds. Why? One possible explanation is the perceived value of professional fund management that is not incorporated in the share price —that is, the net asset value in the case of open-end funds. A recent study that examines the performance of some 270 U.S. open-end equity funds over a 10-year period finds that past performance in fact *is* related to future performance, and that "sophisticated" investors moving into those funds that have performed well in the past also do well in the future.[21] But since actively-managed funds perform poorly on average, there must be plenty of other investors who also do poorly. So why do people continue to invest in funds that perform poorly? The focus has been on "disadvantaged" investors who:

- Act on the basis of advertising and broker advice, and are too lazy to do their own research or move their money;
- Are restricted by fiduciary obligations from investing in better-performing funds—this goes mainly for pension accounts; or
- Are locked into particular investments by reluctance to realize capital gains.

Even sophisticated investors cannot take short positions in poorly-performing

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[21] Martin J. Gruber, "Another Puzzle: The Growth of Actively Managed Mutual Funds," Presidential address presented at the American Finance Association, San Francisco, January 1996, *Journal of Finance*, May 1996.

funds among their investments. All they can do is invest *new* money elsewhere in order to gradually reduce the weight of the bad performers. This suggests that the first category of disadvantaged investor, almost certainly the unsophisticated retail investor, is taking a disproportionate share of the underperforming funds. Indeed, the research finds that load funds perform just about the same as no-load funds, meaning that the disadvantaged investor basically pays the load for nothing, while the sophisticated investor in high-performance no-load funds gets the benefit of successful, professional management for nothing.

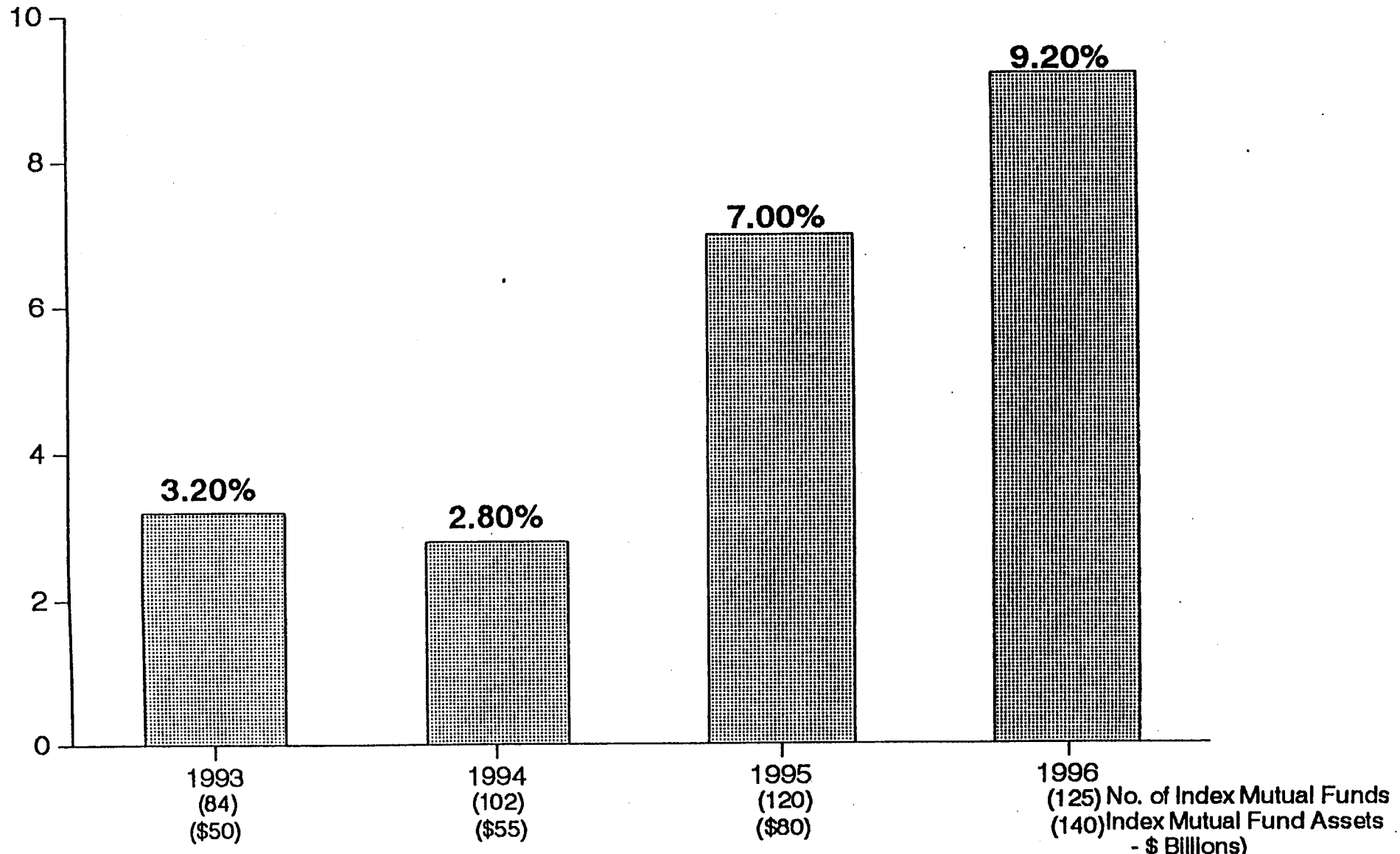
In view of such evidence, investors have increasingly relied on index funds, which as Exhibit 10 indicates have increased their market share rapidly, certainly in the U.S., during the 1990s. It has been argued that the continental European retail investor is more concerned with capital preservation than the American, British or even Japanese investor, given the relatively more limited experience with equity investments and exposure to volatile markets. Consequently, the benchmark tends to be the return on interest-bearing bank deposits together with assured capital preservation, making products like guaranteed return on investment contracts (GROIs)—which combine guaranteed principal plus a low contractual interest rate with an equity index option to provide modest up-side potential—very popular in a number of markets.

Especially in light of the spotty overall performance of the mutual fund industry against benchmarks, brand-name and reputation of fund management companies is of critical importance. Since mutual fund vendors normally run families of funds, questionable conduct such as personal trading by fund managers or violations of

Exhibit 10

Number, Assets and Net Cash Flows Into Index Funds as a Percentage of Net Flow Into All American Equity Funds

(Annual and Year-end Figures)



Sources: Investment Company Inst.; Lipper Analytical Services; Morningstar, Inc.

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portfolio allocation or valuation rules can easily contaminate the competitive position of the entire product range. For example, in 1995 personal trading ahead of fund purchases came to light at the Fidelity Investments, which caused the firm to sack the individuals involved and to substantially restrict personal investment activity on the part of fund managers. Other U.S. mutual companies followed suit, and a "blue ribbon" industry panel was appointed to look into what restrictions on personal trading were appropriate for fund managers. Securities and Exchange Commission Chairman Arthur Levitt noted that, if he were on the board of a fund, "I would have reservations about portfolio managers actively trading for their own accounts...With millions of investors migrating from insured bank accounts, this industry cannot afford even the appearance of conflicts of interest."[22]

The reputation-effect also made itself felt when many money market mutual funds (MMMFs) "broke the buck" after U.S. interest rates turned up in 1994. Large numbers of funds managed by all kinds of firms were jockeying for position in the booming MMMF business in 1992 and 1993. Retail clients, discouraged by declining interest rates, deserted bank deposits and certificates for higher-yielding assets with equal or greater liquidity together with check-writing privileges and credit card services. However, the funds were constrained in their investments to Treasury bills, highly-rated commercial paper and similar short-term money market instruments, so

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[22] Robert McGough and Judith Burns, "Levitt Advises Fund Managers to Fix the Roof," and Robert McGough, "Few Mutual Funds Ban Personal Shorting," *The Wall Street Journal*, May 23, 1996 and June 24, 1996, respectively.

that MMMF managers found it difficult to distinguish themselves in terms of performance. Yet the mutual fund performance-ranking services turned even the smallest of total-return differences into discrete rank-order shifts, which made a major difference to the asset-size of the funds and to the compensation of those managing them. So managers began to use fixed-income derivatives to shift their funds' maturity profiles to increase duration and benefit from declining interest rates without altering their underlying asset mix. All of this was perfectly legal and proper.

Unfortunately, U.S. interest rates started to increase in early 1994 and continued up for the rest of the year, inflicting significant losses on many MMMFs. Suddenly, a share bought for a dollar was worth a good deal less than a dollar, and retail clients, certain that they had bought the "safety-equivalent" of a bank deposit, were outraged. Many fund management firms feared that the investors would abandon their MMMFs and return to bank certificates of deposit, possibly unloading other funds of the management company as well. Sensing this, most mutual fund companies moved quickly to top-up their MMMFs with their own money to protect their reputations. Altogether, more than $650 million was put into the funds by mutual fund management companies to repair the damage.[23]

In another example, during 1996 Morgan Grenfell Asset Management (MGAM) in London found that one of its star portfolio managers had invested heavily in illiquid European small-company stocks, leading to substantial overvaluation of the funds'

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[23] Roy C. Smith and Ingo Walter, *Street Smarts: Linking Professional Conduct and Shareholder Value in the Securities Industry* (Boston: Harvard Business School Press, 1997).

assets. Supervision of the portfolio manager, who had generally been highly regarded, was clearly inadequate. Deutsche Bank, MGAM's owner, immediately injected over $300 million to top-up the funds in September 1996 and provisioned a total of $710 million for investor compensation and regulatory penalties, an expensive lesson in maintaining the firm's reputation.[24]

Despite such upsets, from the retail client's perspective investing in mutual funds often involves fewer hazards than making individual investments. The reason is the generally high degree of transparency, with investigative financial reporters and analysts continuously and publicly comparing the performance of mutual funds over various investment periods. Their track records are easy to determine. Even small blemishes are clearly identified.[25] And the reliance of management companies on solid reputations and band-names reinforces the value of the franchise as essential in protecting the individual mutual fund investor.

Governance and Regulation of Mutual Funds

Governance of mutual funds usually lies with a board of directors elected by the shareholders, with new directors nominated by the board—nominations that tend to be strongly influenced by the management company. Directors are responsible making sure that the objectives of the fund are carried out, as well as other policy matters

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[24] John Gapper and Roger Taylor, "Rescue to Inject $300 Million Into Suspended U.K. Funds," *Financial Times*, September 4, 1996.

[25] For a complete discussion, see Roy C. Smith and Ingo Walter, *Street Smarts: Linking Professional Conduct and Shareholder Value in the Securities Industry* (Boston: Harvard Business School Press, 1997), Chapter 3.

such as establishing fund loads and expenses. They owe shareholders a duty of care and duty of loyalty, but they are specifically *not* responsible for asset selection. They are compensated by means of board and meeting fees, and in the United States are personally exposed to shareholder suits. Marketing and operation of mutual funds are generally covered by the applicable securities regulators—for example, the Securities and Exchange Commission and state securities regulators in the Unites States and the Securities and Investments Board in the United Kingdom—with disclosure usually required as to the fund's date of establishment, its objectives, its performance record, the identity and qualifications of the portfolio manager and the fund's directors, applicable fees and other charges, and how to buy and redeem shares.

In the United States, mutual fund regulations require strict fit-and-proper criteria for management companies of mutual funds sold to the public, as well as extensive disclosure of pertinent information. The National Securities Markets Improvement Act of 1996 makes the Securities and Exchange Commission responsible for overseeing investment advisers with over $25 million under management, with state regulators alone responsible for investment advisers with smaller amounts under management—advisers who had previously been co-regulated together with the SEC. The large investment advisers falling under SEC jurisdiction account for about 95% of U.S. assets under management, although the vast majority of abusive practices and enforcement problems occur among the smaller firms.[26]

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[26] Sana Siwolop, "Regulating Financial Advisers: Are the States Up To It?" *The New York Times,* June 29, 1997.

Threat of regulatory action and civil liability lawsuits keep the pressure on U.S. mutual fund boards to take their obligations to investors seriously to insure that the fund objectives are faithfully carried out. Some fund management companies, however, nominate individuals to serve as directors of numerous—sometimes a very large number—of funds from among those managed by the firm, perhaps raising questions whether such directors can fulfill all of their responsibilities to their investors. Still, if they are thought not to be doing so, they can expect to be the object of suits brought by lawyers representing the investors as a class. All of this information is in the public domain, accompanied by the aforementioned high degree of transparency with respect to fund performance plus ample media coverage and vigorous competition among funds and fund managers. This means that investors today face a generally fair and efficient market in which to make their asset choices. If they fail to choose wisely, that's their own fault. Overall, the mutual fund business, at least in the more developed markets, is probably a good example of how regulation and competition can come together to serve the retail investor about as well as is possible.

Beyond external regulation, mutual fund managers are supposed to follow the terms of the investment prospectus under which the fund is marketed, although in many funds they are permitted a good deal of discretion without violating portfolio guidelines—as much as one-third of the fund's assets in some cases. For example, managers of equity funds may feel that the market will decline and shift into cash or bonds. Or managers of foreign bond funds may worry about a rise in the domestic

currency and swap their exposure to eliminate the foreign exchange risk. Or managers of small-cap funds may believe large-cap companies are likely to perform better in the period immediately ahead, and reallocate significant funds to stocks in major corporations. Or managers of tax-exempt funds may shift a portion of assets into taxable securities they believe will perform better. Or managers of domestic money-market funds may try to enhance returns by adding short-term obligations of emerging-market governments. When such bets pay off, investors may consider that they are getting value for professional management. But when they do not, investors usually are outraged, and charge fund managers with violating their fiduciary obligations.

There are two problems in this regard. As noted earlier, within a given fund category managers try to outperform the competition, and are encouraged to do so by the transparency afforded by widely-available fund performance ratings. But this same asset-allocation discretion runs the risk of displacing investors from their desired portfolios. Whereas pension funds and other institutions have the monitoring capability and market power to hold fund managers to their mandates (and use consultants to help) the retail investor does not.

In contrast to the United States, the rules governing the operation and distribution of mutual funds in the EU have traditionally been highly fragmented—fragmentation that will gradually come to an end in the years ahead. As of the mid-1980s, definitions of mutual funds varied from country to country, as did legal status and regulatory provisions. Door-to-door selling was forbidden in Belgium and Luxemburg, for example, and strictly regulated in Germany. In Britain, on the other

hand, direct marketing was the norm. Market access to clients varied between the extremes of high levels of impenetrability to virtually complete openness.

The EU directive governing the operation and sale of mutual funds—Undertakings for the Collective Investment of Transferable Securities (UCITS)—came into force on October 1, 1989 after 15 years of negotiation. It specifies general rules for the kinds of investments that are appropriate for mutual funds, and how they should be sold. The regulatory requirements for fund management and certification are left to the home country of the fund management firm, while specific rules governing the adequacy of disclosure and selling practices are left to the respective host countries.[27]

Consequently, mutual funds duly established and monitored in any EU member country such as Luxembourg—and that are in compliance with UCITS—can be sold without restriction to investors in national financial markets EU-wide, and promoted and advertised through local marketing networks and via direct-mail, as long as selling requirements applicable in each country are met. Permissible investment vehicles include conventional equity and fixed-income securities, as well as high-performance "synthetic" funds based on futures and options not previously permitted in some financial centers such as London. Under UCITS, 90% of mutual fund assets must be invested in publicly traded companies, no more than 5% of the outstanding stock of any company may be owned by a fund, and there are limits on investment funds'

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[27].For a discussion, see Jonathan Story and Ingo Walter, *Politics of European Financial Integration* (Manchester: Manchester University Press, and Cambridge: MIT Press, 1997).

borrowing rights. Real estate funds, commodity funds and money market funds are specifically excluded from UCITS.

Taxes and the Mutual Fund Industry

Unlike the EU, U.S. mutual funds have operated in a comparatively coherent tax environment. There is a uniform federal income tax code, which requires mutual fund companies to report all income and capital gains to the Internal Revenue Service (IRS)—normally there is no withholding at source—and requires individuals to self-report the same information in annual tax returns, with data reconciliation undertaken by the IRS. Taxable fund income is subject to regular federal income tax rates, while capital gains and losses are recorded as they are incurred in mutual fund trading and net gains attributed to the mutual fund investor and taxed at the federal capital-gains rates. Tax fraud, including the use of offshore accounts to evade tax, is a criminal offense. States and sometimes municipalities likewise tend to tax mutual fund income and capital gains (and sometimes assets) at substantially lower rates. Under the U.S. Constitution the states and the federal government cannot tax each other. So there is a broad range of mutual funds that invest in securities issued by state and local governments with income exempt from federal tax as well as (usually) tax on the income from the state's own securities contained in the portfolio. Similarly, the states do not tax income derived from federal government securities. The U.S. tax environment, while complex, provides the mutual fund industry with opportunities for product development such as tax-efficient funds (*e.g.*, investing in municipals and

capital-gains-oriented equities) and imposes compliance costs in terms of the required tax reporting both to the IRS and to the investor client.

The European tax environment is far more heterogeneous by comparison, with the power of tax authorities stopping at the national border and—in the presence in many EU countries of very high tax rates on capital income—widespread tax avoidance and evasion on the part of investors. In the light of intra-EU capital mobility, the move toward a single currency and the UCITS initiative, narrowing or eliminating intra-EU differentials in taxation of capital income and assets and the establishment of a coherent tax environment that is considered equitable and resistant to evasion has been of growing interest.

In 1988, Germany announced consideration of a 10% withholding tax on interest and dividend income in what became an embarrassing demonstration that such taxes can provoke immediate and massive capital flight. Overall, Bundesbank estimates showed a total long-term capital outflow of $ 42.8 billion during 1988, even though the 10% withholding tax was only being discussed and had not yet been implemented. An estimated $10.7 billion of German investment funds flowed into the Luxembourg bond market alone following the announcement that the tax was to be effective January 1, 1989. Investor reactions to the German tax bid-up the price of Euro-DM issues and depressed yields to the point where in early 1989 it was cheaper for PepsiCo to borrow DM in Luxembourg than it was for the German federal government to do so in the domestic *Bund* market. Four months later, on 27 April, the German authorities announced that the withholding tax would be abolished on 1 July 1989.

In February 1989, midway through the German tax debacle, the European Commission formally proposed a minimum 15% withholding tax (administered at source) on interest income of investments (bonds and bank deposits) by residents of other EU countries, as well as on Eurobonds. Non-EU residents were to be exempt from the withholding tax, as were savings accounts of young people and small savers who were already exempt from taxation in a number of EU countries. Member states were to be free to impose withholding taxes above the 15% floor. Governments could exempt interest income subject to withholding at source from declaration for tax purposes. Also exempted were countries that already applied equal or higher withholding taxes on interest income. Additional aspects of the proposal concerned cooperation in enforcement and exchange of information among EU fiscal authorities. Dividends were omitted from the proposals because they were generally less heavily taxed by EU member countries, and because national income tax systems were thought to capture this type of investment income relatively effectively.[28]

Supporters of abolishing capital-income tax differences within the EU argued that tax harmonization was essential if financial market integration was not to lead to widespread tax evasion. The effort was led by France, together with Belgium, Italy and Spain. All four countries also argued that the absence of tax harmonization would weaken their currencies in relation to those of other EU members. All four had tax

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[28] Richard Levich and Ingo Walter, "Tax-Driven Regulatory Drag and Competition Among European Financial Centers," in Horst Siebert (ed.) *Reforming Capital Income Taxation* (Tübingen: J.C.B. Mohr / Paul Siebeck, 1990).

collection systems considered relatively weak in terms of enforcement and widely subject to evasion.

Opponents to the EU tax harmonization initiative, mainly the United Kingdom and Luxembourg as well as the Netherlands, argued that tax harmonization was both unnecessary and harmful to the functioning of efficient financial markets, and that substantial investments would subsequently flow outside the EU, especially to Switzerland and other non-resident tax havens. They argued that the proposal failed to recognize that Europe is part of a global financial market and that EU securities returns might have to be raised to levels providing equivalent after-tax yields in order to prevent capital outflows from becoming a serious problem. The United Kingdom was also concerned about the special role of the Isle of Man and the Channel Islands (which are fiscally "semi-detached" from the EU) and their treatment in any EU withholding tax initiative.

After two years of intense debate on the issue, the 15% EU withholding tax proposal finally collapsed in mid-1989 as Germany withdrew its support of the Commission's initiative and shifted to the opposition. The idea of harmonizing EU taxes was quietly shelved, with the Finance Ministers agreeing to seek alternative ways of cooperation and more effective measures against money laundering. Nevertheless, there remained little doubt that greater uniformity in capital income taxation and closer cooperation between EU tax authorities would eventually have to be revived —although harmonization of withholding tax rates and enforcement remained constrained by the possibility of capital flight to low-tax environments outside the EU.

At the very least, it was difficult to see how an active EU-wide mutual fund industry could develop under UCITS without a reasonably coherent trade environment.

Meantime, Luxemburg has remained the center of EU tax attention. Funds registered in the country are exempt from local taxation. Investors pay no withholding tax on dividends, and a 1983 law recognized French-type Sociétés d'Investissements à Capital Variable (SICAVs). In March 1988, Luxemburg became the first EU member state to ratify the UCITS in a successful bid to become the functional center for marketing mutual funds throughout the EU. By this time Luxemburg had already attracted 132 foreign banks—of which 37 were German and 16 were Scandinavian, as well as 506 mutual funds, up from 76 registered in 1980[29]—and had licensed 245 new funds by October 1989.[30] The Luxemburg prime minister at the time (and now President of the EU Commission), Jacques Santer, pointed out that open competition in Europe's financial space would determine which financial center won out. But that there were no provisions, he suggested, in EU law for cooperation between tax authorities.[31] Evasion and/or avoidance of its EU partners' taxes was thus implicitly conceded as Luxembourg's principal source of competitive advantage in the European asset management industry.

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[29] "The Switzerland of the Future," *The Banker*, November 1988.

[30] *Financial Times*, October 2, 1989.

[31] The Economic and Social Council expressed concern that capital be invested in tax free bonds, J.O. No. C. 221/29. The European Parliament also regretted that the EU had been able to reach an agreement on an EC system of taxation on interest, J.O. No.C. 68/145. 19.3.1990. See also *Les Echos*, 19.6.1990.

The months leading up to the prospect of uniformity in mutual funds management and distribution via UCITS had already led to moves in a number of high-tax member countries to liberalize constraints imposed on domestic mutual fund asset-allocation and reexamine levels capital-income taxation. For example, mutual funds in France were no longer obliged to hold 30% of their assets in Treasury bonds, and were permitted to focus exclusively on equities.[32] Indeed, the 1989 French budget encouraged funds to convert into capital-appreciation vehicles which did not distribute interest as current income. Instead, accrued interest was paid in the form of capital gains subject to a 17% rather than a 27% tax, which reduced the incentive to shift assets to Luxemburg.

In the 1990s Germany, by now hard-pressed by the cost of reunification, once again went after interest income with a 30% withholding tax at source, triggering an estimated $215 billion capital outflow, mostly once again to Luxembourg. Helping their clients to flee taxation became good business for the German banks' Luxembourg affiliates' deposit and fiduciary accounts. This time, however, the German tax authorities reacted much more aggressively, investigating a number of banks and prominent individuals for aiding and abetting or engaging in tax evasion. Unlike its past position, German authorities in the 1990s have repeatedly called for intra-EU tax harmonization the eliminate the suction of the massive fiscal hole in the middle of the EU—in the memorable words of former EU President Jacques Delors, "We will deal

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[32] *Les Echos*, September 15, 1989.

with Luxembourg when the time comes." There seems little doubt that, in the end, he will be right. A financially integrated Europe can no more afford a haven for tax evaders that the U.S. federal government could afford permitting one of the states declaring itself a domestic version of Luxembourg.

3. Pension Funds

The pension fund market has proven to be one of the most rapidly-growing sectors of the global financial system, and promises to be even more dynamic in the years ahead. Consequently, pension assets have been in the forefront of strategic targeting by all types of financial institutions, including banks, trust companies, broker-dealers, insurance companies, mutual fund companies, and independent asset management firms. Pension assets in 1995 in countries where consistent and comparable data are available (Australia, Canada, Japan, Switzerland the United Kingdom and the United States) were estimated to amount to $8.2 trillion, roughly two-thirds of which covered private-sector employees and the balance covered public-sector employees. This pool, which grew at a rate of 11% per annum during 1990-95, was estimated to grow at roughly 9% per annum and to reach $12.5 trillion in 2000 (see Exhibit 11).[33] Total Western European pension assets at the end of 1994 are depicted in Exhibit 12 had an estimated market value of about $1.6 trillion, with the United Kingdom accounting for almost half the total and the Netherlands second-largest with a 17% share.[34]

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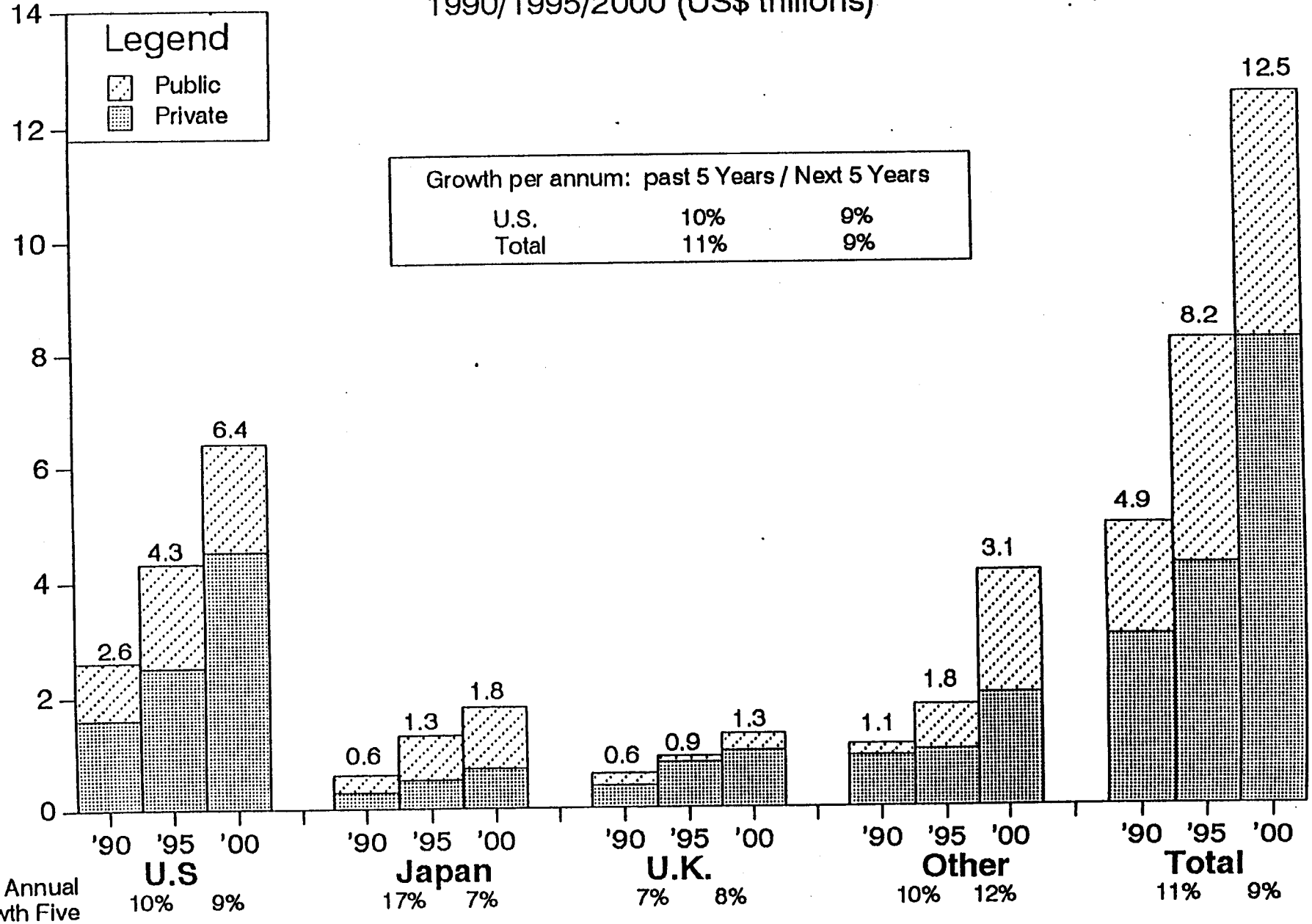
[33] Source: InterSec Research Corp.

[34] There are a number of dissenting opinions with regard to this high-growth scenario, however, some of which suggests that the growth in pension assets may actually decline from the rates achieved

Exhibit 11

World's Pension Assets

1990/1995/2000 (US$ trillions)

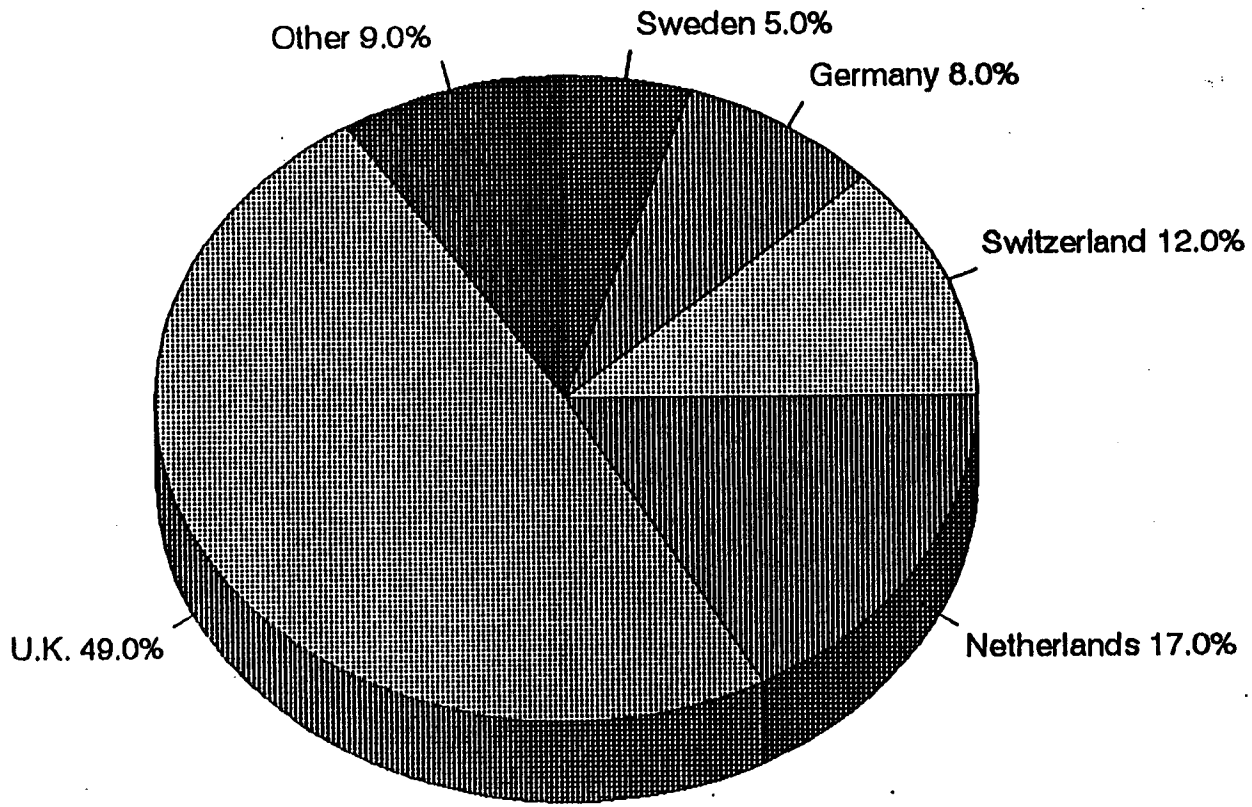


Source: InterSec Research Corp., 1996.

c:\overhds\wrld-pa.wpg

Exhibit 12

European Pension Fund Market, 1994
(1,577 bn)



Source: Intersec

c:\overhds\eur-pfnd.wpg

The basis for such projected growth is, of course the demographics of gradually aging populations, colliding with existing structures for retirement support which in many countries carry heavy political baggage. They are politically exceedingly difficult to bring up to the standards required for the future, yet doing so eventually is an inevitability.[35] The global epicenter of this problem will be the European Union, with profound implications for the size and structure of capital markets, the competitive positioning and performance of financial intermediaries in general and asset managers in particular, and for the systems of corporate governance that have existed in the region.[36]

Demographics of Dependency

The demographics of the pension fund problem are very straightforward, since demographic data are among the most reliable. Exhibit 13 provides data for the so-called "dependency ratio" (roughly, those of retirement age as a percent of those of working age). Unless there are major unforeseen changes in birth rates, death dates or migration rates, for the EU as a whole the dependency ratio will have doubled

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in the 1990s. These forecasts are based on the presumption that Germany's system of defined benefit plans with limited dedicated external asset pools is basically sound (and carries a high weight in the European total), and that enabling legislation to change PAYG systems like France and Italy will be politically difficult and slow to develop. Davis International Banking Consultants, *Trends in European Asset Management* (New York: Smith Barney, 1996).

[35] For a more detailed discussion, see John Turner and Noriyasu Watanabe, Private Pension Policies in Industrialized Countries (Kalamazoo: W.E. Upjohn Institute for Employment Research, 1995).

[36] For a discussion, see Jonathan Story and Ingo Walter, *The Politics of European Financial Integration: The Battle of the Systems* (Manchester: Manchester University Press, and Cambridge: MIT Press, 1997).

Exhibit 13

Projected Dependency Trends in European Union Countries vs. U.S.

(Population Aged 65 and over as a Percentage of Population Aged 15-64)

	Old Age Dependency Ratios	
Country	1990	2040E
Belgium	21.9	41.5
Denmark	22.2	43.4
France	21.9	39.2
Germany	23.7	47.1
Greece	20.5	41.7
Ireland	18.4	27.2
Italy	20.4	48.4
Luxembourg	20.4	41.2
Netherlands	17.4	48.5
Portugal	16.4	38.9
Spain	17.0	41.7
U.K.	23.5	39.1
U.S.	19.0	38.5
Japan	22.7	44.9

Sources: EUROSTAT, World Bank, OECD and EBRI

between 1990 and 2040, with the highest dependency ratios being attained in Italy, Germany and the Netherlands, and the lowest in Ireland. While the demographics underlying these projections may be quite reliable, dependency ratios remain subject to shifts in working-age start- and end-points. Obviously, the longer people remain out of the active labor force (e.g., for purposes of education), the higher the level of sustained unemployment, and the earlier the average retirement age, the higher will be the dependency ratio. In recent years all three of these factors have contributed to raising the EU's dependency ratio, certainly relative to that in the United States, although there are early signs that may eventually stabilize or be reversed under pressure of the realities of the pension issue.

Alternative Approaches to Old-Age Support

There are basically three ways to provide support for the post-retirement segment of the population:

- *Pay-as-you-go (PAYG) programs.* Pension benefits under this approach are committed by the state based on various formulas—number of years worked and income subject to social charges, for example—and funded by current mandatory contributions of those employed (taxes and social charges) that may or may not be specifically earmarked to covering current pension payouts. Under PAYG systems, current pension contributions may exceed or fall short of current disbursements. In the former case a "trust fund" may be set up which, as in the case of U.S. Social Security, may be invested in government securities. In the latter case, the deficit will tend to be covered out of general tax revenues, government borrowing, or the liquidation of previously accumulated trust fund assets.

- *Defined benefit programs.* Pension benefits under such programs are committed to public or private-sector employees by their employers, based on actuarial benefit formulas that are part of the employment contract. Defined benefit pension payouts may be linked to the cost of living, adjusted for survivorship,

etc., and the funds set-aside to support future claims may be contributed solely by the employer or with some level of employee contribution. The pool of assets may be invested in a portfolio of debt and equity securities (possibly including the company's own shares) that are managed in-house or by external fund managers. Depending on the level of contributions and benefit claims, as well as investment performance, defined-benefit plans may be *over-funded* or *under-funded*. They may thus be tapped by the employer from time to time for general corporate purposes, or they may have to be topped-up from the employer's own resources. Defined benefit plans may be insured (e.g., against corporate bankruptcy) either in the private market or by government agencies, and are usually subject to strict regulation—e.g., in the United States under ERISA, which is administered by the Department of Labor.

- *Defined contribution programs.* Pension fund contributions are made by the employer, the employee, or both into a fund that will ultimately form the basis for pension benefits under defined contribution pension plans. The employee's share in the fund tends to vest after a number of years of employment, and may be managed by the employer or placed with various asset managers under portfolio constraints intended serve the best interests of the beneficiaries. The employee's responsibility for asset allocation can vary from none at all to virtually full discretion. Employees may, for example be allowed to select from among a range of approved investment vehicles, notably mutual funds, based on individual risk-return preferences.

Most countries have several types of pension arrangement operating simultaneously—for example a base-level PAYG system supplemented by state-sponsored or privately-sponsored defined-benefit plans and defined-contribution plans sponsored by employers or mandated by the state.

In the United States, so-called 401(k) defined-contribution plans shift the burden of responsibility for pension adequacy from the employer to the employee which—combined with low administrative costs—has made them increasingly popular with employers. Such plans also tend to be popular with employees due to their portability, flexibility, and ability to diversify away from the future financial well-being of the employee's own firm. Self-employed individuals may make similar arrangements,

and most such plans provide for tax-deferred accumulation of assets which can then be rolled-over into an annuity upon retirement. The Employee Benefits Research Institute (EBRI) estimated that at the end of 1996 over 44 million Americans (as against 12 million in 1975) had company-sponsored defined contribution retirement accounts containing over $1.5 trillion (of which about $750 billion was in 401(k) accounts), while non-company-sponsored defined contribution accounts contained roughly the same amount, for a total of about $3 trillion.

Participants in many U.S. 401(k) plans may borrow from their retirement savings, which in some cases has been facilitated by automated loan procedures over the telephone and the Interned established by fund managers. This further increases the flexibility of pension plans and intensifies competition with personal loans from banks. Plan beneficiaries pay an interest charge of one or two percent over the prime rate on borrowings, and obviously lose tax-free asset accumulation in the process. Although servicing such loans is the responsibility of the plan beneficiaries themselves, sponsors and public officials nevertheless face the nagging concern that beneficiaries could be left without sufficient retirement resources, while fund managers confront potential legal problems in events of loan defaults.[37]

During 1985-96, defined-benefit plan assets in the United States grew at a compound annual rate of 6%, while defined contribution plan assets grew at a rate of almost 12% during the same period, and within that category assets of 401(k) plans

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[37] Julie Creswell, "Rules Ease on Loans from 401(k) Plans," *Wall Street Journal*, August 6, 1997.

grew at a rate of 23% annually. A 1997 survey of 50 leading U.S. companies showed a high degree of utilization of 401(k) defined contribution plans, with an average of 8.8 investment options available to participants and an average of 35% of plan assets allocated to diversified equity investments, 83% of the sample offering their employees daily stock-price valuations and 86% allowing employees to switch asset allocation at any time. Most companies also allowed employees to borrow from their accounts.[38]

As of the end of 1997, 54 countries had defined-contribution pension systems of some kind, ranging from nationwide compulsory schemes to funds intended to supplement state-guaranteed pensions. Assets in these funds are expected to grow at a rate of 16% per year outside the United States, compared to a U.S. growth rate of 14%, with the fastest growth (24% annually) expected in Latin America and European pension pools growing at a rate of 14%.[39] Overall, global pension pools are likely to grow from $8.5 trillion in 1997 to perhaps $13.5 trillion in 2002.

For example Australia, with the world's fifth-largest pool of dedicated retirement savings and undergoing reconfiguration of its pension system in one-third of the time it took for the United States, appears to be a good model for what may happen to the industry's competitive structure in Europe. Domestic and foreign-based asset management companies compete vigorously in a market that has become very

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[38]"The Cream of the Crop in Pensions, Too," *Business Week*, May 19, 1997.

[39]Data: InterSec Research Corporation, 1997.

sensitive to the importance of the pension-adequacy issue and highly aware of the alternatives on offer. Many such asset managers have built teams of actuaries, portfolio managers, analysts and marketing specialists targeting both employers (and pension consultants) and master-trusts (basically pension fund supermarkets) as well as marketing directly to households.[40]

The oft-cited Chilean defined-contribution model is another, very different example. It was introduced in 1981 and adopted in part by various other Latin American countries. Employees must contribute 10% of monthly earnings into one of 13 managed funds. In mid-1997 these funds managed $33 billion, amounting to 40% of Chilean GDP.[41] It has been estimated to generate a combined asset pool of over $600 billion by 2011, and requires workers to contribute 13% of their earnings into a personal pension account which can be placed with private-sector asset managers on a competitive basis. Besides de-politicizing the pension issue and avoiding a future PAYG problem sure to face even a relatively young population, it has also avoided barriers to job mobility associated with private defined-benefit plans. Chile's system has (arguably) helped raise savings levels from 8.2% in 1981 to 27.6% in 1995, and contributed to the depth and liquidity of the its financial markets (from a capitalization of 24% of GDP in 1986 to over 100% in 1996), thereby helping to reduce the cost of capital facing national enterprises.

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[40] Ellen E. Schultz, "Seeing Big Prospects, U.S. Funds Set Up Shop Abroad," *Wall Street Journal*, July 22, 1997.

[41] "Pension Reform: A Model Shows Its Age," *The Economist*, September 13, 1997.

Problems with the Chilean system have included high marketing costs, with 18,000 salesmen working to induce employees to switch funds in a near-zero-sum game that have raised expense ratios and cut into portfolio returns. In addition, regulation of fund performance that requires total returns not less that 2% below the average of all funds has encouraged very similar portfolios among the 13 funds and a general reluctance to diversify fund assets internationally. Remedies that have been tried elsewhere is to restrict the frequency of fund-switching and allowing participant selection from among a number of funds with different investment objectives in.

Detractors have argued that the Chilean system only covers only about 60% of the labor force, and that in some years the government has had to spend up to 4% of GDP to provide a safety-net for people who have never had a job or whose fund accumulations are too small to meet a minimum standard of living on retirement. They have also argued (1) that the transition costs from a PAYG system to a Chile-type model can be very high as people opt-out of the state system while current pensioners stay in, (2) that PAYG systems in advanced countries are much more equitable than they had traditionally been in Chile, (3) that most OECD countries already have well-developed capital markets, and (4) that the need to stimulate private savings is less in the OECD countries than it was in Chile.[42] And they contend that the system is expensive, consuming 2% annually in administrative costs and marketing expenses as

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[42] See Robert Holzmann, *Pension Reform, Financial Market Development and Economic Growth: Preliminary Evidence from Chile*, (Washington, D.C.: IMF Working Paper 96/94, August 1996).The author argues that the stimulus to the Chilean savings rate was largely indirect, both through fiscal discipline in financing the transition costs by cutbacks in other spending programs and through the savings-stimulus caused by more efficient financial markets.

private vendors strive to convince potential clients to switch from competitors (far higher than the 0.1-0.2% costs incurred by compulsory defined contribution systems in Singapore and Malaysia, for example).[43] Nonetheless, the 12.2% annual net returns produced since the reform by the Chilean system has made possible pension prospects far better than those existing before, and precluding the growing sense of crisis now faced by most PAYG systems.

In the case of Mexico, a 1997 measure to privatize the country's social security system led to private pension fund companies signing-up 10.0 million workers by year-end, or about 91% of all eligible participants. Such moves are paralleled in other emerging-market countries, notably Thailand and Indonesia.

An example of a well-functioning defined-contribution pension program (and the world's largest) is TIAA-CREF in the United States, which pools retirement savings of some 1.4 million U.S. college and university educators in equities of over 7,000 companies, government and corporate fixed-income issues and real estate investments. Total assets stood at about $200 billion in mid-1997. The fund competes for clients with other investment companies, offering them 10 investment portfolios as well as insurance (in 1997 it was the third largest life insurer in the United States) with roughly average portfolio performance but very low overall expense levels of 0.32% of assets, as compared to an industry mean expense level of 2.16% in 1996.[44]

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[43] Stephen Fidler, "Lure of the Latin Model," *Financial Times*, April 9, 1007.

[44] Data: TIAA-CREF and Morningstar, Inc.

The collision of the aforementioned demographics and heavy reliance on the part of many countries on PAYG approaches is at the heart of the pension problem, and forms the basis for future opportunities in this part of national and global financial systems. In the United States, for example, the PAYG attributes of Social Security and projections as to the future evolution of the trust fund have been highlighted by a number of commissions to study the problem, and the conclusions have invariably pointed to some combination of increased retirement eligibility, increased Social Security taxes, increased taxation of social security benefits, and means-testing of benefits so that those who have saved more for retirement on their own would receive smaller benefits or be taxed at higher rates on the benefits they receive—so-called "success taxes."[45] Public opinion polls show that this progressive problem is well understood among the U.S. working population. Even the Social Security trustees project that by 2030 only 3/4 of existing benefits can be maintained at current tax rates. This certainly helps account for the rapid growth of U.S. pension assets. In the face of a low U.S. discretionary savings rate, the American way of saving has been through pension accumulations.

While the American pension problem is cause for concern—and is being more or less adequately addressed by government, employers and individuals on their own—it pales by comparison to the problems confronting Europe and to a lesser extent

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[45] For a survey, see Walter M. Cadette, "Social Security: Financing the Baby-Boom's Retirement," The Jerome Levy Economics Institute, Working Paper No. 192, April 1997. See also 1994-96 Advisory Council on Social Security, *Report of the 1994-96 Advisory Council on Social Security: Findings and Recommendations* (Washington, D.C.: U.S. Government Printing Office, 1997).

Exhibit 14

U.S. vs. European Pension Assets and Populations

(End-1994)

Country	Population (Millions)	% of Labor Force Covered by Occupational Pension Scheme	% of Pop. over 65	Pension Assets ($ Billions)	Pension Assets per capita ($000)	Pension Assets as % of GDP
Belgium	10.1	5	15	17	1.7	8
Denmark	5.2	NA	16	105	20.2	72
Finland	5.1	NA	14	28	5.5	29
France	58.1	80	15	NA	NA	NA
Germany	81.2	65	15	285	3.5	14
Ireland	3.6	NA	11	15	4.2	28
Italy	57.0	5	11	50(a)	0.9	5
Netherlands	15.4	82	13	380	24.7	116
Portugal	9.9	NA	13	5	0.5	6
Spain	39.2	3	15	10(a)	0.3	2
Switzerland	7.1	92	15	187	12.3	73
U.K.	58.3	55	16	775	3.3	76
U.S.	261.0	55	13	3,760	14.4	56

Source: William Mercer; EBRI, World Bank, EIU Limited 1995, InterSec and *Euromoney*; E.P. Davis, *Pension Funds* (New York: Oxford University Press, 1995; World Bank, *Averting The Old Age Crisis* (Washington, D.C.: World Bank, 1994).

Even a number of the Eastern European countries seem to be ahead of their Western European counterparts such as Germany and Italy in designing viable pension systems as well, most of which follow a defined contribution model. Hungary and Poland, for example, have drawn on experience of Chile and other Latin American countries in reforming their PAYG systems. In the case of Hungary, the PAYG system will be phased-out gradually and new entrants to the work force must join one of a number of new private pension schemes. Workers under the age of 47 may choose between the state system and private schemes, while those 47 and older are expected to remain with the state system, thus easing the transition process. This is expected to make a major contribution to future capital market development, as well as creating a permanent constituency for economic reforms.

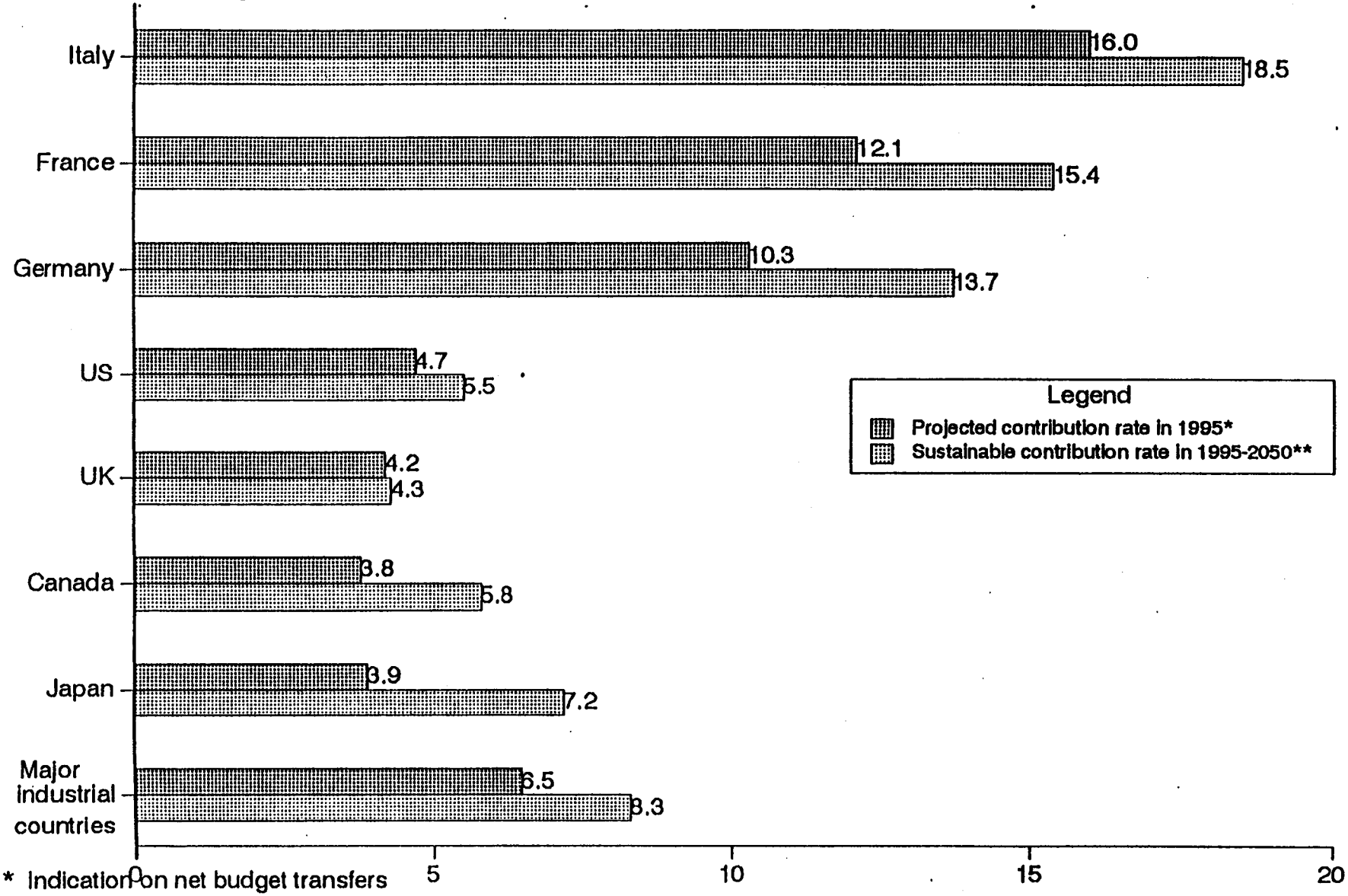
Today's conventional wisdom is that the pension problems that are centered in Europe will have to be resolved in the foreseeable future (see Exhibit 15), and that there are only a limited number of options in dealing with the issue:

- Raise mandatory social charges on employees and employers to cover increasing pension obligations under PAYG systems. It is unlikely that a any degree of uniformity in the EU can be achieved in this regard, given the aforementioned large inter-country differences in pension schemes and their financing. The competitive effects of the required major increases in employer burdens, especially in a unified market with a common currency, are unlikely to make this a feasible alternative. No more palatable is likely to be saddling employees with additional social contributions in what are already some of the most heavily-taxed environments in the world.

- Make major reductions in retirement benefits, cutting dramatically into benefit levels. This is unlikely to be any more feasible politically than the first option, especially considering the way many PAYG systems have been positioned—as "contributions" (not taxes) which would assure a comfortable old age. Taking away something people feel has already been "paid for" is far more difficult

Exhibit 15

Projected Public Pension Burden as Percent of GDP



* Indication on net budget transfers

** Defined as the constant contribution rate over 1995-2050 that equalizes the net asset position in 2050 with the initial net asset position in 1995.

Source: Sheetal K. Chand and Albert Jaeger, Ageing Populations and Public Pension Schemes (Washington, D.C.: IMF Occasional Paper No. 147, Dec. 1996.

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politically than denying them something they never had in the first place. The sensitivity of fiscal reforms to social welfare is illustrated by the fact that just limiting the growth in pension expenditures to the projected rate of economic growth from 2015 onward would reduce income-replacement rates from 45% to 30% over a period of 15 years, leaving those among the elderly without adequate personal resources in relative poverty.

- Significant increases in the retirement age at which individuals are eligible for full PAYG-financed pensions, perhaps to age 70 for those not incapacitated by ill health. This is unlikely to be any more palatable than the previous option, especially in many countries where there has been active pressure to go the other way, i.e., to reduce the age of eligibility for PAYG retirement benefits to 60 or even 55. This is compounded by a chronically high unemployment rate in Europe, which has been widely used as a justification for earlier retirements.

- Major increases in general taxation levels or government borrowing to top-up eroding trust funds or finance PAYG benefits on a continuing basis. Again, this is an unlikely alternative due to the economic and competitive consequences of further increases in tax rates, major political resistance, and Maastricht-type fiscal constraints that are likely to obtain in the EU. Even if they do not, the fact is that national states maintaining PAYG systems—under a single currency and without the ability to monetize debt—will have to compete for financing in a unified, rated bond market, which will constrain their ability to run large borrowing programs to something akin to those of the states in the U.S.

- Major pension reforms to progressively move away from PAYG systems toward defined-contribution and defined benefit schemes such as those widely used in the U.S., Chile, Singapore, Malaysia, the U.K., the Netherlands, Denmark and certain other EU countries. Each of these differ in detail, but all involve the creation of large asset pools that are reasonably actuarially sound. Where such asset pools already exist, more attention will have to be focused on investment performance, with a shift away from government bonds toward higher-yielding assets in order to help maintain benefit levels.

Given the relatively bleak outlook for the first several of these alternatives, it seems inevitable that increasing reliance will be placed on the last of these options. The fact that future generations can no longer count on the "free ride" of the present value of benefits exceeding the present value of contributions and social charges as the demographics inevitably turn against them—in the presence of clear fiscal

constraints facing governments—requires fundamental rethinking of pension arrangements in most OECD countries, notably those of the European Union. Alternatively, the fiscal deficits required by unreformed national PAYG pension schemes in those EU countries that are part of a single-currency zone would imply higher interest rates across the euro-zone than would otherwise be the case and/or higher levels of inflation if there is monetization by the European Central Bank of some of the incremental public debt.

An example of serious pension reform legislation in Europe is the 1995 U.K. Pensions Act, which came into force in 1997—partially in response to the £440 million looting of his public companies' pension assets in a massive fraud perpetrated by the late Robert Maxwell. The Act created a powerful new pensions watchdog, the Occupational Pensions Regulatory Authority (OPRA), and mandated that defined benefit schemes are fully funded. It also established a guarantee fund that protects participants against fraud, and required fund trustees to set out a statement of investment principles in ways that are understandable to beneficiaries.

The U.K. has gradually reduced the role of the state and increased the role of the private sector in pension finance since the early 1980s, encouraging people to opt out of the State Earnings-Related Pension System (Serps)—the second tier of the government system—and into private-sector personal pensions managed by insurance companies and fund managers. By the end of 1996 nearly two-thirds of British workers had opted out of that part of the state system, building an asset pool of over $1 trillion—larger that the pension assets of the rest of Europe put together. By

achieving a 13.3% average annual rate of return, this helped to raise pensioners' income by 60% in real terms since 1979. One disadvantage of the U.K. scheme involved high marketing costs incurred by competitive vendors of pension products. Moreover, mis-selling under the U.K. personal pension schemes developed into a major problem, with insurance companies and other fund managers wrongly advising people in the late 1980s and early 1990s to give up their company pension schemes in favor of poorly performing personal pensions. Damage claims rolled in, and at the end of 1997 were expected to exceed $14 billion, an average of about $13,000 per client, to be paid by the fund managers in order to effect full restitution.

The conservative government in early 1997 proposed that the transition be completed by gradually phasing-out Serps and providing public pension assistance only to the truly needy—i.e., essentially eliminating PAYG pension financing in the U.K., with the tax-advantaged, compulsory use of private pension schemes presumably cutting-down marketing expenses. Following the Labour Party's return to power in 1997 these plans were subject to reexamination, focusing in particular on (1) high expense levels in existing private pension schemes, especially front-loaded expenses, which often cut severely into fund performance; (2) attacking the mis-selling of pensions and much-improved information to be made available to participants in pension plans; (3) increasing portability of pensions and stronger pressure on people to participate in funded pension plans; and (4) provision of a publicly-funded safety-net pension scheme for those too poor to save on their own. Additional problems that need to be addressed include personal liability exposure that biases occupational

pension fund trustees toward highly conservative portfolios. The Labour government's hybrid "stakeholder" pension initiative (designed to replace Serps) was intended to avoid this problem by encouraging covered employees to remain with their companies' programs and those not covered to pay into a fund a sufficient amount to provide an adequate pension. The minimum state-funded "lifeline" pension remains in force, with part of National Insurance contributions paid into the private employee-sponsored or personal pension schemes. The intent includes full transparency and high portability, with participants able to select vendors on a competitive basis and determine the value of their assets regularly. The U.K. thus went a long way toward sustainable pension reform, well ahead of many of its continental EU partners.

Asset Allocation and Cross-Links with Mutual Funds

Whereas there are wide differences among countries in their reliance on PAYG pension systems and in the degree of demographic and financial pressure to build actuarially viable asset pools, there are equally wide differences in how those assets have been allocated.

As depicted in Exhibit 16, the United States (not including the Social Security Trust Fund) and the United Kingdom have relied quite heavily on domestic equities, 48% and 56% respectively. The largest 15 pension fund managers in 1997 had about 50% of equity assets invested in passive funds, versus about 5% in the case of mutual funds. The share of asset-allocation to domestic bonds is highest in Germany and Denmark, followed by Portugal, Switzerland and the Netherlands. Foreign equity

Exhibit 16

Pension Fund Asset Allocation

(End-1994)

Country	Domestic equities	Domestic Bonds	Foreign Equities	Foreign Bonds	Real Estate	Cash
Belgium	217	22	33	18	4	6
Denmark	14	70	3	2	9	2
Germany	6	72	3	4	13	2
Ireland	25	19	42	3	6	5
Netherlands	9	49	20	7	13	2
Portugal	3	58	6	7	1	25
Switzerland	8	54	5	5	19	9
U.K.	56	7	26	5	4	2
U.S.	56	26	12	2	4	8

Note: U.S. Reflects Defined Benefit Assets only.

holdings are proportionately highest in Ireland, the Netherlands and Belgium (each with small domestic stock markets). Foreign bond holdings play a major role only in the case of Belgium. Equity holdings among European $1.9 trillion in pension assets (mid-1996) varies widely, ranging from 75% of assets in the U.K., 42% in Belgium, 34% in the Netherlands, 13% in France, 11% in Spain.

With the euro, regulations that require pension funds to match the currency of their assets with the currency of their liabilities drop away within the single-currency zone, which will greatly broaden the equity opportunities open to fund trustees. In some cases currency-exposure restrictions have forced pension fund equity allocations to be overweight in certain industries (such as petroleum in the Netherlands) due to the importance of a few companies in national equity market capitalization, in which case the euro will permit significantly improved sectoral asset-allocation in pension portfolios. This suggests large increases in cross-border equity flows in Europe, and the creation pan-European pension fund performance benchmarks to replace existing national benchmarks.[48]

A recent study of the pension systems that incorporate dedicated financial asset pools projects $761 billion for net new investments in domestic equities by 2000, $1.063 trillion in foreign equities, $132 billion in foreign bonds, and $172 billion in real estate investments, together with net sales of $40 billion of domestic bonds.[49]

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[48]Jane Martinson, "Management Revolution," *Financial Times*, November 21, 1997.

[49] Mark Griffin, *The Global Pension Time Bomb and Its Capital Market Impact* (New York: Goldman Sachs & Co., 1997).

Assuming moderate capital gains, the study projects incremental demand for different asset classes as follows: Domestic equities $4.6 trillion, international equities $2.1 trillion, domestic bonds $3.4 trillion, international bonds $404 billion, real estate $1 trillion and cash $545 billion.

Asset allocation patterns are clearly linked to the types of program pension program that are being operated. Trust funds associated with public-sector programs tend to have exclusive or heavy asset-weightings in domestic government securities, not incidentally providing a source for financing budget deficits and public-sector projects. As in the case of Singapore's Central Provident Fund, by contrast, extensive foreign securities and other international asset allocations are driven by limited domestic absorptive capacity relative to the massive annual fund accumulations, and are handled by the Government Investment Corporation.[50] Private- and public-sector defined benefit programs requiring fixed pay-outs tend to rely mainly on public-sector or corporate debt obligations, depending on the structure and development of the indigenous capital market, as well as domestic equities and foreign securities to benefit from international portfolio diversification (see below). Defined contribution programs run the gamut from relatively restricted asset-selection to a wide range of choice largely left to the discretion of program participants.

Defined benefit programs that are required to be fully funded at all times (as in the case of the U.K.) can impose serious constraints on asset managers, since they

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[50] See Ingo Walter, *High-Performance Financial Systems* (Singapore: Institute for Southeast Asian Studies, 1993).

may force them to sell securities when prices are falling in order to maintain mandatory asset levels and, in addition, bias investment strategies toward less volatile but lower-return financial instruments. They may also force sponsors to set aside incremental assets during recessions, potentially endangering financial viability especially in the case of corporations. Such factors make defined contribution schemes that much more attractive to employers.

The growing role of defined-contribution plans in the United States has led to strong linkages between pension funds and mutual funds. Numerous mutual funds—notably in the equities sector—are strongly influenced by 401(k) and other pension inflows. This is depicted in Exhibit 17 for the ten-year period 1986-95, at the end of which mutual funds controlled almost 40% of such assets. At the end of 1996, over 35% ($1.2 trillion) of mutual fund assets represented retirement accounts of various types in the United States. Some 15% of total retirement assets were invested in mutual funds, up from about 1% in 1980.[51]

All of this is reflected in the structure of the pension fund management industry in the United States. The top-25 defined-benefit asset managers in 1995 were trust departments of commercial banks, with the top-10 averaging discretionary assets of about $150 billion each. There is little evidence of increasing market concentration in the fixed-income part of the trust business, with the top-25 firms controlling 62% of assets in both 1990 and 1995. However, the top-25 market share in the equities

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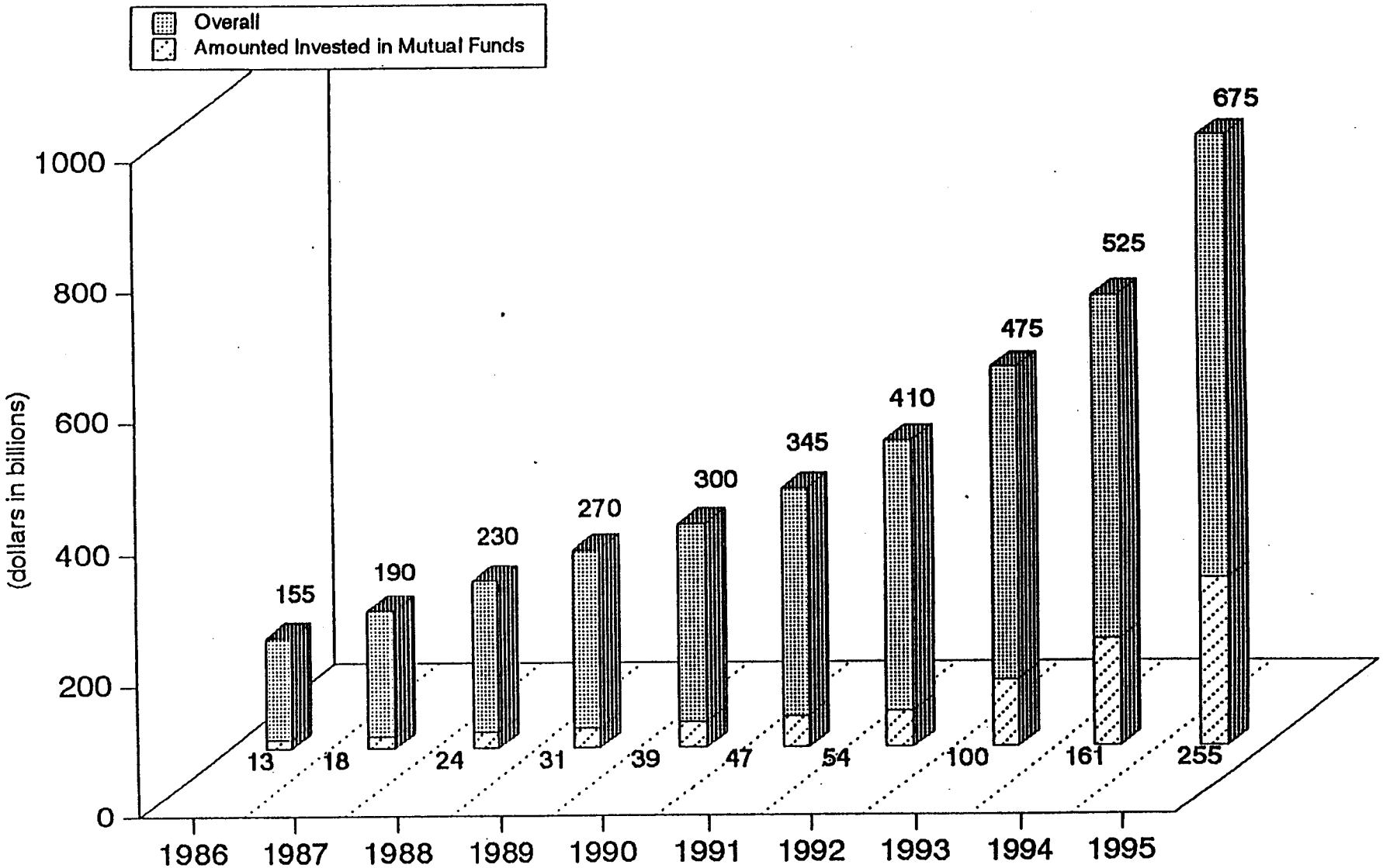
[51]Brian Reid and Jean Crumrine, *Retirement Plan Holdings of Mutual Funds,* 1996 (Washington, D.C.: Investment Company Institute, 1997).

Exhibit 17

Estimates of 401(k) Pension Plans Invested in Mutual Funds, 1986-1995



Source: Investment Company Institute Mutual Fund Fact Book 1996, Access Research

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segment (which was roughly twice as large) rose from 29% in 1990 to 35% in 1995, presumably due to the importance of performance differentials in attracting assets.[52] Among the top-25 401(k) plan fund managers in 1995, three were mutual fund companies, ten were insurance companies, five were banks, one was a broker-dealer, two were diversified financial firms, and four were specialist asset managers.[53]

Based on domestic experience, U.S. firms such as Fidelity Investments and Vanguard have marketed their brand-names and investment styles well in advance of national pension reforms abroad, especially in Europe, in order to have name-recognition in place at the time households make their initial decisions on asset allocations in defined-contribution pension plans. More such firms will follow.

European pension funds' retention of asset managers has changed significantly over the years. In 1987 banks had a market share of about 95%, while insurance companies and independent fund managers split the rest about evenly. By 1995 independent fund managers had captured over 40% of the market, banks were down to about 55% and insurance companies captured the rest. The rankings of managers for European pension funds at the beginning of 1995 is given in Exhibit 18. There is also some evidence of increasing pension fund management concentration, at least in the U.K., where in 1995 six pension fund managers accounted for about 70 percent of the market. Of these, five were actively-managed funds and one (Barclays Global Investors) specialized in index funds.

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[52] Sources: JP Morgan, U.S. Department of Labor, *Pensions and Investments*, EBRI.

[53] Source: *Pensions and Investments*.

Exhibit 18

Ranking of 25 Largest Managers of European Pension Funds, End-1994

	Home	European Pension Fund Assets
Mercury Asset Management*	UK	56,707
United Bank of Switzerland**	SWI	54,001
Schroders	UK	38,658
Barclays de Zoete Wedd (now Barclays Global Investors)	UK	29,514
Gartmore	UK	23,123
DEGEF/DBAM (Deutsche Bank)	GER	15,596
Prudential	UK	15,216
NatWest Investment Management	UK	14,880
Baring Asset Management (now ING)	UK	12,872
Morgan Grenfell Asset Management (Deutsche Bank)	UK	11,969
Fleming Investment Management	UK	10,454
Commerzbank	GER	10,300
ABN AMRO Asset Management	NL	8,011
Baillie Gifford	UK	7,688
Dresdner Bank	GER	7,533
Henderson	UK	7,525
Wells Fargo Nikko Investment Advisors (now Barclays Global Investors)	UK/US	6,875
HSBC Asset Management	UK	6,497
Hill Samuel	UK	5,952
Legal & General	UK	5,751
Jupiter Asset Management	UK	4,467
State Street Global Advisors	UK/US	4,367
Newton	UK	4,279
Mutual & General	UK	4,120

* Acquired by Merrill Lynch in 1997.

** Combined UBS (PDFM and UBSII and SBC Brinson) assets under management in 1994.

Source: William Mercer.

With respect to performance, pension fund management goals are often set a "median-plus" objective—that is, the manager should beat the median performance of all pension funds by, say, 1 or 2 percentage-points annually over three-year rolling periods. As in the school where "all the kids are above average," this is not easy. Only 11% of U.K. pension fund managers managed to achieve the 1% goal and 6% managed to achieve the 2% goal during the three-year period ending in 1996, although their performance was somewhat better in earlier periods.[54] Among U.S. pension fund managers, only 44.0% of equity fund managers and 35.3% of specific funds outperformed the S&P 500 index during 1994, while for 1 and 3-year time-frames the outperformance percentages dropped to 33.0% and 25.2%, respectively and for 1, 3 and 5-year time-frames they dropped to 28.3% and 20.1%. With respect to fixed-income pension funds, 77.1% of fund managers and 74.6% of specific funds outperformed the Lehman Brothers Government and Corporate Bond (LBGC) index during 1994, while for 1 and 3-year time-frames the outperformance percentages dropped to 53.5% and 41.2%, respectively and for 1, 3 and 5-year time-frames they dropped to 43.0% and 31.3%.[55]

4. Asset Management for Private Clients

One of the largest pools of institutionally-managed assets in the world is associated with high net-worth individuals and families, generally grouped under the

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[54] Barry Ridley, "Fund Managers Attempt Mission Impossible," *Financial Times*, July 27, 1997.

[55] Data: Plan Sponsor Network, "Historical Performance of Managers vs. Indexes," 1995.

heading of "private banking." Total funds under management have been variously estimated at up to $23 trillion[56]—significantly exceeding the size of the global pension asset-pool—although the confidentiality aspect of private banking makes such estimates little more than educated guesses. Exhibit 19 provides a rough estimate of the global total high net-worth assets under management, while Exhibits 20 and 21 show the sources and destinations of private wealth held outside the home-country of the investor.

Personal wealth can conveniently be classified according to the source of the assets that need to be managed, which in turn affects high net-worth clients' investment attitudes and fund-management requirements. There are at least five main sources of private wealth:[57]

- *Corporate wealth*: Wealth generated through personal service within a corporation in the form of salaries, bonuses, stock options, severance payments, etc. This form of wealth is increasingly common, particularly in the U.S., Japan and Western Europe where corporate activity is strong and executive compensation levels are high. Also included in this category might be wealth generated in increasingly professionalized and commercialized sports, the arts and entertainment.

- *Entrepreneurial wealth*: Wealth that an individual has accumulated, e.g., either as sole or co-owner of a business enterprise. It is particularly pervasive in the U.S. and Asia due to the respective patterns of economic development. To a large extent entrepreneurial wealth is paper wealth, and in the case of private companies may be realized when the enterprise is sold or goes public.

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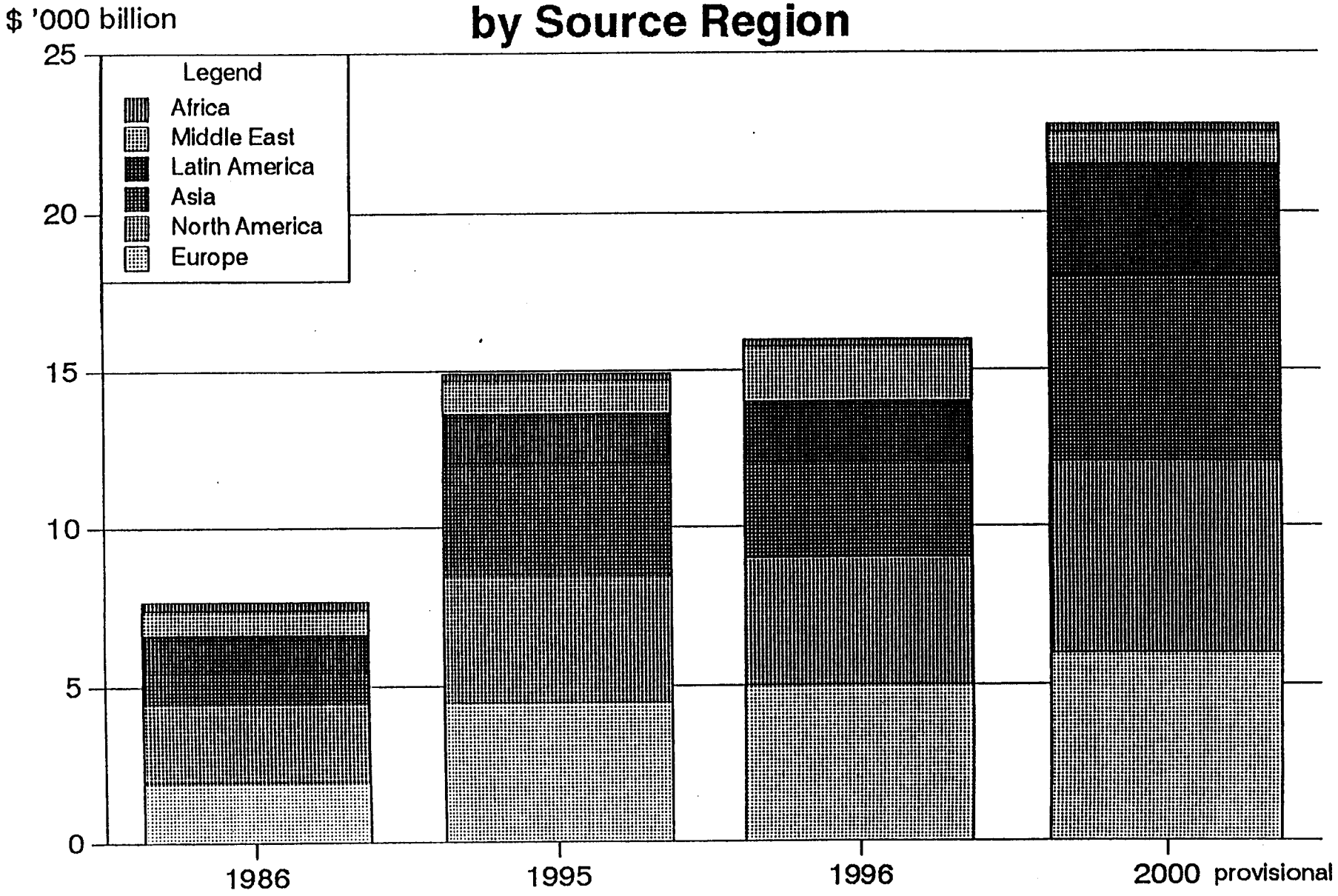
[56] Chase Manhattan, 1994 estimate.

[57] For a detailed discussion, see Roy C. Smith and Ingo Walter, *Global Banking* (New York: Oxford University Press, 1997).

Exhibit 19

Global High-Net-Worth Assets, by Source Region



Source: Gemini Consulting, 1997

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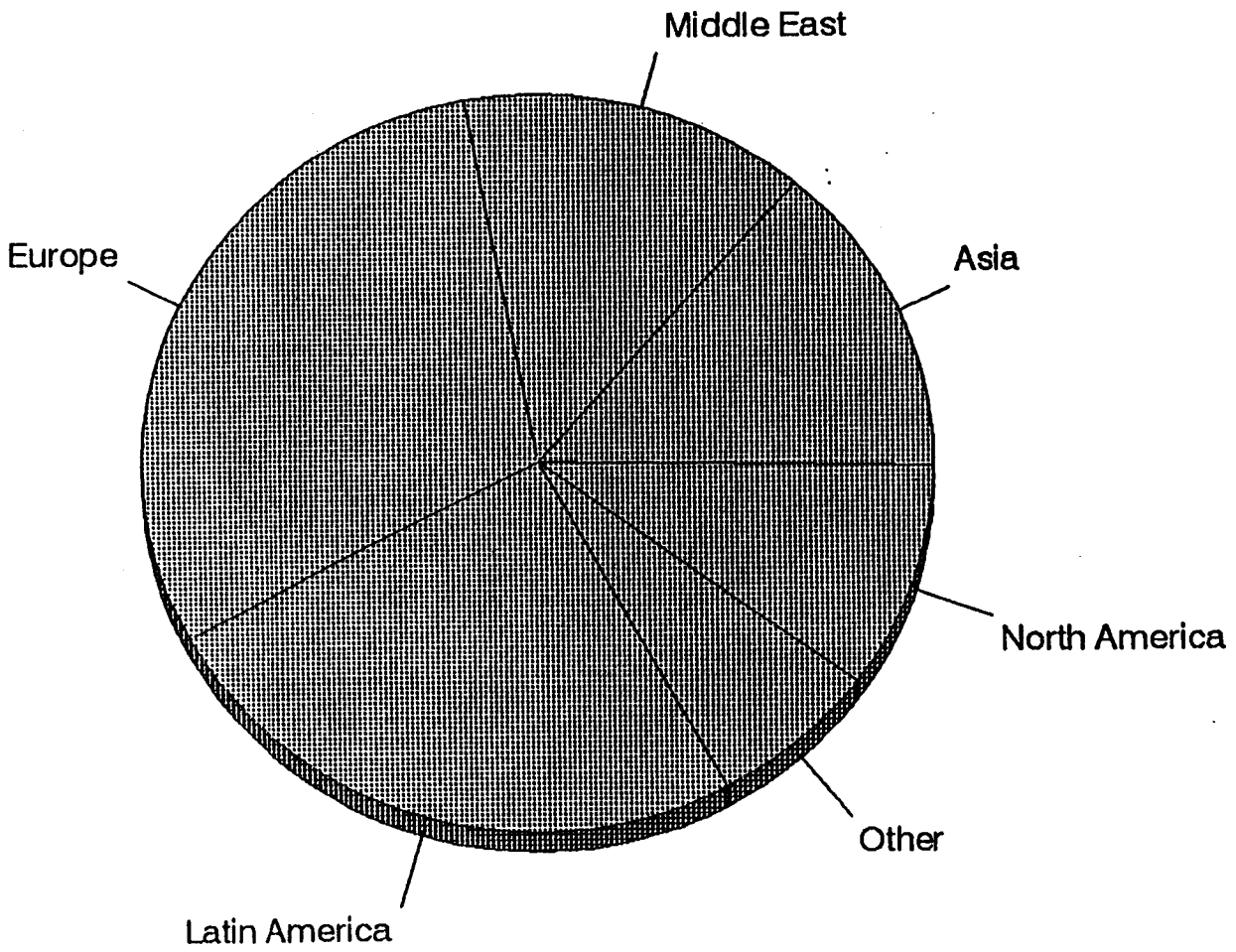
Exhibit 20

Global High-Net-Worth Offshore Assets, by Source Region

1996 total: $5,500 billion



Source: Gemini Consulting, 1997

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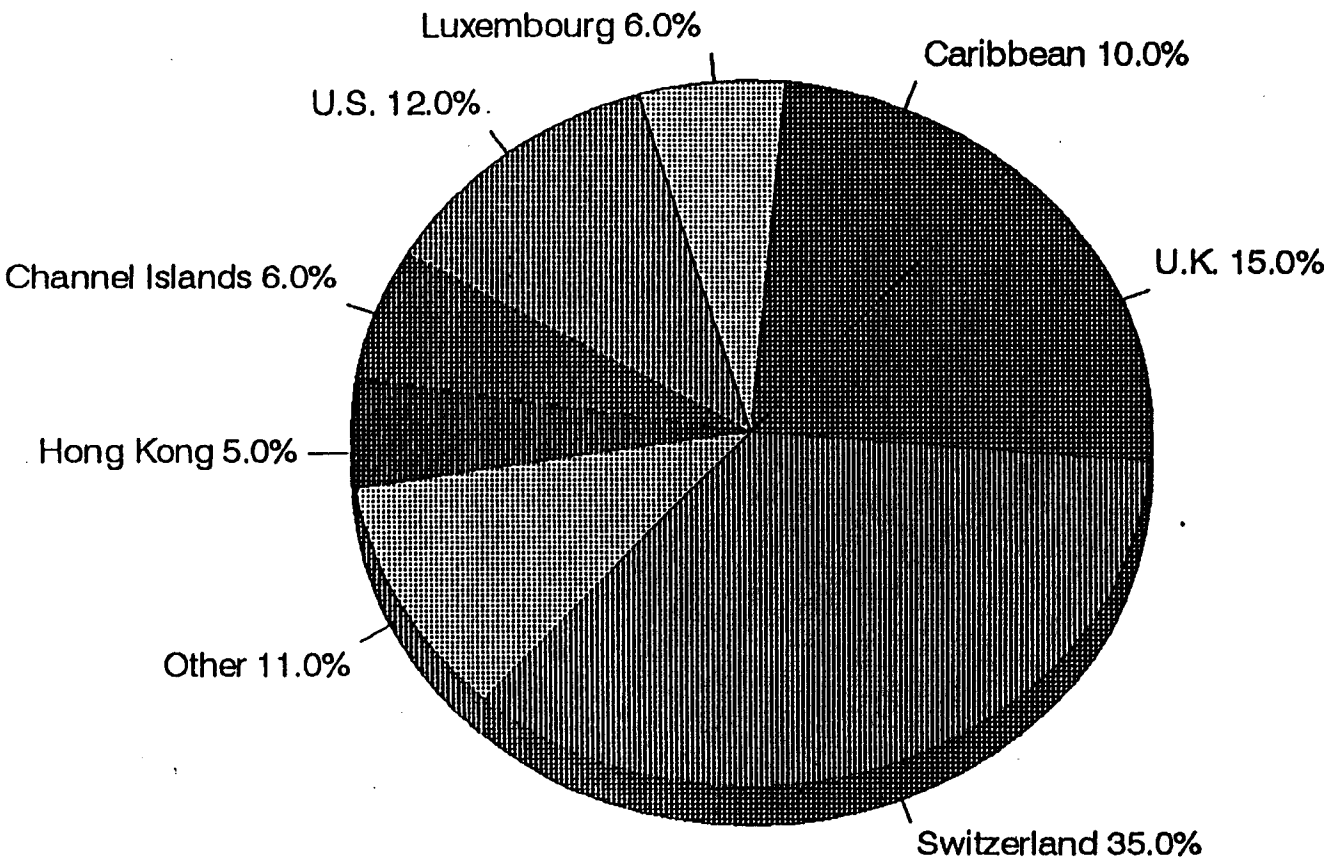
Exhibit 21

Estimated Destination of Offshore Private Banking Wealth



Total onshore: $7.5 trillion
Total offshore: $2.1 trillion

Source: The Chase Manhattan Private Bank, 1996

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- *Family (inherited) wealth*: This involves the transfer of wealth from one generation to another, and is therefore highly dependent upon national fiscal and economic policies. "Old" wealth is probably more pervasive in Europe than elsewhere. It can usually be traced to one of the other sources of wealth specified here.

- *Political wealth*: This category comprises assets that may be derived from corruption in political office at varying levels within national or regional governing structures. The sources include misappropriation of public funds, bribery, extortion, political contributions, kickbacks, and financial holdings benefitting from government contracts. Although functionaries within government usually receive limited official compensation, the power residing in their hands often makes siphoning-off funds relatively easy. This form of wealth may be more pervasive in some emerging-market countries than in the U.S., Japan and Western Europe, although scandals and official corruption afflict virtually all countries from time to time.

- *Criminal wealth*: This represents wealth deriving from organized crime and other activities. Illegal organizations thrive on every continent, ranging from the Italian, American or Russian Mafias through Chinese Tongs and Japanese Yakuza to the Latin American drug syndicates. This type of wealth can be expected to arise in most societies, and can easily get intermingled with legitimate sources of wealth in the global private asset pool.

While it is dangerous to generalize, it may be reasonable to argue that the more reliance governments place on the operation of free markets and transparent, rule-based democratic politics and administration, the more important will be entrepreneurial and corporate wealth and the less important political and criminal wealth. There are a number of factors that determine the geographic distribution of private wealth.

First, although personal wealth is a "stock" measure, while income is a "flow" measure, since capital (along with labor, natural resources and total factor productivity) determines national income and output, higher-income countries should harbor greater wealth concentrations than poorer ones.

Second, the distribution of property rights as well as those capital ownership, education levels and other sources of earning power differ significantly from one country to another. In these circumstances, markets for goods and services, capital, natural and human resources may generate quite different distributions of wealth and income between countries, even when economic size and per capita income are comparable.

Third, government policies toward wealth accumulation tend to emanate from a confluence of historical, religious, cultural and sociological factors that generate a political concept of a "fair" distribution of income and wealth—and more importantly, the extent to which markets are permitted to determine that distribution. This tends to determine national policy on taxation, wealth and income transfers, nationalization, expropriation, and other policy measures affecting the wealthy and how they in turn react to such policies.

These three factors, taken together, probably explain to a large extent the geographical distribution of global private wealth—not only where wealth may be found, but also where it is privately held rather than institutionalized in state hands.

Private-Client Asset-Allocation Objectives

Private clients' asset management objectives are an amalgam of preferences across a number of variables among which liquidity, yield, security, tax-efficiency, confidentiality, and service-level are paramount. Each of these plays a distinctive role.

- *Yield*. The traditional European private banking client was concerned with wealth preservation in the face of antagonistic government policies and fickle asset markets. Clients demanded the utmost in discretion from their private bankers, with whom they maintained lifelong relationships initiated by personal recommendations. Such high net-worth clients have to some degree given way to more active and sophisticated customers. Aware of opportunity costs and often exposed to high marginal tax rates, they consider net after-tax yield to be far more relevant than the security and focus on capital-preservation traditionally sought by high net-worth clients. They may prefer gains to accrue in the form of capital appreciation rather than interest or dividend income, and tend to have a much more active response to changes in total rate of return.

- *Security*. The environment faced by high net-worth investors is arguably more stable today than it has been in the past. The probability of revolution, war and expropriation has declined over the years in Europe, North America, the Far East and Latin America. Nevertheless, a large segment of the private banking market remains highly security-conscious. Such clients are generally prepared to trade-off yield for stability, safety and capital preservation.

- *Tax-efficiency*. Like everyone else, high net-worth clients are highly sensitive to taxation, perhaps more so as cash-strapped politicians target "the rich" in a constant search for fiscal revenues. International financial markets have traditionally provided plenty of tax-avoidance and tax-evasion opportunities ranging from offshore tax havens to private banking services able to sidestep even sophisticated efforts to claim the state's share.

- *Confidentiality*. Secrecy is a major factor in private banking—secrecy required for personal reasons, for business reasons, for tax reasons and for legal or political reasons. Confidentiality, in this sense, is a "product" that is bought and sold as part of private asset management business through secrecy and blocking statutes on the part of countries and high levels of discretion on the part of financial institutions. The value of this product depends on the probability and consequences of disclosure, and is "priced" in the form of lower portfolio returns, higher fees, sub-optimum asset allocation, or reduced liquidity as compared with portfolios not driven by confidentiality motives.[58]

- *Service level*. While some of the tales of personal services provided for private banking clients are undoubtedly apocryphal, the "fringe benefits" offered to high net-worth clients may well influence the choice of and loyalty to a particular financial institution. Such benefits may save time, reduce anxiety,

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[58] See Ingo Walter, *The Secret Money Market* (New York: Harper Collins, 1990).

increase efficiency, or make the wealth management process more convenient. Personal service is a way for personal asset managers to show their full commitment to clients accustomed to high levels of personal service in their daily lives.

The essence of private banking is to identify accurately each client's unique objectives, and to have the flexibility and expertise to satisfy these as fully as possible in a highly competitive marketplace. On the assumption that the vast majority of funds managed by private banking vendors have not been accumulated illegally, the demand for financial secrecy in Europe relates mainly to matters of taxation and transfers of funds across borders. EMU will eliminate the latter among the participating countries, something that has long been a concern of virtually all Europeans with assets to preserve. As noted earlier, tax issues will take much longer to address, and will probably always be a major driver of the international private banking industry.

In particular, substantial private assets have traditionally made the one-way journey to Switzerland, Luxembourg, Austria, or other locations where they can be concealed from local fiscal authorities while being prudently managed by trustworthy and reliable bankers or investment managers. This is likely to change. We have already noted that the tax-haven status of Austria and Luxembourg will sooner or later be eliminated under fiscal pressure from partner countries, and EU states will eventually to come together on rules regarding personal taxation and disclosure of tax information. Should this happen, the ability to conceal private wealth from tax collectors will diminish within the EU, and with it the "value" of secrecy as one of the services offered by EU investment managers. Only Switzerland will remain as a

European haven for tax evaders (as distinct from those committing fax fraud as defined under Swiss law).[59]

Competitive Dynamics in Private-Client Asset Management

The range of private banking services is extraordinarily broad, from deposit and payments services to traditional fiduciary activities to arranging personal lines of credit, secured loans, leveraged buyouts and tax-shelter financing. The personal nature of private banking causes high net-worth clients generally to prefer maintain long-term asset-management relationships, if possible (see Exhibit 22). This may result in lower price elasticity of demand, facilitating product cross-selling and enabling institutions to compete on qualitative variables instead of price alone. In addition, the cost structures of many banking activities allows significant potential economies of scale and scope in transactions processing and portfolio-management activities linked to managed institutional asset pools like mutual funds and pension funds.

The attractiveness of the private client market has resulted in fierce competition among firms engaged in private banking. Institutions competing for the business include commercial and universal banks, securities firms, asset management companies, and specialized private banks. Major U.S. competitors in global private

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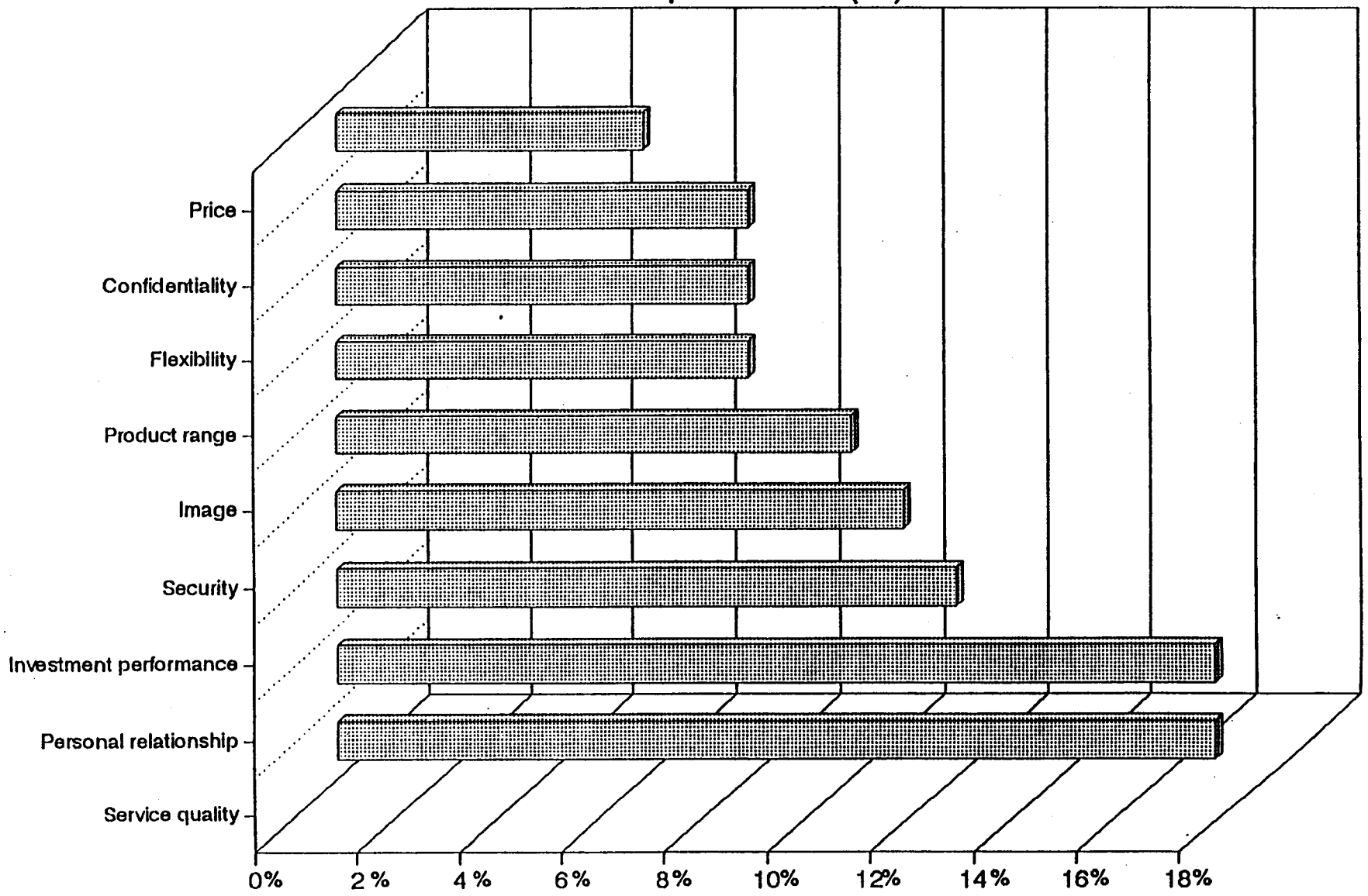
[59] As long as a decade ago, Dr. Marcus Lusser, then President of the Swiss National Bank, conceded the diminishing value of banking secrecy. In his opinion, the strengthening of the EU was bound to weaken Switzerland as a center for the management of private wealth. He advised bankers in Switzerland to concentrate on the institutional investment management sector in the future. "Good-bye to Complacency," *Financial Times,* December 19, 1988. In conversation, Swiss private bankers appear to agree that upwards of two-thirds of assets under management of OECD-based private clients could disappear if Swiss banks reported assets and income to home-country tax authorities.

Exhibit 22

Key Factors in Retaining Private Clients

Relative Importance (%)



Source: Price Waterhouse Survey of Private Bank CEOs.

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banking include Merrill Lynch, Citicorp, Chase Manhattan and JP Morgan. Europe has its traditional Swiss private banks such as Lombard Odier and Darrier Hentsch in Geneva and Bank Julius Baer and Bank Vontobel in Zurich plus the Big-3—Crédit Suisse, Swiss Bank Corporation and Union Bank of Switzerland—as well as Coutts & Co. (a subsidiary of National Westminster) and Barclays of the United Kingdom, Trinkhaus & Burkhardt of Germany and MeesPierson of the Netherlands. Based on estimated revenue growth of 10-20% annually for the foreseeable future and the ability to link product development and delivery to other types of managed asset pools, private banking is understandably high on the priority list of many financial services firms.

Invariably the key is the relationship with a client and bundling a variety of different services in which it is often difficult for the client to evaluate the cost of each, and higher overall fee income is possible. It is also likely that the client may be more price-insensitive with respect to the purchase of bundled services than for each of the services separately. While other segments of the asset management industry have been subject to a general unbundling of services as a result of a proliferation of new financial products and distribution techniques, this has probably been less true of private banking.

Continuous personal marketing is vital in order to persuade private clients to stay with a given supplier even when their wealth and portfolio preferences change, so that the most important component of any private banking effort is the quality of the bankers. It is not easy for a private client to share confidences with his or her

banker, so that a low turnover in staff is particularly important. Given the tendency for high net-worth clients to prefer to stay with the private banker they know, it is not surprising that the predominant competitive focus is to find new clients rather than to poach existing ones from other financial institutions.

Fiduciary activities dominate the private-client product range. As noted, the objective is to build a portfolio appropriate to each client's needs, which manages effectively the interrelationship between risk, return, liquidity, and confidentially, all of which are interdependent and among which difficult tradeoffs often have to be made. The firm provides clients with access to financial and real-asset exposures in a number of currencies and across a range of locations within the context of complex personal financial objectives. A broad range of portfolios can be made available to satisfy a given individual's specific requirements, and these are often centrally managed and commingled in order to achieve available economies of scale and scope.

Competition among European and other private banking firms is likely to continue to intensify, and will have to contend as well with a serious effort on the part of American and other non-European asset managers to offer global real-time asset management services to European private banking clients. Others will be offering very sophisticated products, perhaps at lower cost than the European private banks have charged in the past. Some will be offering innovative mutual funds or shares in limited partnerships or other specialized investments. Certainly there will be a profusion of both services and those offering them. And the field of competitive struggle will be in marketing just as much as it is in product development and investment performance.

Such competition is bound to lower fees and commissions for private-client asset management, and the inherent strength of the European banks' control over their high net worth clients will be tested.

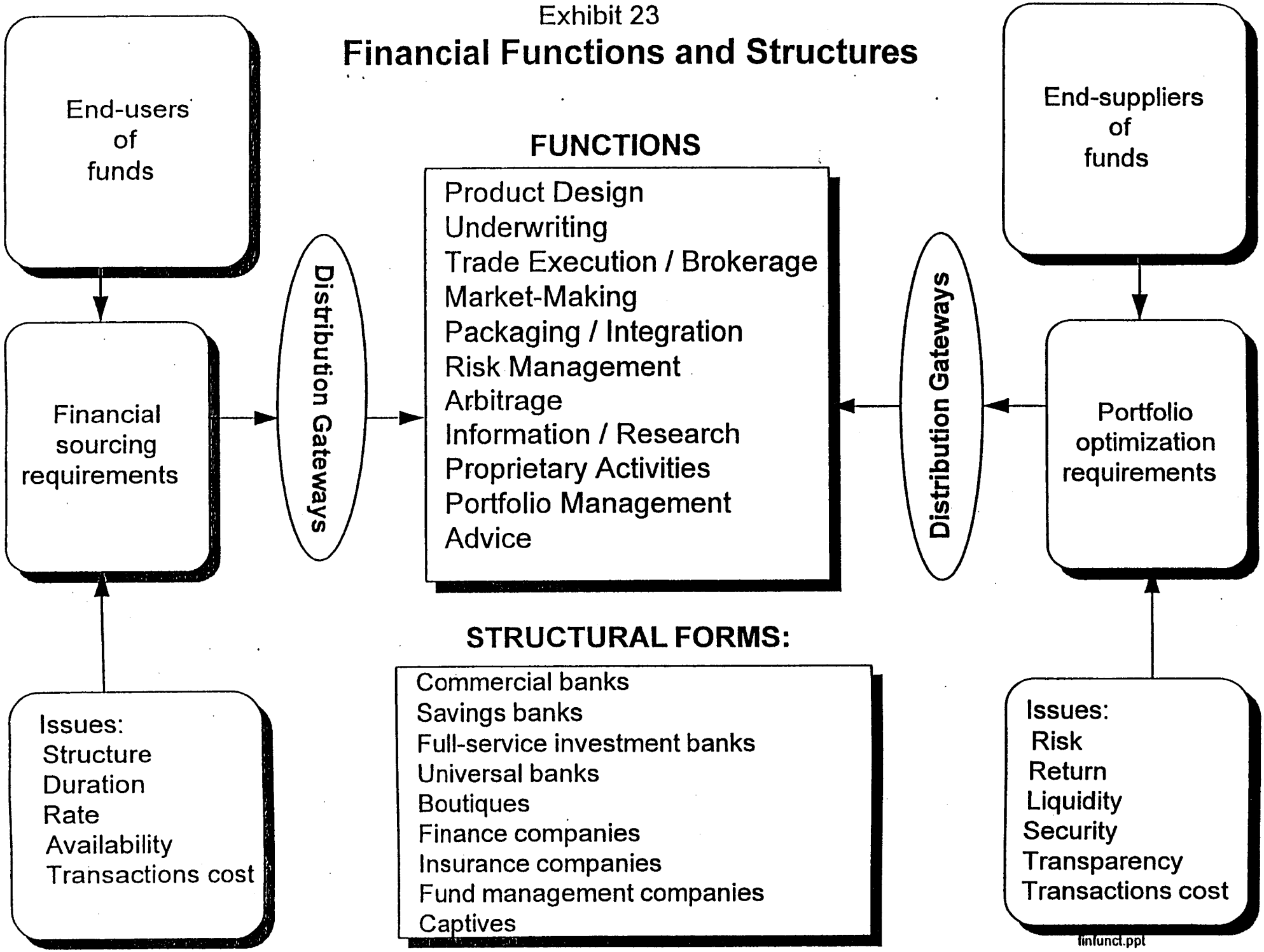
5. Competitive Restructuring of the Asset Management Industry

Exhibit 23 returns to the flow-of-funds framework with which this paper began. On the left are end-users of funds, motivated by the objective of cost-effective financing which represents an amalgam of cost, maturity, availability and structural dimensions. On the right are end-suppliers of funds, mainly households and those acting on their behalf, such as pension fund trustees, whose concern is portfolio optimization involving risk, return and liquidity, as well as security, transparency and transactions costs. In the center are the functions that are performed by the financial intermediaries, ranging from securities underwriting to asset management.

Various kinds of financial firms emerge to perform one or more of the roles identified in Exhibit 23—commercial banks, savings banks, postal savings institutions, savings cooperatives, credit unions, securities firms (full-service firms and various kinds of specialists), insurance companies, finance companies, finance subsidiaries of industrial companies, mutual fund companies, financial advisers and various others. Members of each *strategic group* compete with each other, as well as with members of other strategic groups. Assuming it is allowed to do so by the regulators, each firm elects to operate in one of the structural forms identified in Exhibit 20, according to its own competitive advantages, i.e., its comparative efficiency in the relevant

Exhibit 23

Financial Functions and Structures



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organizational form as compared to that of other firms as well as its ability to effectively access the end-user.

With respect to asset management, there are two questions. First, what determines competitive advantage in operating distribution gateways to the end-investor? Second, what determines competitive advantage in the asset management process itself?

One supposition is that distribution of asset management services is both scope-driven and technology-driven. That is, it can be distributed jointly with other types of financial services, and thereby benefit from cost economies of scope as well as demand economies of scope (cross-selling). This would tend to give retail-oriented financial services firms like commercial and universal banks, life insurance companies and savings institutions a competitive advantage in distribution. At the same time, more-specialized firms may establish cost-effective distribution of asset management services using proprietary remote-marketing techniques like the mails, telephone selling or the Internet, or by "renting" distribution through the established infrastructures of other financial intermediaries like banks, insurance companies or mutual fund supermarkets. They may also gain access through fund management consultants and financial advisers.

Asset management itself depends heavily on portfolio management skills as well as economies of scale, capital investment and technologies involved in back-office functions, some of which can be outsourced. Since fiduciary activities must be kept separate from other financial services operations that involve potential conflicts of

interest, either through organizational separation or Chinese walls, there is not much to be gained in the way of economies of scope.

The fact is that every one of the organizational firms listed in Exhibit 20 is involved in asset management, and firms in each "strategic group" have targeted this sector for growth and development. This inter-sectoral competition, alongside already vigorous intra-sectoral competition, is what will make asset management one of the most competitive areas of finance, even in the presence of rapid growth in the size of the market for asset management services.

Certainly the dynamics of competition for the growing pools of defined benefit and defined contribution pension assets in various parts of the world, and its cross-linkage to the mutual fund business, has led to various strategic initiatives among fund managers. These include alliances among fund managers as well as between fund managers, commercial and universal banks, securities broker-dealers, and insurance companies.

A good example in the United States is the 1997 JP Morgan investment of $900 million in a 45% stake in the American Century Companies of Kansas City, with $60 billion under management, the fourth-largest U.S. operator of no-load mutual funds, in order to gain access to the fast-growing defined-contribution pension fund and mutual fund markets to complement the bank's traditionally important role in managing a relatively slow-growing $230 billion pool of assets for defined-benefit plans and private clients. Morgan also obtained the right to acquire control of American Century at a later time. The acquisition gave Morgan an established infrastructure and

large retail sales force of financial planners to help achieve retail penetration of what the bank calls the "mass-affluent" market (households with over $1 million to invest).[60] In part, the bank was following its clients from defined-benefit to defined contribution pension programs, combining Morgan's product and global strengths and existing Pierpont family of funds with American Century's distribution infrastructure. The stability of fund management earnings, higher customer loyalty and higher fees also complement Morgan's volatile earnings in such highly competitive areas as securities trading and corporate finance.

Another example is the acquisition by the Morgan Stanley Group of Van Kampen Merritt American Capital in 1996, with $57 billion in funds under management marketed through banks, financial planners, and broker-dealers, as a way for the firm to combine its own product skills with Van Kampen American Capital's asset management franchise and leverage them into global markets. This followed Morgan Stanley's 1995 acquisition of Miller Anderson & Sherrard, an equity fund manager and brought Morgan Stanley's assets under management to over $157 billion. It was in turn followed by a 1996 merger with Dean Witter Discover & Co., a retail broker-dealer—which brought with it the TCW Group of mutual funds marketed by the firm's sales force to retail clients—to form Morgan Stanley Dean Witter. The group's 306 mutual funds alone held $146 billion at the beginning of 1997. Exhibits 24 and 25

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[60] The price represented 20 times earnings, or five times book value. See Saul Hansell, "J.P. Morgan Shifts Strategies to Buy a Stake in Fund Concern," *New York Times*, 31 July 1997. See also Saul Hansell, "From Icon to Consumer Brand," *New York Times*, July 10, 1997.

Exhibit 24

Chronology of Acquisitions of U.S. Mutual Fund Companies, 1992-97

Announcement Date	Acquirer	Target	Value	Asset Under Management ($ Billion)
Jun-92	Franklin Resources	Templeton, Galbraith	780	21,300
Oct-92	Clayton Dublier & Rice	Van Kampen Merritt	415	33,742
Dec-93	Mellon Bank	Dreyfus	1,228	79,200
Jul-94	Van Kampen Merritt	American Capital Mgt.	430	16,717
Oct-94	Liberty Financial	Colonial Group	318	14,312
Dec-94	Lincoln National	Delaware Management	633	27,000
Apr-95	Zurich Group	Kemper	885	65,366
Jun-96	Franklin Resources	Heine Securities	705	17,000
Jun-96	Morgan Stanley	Van Kampen/American	1,136	57,123
Jul-96	Liechtenstein Gl.Tr.	Chancellor Cap. Mgt.	320	N.A.
Sep-96	First Union	Keystone Investments	301	11,600
Nov-96	Invesco	Aim Management Group	1,678	57,100
Jun-97	Zurich Group/Kemper	Scudder, Stevens & Clark	1,666	120,000
Jul-97	JP Morgan	American Century	900	60,000

Source: Putnam, Lowell R. Thornton, 1997.

Exhibit 25

Major Non-U.S. Asset Management Acquisitions

Date	Target name	Target activity	Bidder name	Bid value ($ million)
19-Feb-96	Gartmore (UK) (25%)	Investment and asset management	National Westminster Bank (UK)	214
23-Oct-96	Prime (Italy) (95%)	Investment fund management	Assicurazioni Generali (Italy)	226
6-Jun-96	Robeco (Netherlands)	Fund management	Rabobank Nederland (Netherlands)	320
19-Feb-96	Indosuez UK Asset Management (UK)	Investment management	National Westminster Bank (UK)	578
25-Mar-96	Clerical Medical Investment Group (UK)	Insurance & fund management	Halifax Building society (UK)	1,360
Nov-97	Mercury Asset Management (UK)*	Fund management	Merrill Lynch (US)	5,300
Nov-97	Union Bank of Switzerland	Fund management and private banking	Swiss Bank Corporation	25

Source: Acquisitions Monthly; Securities Data Company

*Note: MAM had been an implicit target of an abortive $7.8 billion Morgan Stanley bid for S.G. Warburg in late 1994. Warburg owned 75% of MAM at the time, and the deal failed in part due to disagreements on the future status and independence of MAM. Warburg was acquired by Swiss Bank Corporation in 1995 and MAM was spun-off as an independent firm.

provide a chronology of recent acquisitions of U.S. and non-U.S. mutual fund companies.

Other ways to achieve improved competitive performance in the asset management industry have also been tried. For example, mutual fund companies are naturally interested in gaining access to initial public offerings of stock brought to the market by underwriters. There has long been evidence that IPOs tend to be underpriced against subsequent secondary market trading, so that purchases of new issues can do more for fund performance than buying the same securities in the aftermarket. Funds that are part of banks or securities firms involved in underwriting have such access, but independent mutual fund companies do not. Especially funds affiliated with securities firms that are very active in new issues, such as Goldman Sachs, Merrill Lynch and Morgan Stanley may have a built-in advantage over commercial banks, insurance companies and mutual fund operators. To address this problem, the Fidelity Group in 1996 for example struck a deal with Salomon Brothers Inc. to offer its funds part of any deals the firm originates, in return for which Salomon obtains retail distribution, which it otherwise lacks. Charles Schwab in 1997 went beyond the Fidelity-Salomon arrangement and signed an agreement with Crédit Suisse First Boston, JP Morgan and Hambrecht & Quist to help underwrite new issues of securities, which places the discounter's own capital at risk as opposed to simply executing customer orders for new issues, as in the Salomon deal. In return, Schwab too obtains direct access to initial public offerings.

Among the notable strategic initiatives are a number of cases of European banks acquiring U.S. asset management firms for their expertise in the institutional investment field. One example is the $1.7 billion purchase of Scudder, Stevens & Clark by the Zurich Group in 1997, to complement its earlier $2.3 billion purchase of the Kemper insurance and fund management business, targeting especially the defined-contribution pension market and giving Zurich over $200 billion in U.S. assets under management (of which $69 billion were in mutual funds). Other cross-border examples include Dresdner Bank AG's acquisition of RCM Capital Management of San Francisco, providing the bank with a significant presence in the U.S. institutional asset management business and with the fund management activities of Dresdner Kleinwort Benson (DKB) in London formed the basis for the bank's $50 billion global institutional asset management business. Swiss Bank Corporation's acquisition of Brinson Partners of Chicago in 1995 likewise was an effort to complement the bank's traditional Europe-based strengths in private banking with institutional asset management expertise that can potentially be leveraged globally, especially into Europe. Similarly, Germany's Commerzbank in 1997 acquired the asset management business of Montgomery Securities of San Francisco, following acquisition of the rest of the firm by NationsBank. And by acquiring Wells Fargo's passive fund management joint venture with Nikko Securities of Japan in 1995 Barclays Bank PLC became, through Barclays Global Investors (BGI), the fourth-largest asset manager in the world, with $420 billion under management in 1997.

U.K. institutional asset management expertise has been equally sought-after. The Morgan Stanley Group made an abortive attempt in 1994 to acquire S.G. Warburg & Co. mainly to gain control of Warburg's asset management affiliate, Mercury Asset Management (MAM), which remains independent after Swiss Bank Corporation's subsequent acquisition of Warburg. As part of its acquisition of U.K. broker Phillips & Drew following London's 1986 Big Bang by Union Bank of Switzerland, its fund management arm PDFM has been the focus of the bank's European thrust into institutional asset management, as has been the case of Deutsche Bank and Morgan Grenfell Asset Management (MGAM), discussed earlier. National Westminster Bank, in 1995 won one of Britain's Big-5 pension fund managers, Gartmore PLC, against a number of other European bidders such as the AEGON insurance group of the Netherlands.[61] Other intra-European acquisitions involving U.K. targets have included Foreign & Colonial by Bayerische Hypo Bank (now merged with Bayerische Vereinsbank), Framlington by Crédit Commercial de France, Baring Asset Management by Internationale Nederlanden Groep, GT by Bank in Liechtenstein, and Juniper Tyndale by Commerzbank.

In order to bolster their international asset management capabilities, a number of U.K. firms have been acquired by American fund managers, including Murray

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[61]U.K. pension fund management is dominated by five firms – Mercury Asset Management (Merrill Lynch), Shroders, PDFM (Union Bank of Switzerland), Gartmore (National Westminster Bank) and Morgan Grenfell Asset Management (Deutsche Bank). Several have been tainted by problems, including poor performance, fraud, management instability, and the adverse effects of sheer size – including the herd-behavior triggered by performance benchmarks comprising so few fund managers – which has left an opening for smaller players, including those based abroad.

Johnston by United Asset Management and Cursitor by Alliance Capital. And Société Generale of France announced its intent to become a major European asset manager by acquiring key executives from both MAM and MGAM. One can expect the 1997 acquisition of Winterthur Insurance by the Crédit Suisse Group to undertake strategic initiatives in U.S. or U.K. institutional asset management as well.

In November 1997 Merrill Lynch agreed to buy Europe's largest independent asset manager, Mercury Asset Management, with some $177 billion under management, for $5.3 billion. Merrill thus became the dominant player in the UK pension fund management market and one of the largest in Europe. The price represented a PE of 25.4 times trailing earnings, 3% of funds under management (as against an industry average of 2-2.5%), a premium of about 32% to market and a level some 40% higher than offered in Morgan Stanley in its abortive 1994 bid for S.G. Warburg, which controlled 75% of MAM shares. The new firm, Merrill Lynch Mercury Asset Management, incorporates all of Merrill's pre-existing institutional business, and complements Merrill's strong U.S. retail business by adding a powerful international institutional and retail presence. The firm thus placed a bet on disproportionate institutional asset growth outside the United States, notably Europe, producing a firm-wide balance of retail and institutional funds under management and adding to the stability of Merrill's overall revenue-stream.

And by announcing their merger into United Bank of Switzerland late in 1997, SBC and UBS created a pool of over $800 billion in assets under management, the world's largest.

Much of this is reflected in the data. Exhibit 26 presents the volume and number of mergers and acquisitions involving asset managers through 1997 (completed deals only), both in total and managers of open-end mutual funds only, covering the 12 ½ year period from 1985 through the first half of 1997. Altogether, there were over a thousand transactions valued at $36.5 billion, of which 242 transactions worth $15.7 billion involved mutual funds—note that the average size of mutual fund transactions was much larger than the average size of the overall deal-flow. About 70% of the total M&A value involved European targets, and 25% involved U.S. targets. Geographically, British asset managers represented the largest single target group, with 260 transactions worth $12.3 billion during this period, with the predominant buyers representing continental European institutions, mainly banks and insurance companies. There was roughly the same volume of activity within continental Europe, with 231 transactions valued at $12.5 billion. U.S. acquirers were mostly confined to domestic transactions, and only represented about 1/4 of the volume of intra-European transactions. Note also that in the case of mutual fund acquisitions, the focus of transactions again was within continental Europe. These data suggest that M&A market action and strategic repositioning substantially reflects the economic drivers of the asset management industry's restructuring. The action, both with respect to pension funds and mutual funds, is in Western Europe.

Market valuations of asset management companies have been quite high in comparison with other types of firms in the financial services industry, and this has been reflected in prices paid in M&A transactions. At midyear 1996 in the United

Exhibit 26
Merger and Acquisitions Activity in the Asset Management Industry
(1985-1997, Millions of U.S.$ and Number of Transactions)

Total	Total Asset Managers	Open-end Mutual Fund Managers
Global Target	36,502 (1,038)	15,677 (242)
European Target	25,213 (509)	11,808 (135)
U.S. Target	9,146 (341)	3,706 (67)
Other Target	2,143 (188)	163 (40)

Total Asset Managers	Total	European Acquirer	U.S. Acquirer
U.S. Target	9,146 (341)	2,477 (19)	6,102 (311)
U.K. Target	12,326 (260)	11,434 (227)	289 (35)
Cont. Eur. Target	12,617 (245)	12,504 (231)	0 (0)

Open-end Mutual Fund Managers	Total	European Acquirer	U.S. Acquirer
U.S. Target	3,706 (67)	1,549 (5)	1,661 (64)
U.K. Target	870 (21)	736 (17)	33 (2)
Cont. Eur. Target	10,991 (119)	10,683 (107)	0 (0)

Note: Data through June 1997. Paren. = No. of deals.
Data: Securities Data Corporation. Author calculations.

States, when the price to earnings ratio (based on expected 1996 earnings) for the S&P 500 stocks averaged 16.2, the price-earnings ratios of the top-ten domestic commercial banks with strong retail banking businesses averaged 10.3, and the top life and casualty insurance companies averaged price-earnings ratios of about 10, the top-eight publicly-owned investment banks (including JP Morgan and Bankers Trust) only 7.9 while the price-earnings ratios of the top-9 asset managers averaged about 14. The average share-price to book-value ratio for the top ten US commercial banks in 1996 was 1.83, for the top investment banks it was only 1.27, while for the top-9 asset managers it was 4.64.

Besides gaining access to distribution and fund management expertise, the underlying economics of this deal-flow presumably have to do with the realization of economies of scale and economies of scope, making possible both cost reductions and cross-selling of multiple types of funds, banking and/or insurance services, investment advice, high-quality research, etc. in a one-stop-shopping interface for investors —despite a good deal of evidence that investors are quite happy to shop on their own with low-cost operators like Vanguard or the Charles Schwab *OneSource* mutual fund supermarket. Empirical evidence of either economies of scale or economies of scope in this sector is lacking, although the plausibility of scale economies exceed that for scope economies. In any event, there has been little evidence so far that M&A activity in this sector has led to lower fees and charges to retail investors.[62]

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[62] Charles Gasparino, "Do Mutual Fund Mergers Hurt Small Investors?' *Wall Street Journal*, July 8, 1997.

In addition to U.S. and European strategic moves in the asset management business, few national markets have been as attractive as Japan's. The size of the pension fund market was estimated to be $1.3 trillion at the end of 1996, perhaps 10% of an estimated $13 trillion of discretionary savings that are mostly allocated to low-yield bank assets. The aforementioned prospects for rapid future growth of Japan's dedicated pension pool under demographic pressure, together with reallocation of discretionary household savings into better-performing managed and index portfolios—especially cross-border—creates enormous potential for asset managers. Foreign fund managers accounted for only 3% of Japanese assets under management at the end of 1996, dominated by independent foreign-based firms such as Schroders and Mercury Asset Management of the U.K. and loose alliances such as one between Fidelity and Mitsubishi Bank, and have been impeded by barriers to entry that precluded effective distribution of their more innovative and higher-performing products.

In anticipation of Japanese deregulation of the asset management industry, Nomura Securities in 1997 merged its trust and advisory businesses into Nomura Asset Management with about $115 billion in assets the largest Japanese asset management group. It also negotiated strategic alliances with regional commercial banks to rent space in bank branches for mutual fund sales, in anticipation of direct competition from the major banks' ability to sell their own mutual funds to the public in anticipation of a rise in mutual funds' share of household assets from 3% in 1997 closer to U.S. levels of 10% over a number of years.[63]

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[63]Gillian Tett, "Nomura in Talks With Regional Banks Over Fund Sales," *Financial Times*, September 29, 1997.

Coupled to what appears to be serious deregulation of the country's financial system, Japan has emerged as a major target for the 15 or so foreign-based asset managers active there since 1987, including a number of major strategic alliances. For example, in 1997 Swiss Bank Corporation and the Long-Term Credit Bank of Japan took a 5% stake in each other (which may be increased to 7%). Besides setting up an investment banking business named LTCB-SBC Warburg Dillon Read, the venture creates a Japanese private banking unit to capitalize on SBC's traditional strengths in that area as well as LTCB-SBC Brinson in the institutional asset management business, linking it to the bank's Chicago-based institutional fund-management unit. Opportunities for foreign-based fund managers in Japan benefitted from the misfortunes of the country's large life insurers, notably the collapse of Nissan Mutual, which traditionally held a firm grip on Japanese pension funds, as well as prospects for elimination of the requirement that foreign fund management groups use Japanese brokers to sell mutual funds to the general pubic—usually employing selling tactics that emphasized short-term trading rather than long-term investing.

This followed other foreign linkups such as Bankers Trust Company and Nippon Credit Bank, Barclays PLC and Hokkaido Takushoku Bank, as well as Smith Barney and Nikko Securities. Another alliance was announced in 1997 between the largest foreign insurer, AIG, and Japan's largest trust bank, Mitsubishi Trust, and the 1997 announcement by the Franklin/Templeton Group (the fourth-largest U.S. mutual fund manager) of a strategic alliance with the Sumitomo Life Insurance Company of Japan covering international equity investments, presumably facilitating Franklin/Templeton's

access to the enormous Japanese fund management market and improving Sumitomo Life's chances of its improving investment performance against traditionally lackluster Japanese standards.[64] It mirrors a similar 1997 arrangement between Putnam Investments of the U.S. and Nippon Life, the world's largest insurance company in the pension fund management sector. Commerzbank of Germany also announced plans to establish mutual fund operations in Japan in 1998 through its Commerz International Capital Management affiliate.

Exhibit 27 provides some indication of the relative size of the 38 top asset managers. Overall, countries with traditional reliance on funded pension schemes and mutual funds marketed to retail investors—the United States, Japan and the United Kingdom—were home to 72 of the top-100 asset managers and 76% of the assets under management.[65] Continental European countries captured only a fourth of the top spots and 22% of the assets, although this is likely to change as PAYG pension programs increasingly give way to dedicated asset pools and as financial market integration stimulates a competitive battle among different types of financial institutions for asset management services. Within Europe, 31% of assets are managed in the United Kingdom, 20.3% in Switzerland, 16.5% in Germany, 15.6% in France, 8.4% in the Netherlands, the balance in Liechtenstein, Denmark, Spain, Belgium, Sweden and Italy.[66]

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[64] William Dawkins, "Mitsubishi and AIG in Trust Venture," *Financial Times*, March 7, 1997.

[65] "Watson Wyatt World-500," Pension Age, September 1996.

[66] *Institutional Investor.*

Exhibit 27

Top Global Money Managers: AUM Exceeding $100 Million

(As of December 31, 1997)

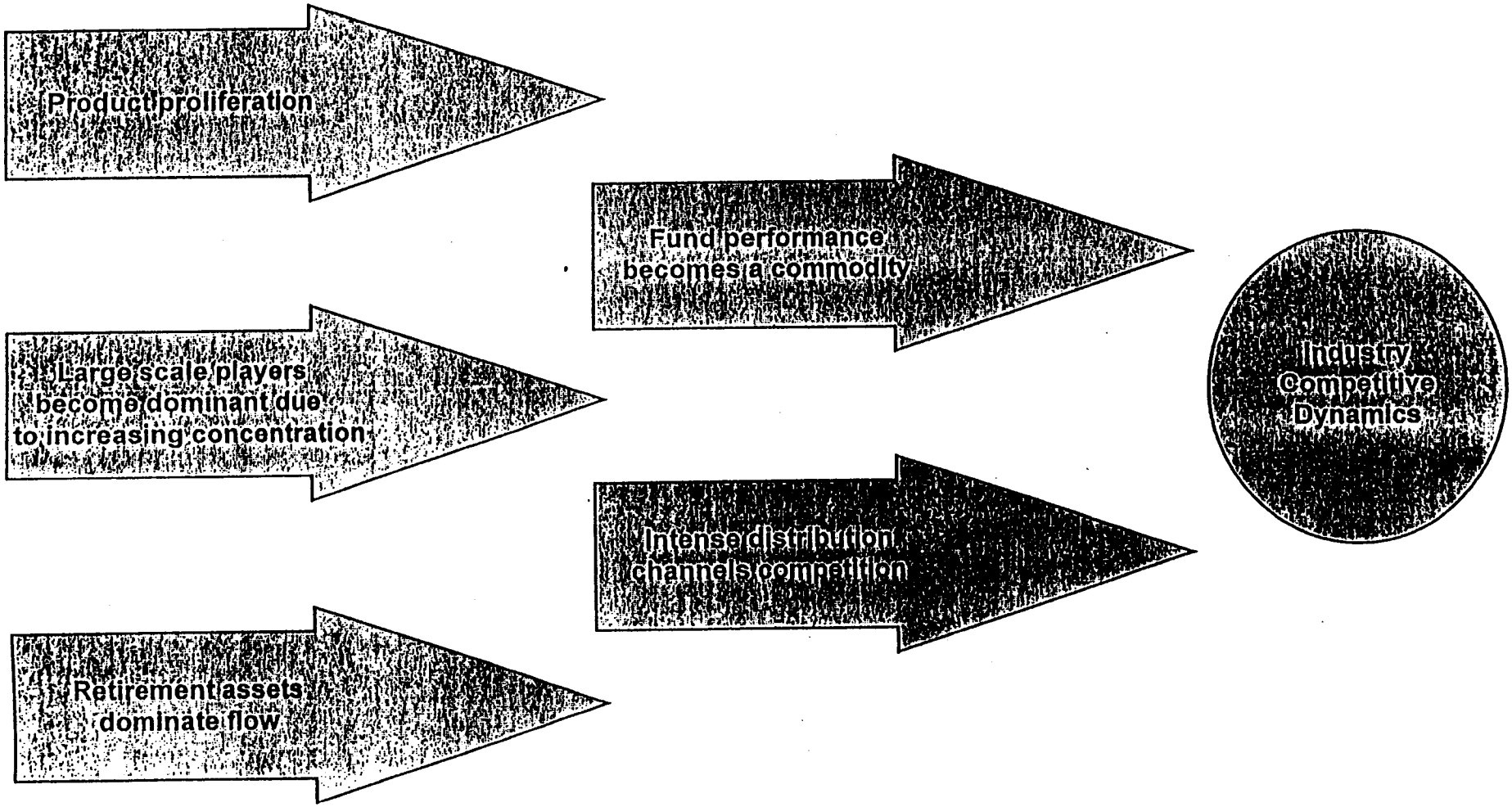
	Total Assets Under Management (millions)
United Bank of Switzerland (Zurich, Switzerland)	920,000
Japan Postal Insurance System (Tokyo, Japan)	865,020
FMR Corp. (Boston, MA)	515,300
Groupe AXA-UAP (Paris, France)	500,300
Zurich Group (Zurich, Switzerland)	460,000
Merrill Lynch & Co. (incl. MAM) (New York, NY) - merged Nov. 97	450,000
Union Bank of Switzerland (Zurich, Switzerland)	449,000
Barclays Bank PLC (London, UK)	385,449
Credit Suisse/Winterthur (Zurich, Switzerland)	380,000
The Prudential Corporation (London, UK)	350,000
Nippon Life Insurance Co. (Tokyo, Japan)	342,800
The Vanguard Group (Valley Forge, PA)	310,500
State Street Boston Corp. (Boston, MA)	300,947
The Prudential Ins. Co. of America (Newark, NJ)	271,700
Capital Group Cos. (Los Angeles, CA)	259,704
Mellon Bank Corp. (Pittsburg, PA)	258,923
Deutsche Bank, AG (Frankfurt, Germany)	240,000
Bankers Trust Co. (New York, NY)	239,582
Morgan Stanley, Dean Witter & Discover Co. (New York, NY)	234,806

	Total Assets Un Management (millions)
Allianz AG (Munich, Germany)	210,000
J.P. Morgan & Co. (New York, NY)	208,605
Equitable Life Assurance Society of the U.S. (New York, NY)	207,999
Franklin Resources (San Mateo, CA)	174,954
Marsh & McLennan Cos. (New York, NY)	173,443
United Asset Management Corp. (Boston, MA)	168,024
Putnam Funds (Boston, MA)	161,000
American Express Co. (New York, NY)	147,696
Internationale Nederlanden Groep (Amsterdam, The Netherlands)	140,000
Travelers Group (New York, NY)	133,337
Wellington Management Co. (Boston, MA)	133,162
Northern Trust Corp. (Chicago, IL)	130,252
Chase Manhattan Corp. (New York, NY)	130,095
Invesco Group Ltd. (London, UK)	126,172
Nomura Securities Corp. (Tokyo, Japan)	115,000
PNC Bank Corp. (Pittsburg, PA)	110,396
Pimco Advisors (Newport Beach, CA)	110,022
Federated Investors (Boston, MA)	101,300
T. Rowe Price Associates (Baltimore, MD)	100,390

What all of this suggests is competitive dynamics in the asset management industry such as those depicted in Exhibit 28. Proliferation of products is already exceedingly high in the United States and the United Kingdom, and will no doubt be no less impressive in the remainder of the EU as financial markets become more fully integrated, especially under a common currency. There will be a great deal of jockeying for position and higher levels of concentration, especially in the fast-growing pension fund sector, that will begin to permeate the mutual fund business through defined contribution plans—given the importance of economies of scale and the role of pension fund consultants. However, as in the United States the role of fund supermarkets, low-cost distribution via the Internet, as well as the very large contingent of universal banks, insurance companies and non-European fund management companies is likely to prevent market structure from becoming monopolistic to any significant degree. Fund performance will become a commodity, with few differences among the major players and the majority of actively managed funds underperforming the indexes. This implies a competitive playing field that, in Europe and Japan as in the United States, will be heavily conditioned by branding, advertising and distribution channels, which in turn are likely to move gradually away from the traditional dominance of banks in some of the EU markets. All of this implies that asset management fees—historically quite high, particularly in continental Europe—will come under pressure as competition heats-up, to the benefit of the individual investors and participants in funded pension plans.

Exhibit 28

Ongoing Asset Management Industry Developments



Source: Goldman Sachs & Co.

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Still, consolidation of the global asset management industry has developed its own momentum, with the assets under management by the top-10 firms increasing from $3.39 trillion to $4.22 trillion during 1997. Size and global reach into growing asset pools (especially pension-related) seem to be the major drivers, along with presumptive economies of scale and high costs associated with investments in information technology and talented people, plus perhaps a good deal of management hubris. Consolidation continues despite lack of evidence of scale economies and mixed results in terms of benefits either to clients or to shareholders of asset management companies.[67]

6. Institutional Asset Pools and Capital Market Development

The impact of the growing role of performance-driven asset managers is likely to run the gamut from the composition of financial assets and the scope available for portfolio diversification to competition among financial centers and corporate governance.

Composition of Financial Assets

The role of a burgeoning Global asset management industry in promoting disintermediation in an increasingly unified financial market is unlikely to differ very

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[67] One of the major British pension fund consultants identifies the following requirements for profitability in the asset management business: Consistency of products in different markets, equal access to research for all units, use of global expertise for all clients, a culture that rewards global success, a strong global brand, and a significant share in the major markets for asset management. Jane Martinson, "A Hurrying Sickness," Financial Times, December 10, 1997.

much in character from what has occurred in the United States, except that its pacing may be quite different under distinctly different institutional and regulatory conditions. Exhibit 29 shows that U.S. intermediated financial assets on the books of credit institutions have declined significantly over time in comparison with securities managed by fiduciaries of various types, notably mutual funds and 401(k) pension plans. In 1996 mutual funds alone held 12% of the capitalization of the U.S. stock market, 16% of the market for state and local bonds, 7% of the corporate and foreign bond market, and 5% of the U.S. Treasury and federal agency bond market.[68]

The reason for this migration has much to do with changes in the relative static and dynamic efficiency characteristics and costs (or spreads) of intermediation via traditional financial institutions, as against more direct securities market processes driven by institutional fund managers deploying rapidly-growing asset pools in search of optimum portfolio performance on the one hand, and issuers seeking cheaper financing and more flexible structures in the capital market on the other. Differential regulatory burdens, technology and financial innovation (notably securitization) have played major roles in this process.

Europe, with roughly twice the proportion of financial assets on the books of banks and other financial intermediaries than the United States, will go through much the same process, propelled by the imperatives associated with rapidly-growing pools of professionally-managed funds. Notably asset securitization—which except for

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[68] Eli M. Remolona, Paul Kleiman and Debbie Gruenstein, "Market Returns and Mutual Fund Flows," *Federal Reserve Bank of New York Economic Policy Review*, July 1997.

Exhibit 29
Relative Shares of Total Financial Intermediary Assets
1950-95
(Percent)

	1950	1960	1970	1980	1990	1995
Depository institutions (banks)						
Commercial banks	55.9	38.0	38.4	36.5	30.2	27.7
Savings and loans and mutual savings	11.3	18.6	18.8	19.5	12.3	6.3
Credit unions	1.0	1.0	1.3	1.7	2.0	1.9
Insurance companies						
Life insurance	21.3	19.2	14.9	11.4	12.4	12.8
Other insurance	3.0	4.4	3.8	4.5	4.8	4.6
Pension funds						
Private	3.1	6.8	9.2	12.4	14.6	16.2
Public (state and local government)	1.3	3.3	4.5	4.8	7.4	8.5
Finance companies	2.0	4.8	5.3	5.4	6.0	5.3
Mutual funds						
Stock and bond	1.1	3.9	3.9	1.7	6.0	12.1
Money market	0.0	0.0	0.0	1.9	4.5	4.6
Total	100	100	100	100	100	100

Note: The share is the percentage of the intermediary's total financial assets relative to the sum of total financial assets for all categories listed. The percentages do not add to 100 due to rounding.

Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

traditional mortgage-backed securities like the Pfandbrief in Germany, have experienced limited development in Europe outside the United Kingdom—may expand dramatically in the years ahead. This includes securitization of commercial and industrial loans which, in a lending-oriented environment like Europe, offers great potential. In the modern financial environment of today, borrowers face a range of alternatives for obtaining financing, and even retail borrowers and small or medium-size companies which are basically limited to bank borrowing can subsequently have their loans securitized and benefit from both access to a much broader pool of institutional funding sources as well as conversion of illiquid bank loans into liquid securities form. The gains from both types of activities will be partially passed backward to the borrower, partially passed forward to the investor, and partially retained by the financial intermediaries providing the structuring, underwriting and distribution services.

For example, one study suggests that the aforementioned, gradual shift from banking to securities transactions is likely to be accelerated by EMU because the factors that underlie this development, by reducing transactions and information costs (both heavily driven by technology) and making available new products to end-investors, cannot be fully exploited in a fragmented foreign exchange environment, i.e., one characterized by widespread currency-matching rules bearing on issuers and investors. This includes a range of financial instruments that are broadly available in the United States but have been unable to reach critical-mass needed for trading efficiency and liquidity in Europe "If EMU has the side-effect of bringing those assets

to the market, then the playing-field will tilt a little. If technology shifts the 'management expenses' goal posts as well, then we may be in a new ball game."[69]

The next set of developments in both the United States and Europe in the presence of major performance-oriented managed asset-pools may involve direct placement mechanisms for ditributing securities to institutional investors, including automated links that have the potential of further cutting-out traditional financial intermediaries.

The rise to prominence of institutional asset managers worldwide will do a great deal to enhance financial market liquidity. Mutual funds—whether part of defined contribution pension schemes or mass-marketed as savings vehicles to the general public—and other types of money managers are so-called "noise traders" who must buy and sell assets whenever there are net fund purchases or redemptions, in addition to discretionary trades to adjust portfolios. They therefore tend to make a disproportionate contribution to capital market liquidity. Mutual funds alone account for the largest share of U.S. equity turnover, for example, with the trades of the largest mutual fund company (Fidelity) estimated to account for 12-15% of daily stock trading and generating some $200 million annually in dealing commissions. Exhibit 30 shows the relevant equity and fixed-income turnover ratios (trading volume divided by market capitalization) for different types of asset managers in the United States from 1993 to 1996.

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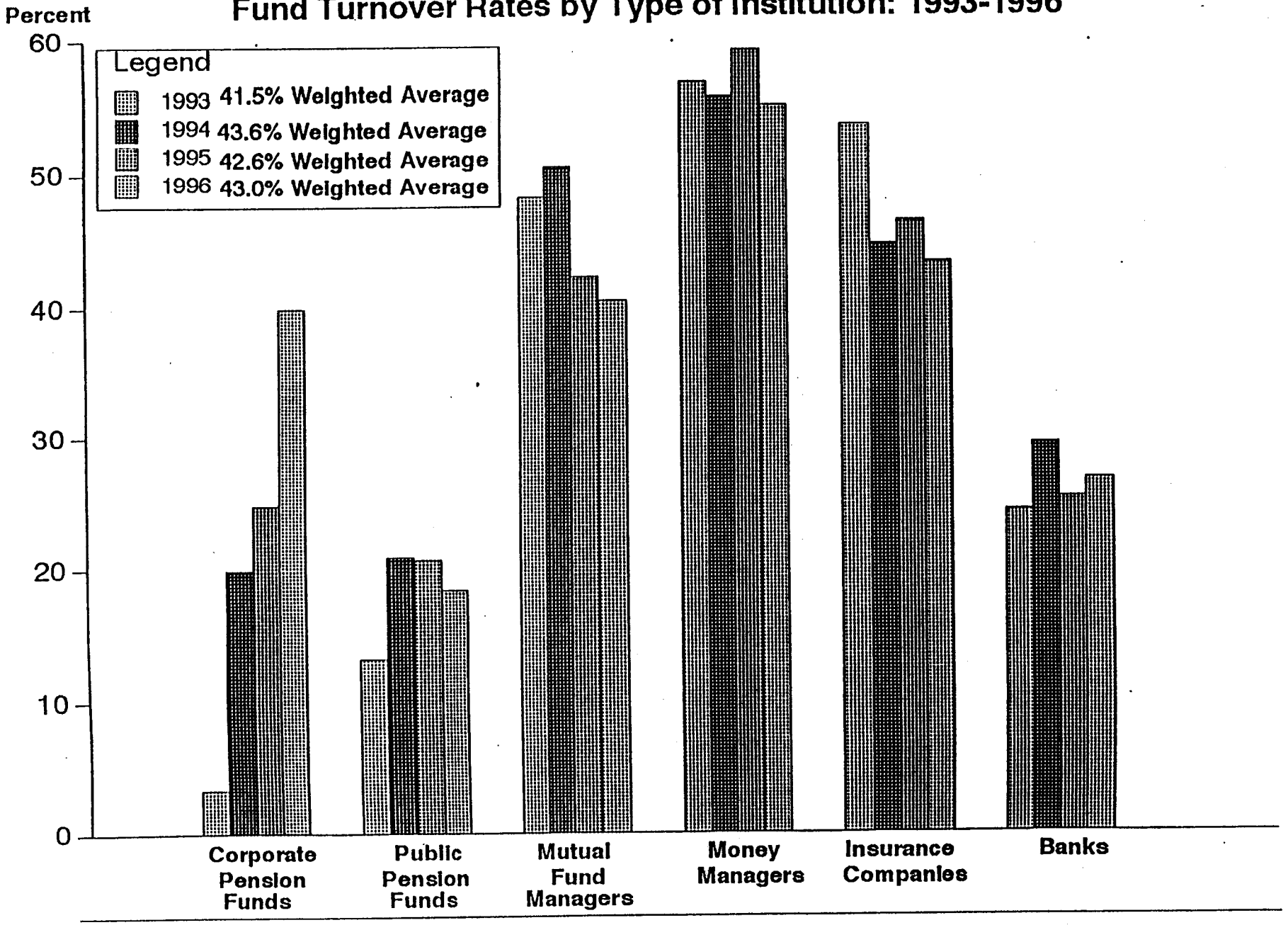
[69] Graham Bishop, *Post Emu: Bank Credit Versus Capital Markets* (London: Salomon Brothers Inc., 1997).

Exhibit 30

Fund Turnover Rates by Type of Institution: 1993-1996



Source: Georgeson & Co.

c:\overhds\turnrate.wpg

For example, in Europe it is likely that EMU will favor the asset management industry, both in terms of market share in the financial intermediation process and in terms growth prospects. Asset managers will be less affected than banks in terms of the cost-implications of EMU and will benefit disproportionately from the increased depth and breadth of the European capital market that a single currency implies. At the same time, they will be favored by the fiscal implications of Maastricht-type criteria, which will place greater pressure on governments to accelerate the transition from PAYG pension schemes to various types of defined contribution programs.[70]

The Market for Markets and the Location of Financial Activity

Given their size and the performance pressures bearing on them, institutional asset managers try to focus their trading on financial markets that are marked by the following characteristics:

- A high degree of liquidity, notably for block trades, and good after-hours capabilities.
- Low transactions costs, notably for commissions and spreads, clearance and settlement services, back-office operations, custody services, telecommunications and other financial infrastructure services.
- High levels of transparency in securities transactions and in the securities themselves, including strong regulatory and enforcement capabilities to ensure honest dealing and a level playing field.
- A broad product range of underlying securities and derivatives, and strong innovative capabilities.

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[70] For a discussion of the overall capital market effects of EMU, see JP Morgan, *EMU: Impacts on Financial Markets* (New York: JP Morgan, 1997).

- A uniform accounting and legal infrastructure that meets global standards.
- A major equities component of capital markets, of prime interest to both pension funds and mutual funds, running from large-cap global companies to IPOs and private equity, with strong turnover and deep investor participation.

The battle among equity markets will perhaps be the one most heavily affected by the behavior of highly performance-oriented asset managers. For example, in Europe the EU's Investment Services Directive (ISD) has permitted exchanges to place trading screens in other financial centers. Easdaq has been in the process of creating a pan-European over-the-counter exchange patterned on NASDAQ in the United States to attract new, high-growth companies. National markets in Frankfurt, Paris, Brussels and Amsterdam have been trying to do the same thing and link-up in the form of EuroNM to compete with both NASDAQ and Easdaq, even as comparable initiatives are underway among the Nordic countries. The rapid growth of institutional asset management in Europe, however, is likely to promote a fairly rapid shakeout of these competing market initiatives based on how they meet the aforementioned criteria, certainly under conditions of a common currency—with perhaps two or three OTC and organized exchanges accounting for the vast bulk of European trading activity in the medium-term future. The large, integrated U.S. market supports only one major exchange, and one major OTC trading system, alongside a number of specialist exchanges in New York, Philadelphia, Chicago and San Francisco plus continued challenge from electronic exchanges such as the Arizona Stock Exchange (AZX). The U.S. "equilibrium" market structure may well be an inappropriate indicator for a future integrated European market supporting the rapidly growing needs of institutional asset managers.

Indeed, the U.S. locational pattern as it has evolved over a much greater span of time may also be a reasonable model of what will eventually develop in Europe: (1) A single wholesale market for transactions-execution (New York) not necessarily identical to the seat of monetary policy and financial regulation (Washington), with a reasonable argument to be made that a bit of "distance" between the markets and their regulators can be helpful. (2) Dispersed asset management centers (Boston, Chicago, Philadelphia, Stamford, San Francisco), and sometimes no centers at all in a business where the necessary information, interpretation and transactions services can all be delivered electronically and in real-time. (3) Specialist centers focusing on particular financial instruments (Chicago, Philadelphia) or industries (San Francisco) that have their roots in history or ongoing economic developments.

In Europe, few comprehensive data are available, although it is likely that Switzerland (Zurich and Geneva) and London share the top spot in asset management, with very different businesses centered on private banking and institutional asset management, respectively. Other continental European asset management centers are far behind. In the equity sector, London ranks first with over $1 trillion under management, followed by Zurich, Basel and Geneva combined with $740 billion, Frankfurt with $157 billion (excluding intercorporate holdings), Edinburgh with $138 billion and Stockholm with $89 billion. None of the other European financial centers rank in the top-25. These numbers compare with $1.5 trillion managed in Tokyo and

$896 billion in New York.[71] Such rankings in the future are likely to shift as European financial integration continues, especially under a single currency,. with greater polarization possible.

Portfolio Diversification and Globalization

Professional fund managers attempt to optimize asset allocation in line with modern investment concepts by taking advantage of the potential for domestic and international portfolio diversification inherent across the range of financial instruments being offered, as well as by using the most efficient (friction-free) available securities markets and infrastructure services. Both dimensions are likely to be affected by European financial integration and a common currency.

Within a modern portfolio optimization framework the attractiveness of adding any individual asset or group of assets—cash, gold, stocks, bonds, real estate, and assets denominated in various currencies—to a portfolio depends on the expected total returns on that asset and what impact it has on the risk of the overall portfolio. The less correlated the returns of a given asset are with the other assets already in the portfolio, the greater the benefits from diversification, and therefore the less risky the overall portfolio. This is the key element in international portfolio diversification, based on less than perfect correlations across exchange rates, interest rates, and equity market prices, and has led to rapid expansion of cross-border institutional asset allocations—see Exhibit 31 regarding pension fund cross-border asset allocations.

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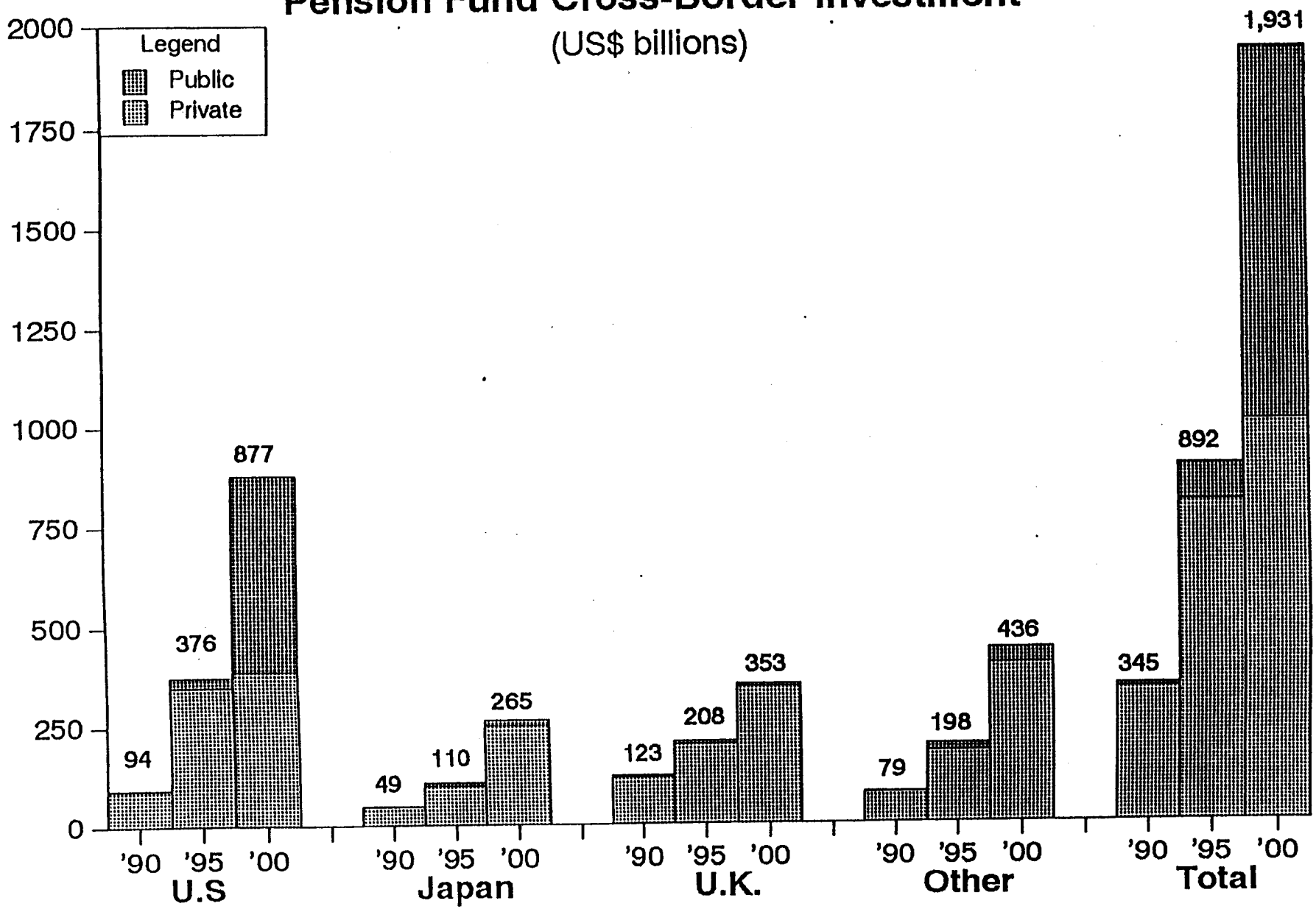
[71] *Financial Times*, "Survey of Global Fund Management," April 27, 1997.

Exhibit 31

Pension Fund Cross-Border Investment

(US$ billions)



Source: InterSec Research Corp., 1996. Data for Ausralia, Canada, Japan, Switzerland, U.K. and U.S.

Cross-border mandates for managing U.S. pension fund assets, for example, have grown from $94 billion in 1990 to over $400 billion in 1996, and are expected to continue to expand to perhaps $900 billion by 2000, about 60% of which will involve equity holdings. As a proportion of total assets under management, large U.S. pension plans have increased their international holdings from 2% in 1986 to 15% in 1996, with a further increase to 19% expected by 2001.[72]

For European institutional investors, on the other hand, national currencies will obviously disappear among participating EU countries as a source of portfolio diversification. So will variations in interest rates, with a single rate-structure prevailing in the entire region. Investors seeking sources of diversification across less than perfectly correlated exchange rates and interest rates will thus have to look outside the region covered by the euro, while external investors will lose any comparable diversification gains that may have existed within the region. The euro-zone becomes a single market-risk and sovereign risk "bucket" from the perspective of portfolio diversification. EMU is also likely to increase correlations across equity markets covered by the euro, representing a continuation of the gradual increases in inter-market correlations that have already been observed.[73] This will force portfolio

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[72] Data: JP Morgan.

[73] See, for example, François Longin and Bruno Solnik, "Is the Correlation of International Equity Returns Constant?" *Journal of International Money and Finance*, Vol. 14, No. 1, 1995. Portfolio diversification gains tend to be greater across global equity markets than across global bond markets, where they derive solely from less than perfectly correlated interest rate and exchange rate movements. Moreover, unlike the global bond markets, stocks tend to be more highly differentiated and subject to local trading conditions, although listings on foreign stock exchanges through depository receipts have made some foreign equities considerably more accessible to foreign investors.

managers to focus relatively more heavily on diversification strategies involving non-European markets. The attractiveness of emerging market equities may therefore increase due to potentially lower correlations between emerging market stock returns and the major market indexes such as the Standard & Poors 500 index, the French CAC-40 or the German DAX equity averages.

In terms of asset classes, we have already noted that EMU will create a new, generic type of fixed-income security that will be very similar to municipal bonds in the United States. Since national central banks and the possibility of debt monetization at the national level will disappear among EMU countries, borrowing requirements of national governments will involve rated debt instruments denominated in euros that will be available to institutional investors, with spreads differing among issuing governments based on the market's perceptions of the degree of risk involved. Since currency risk will be eliminated within the EMU region, the focus will be entirely on market risk and credit risk, and such "Euro-munis" will represent a major asset class in institutional funds pools for both EU and non-EU portfolios such as those managed in the United States and Japan.

Taxation remains a major problem in the creation of efficient pension asset allocations via international portfolio diversification. The reason is that governments often do not provide reciprocal tax exemption for pension assets invested abroad. For example, many countries exempt employee and employer pension contributions and pension fund earnings from tax, and subsequently taxed at prevailing personal income tax rates when it is distributed upon retirement—although some countries tax

retirement income at concessionary rates as well. If part of a retirement fund is invested abroad, however, the host country often treats the assets the same as all other financial assets, and levies taxes on interest, dividends and/or capital gains at regular withholding rates. Such differential tax treatment obviously biases asset-allocation toward domestic investments, and can significantly affect portfolio optimization. Several proposals have dealt with this issue. The OECD Model Tax Convention would tax dividend income 15%, interest income at 10% and capital gains at 0% without regard to the distinction between retirement and non-retirement assets. The U.S. Model Income Tax Convention would tax dividend income of foreign assets at 15% and exempt interest income and capital gains, but would also exempt all income on retirement assets as long as at least half of the participants of the fund are residents of the home country. Ideally, of course, there should be reciprocal exemption from tax of all retirement assets invested internationally together with reciprocal acceptance of certification of retirement plan qualifications.[74]

Asset Managers, Shareholder Value.and Corporate Governance

Assuming the rapid advance in prominence of institutional asset managers follows along the lines suggested in this paper, the capital markets will increasingly be the major source of external financing for corporations in the future—as against the traditional, heavy reliance in Europe and Japan (compared with American and British

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[74]Paul Schott Stevens, "Selected Issues in International Taxation of Retirement Savings, *Investment Company Institute Perspective*, August 1997.

companies) on bank finance for debt and bank and corporate long-term shareholdings for equity. Fiduciary asset pools managed against performance benchmarks by mutual funds and pension funds will create increasingly fluid sources of capital for industry, and a fundamental shift in the accountability of management and monitoring of corporate performance.[75]

In such a system, industrial restructuring will increasingly be triggered by the emergence of a control premium between the existing share price of a corporation and the value that an unaffiliated acquirer (whether an industrial company or an active financial investor) perceives could be unlocked by changes in management strategies or policies. Based on such a view of corporate underperformance, an investor may purchase a significant block of shares and signal his unhappiness with the company's performance, or perhaps initiate a full takeover bid for the target firm (which is now "in play"). Institutional asset managers can assume a critical role in such a scenario. They may agree that a control premium does indeed exist and themselves begin purchasing shares, thereby placing still greater pressure on management of the target company.[76]

Even in the absence of a potential acquirer putting the company in play, major institutional asset managers who, because of their size or portfolio constraints, find it difficult or impossible to dispose of their ownership interest in a company they feel

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[75] For a full discussion, see Arnold Sametz, The Power and Influence of Pension and Mutual Funds (Amsterdam: Kluwer, 1998 - forthcoming).

[76] For a comparison between traditional market-based and institution-based approaches to corporate control, see Jonathan Story and Ingo Walter, *The Politics of European Financial Integration* (Manchester: Manchester University Press, and Cambridge: MIT Press, 1997).

is performing poorly can request a meeting with management about the firm's strategy, financial performance, and realization of shareholder value, and perhaps speak-out at annual general meetings. Concerns about unwanted takeover efforts and institutional investor dissatisfaction may in turn prompt management to undertake a self-restructuring, seek an acceptable merger partner ("white knight"), pay-out special dividends or initiate share repurchases, or find other ways to enhance shareholder value and efficiency in the use of capital to preclude the emergence of a control premium and hostile action.

Such a transition—from the traditional corporate governance process with two-tier boards and large, friendly ownership stakes insulating management from the pressure of external shareholders seeking improved total returns to a more "contestable" model along Anglo-American lines—is an important possible consequence of the growing role of professionally managed asset pools in various parts of the world, notably in Europe. The potential benefits of such developments involve reduced cost-of-capital through higher share prices and improved access to global financial markets and a greater capacity for industrial restructuring in response to changes in technology, market competition and other fundamentals.

Investor-driven, market-based systems such as this will require much higher levels of transparency in corporate accounting and disclosure than has been the norm in most of Europe, together with greater reliance on public information provided by management and systemic surveillance by research analysts working aggressively on behalf of investors. It implies arm's length financing on commercially viable terms by banks and financial markets, with financial institutions active in giving strategic and

financial advice and sometimes taking transitional, non-permanent equity positions in (and occasionally control of) corporations in the process of restructuring.

It also assumes that the principal stakeholders in corporations (shareholders, employees, managers and customers) accept that the central claim to legitimacy of free, investor-driven capital markets is that they generally provide the most efficient way of augmenting economic wealth, as against less viable politically-driven allocation of capital. This approach assumes that government will not prove a light touch for corporate lobbies seeking to avoid restructurings or takeovers through access to the public purse as a less demanding and less disciplined source of capital. The labor market likewise needs to be supportive, so that work-forces can be adapted and reallocated both functionally and geographically with the minimum of friction. Government's major task is to provide wide macroeconomic stability together with the regulatory and legal structure within which open capital markets may function, and to supply an acceptable and affordable social safety net.

7. Summary and Conclusions

The focus of this paper has been the structure, conduct and performance of the asset management industry. The industry was positioned in a domestic and global flow-of-funds framework as "collective investment vehicles," with emphasis on its three principal components—mutual funds, pension funds and assets under management for high net-worth individuals—and their interlinkages. There are six principal conclusions that can be drawn.

First, the asset management industry is likely to grow substantially in the years ahead. Institutionalization and professional management of household discretionary assets through mutual funds has probably run its course for the time being in terms of market share some countries like the United States and the United Kingdom, but has barely begun in many of the continental European countries and Japan, which have traditionally been dominated by bank assets. Demographic and structural problems in national pension systems will require strong growth in dedicated financial asset pools as pay-as-you-go systems become increasingly unsupportable fiscally, and alternative means of addressing the problem show themselves to be politically difficult or impossible to implement. There are, however, substantial differences of view as to the timing of these developments within national environments, since pension reform is politically difficult to carry out and the political willingness to do so is difficult to predict. In both mutual funds and pension funds, and their linkage through participant-influenced defined contribution pension schemes, the center of global growth is likely to be Western Europe, with Japan not far behind.

Second, despite the prospects for rapid growth, the asset management industry is likely to be highly competitive. Major asset management markets are being aggressively targeted by virtually every *strategic group* in the financial services sector—commercial and universal banks, private banks, securities firms, insurance companies, mutual fund companies, financial conglomerates, and financial advisers of various types.

Normally, the addition of new vendors in a given market would be expected to reduce market concentration, increase the degree of competition, and lead to an erosion of margins and trigger a more rapid pace of financial innovation. If the new vendors are from the same basic strategic groups as existing players, the expected outcome would be along conventional lines of intensified intra-industry competition. But if, as in this case, expansion-minded players come from very different strategic groups, the outcome may involve a substantially greater increase in the degree of competition. This is because of potential diversification benefits, possibilities for cross-subsidization and staying-power, and incremental horizontal or vertical integration gains that the player from "foreign" strategic groups may be able to capture. And natural barriers to entry in the asset management industry—which include the need for capital investment in infrastructure (especially in distribution and back-office functions), human resources (especially in portfolio management), technology, and the realization of economies of scale and scope—are not excessively difficult for newcomers to surmount. So the degree of internal, external and inter-sectoral competition in this industry is likely to promote market efficiency for the benefit of the end-users in managing discretionary household asserts, pension funds, the wealth of high net-worth individuals, and other types of asset pools in Europe.

Third, the rapid evolution of the global institutional asset management industry will have a major impact on financial markets. The needs of highly performance-oriented institutional investors will accelerate the triage among competing debt and equity markets in favor of those that can best meet their evolving requirements for

liquidity, execution efficiency, transparency, and efficient regulation. In turn, this will influence where firms and public entities choose to issue and trade securities in their search for cost-effective financing and execution. At the same time, the growing presence of institutional investors in national and regional capital markets will greatly increase the degree of liquidity due to their active trading patterns, and create a ready market for new classes of public-sector and private-sector securities that will emerge. And it will intensify competitive pressure and enhance opportunities for the sales and trading activities of banks and securities firms, and for the role of product development and research in providing useful investment ideas.

Fourth, cross-border asset allocation will grow disproportionately as a product of institutional investors' search for efficient portfolios through international diversification. IPD is inherently a global process, so that the gains will depend on intermarket correlations of interest rates, exchange rates, equity-markets and other asset classes worldwide.[77]

Fifth, the development of a deeper and broader pan-European capital market spurred by the development of the institutional asset management industry will fundamentally alter the European market for corporate control, into a much more fluid one focused on financial performance and shareholder value. This in turn has the

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[77]For example, with the EMU zone as essentially one "bucket" with respect to currencies and interest rates, IPD options will shift to other asset classes, including emerging market debt and equities. Arguably, much of this has already occurred as intra-EMS rates have converged in anticipation of EMU. This development will tend to promote the market share of passive funds, and increase the need for portfolio management skills applied to diversification outside the EMU region.

potential of triggering widespread and long-overdue European economic restructuring and creating a much trimmer, more competitive global economic force willing and able to disengage from uncompetitive sectors through the denial of capital promoting leading-edge industries though venture capital and other forms of start-up financing. Such a transformation will hardly be painless, and will depend critically on political will and public support for a more market-driven growth process.

Finally, developments in institutional asset management will pose strategic challenges for the management of universal banks and other traditional financial institutions in extracting maximum competitive advantage from this high-growth sector, in structuring and motivating their organizations, and in managing the conflicts of interest and professional conduct problems that can arise in asset management and can easily cause major problems for the value of an institution's competitive franchise. The fact that institutional asset management requires a global perspective, both on the buy-side and on the sell-side, reinforces the need to achieve a correspondingly global market positioning for many financial institutions, although technology and the changing economics of distribution virtually assures the survival of a healthy cohort of asset management boutiques and specialists.

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