



Investment Management Industry Group

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Asset Management in the 21st Century: New Rules, New Game

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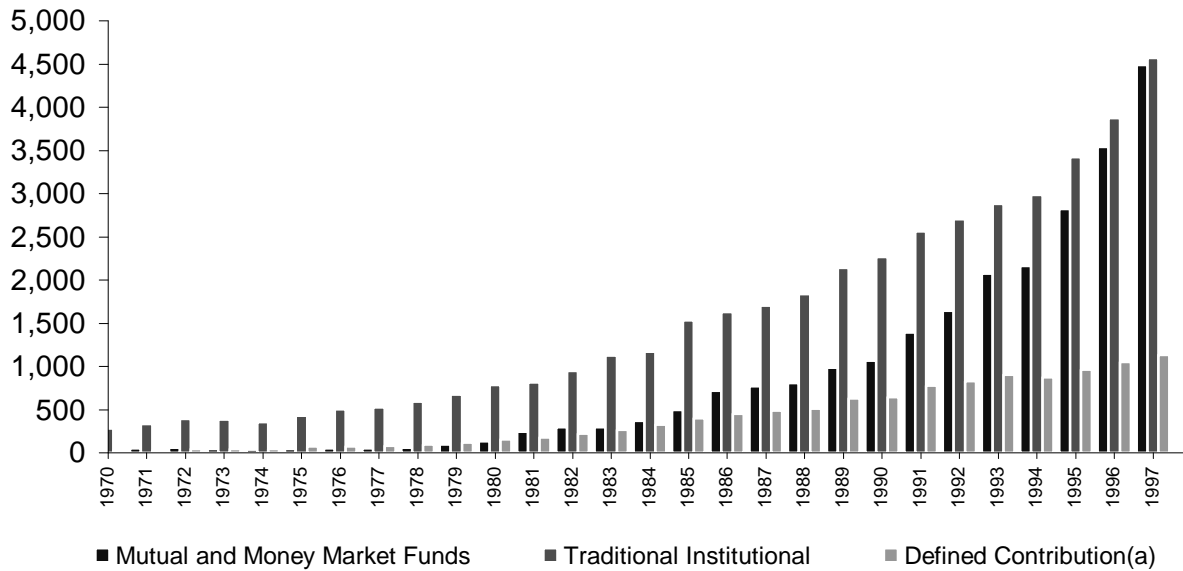
Executive Summary

In this paper, we examine shifts in certain fundamental factors that will influence the asset management industry as it enters the 21st Century. **Our current industry outlook is quite positive and we see no reason for that view to change. We do believe, however, that U.S. asset management will be entering a new phase in its life cycle.** The bull market continues to rage, driven by positive fundamentals of its own, and the favorable outlook for the markets continues to be a positive for the industry. The bull market notwithstanding, the asset management industry will face some clear challenges as the industry matures, the nature of the business evolves, and competition increases;

- Demographic changes over the next decade will turn prime savers (ages 40-60) into dissavers and result in moderating fund flows into retirement savings. This shift will, in turn, result in growing competition among asset managers who have historically enjoyed high rates of secular industry growth.
- Legislation favoring defined contribution over defined benefit plans implies a shift toward a greater retail-orientation in the industry and continued development of the “instividual” market.
- Both retail and institutional customers are growing more sophisticated and more demanding, increasing the pressure to deliver on service as well as performance.
- Branding and distribution, always important, will reassert their primacy in attracting assets as companies compete more for existing asset dollars and the retail and instividual markets grow in significance.
- Increased competition, growing retail orientation, greater emphasis on marketing, and opportunities abroad will result in a massive effort to gain scale and scope. As a result, further consolidation in a historically fragmented but rapidly consolidating industry is likely. International opportunities for global asset managers appear very attractive as a result of having similar fundamentals but a relatively less-developed asset management market abroad.
- The European asset management industry faces many of the same challenges as the U.S. industry but from a different starting point: Financial services oligopolies dominate specific local markets within Europe, but these markets are rapidly being redefined by European integration. The race to pan-European dominance will result in a push for scale and scope with important ramifications for global asset managers. We discuss strategic alternatives for market participants.
- In Japan, a troubled and antiquated financial system has driven a push for financial deregulation through the country’s own “Big Bang,” currently under way. The likely result will be a more vital and open financial services sector that will provide great opportunities for global asset managers.

Exhibit 1: The U.S. Asset Management Industry, 1970-1997

(\$ in billions)



Source: Investment Company Institute, Federal Reserve Board of Governors, EBRI, our estimates

(a) Excludes money market and mutual funds represented separately.

I. Introduction

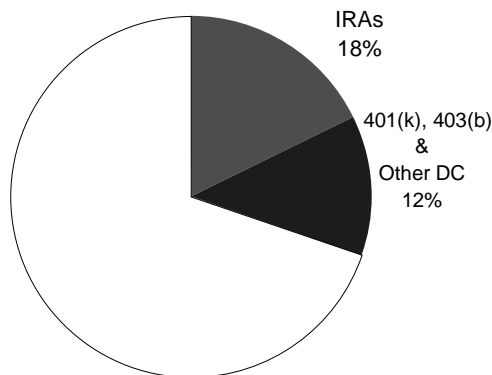
The asset management business continues its extraordinary run. Fund flows and capital markets are moving to new highs. Never has Washington been more supportive of the individual saver, as evidenced by recent tax and savings legislation. And any plan to save Social Security through a full or even partial privatization would imply an even greater windfall to the industry. Meanwhile, attractive profits are the norm: pretax margins are hovering at about 30%-35% for the public firms in our asset management universe, with smaller private firms typically doing better and some managers even posting 70% margins or higher, even as the industry's aggregate annual growth has been about 14% over the past 15 years and even higher for the retail segment of the industry (see Exhibit 1). Currently, one would be hard pressed to identify a business with better fundamentals. But what's in store for the future? Who will be best positioned to meet the challenges ahead? What should asset managers be doing now to prepare? Although our current outlook is quite positive, and we see no reason for that view to change, we do believe that the U.S. asset management industry will be entering a new phase in its life cycle, that certain trends are inevitable, and that an awareness of those trends — which are listed below — are key.

1. Demographic changes will influence competition. It is well documented that one of the more important drivers of inflows into money management (and an accompanying outflow of money from traditional depository institutions) has been the need for baby-boomers to save for retirement, a trend that is still fueling the rise

in assets. But the population of prime savers (individuals ages 40-60) that has been rising rapidly since the mid-1980s, both in absolute numbers and as a proportion of the adult population, will peak in 2006. Thereafter, the group will start to contract as savers gradually become dissavers (people over age 65). As prime saver growth slows so will flows to long-term assets. Historically, a shrinking prime saver ratio (defined as prime savers as a percent of the adult population) has been associated with moderating growth. We saw this phenomenon at work in the 1970s when the ratio dropped from a peak of 30.8%, falling rapidly through the 1970s and then turning around after reaching a low of 25.5% in 1986.¹ Mutual fund growth inched ahead at a meager 0.7% annual growth rate through the 1970s. Poor markets, of course, were also responsible for those disappointing results, and positive exogenous factors such as a continued bull market would have a moderating effect on the important demographic factor. Nevertheless, retirement money — generally viewed as a more stable source of cash, independent of the capital markets — now composes at least 30% of new flows (see Exhibit 2), a level that is far higher than in the 1970s when defined contribution was in its infancy. As such, fund flows today are less driven by market movements than they had been historically, a trend that should continue. The net result: a more competitive asset management environment in which companies must undertake the costlier effort of marketing for existing assets on a constant basis, even as secular growth moderates.

2. The traditional domain of the institutional manager is becoming more retail-oriented. The current favorable legislative attitude toward individual savings and the resulting laws that have shifted pension assets from defined benefit to defined contribution have given rise to a segment of the market that we refer to as the

Exhibit 2: Retirement Savings in Long-Term Mutual Fund Flows: 1996



Source: Investment Company Institute.

¹ US Bureau of the Census. See Exhibit 6.

instividual market — pretax institutional retirement money with selection controlled by the individual employee. An institutional plan must offer a broad range of funds, often not just the provider's funds but also competing funds from other families. Hence, the provider must now jump through two hoops, not just one: The first is to get chosen by the corporate sponsor, and the second is to have funds that are actually selected by employees. To satisfy the sponsor, an asset manager must prove it is technologically advanced enough to handle the operational complexities of servicing a broad employee base. To win over the employee, the provider needs not only good funds, but the brand recognition to mass market its products as well as high levels of customer service. The brass ring, of course, is stable cash flow into long-term funds sourced to a DC (defined contribution) market which now stands at about \$1.5 trillion in size and is growing at 12% annually.² Nonetheless, the cost in achieving a position of dominance can be staggering, and largely for that reason, the entire business is becoming far more capital intensive than ever before.

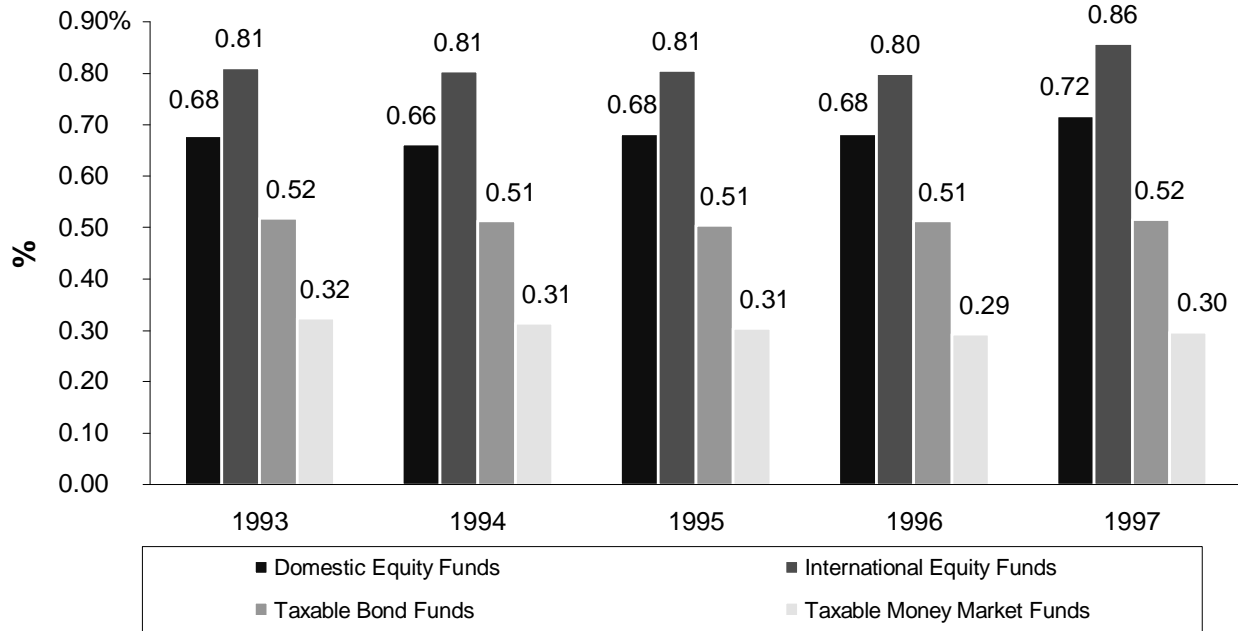
3. The consumer is getting smarter, more demanding, and is increasingly looking for alternative solutions. Although management fees on the retail side have been stable to up, (see Exhibit 3), and have been bolstered by optimal industry conditions, still individuals are getting more demanding — not only in terms of investment performance, but also with respect to their growing requests for more (and constant) information, marketing literature, updates, and general hand-holding services.

At the same time, indexing is one of the fastest-growing segments of retail money management (see Exhibit 4), owing its soaring popularity not so much to a flash-in-the-pan marketing phenomenon than to an empirical fact: Over the past 15 years, indexing has proven itself to be an extremely effective form of investing, not only in terms of outperformance vis-à-vis the active manager, but also in terms of the lowest management fees and expense ratios. While few firms other than Barclays and State Street in the institutional market and Vanguard on the retail side have made it a priority to market the virtues of this product, indexing undoubtedly will play a much more significant role in the landscape of both retail and institutional asset management in the years to come — a trend that will translate into considerable pressure on active managers, particularly marginal players, to deliver both performance and service.

Interestingly, a countervailing trend we see shaping up in the market is the growing demand for alternative investments that aim to hedge traditional market risk. While indexers aim to deliver market (or “beta”) risk and return at low-cost, alternative investment funds seek to deliver positive risk-adjusted returns

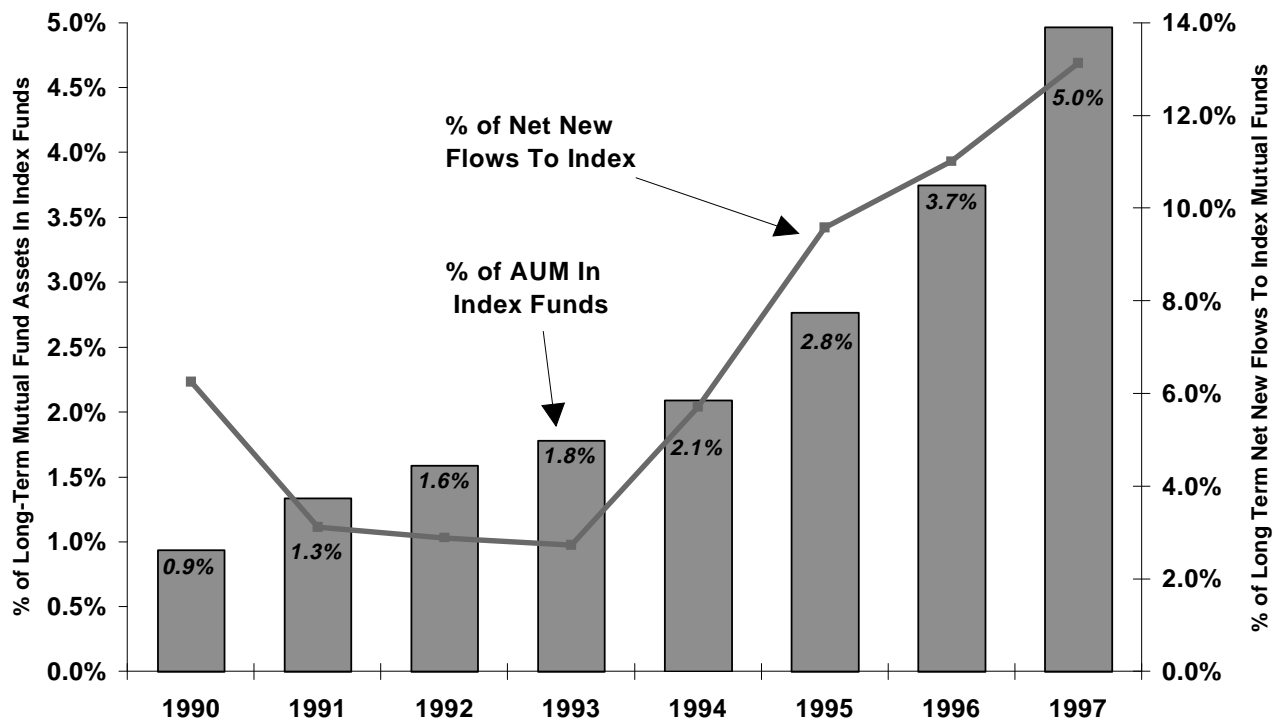
² CAGR 1984-1996. Source: EBRI, Cerulli Associates.

Exhibit 3: Retail Fund Advisory Fees, 1993-1997



Source: Lipper Analytical Services, Our Estimates.

Exhibit 4: The Rise of Index Mutual Funds, 1990-1997



Source: Strategic Insight, Simfund.

(“alpha”) on low or zero beta investment portfolios. Broadly defined, this class of products includes investments in real estate, precious metals and commodities, insurance-linked securities, and the use of specialized hedging strategies of equity and fixed income securities. The level of sophistication of certain retail as well as institutional investors is growing, and with it a demand for alternative investments outside of traditional equity and bond funds.

4. The marketing and distribution aspects continue to grow in strategic significance, and the factors crucial to success are shifting from manufacturing to the distribution of asset management product. Product proliferation, evidenced by a tripling in the number of mutual funds over the past decade, has brought about a strategic imperative to differentiate one's product — always important and now paramount to success. Even good performance does not necessarily guarantee large sales, and indeed, there are many instances of excellent companies with above-average performance whose coffers are not getting filled despite robust market conditions. Effective distribution is critical. Often, for no-load managers without extensive proprietary channels, it is not until a company joins a fund supermarket or a wirehouse wrap program that the money truly begins to flow. Their distributors, however, are demanding a greater share of the fees and will continue to do so.

There are three themes that will shape strategic decision making as asset management firms respond to these trends:

New players, new technologies, new channels

The recently enhanced regulatory flexibility of banks and insurers is contributing to the steadily multiplying number of entrants into the business. At the same time, fund supermarket and wirehouse wrap programs are proving key to the success of many no-load funds. Some high-profile load companies have been quite successful in consistently securing distribution through major wirehouses, banks, regional brokerage firms, financial planners, and insurance agents. As for self-manufactured wirehouse funds, they have relied heavily on proprietary distribution as a means of marketing their own product, which is sometimes of only moderate quality but nevertheless well placed on the shelf and well marketed. Intriguingly, we consider the biggest boon and threat to the status quo the Internet, where, according to independent estimates, mutual fund sales will increase 50% annually through the year 2002.³

The inevitability of the branded product

The convergence of financial services has offered some large financial institutions the opportunity to cross-sell a wide range of savings products under the umbrella of a trusted name. Still, the combination of technology, supermarkets, and demographics —

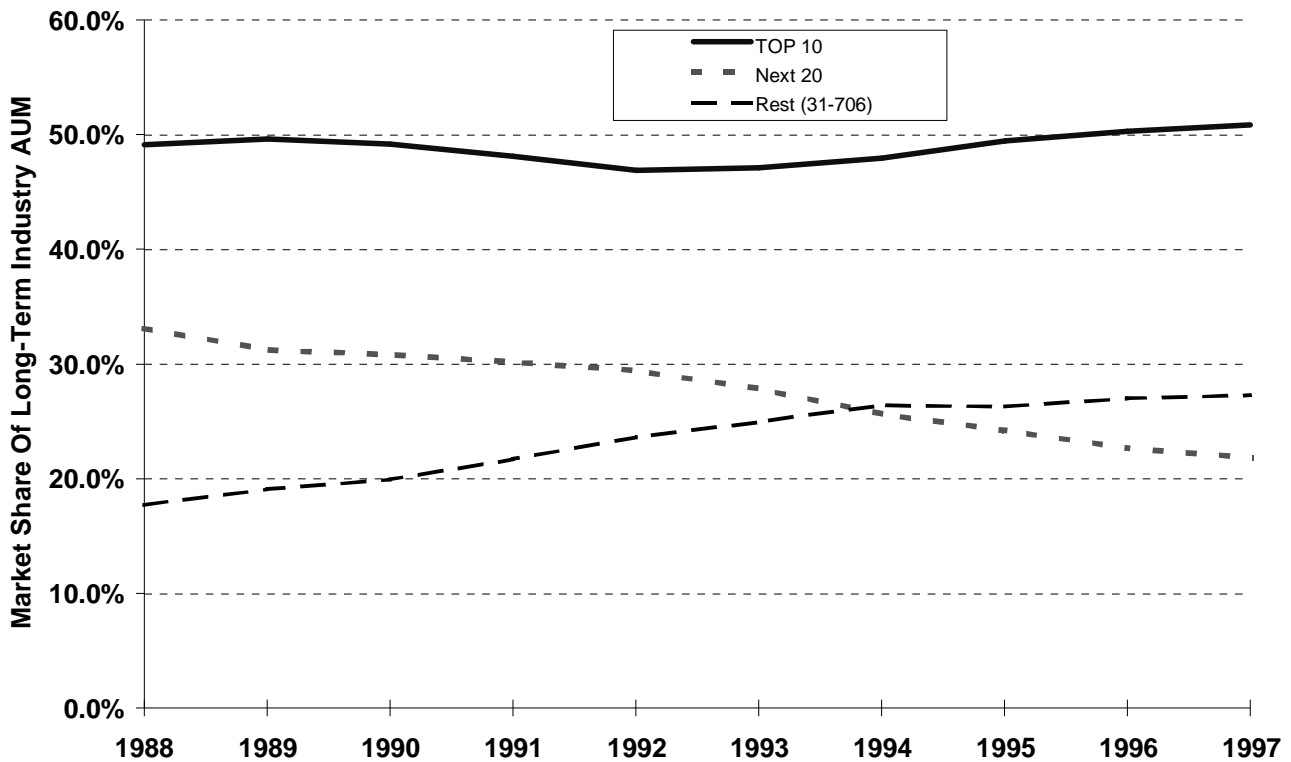
³ Forrester Research. See exhibit 11.

which indeed have lowered barriers for new entrants — has rendered the current era the golden age of the small money manager. Several large, brand name players have recently stumbled, largely because of lackluster investment performance. Nevertheless, performance is a setback that every manager, large or small, must face at some time, and although we view performance difficulties as a penalty play, the severity of that penalty is inversely proportional to the depth of the franchise and the breadth of product. Meanwhile, as demand begins to moderate over the next several years, brand marketing — always an important element in attracting money — will reassert its primacy. **Our best advice is the following: In anticipation of moderating industry growth, take this time to build the brand, secure distribution, and increase the breadth of the franchise.** The easy money won't last forever, but for managers who plan on sticking around, there is still time to parlay performance, capital, and marketing into a franchise that is prepared for rougher waters, and in so doing, create a firm that attains real staying power.

Scale now or never

Unlike the traditional institutional asset management business, retail asset management is a marketing-intensive business that requires scale and scope. We have long believed that although the asset management industry has been rather fragmented historically, the strongest participants with the greatest resources will ultimately be the most successful. We also have stated that the smallest firms — assuming they are able to deliver on the performance front and are aided by independent distributors — would be able to increase their share for a time but would eventually reach a point at which they would either have to tap into enough capital to compete with the bigger players or be acquired. Meanwhile, we expect the middle tier to get squeezed as industry giants outmuscle the group, even as smaller new entrants (who generally have lower overhead) crowd in. Exhibit 5 shows what's happened in mutual funds: A number of small companies have exhibited remarkable growth in recent years, and in the process, they are applying considerable pressure to the middle tier, which has fallen off meaningfully. Meanwhile, the squeeze continues from the largest companies, where that group — despite its size — still manages to keep pace with impressive industry gains and to defend its aggregate 50% market share. Specifically, the industry giants have been bolstered when it comes to (1) increased visibility of their larger-than-life brand names; (2) the expenditures big firms are able to make in widening distribution or constructing proprietary channels; (3) the ability to invest large sums of capital to make acquisitions; and (4) their ability to attract and retain top talent.

Exhibit 5: Mutual Fund Market Share by Size of Firm, 1988-1997



Source: Simfund

Looking ahead, the top tier is actually better positioned now than ever before as a number of these industry titans are closer to having all the pieces in place — not only great distribution and the resources to acquire worthy companies but also a wide selection of excellent product. Many are Morningstar 4 or 5 star rated funds that attract more than 80% of new cash flow into funds. The Simfunds data for mutual funds in Exhibit 5 is consistent with the even starker findings we have gathered on the asset management industry taken as a whole. The top 20 asset managers of all types controlled 43% of the assets of the top 200 in 1986. In 1996, the top 20 asset managers controlled 49% of the assets.⁴

5. Global opportunities are extraordinary but only in reach of the largest companies with long-term track records and the breadth of funds to manage volatility. Global diversification makes sense for the investment manager as well as the investor. Despite the recent Asia turmoil, we are extremely bullish on international opportunities, certainly as they pertain to asset management. In Europe, the common currency will unleash massive consolidation activity, likely to be a boon for both the pan-

⁴ Sources: Institutional Investor, July 1997; Nelson's Directory of Investment Managers; Directory of Corporate Affiliations.

European economy and its markets. Meanwhile, in Asia, after the dust settles, the turmoil will ultimately yield a more open and vastly more competitive industry. Japan in particular is undergoing its own "Big Bang", and numerous government restrictions are coming down, allowing financial institutions greater access to Japanese markets. Simultaneously, barriers preventing the investment of Japanese pension money in stocks and money management product are being dismantled.

These opportunities notwithstanding, truly global operations on a stand-alone basis are in reach of only the most established asset managers. Because prospective clients believe global investing can be a more treacherous prospect (and rightly so), they are drawn to managers that have not only a trustworthy brand name but who also boast five- and ten-year track records of international experience — a distinction that weeds out much of the competition. Furthermore, because international operations are more volatile, backers of investment management companies often do not want to go along for the ride, unless a manager has a broad-based franchise that is diversified enough to weather turbulence. Not many asset managers meet these requirements. But those that do are advantaged by an alternative source of sustainable growth. Franklin/Templeton, for example, has reported strong profits throughout the recent Asian crisis — and two years ago, the company did the same through Mexico's Peso devaluation — owing to a broad-based franchise that boasts 90 rated funds (domestic and international; fixed income and equity), 75% of which are 4 or 5 star. It is this type of company that is positioned to reap the rewards of global investing. Ultimately, even the largest asset managers will need to come to terms with the fact that distribution in almost every non-U.S. financial services market is controlled by a few local oligopolists, typically big banks. Access to their distribution network usually can be achieved only if a manager is willing to sell to the bank, as was the case with Dresdner/RCM.

**Hence, explore global
but secure local**

And yet, while global is the next frontier with many exciting opportunities pending, roughly half of all assets under management are still sourced in the United States, and for all the excitement and talk about being a global player, we should never lose sight of the primary importance of the U.S. marketplace. The truth is that global opportunities — because international markets remain more closed and relatively smaller in size and because there are few worthy international stand-alones ripe for purchase — are still somewhat limited. That is the key reason why few U.S. managers have been successful in globalizing their operations. Franklin has globalized with style via its acquisition of Templeton, and the recent acquisition of Mercury by a bulge bracket investment bank could prove effective; but both deals were consummated with large sums, the kind of money to which few companies have access. Furthermore, capital is not a panacea: We

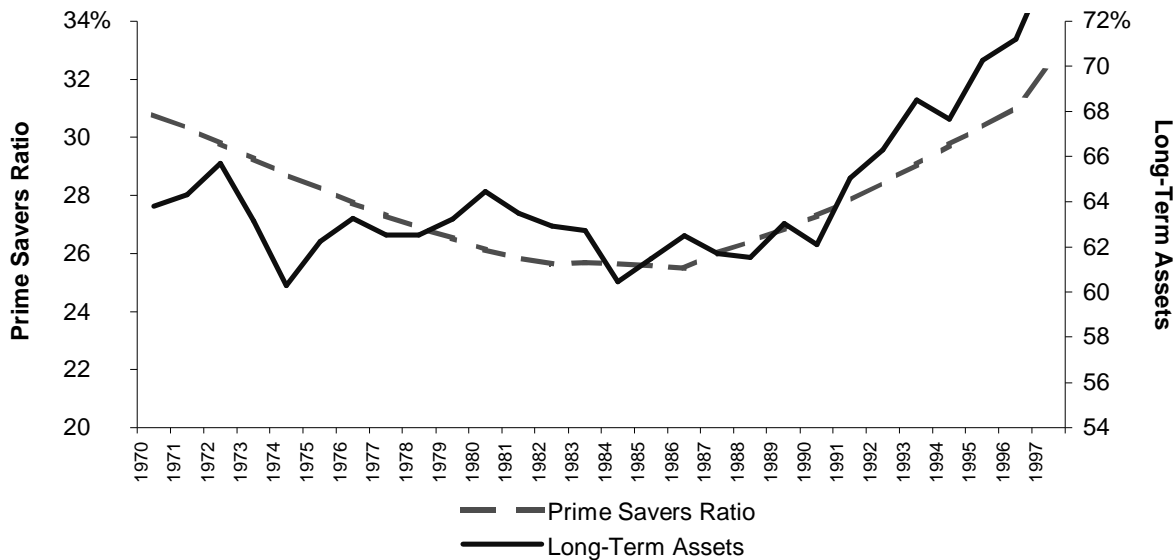
can think of some high-profile U.S.-based money managers that have spent heavily and still failed in their efforts to move into Europe and Asia. It often has been easier for established non-U.S. money managers to become U.S.-oriented simply because of the sheer number of plum properties from which they have to choose. Invesco's purchase of AIM would be a good example, one that highlights the acquisition of both profitability and growth; and the company's recent addition of LGT/Chancellor now offers the potential to build institutionally in the United States. Clearly, the way to position for the inevitable globalization to come is to establish a credible platform here in the United States from which to launch a global effort when the opportunities arise.

Asset Management at the Crossroads

Asset management is at a critical period in its development — about to enter the next stage in its industry life cycle. **As fundamentals moderate, money managers will find that to grow, more time and effort will have to be spent on competing for market share instead of relying on secular growth, which for many years has helped carry everyone to higher ground.** The increased cost of competing for the existing asset dollar will make conditions far more challenging, but particularly for marginal participants. At the same time, the shift in the asset management business from institutional to retail focus implies greater benefits to scale and scope, raising the stakes for everyone. The result: accelerated industry consolidation, with transactions increasing in size and frequency. Meanwhile, globalization will fuel this dynamic as it further discriminates the haves from the have-nots.

The rest of our report is organized into two main sections. Section II details the points made above, largely focusing on the U.S. asset management industry and how we see the industry evolving as it moves into the 21st Century. Section III highlights opportunities and potential strategies for asset managers evaluating international markets. In this latter section, we focus on the two largest markets, United Europe and Japan.

Exhibit 6: The Impact of Prime Savers on Long-Term Assets, 1970-1997



Source: Federal Reserve Flow of Funds Data

I. The Changing Landscape of Asset Management

Demographics and 2006

Since the mid-1980s the proportion of prime savers to the rest of the adult population has been rising rapidly to 31.1% from 25.5% of the adult population between 1986 and 1997. The aging, wealthy baby-boomers have fueled broad demand for retirement assets. As shown in Exhibit 6, this trend has been responsible for vast pools of savings pouring into long-term investments (pension funds, corporate and noncorporate equities, mutual funds, and corporate and foreign bonds).⁵

However, according to the U.S. Census Bureau, prime savers (individuals ages 40-60) will peak at 35.7% of the adult population in 2006. The growth in the number of prime savers began decelerating in 1997 and the absolute number of prime savers is projected to begin shrinking by 2006, giving way to a growing population of *dissavers* (defined as those individuals age 65 and over). Exhibits 7 and 8 graphically depict the coming shift. **Although bull markets in stocks and bonds can mask the trend, perhaps even for some time, the underlying demographics are still shifting and will influence the evolution of the industry.**

⁵ A simple ordinary least squares regression of the long-term assets ratio on the prime savers ratio, dissavers ratio and a time trend from 1970-1996 yields a highly statistically significant relationship among the variables: Regression coefficients for the variables are 1.11, -7.37, and 1.05, respectively, all significant at the 99% confidence level. The model yields an R-squared of 79.9%.

Exhibit 7: Change in Prime Savers Ratio

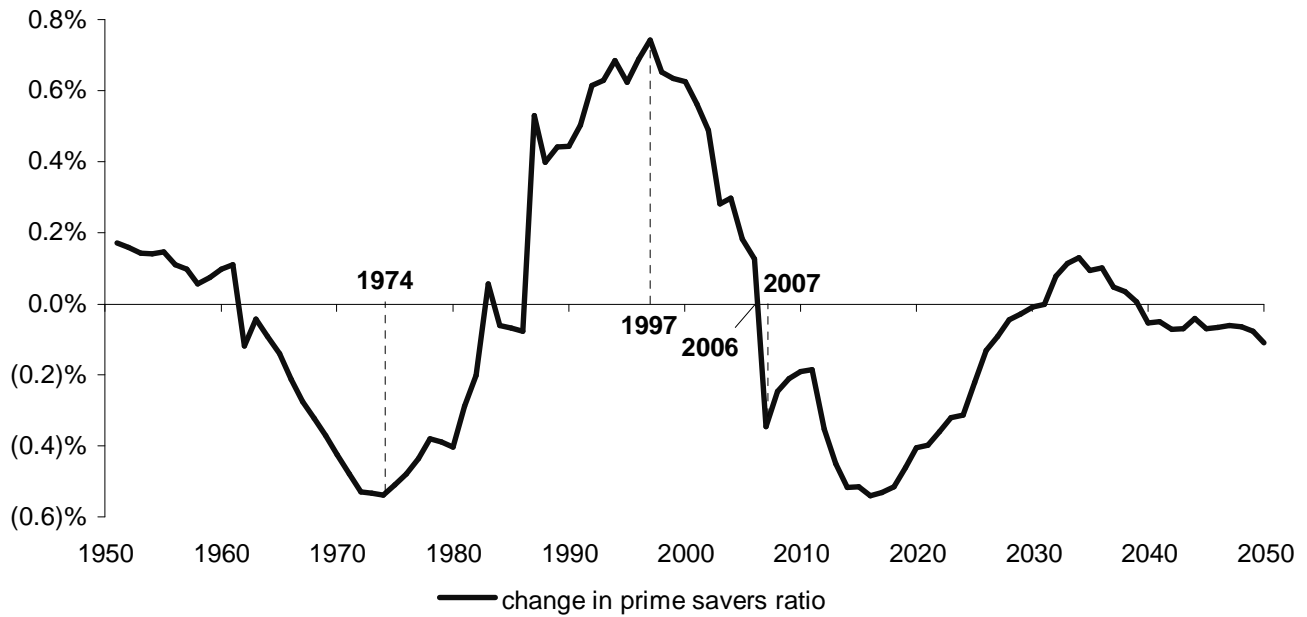
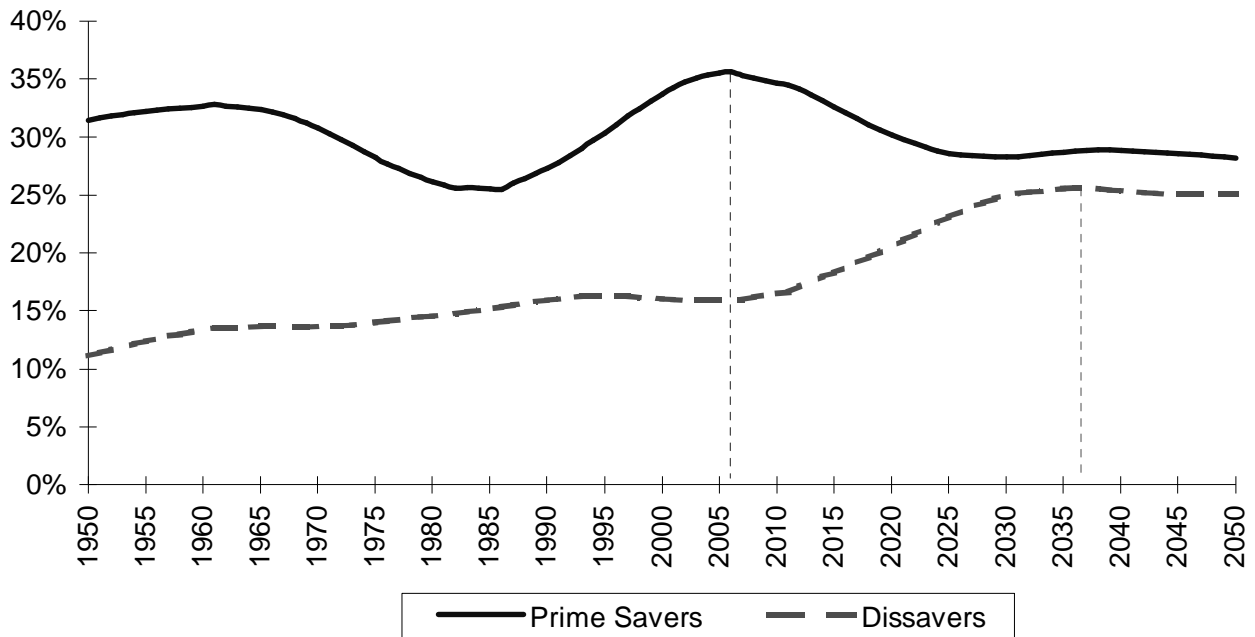


Exhibit 8: Prime Savers and Dissavers as a Percentage of the U.S. Adult Population, 1950-1997



Source: U.S. Bureau of the Census

The concurrent sea change will fuel three trends in the U.S. asset management industry:

1. Increased Competition — Due to the demographic and macroeconomic dynamics, growth in the asset management industry will moderate. Slower growth will spur increased competition among asset managers, particularly in the retail sector.

2. Product Evolution/Maturation — As baby-boomers turn from prime savers to dissavers, their portfolio preferences will evolve from a growth orientation to an income orientation. This shift in demand will cause a high priority to be placed on product innovation.

3. Future Reforms/Deregulation — Clearly, the most exciting new policy to consider is the possibility of full or partial privatization of Social Security. Future funding and benefit levels are unsustainable for the current pay-as-you-go system, and it is clear that change in one form or another is inevitable. Unleashing hundreds of billions, if not trillions, of new asset dollars into the private sector would be a tremendous windfall for the industry by any measure. Of course, while various proposals have already been forwarded, it is too early to predict precisely whether and how privatization will take place. What is clear is that demographics will force the government to take action in one form or another. Social Security represents an important wildcard in the ultimate fate of the asset management industry.

Tracking Asset Flows

Formulating a strategy that responds effectively to coming trends requires an understanding of what has taken place already. Historically, there have been two well-developed themes that have had important implications for the current-day complexion of the asset management business.

On the supply side, disintermediation of savings from traditional deposit accounts by the money market mutual funds' end-run around the banking system has played a critical role in shaping financial services. The money market fund boom provided a profitable product line for the asset management business while riskier equity and bond funds suffered through the 1970s. What's more, the ascent of the money market funds underscored the inequity of existing banking regulations and revealed the need for major regulatory reform. The result has been the elimination of Regulation Q limits on deposit interest as well as Glass-Steagall reforms that have broadened product offerings and markets and allowed banks to engage in heretofore impermissible activities such as retail asset management and brokerage, among others.

Meanwhile, on the demand side, government policies promoting greater participation by the individual in planning for retirement have fundamentally altered the way in which products are

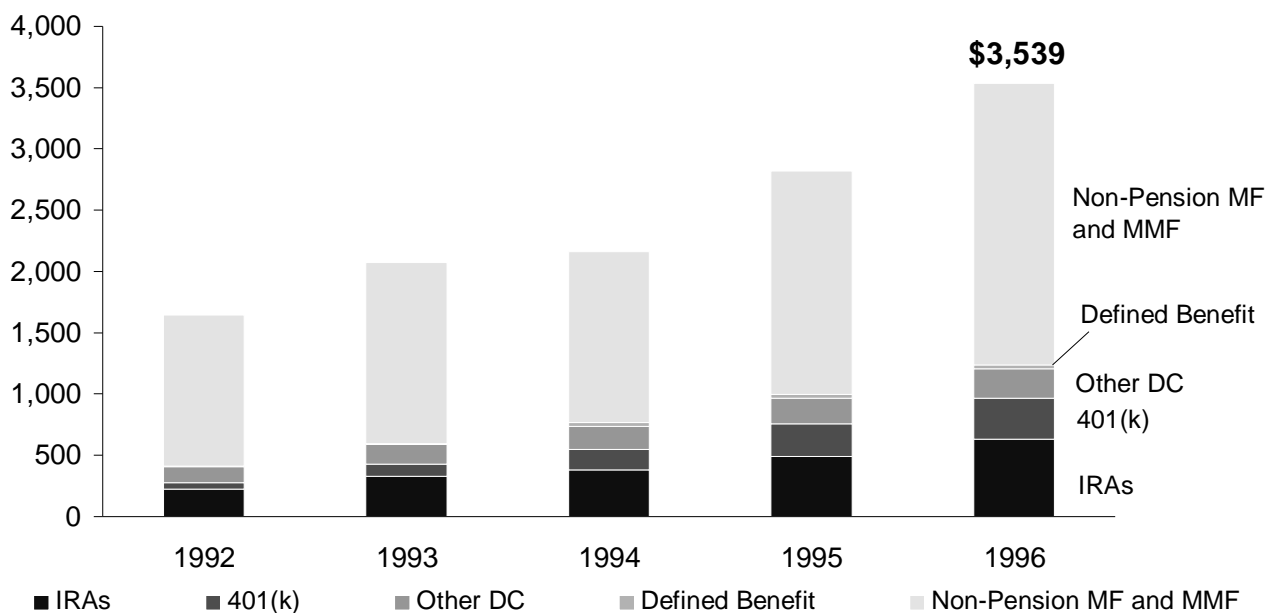
marketed and sold. It has also induced the middle-class to take greater responsibility in financial planning, thereby shifting purchasing authority and spurring retail demand.

The Rise of the Individual Impels a Shift Toward Retail

U.S. government policy over the past 25 years has shifted greater emphasis on individual responsibility in a broad range of policy matters. One manifestation of this shift has been a growing body of legislation promoting individual responsibility for retirement savings. (See Appendix 1 for a timeline of the most important pieces of legislation.) Some of this has been the result of uncertainty surrounding the long-run viability of Social Security. However, there are other fundamental reasons why government policies will continue to support this trend. Traditional corporate pension plans that were well-suited for lifetime employees will play a smaller role as a more flexible and transient workforce makes portable defined contribution retirement plans more attractive. Exhibit 9 illustrates the growth in the retirement market.

Defined contribution programs push financial planning decisions down to the ultimate beneficiaries and allow them to tailor retirement plans to individual risk-reward preferences rather than having to accept the risk-reward characteristics dictated by employers. Defined contribution plans shift greater control of the payment of fees from a fiduciary to the end consumer who can determine whether he or she benefits from those fees and can choose investment options based on expenses as well as risk and performance. **The shift from defined benefit to defined contribution has begun a convergence of sorts: Institutional**

Exhibit 9: Retirement Assets in Mutual Funds, 1992-1996



Source: Investment Company Institute, Federal Reserve Board of Governors, EBRI, our estimates

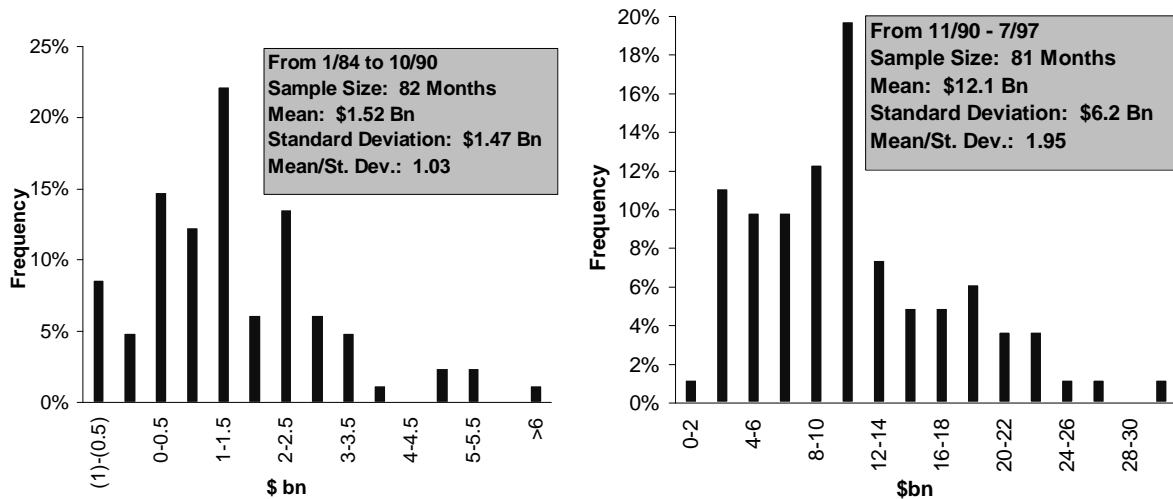
asset managers continue to seek growth by marketing retirement programs to the institutions they have traditionally called on, and the mutual fund companies market their retail product to employers. We refer to this hybrid market as the “instividual” market.

At the same time, however, as this market becomes more distribution intensive, the instividual market will become more attentive, with sponsors scrutinizing fee structures and measuring long-run performance against exacting benchmarks. A number of new initiatives that address this evolution have recently been undertaken. J.P. Morgan’s new relationship with American Century is an excellent example of how institutional firms have begun recognizing the need to acquire significant retail capabilities. The largest retail firms have already begun developing state-of-the-art distribution capabilities to boost their efficiency in reaching this market.

Also, the number of hybrid companies, those companies whose assets are at least one-third mutual funds and at least one-third institutional assets, has grown significantly from 1986 to 1996, largely due to a number of institutional managers who have developed mutual fund offerings over the past ten years through acquisition or internal development. While the number of mutual fund companies (although not the same companies) remained relatively stable growing from 19 firms to 20 in 1996, the number of hybrid companies rose significantly from 10 companies in 1986 to 25 companies by 1996. This number understates the true number of companies operating in the mutual fund market, as it does not include those companies that have mutual fund operations that do not represent at least one-third of their overall assets under management. 132 of the top 200 asset managers offer some mutual fund product, as institutional asset managers have seen the growth opportunities in the retail segment of the business and have begun developing retail products.

In addition to changing the nature of distribution and marketing, the instividual has provided the industry with a stable source of fund flows. Our December 1997 report, *Brokers & Asset Managers — 1998: Issues and Outlook*, compares the flows into stock funds during the late 1980s with the flows from 1990 through the middle of 1997. We conclude that although flows into equity funds are certainly correlated with the returns on the S&P, they are more stable in the 1990s than they were in the 1980s. We found that monthly fund flows in the 1990s have been, in the aggregate, larger and more tightly distributed around the mean than the flows from the 1984-1990 sample (see Exhibit 10). In addition, there have been no months with net outflows (for equity funds) since early 1989. We attribute this smoother stream of fund flows in part to the long bull market, but also to the massive flows

Exhibit 10: Comparative Distributions of Monthly Net Flows Into Equity Funds, January 1984-October 1990 and November 1990-July 1997



Source: Investment Company Institute

of retirement savings that have been pouring into mutual funds and have made the mutual fund business one of the most attractive industries anywhere, even when the market has its bad months. We attribute this amazing performance largely to individuals investing retirement assets, month in and month out, in mutual funds selected by their employers — in short, to the individual.

The Continued Rise of Distribution

Continued innovations in communications, media, and technology are giving rise to better information for individuals, and better informed individuals are exhibiting greater participation in the asset management industry. At the same time, technology is empowering asset management companies to improve front and back office services. It's no wonder the number of companies entering the business is expanding by leaps and bounds.

Load Is Not a Four-Letter Word

As we noted earlier, a presence in a fund supermarket or wirehouse wrap program is key to the success of many no-load funds. Although those major channels are effective, the price is high, and in a more moderate market environment, costs will become prohibitive for many. Schwab, for example, which originally was charging an annual fee of 25 basis points (bp) to OneSource money managers, has raised its fee 40% over the last few years to its current level of 35 bp — about half the average management fee on a diversified equity mutual fund. Wirehouse wrap programs, which charge about 220 bp on average, are even a higher cost channel for consumers and do not leave managers much flexibility for more aggressive pricing, especially in a less robust market. With respect to load companies, those operations have seen point-of-sale profits dwindle significantly, as loads have been reduced in recent years to about 4.5% from 8.0%, with the

fund company certainly getting squeezed. But advisory fees still represent hallowed ground: In protecting them, managers have put up something of a diversion by taking down the front-end load moderately, but offsetting that reduction with other charges (CDSCs, 12b-1s, dividend reinvestment charges, and so on). The result has been the belief among many that the price of investing in mutual funds has gone down, which is not the case.

To those who think they will find refuge from higher distribution costs through selling no-load funds, a move that potentially could circumvent higher distribution charges, we think it unlikely that such a strategy will prove effective. Although ICI data does show that a greater percentage of fund flows in recent years is represented by no-load, the trend reflects the burgeoning 401(k) market more than anything else. Adjusting for retirement flows, we believe the balance has remained fairly static. Scudder, Stein Roe and Pilgrim Baxter, all companies thought of as being no-load in nature, have recently filed to expand their load offerings. Meanwhile, Scudder and Gabelli, longtime supermarket holdouts, both recently signed up. **The silver lining: Load is no longer a bad word, and it is all right to pay for advice; load funds have always been popular and if the distributors have their way (which is likely) they should remain so.**

Convergence in Financial Services: Asset Management at Center Stage

The relatively fragmented U.S. asset management business is in stark contrast to almost every other country in the world where asset management is subsumed in large diversified financial institutions. A history of rigorous regulation has kept the various financial services separate and distinct industries in the United States, and although Glass-Steagall and other Depression-era legislation have eroded considerably, the restrictions continue to explain why the structure of the U.S. asset management industry remains distinct. As Glass-Steagall continues to fade, so will the differences between the U.S. industry and the rest of the world.

Deregulation has important implications for the future complexion of the asset management business. Banks and insurance companies are responding to expanded powers by leveraging their capital, distribution, and marketing expertise to recapture institutional as well as new retail clients lost through the rise of the independent asset management business. Mergers and acquisitions of asset management companies have had and will continue to play a significant role in recapturing this business for these financial institutions. **The outcome will be continued consolidation, and more importantly, convergence among historically distinct businesses.**

The migration of assets from traditional financial institutions to asset managers will continue: Bank deposits have been growing at a mere 0.8% annually during the 1990s while mutual funds are growing in excess of 22% and even money market mutual funds

have been growing at 6.5%. Insurance assets have fared somewhat better, with 7.7% annual growth in the 1990's. The strategic response of banks and insurance companies has been to push for deregulation and focus on ways to recapture these lost assets through strategic acquisitions and greenfield development of asset management companies.

Banks and Asset Management

Much attention has been given to the distribution synergies that exist between banks and asset management companies. This has been a primary motivation in the many acquisitions of asset management companies by banks during the 1990s including Mellon's acquisitions of Dreyfus, Boston Company, and most recently, Founders Asset Management; First Union's acquisitions of Keystone Investments and Lieber & Co., and Fleet's acquisition of Columbia Management. While the dislocation resulting from the merging of cultures as well as businesses has been substantial at times, it is clear that ultimately many of these banks have been able to integrate asset management capabilities successfully. These banks have positioned themselves well for the future with a more growth-oriented and stable fee-based revenue stream and are now lauded by the investor community for their foresight. **With the appropriate tactical approach, this general strategy remains a highly attractive alternative for many banks that remain on the sidelines today and will continue to drive M&A activity between the banking and asset management industries.**

Insurance and Asset Management

Consistent with recent developments, there are even greater opportunities in the marriage of insurance and asset management. First, the potential distribution synergies that exist between the network of agents at an insurance company and the asset management product are at least as large if not larger than they are with banks.

Both banks and insurance companies have relationships with a potentially highly profitable customer set of retail savers with financial assets and little reluctance to pay fees for services and advice they think they need. Moreover, insurance companies arguably hold more "intimate" relationships with their clients, focusing on long-term financial planning which represents a different relationship from that held by most banks with their customers. Mutual funds are "sold to" (not "bought by") these retail investors; hence, insurance companies are arguably better positioned to market funds to these clients.

Additionally, there are clear and significant product synergies that can also be tapped by insurance and asset management companies. Annuities and other long-term retirement products remain a highly attractive business with attractive prospects. First and most immediately, the tax-advantaged nature of the insurance wrapper ensures that these products will remain attractive to large segments

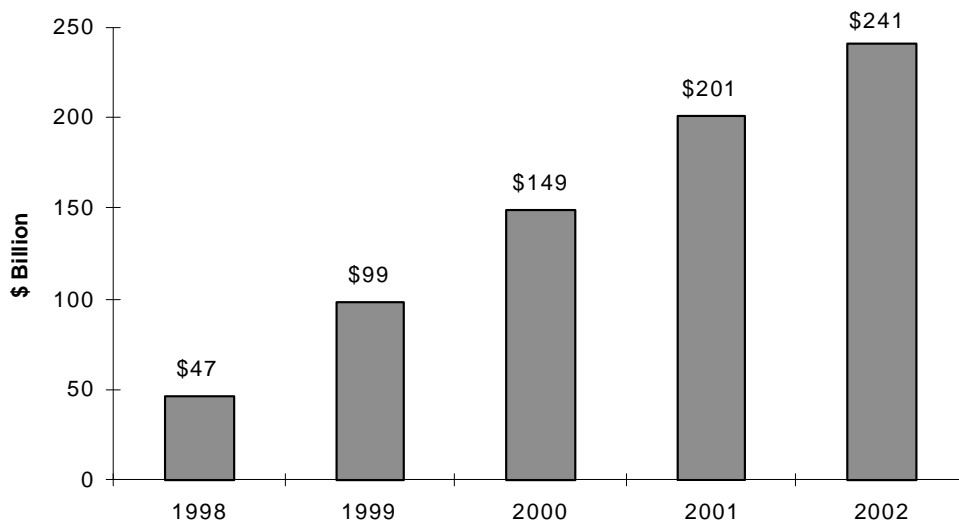
of the population that wish to save on a long-term, tax-deferred basis. But also as baby-boomers' investment objective matures from a growth orientation to an income orientation, there will be long-term opportunities for those who can meet this demand. In contrast to short-term investment products like money market mutual funds, which have already become low-margin commodity products, income-oriented retirement assets will continue to command attractive fees. Insurance companies provide financial advantages in the fixed income arena as the leverage of a balance sheet offers greater flexibility in designing products with a guaranteed return component. **Fixed income and insurance products will receive greater interest as more funds flow into later-stage retirement savings vehicles from investors seeking a consistent or guaranteed income stream.** At the same time, there are synergies in the opposite direction. Asset managers can often more effectively manage assets held by insurance companies that have historically demonstrated lower returns.

Progressive Models of Retail Distribution: The On-Line Outlet

Over the past ten years, new and existing channels have been successfully developed and exploited by asset managers and distributors of retail fund products.

Charles Schwab, for example, has been successful in selling its OneSource supermarket of funds through the Internet, retail banks and its extensive branch network. Schwab's success illustrates two retail phenomena — the rise of the supermarket and the rise of the Internet. The Internet will be a huge channel for retail fund sales in the future. As shown in Exhibit 11, 50% annual growth is predicted in mutual fund assets held in on-line accounts between 1998 and 2002, reflecting a number that is consistent with growth seen at the on-line shops that publicly disclose such information.

Exhibit 11: Projected Growth in Mutual Fund Assets in On-Line Accounts, 1998-2002



Source: Forrester Research

Clearly, the Internet is both a useful means of distributing information about funds and a very low-cost customer acquisition venue. In fact, many discount securities brokers list the Internet as their most cost-effective source of new business. Yet, ironically, the Internet is emerging as a two-edged sword for established asset managers: On the one hand, it has served as a vehicle for expanding supply — through both product and easy-to-understand information — to an ever-larger consumer base from which demand is now at an all-time high. But on the flip side, the net is also making it easier for anyone with just a little seed capital to gain access to people with money to invest, thereby reducing barriers to entry and increasing competition. **The challenge for many firms will be to get product on line (like a presence in Schwab's OneSource), and then successfully market that on-line product in an increasingly competitive channel.**

The Inevitability of the Branded

Brand awareness and reputation, marketing, access, and service all play at least as great a role as performance in determining fund sales. Rather than merely seeking the historically highest-performing fund, investors seek stability, service, and a brand that they can trust with, literally, their life savings.

As the end consumer develops greater authority in retirement savings, the well-branded firms will carry the day. This trend has begun, but it is not too late for others to join the ranks. In the long run, brand equity will be key to retaining and attracting customers throughout the cycle. It will also be key to opening new markets. Consequently, the astute manager will use the good times to build scale and a strong brand.

Supermarkets Shift Costs From Distribution to Branding

With a wide range of no-load funds available through supermarkets, marketing to the end user in this channel is increasingly important. Shelf space alone will not guarantee success in the retail fund market. Although supermarkets are an effective low-cost distribution channel for smaller fund families, they may in fact require higher marketing investments to increase brand awareness. They do not eliminate the need for marketing, rather they shift the point at which marketing takes place. Shelf space alone will not guarantee success in the retail mutual fund market any more than merely having shelf space at a supermarket guarantees sales of cereal. **Indeed, "unbranded" goods will lose shelf space because maintaining low sale items is costly and inefficient for the supermarket that must serve its customers by discriminating the "good" brands from the many sold.**

Convergence Makes Possible “Full-Scope” Branding

As some financial services firms have become increasingly large, the power of cross-selling has become ever more apparent. No financial services organization has the diversity of products or the distribution resources of Travelers, the master of cross-fertilization (see Table 1). Travelers, with 1,100 offices, vigorously markets a broad range of products through all of its channels. For example, in addition to retail distribution of traditional securities through its brokerage sales force, its brokers are also responsible for 38% of Travelers’ deferred-annuity sales. Meanwhile, Primerica Financial Services (PFS), which has expanded to 38 states from just 2 at the beginning of 1995, may be *the best* example of the mass-market approach. It is a classic example of middle America selling to middle America. With it, Travelers has an army of representatives selling a wide variety of retail products: The unit has the strongest (and most rapidly accelerating) operating margin of any of the Travelers segments, with the sales force marketing life insurance, mutual funds, consumer loans, and home and auto insurance policies. Citicorp represents the quantum leap that transforms Travelers into a truly global franchise, with unparalleled global delivery for its asset gathering product.

A Window of Opportunity to Develop Scale and Scope

The new emphasis in the asset management business on retail marketing and distribution and the specter of long-term moderation of overall asset growth all have important ramifications for asset management companies. These trends will inevitably push further consolidation and continued bifurcation of the industry into large, retail-oriented asset managers seeking growth and smaller firms managing institutional assets, which will

Table 1: Travelers’ Manufacturing Capabilities / Distribution Clout

Products		
Securities Brokerage	Long Term Care	Credit cards
Mutual Funds	Term Life	Second Mortgage
Annuities	Auto Insurance	Personal Loans
Universal Life	Homeowner Insurance	
Distribution		
Captive:	10,397 Smith Barney FC's	PFS Agents: 86,115 Life Insurance
	859 Commercial Credit Branches	83,409 Loans
	600 Copeland Account Executives	27,492 Mutual Funds
		6,342 Auto & Home-Owner Insurance
Captive-in-progress:	Diversified Distribution Services	
Semi-captive:	150 TL&A Agents	5,500 P&C agents
Customer		
High-end	Middle	Low-end

Source: Company Reports

trade off growth for stable profitability. **The economics of the retail segment of the business will force managers to recognize that to pursue growth, scale will become an increasingly important dimension to the business.** There's no time like the present to develop economies of scale, as the industry is experiencing an exceptionally prosperous time. When the good times stop rolling it will be difficult for all but the biggest firms to continue growing organically.

To understand how the emerging trends will impact the asset management industry, it is important to examine the economics of asset management companies. Our October 1995 report, *The Coming Evolution of the Investment Management Industry: Opportunities and Strategies*, triggered heated debate on the economics of asset management companies, which continues to this day. On the one hand, Hurley et al., and many others since then, have posited that there are significant economies of scale and scope that will drive asset management companies to consolidate or pursue specialized niche strategies to survive in the long-run. Others, including many asset managers, have argued that their organizations remain profitable and viable without the scale of the largest players, citing continued growth and profitability. We believe that continued consolidation is inevitable as the industry conforms to the economic realities of the business: From 1986 to 1996, the top 20 asset managers have grown the share of assets under management by the top 200 to 49% from 43%.

The Big Get Bigger in Retail

Clearly, the mutual fund business requires greater scale than the institutional business. The retail segment of the asset management industry requires more emphasis on distribution and marketing activities than the traditional institutional asset management business because mutual fund companies must market to and service thousands of investors while a typical institutional manager need only cater to a limited number of institutions.

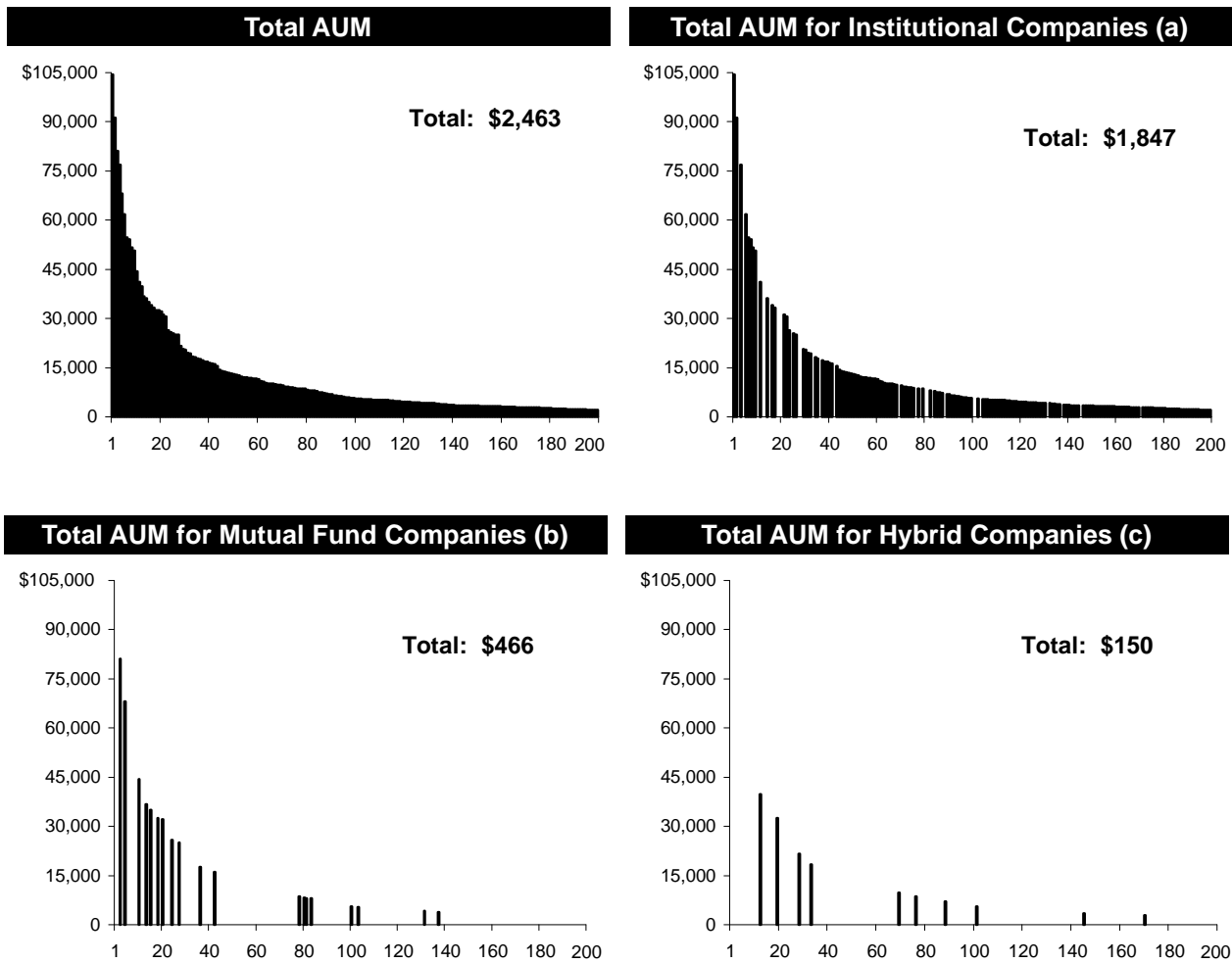
We find support for this assertion from the structure of the industry itself as shown in Exhibits 12, 13 and 14. The data reveal that mutual fund companies are over-represented in the 100 largest asset managers and under-represented in the next 100 largest asset managers, suggesting that there are benefits to size for retail fund complexes. The 1996 data in Exhibit 13 underscore this point and illustrate the industry's embrace of the individual. In 1996, 15 out of the 20 mutual fund companies in the top 200 (75%) were found in the top 100 funds. In addition, the hybrid companies have blossomed.

Performance Is Important, But Size Also Matters in Retail

To examine whether scale is a determinant of success for retail funds, we use regression analysis to examine net new sales to equity mutual funds over the 1986-1996 period. Our findings indicate that although performance is clearly important, the factors correlated with fund size are also important in determining net new

sales. (See Appendix 2 for specific regression results and a detailed discussion of methodology.) We find that, all else being equal, a large fund will attract proportionally more new sales. In a related study, economists Sean Collins and Phillip Mack recently conducted a study at the Federal Reserve Board of Governors where they analyzed fee and expense data for mutual funds from 1990-1994 and found significant economies of scale in the mutual fund industry. They concluded that fund complexes with assets under management of less than \$20 billion may find it difficult to compete against larger competitors. Moreover, a firm has more influence over the quality of its sales and marketing organization than it does on the performance of its portfolios over time.

Exhibit 12: The Top 200 U.S. Asset Managers by Asset Type, 1986

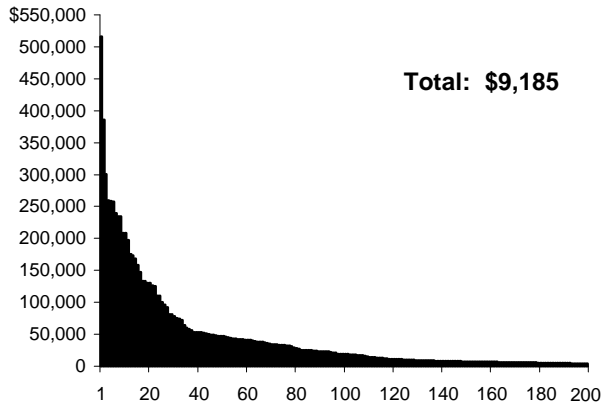


Sources: *Strategic Insight, Nelson's Marketplace Database, Directory of Corporate Affiliations and Institutional Investor*

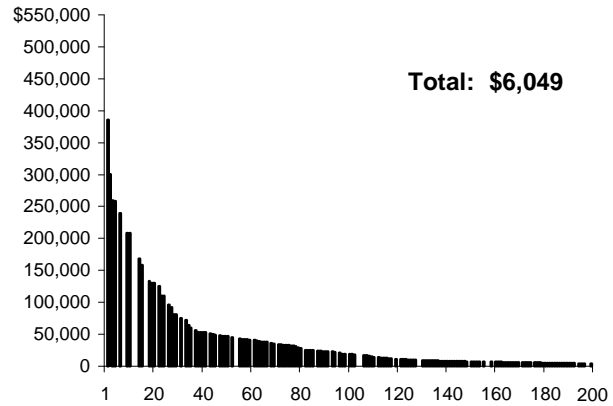
- (a) Institutional companies have less than one-third of their AUM in mutual funds.
- (b) Mutual fund companies have at least two-thirds of their AUM in mutual funds.
- (c) Hybrid companies have one-third to two-thirds of their AUM in mutual funds.

Exhibit 13: The Top U.S. Asset Managers by Asset Type, 1996

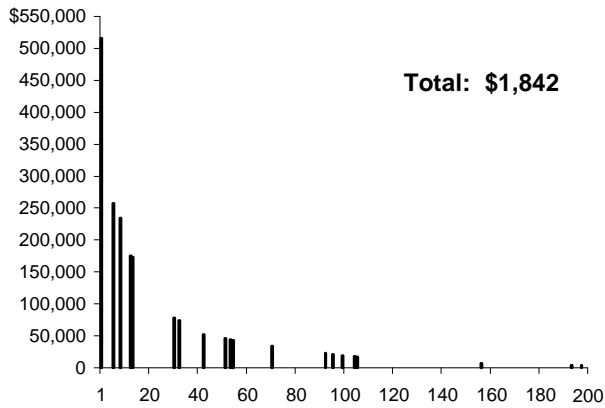
Total AUM



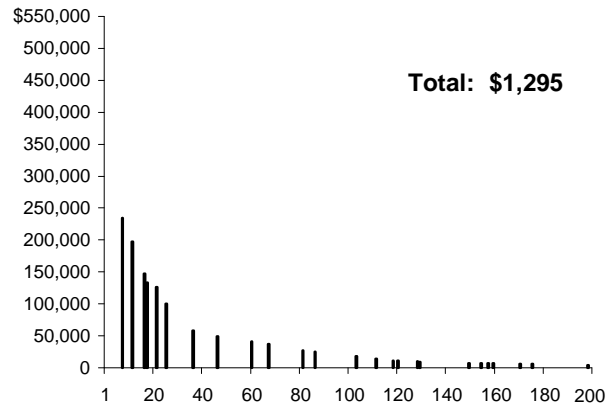
Total AUM for Institutional Companies (a)



Total AUM for Mutual Fund Companies (b)



Total AUM for Hybrid Companies (c)



Sources: *Strategic Insight, Nelson's Marketplace Database, Directory of Corporate Affiliations and Institutional Investor*

- (a) Institutional companies have less than one-third of their AUM in mutual funds.
- (b) Mutual fund companies have at least two-thirds of their AUM in mutual funds.
- (c) Hybrid companies have one-third to two-thirds of their AUM in mutual funds.

Exhibit 14: Summary Statistics of Top 200 Asset Management Companies

(AUM in \$ billions)

	Institutional	Hybrid	Mutual Fund
1986			
High	\$104.5	\$ 39.8	\$ 81.0
Mean	10.8	15.0	24.5
Median	5.2	9.1	17.7
Low	2.0	2.8	3.7
Number	171	10	19
1996			
High	\$385.4	\$234.8	\$515.5
Mean	39.0	51.8	92.1
Median	16.7	18.2	43.6
Low	4.2	4.2	4.2
Number	155	25	20

Sources: *Strategic Insight, Nelson's Marketplace Database, Directory of Corporate Affiliations and Institutional Investor*

Scale Now?

Strategically, there are a couple of ways of realizing efficient scale. The first is to commit to growth by aggressively targeting the retail segment of the market, building a sales network, marketing aggressively to develop brand awareness and loyalty, and investing in the systems needed to develop state-of-the-art customer service capabilities. We observe that the largest mutual fund companies have already embarked on this strategy of pursuing growth and will attempt to take it to the next level — a global scale. **The introduction of a global dimension to the asset management business will only increase the minimum efficient scale for retail-oriented asset managers pursuing this strategy.** Although domestic retail operations are expensive, the investments get even larger when a company attempts to develop them abroad. Nevertheless, we see many of our largest mutual fund clients already trying to capitalize on the opportunities in other countries. Many of the largest institutional asset managers are also making a push globally *and* into the retail segment of the business, pursuing their large retail brethren into the high-growth areas. In addition, some of our medium scale clients seem set on aggressively pursuing the retail asset management business through heavy investments in sales, marketing, and systems. Others are considering a strategic partnership of one form or another. Mergers and acquisitions activity in the asset management industry has never been higher, and this strategy is no longer solely for smaller scale participants. With the recent combinations of Invesco and AIM, Scudder, Stevens & Clark and Zurich Insurance, and Mercury Asset Management with Merrill Lynch, these cross-border combinations announce the arrival of a truly global market

for asset management. Competing on a level with the largest retail-oriented companies will only become more difficult as market maturation and the growing trend toward retail make the business more competitive.

Institutional Asset Management Still Requires a Proven Track Record Against Exacting Benchmarks

Many of those who do not believe scale to be an important factor argue that fund performance is the key driver of success in the asset management industry. This school of thought maintains that consistent superior performance of funds is all that is truly necessary to succeed in the asset management industry. If you can beat the objective benchmark for your fund class consistently, do it. This is the simplest route to success. Of course, for most asset managers this statement is obvious but easier said than done. Time and again, studies have shown that most equity funds do not consistently beat the S&P 500. For us, the question is not “is performance more important than scale?” The question is “for a given level of performance, is scale important?” Although past performance is a factor that investors consider when choosing investment options, it is only one among many criteria. However, for institutional managers who are not compelled to grow into the retail or individual market, performance is clearly the most important competitive advantage.

Scale Never?

A group of our medium-scale clients believe that by focusing on their existing asset base they can continue to be profitable indefinitely. They are implicitly taking a niche strategy, focusing on their existing clients and asset base. Many of these companies tend to be institutional companies that are currently enjoying growth through market appreciation in addition to some new mandates. While the niche strategy may work for some, especially those with stellar track records, some smaller institutional firms have been selling at startling prices recently. **Despite the profitability and independence offered by the niche strategy, the current bull market in money managers will seduce more into selling their businesses before the industry fundamentals have a chance to deteriorate.**

III. Exploring Global Opportunities

The structure of the asset management industry in Europe and Japan is quite different from the structure in the United States. An oligopoly of banks and insurers dominate these markets by offering a generally less sophisticated set of low-yielding savings products. What is intriguing, however, is that the demographic predicaments facing Europe and Japan (which are of greater severity than the problem in the United States) will significantly affect industry growth. Demographic pressures facing these countries stress the need for the sort of products that, until now, have been largely shunned. Thus, we believe that the global arena offers incredible growth opportunities to experienced companies and will continue to serve as a source of growth once fundamentals moderate in the United States. True, the effort to create a single market in Europe and financial deregulation in Japan will effect

many changes, not all of which are easy to predict. But until recently, the call for a fundamental adjustment of financial services in the international arena was suspiciously ignored. As changes are implemented, sustainable growth abounds for those asset managers with long-term track records and the breadth of funds to manage volatility. The remainder of this report surveys some key developments in the global arena, and offers our opinion on what it takes to be a truly global competitor.

Opportunities and Issues in a United Europe

Like the United States, the European financial arena is in the midst of a major transformation that, while fraught with risk, will yield handsome rewards for many participants. In this section, we examine three pivotal developments that will determine the future landscape of the European asset management industry.

The Pension Time Bomb

As our colleague, Mark Griffin, has pointed out, a number of European countries have recently enacted or formally proposed social security reforms as it becomes clear that demographic trends will result in pension shortfalls. Griffin provides an in-depth analysis of this phenomenon in his research, *The Global Pension Time Bomb and Its Capital Market Impact*. These pension reforms give rise to three discernible trends regarding the management of newly privatized funds:

- There is a growing preference for defined contribution plans.
- Mounting liabilities have intensified the need for greater risk/greater return investment profiles (i.e., greater emphasis on equities).
- The costs of investment and administrative expertise have prompted more companies to outsource the management of pension assets.

The Development of a More Liquid and More Efficient Euro Market

European companies will likely grow to rely more on capital markets as EMU and the resulting financial integration introduce the liquidity and scale necessary to turn European financial markets into true rivals of U.S. markets. As more companies are able to obtain lower cost or more creative financing from the markets, traditional bank-industry relations will weaken. As a result, European financial institutions will come under increasing pressure to adapt to changing markets.

Positioning in the Pan European Market

The twin forces of changing investor demand and the availability of attractive alternatives to traditional lending are accelerating against a backdrop of intra-European market liberalization. Europe's largest financial institutions must decide whether competing for pan-European dominance is cost effective or even possible. In some cases, previously viable companies will struggle to remain competitive within their local market, while others will seek a strategic combination with a more promising front-runner.

A few large institutions will make the necessary investment and adjustments to become truly global institutions. **Independent asset managers who wish to participate in European opportunities as they develop must consider strategic alternatives today.**

Within the European asset management market, we address two discrete constituencies — the European universal banks (investment banks, insurers, etc.) and the increasingly global, mostly U.S.-based, asset managers. Broadly speaking, the asset managers possess superior investment expertise and servicing capabilities, while the European banks and insurers control local distribution. The strategic lines are clearly drawn. For the large European financial institutions, a sophisticated product set has become a strategic imperative. Naturally, the acquisition of a suitable asset manager can contribute greatly to such a goal. For the global asset manager, a strategic transaction with a competitive European bank could well provide the distribution that is key to penetration of the European market. If the local universal banks are slow to react, however, it may be worthwhile for asset managers to compete head-on, targeting the institutional segment and/or leveraging their competencies and rapidly developing alternative distribution channels.

What's Key in the Distribution Puzzle

It is well known that the largest national banks and insurers dominate the European fund industry. In Germany, for instance, banks control 94.3% of domestic assets, with the top five promoters accounting for 74.9% of the market. In France, banks and insurance groups have market shares of 73% and 11.3%, respectively, with the five largest groups accounting for 52.1% of domestic fund assets. In Italy, banks control 73% of domestic assets, with insurance groups accounting for an additional 16%. The Italian market is less concentrated with the top five companies representing only 38% of the market.⁶ This count includes the assets controlled by joint ventures among the largest asset management companies. Nevertheless, the statistics provide stark contrast to the U.S. financial services industry (and some insight into a post-Glass-Steagall world in the United States).

The concentration of European asset management business among each country's largest banks is a direct result of the organizational structure of the Continent's financial institutions. Europe's *universal* banking system has given rise to a small number of stalwart institutions that exercise immense control over the broad allocation of economic resources within their respective countries.

A divergent history of banking regulations has had profound implications on the intermediation of economic resources between the United States and Europe. Arguably, the development of the

⁶ Lipper Analytical Services.

universal banking model adopted by continental Europe inhibited the historical development of capital markets in these countries as giant financial service providers served the role of capital markets, in contrast to the United States. **In economies where capital markets development lagged, it has been possible for banks to retain clients through traditional lending activity. However, with the introduction of deeper, more liquid capital markets, alternative intermediaries will vie quite effectively for traditional banking relationships.** The next decade will be a very exciting period in the financial development of Europe. The aforementioned dynamics are compelling Europe's largest financial institutions to rethink the formula that has brought them historical success.

The Pension Issue in Europe

In his report *The Global Pension Time Bomb and Its Capital Market Impact*, Mark Griffin points out that Europe faces the same demographics-driven pressure on their social security systems as the United States. The European Federation of Retirement Provision (EFRP) estimates EU pension fund assets totaled U.S. \$1.5 trillion at the end of 1995, less than one-third of U.S. retirement assets, despite the EU having 100 million more people. Significantly, only two countries, Britain and the Netherlands, account for 74% of the EU pension fund assets.⁷ Mark Griffin refers to this as the "pension time bomb." Exhibit 15 illustrates the startling rate at which the dissavers ratio is expected to outstrip the prime savers ratio, resulting in an asset/liability mismatch in the E-4. As the projections indicate, this demographic shift will be particularly dramatic from 2010 onward. Yet, because funding of a plan requires contributions over a pensioner's lifetime, it is imperative that governments address this asset/liability mismatch today.

European Pension Reforms

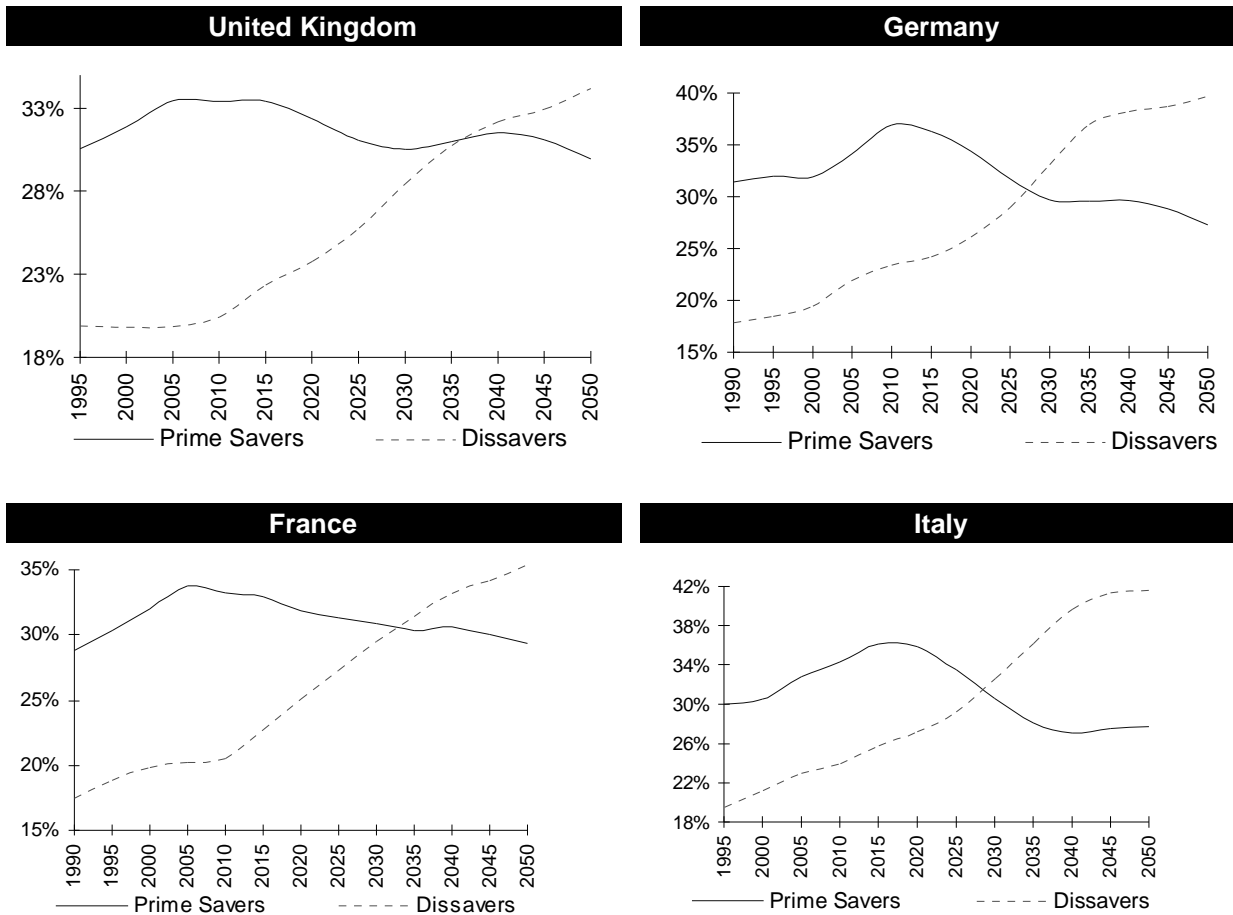
Recently, there has been considerable debate over the issue of pension reform in the EU. Even if the EU governments muster the political resolve to cut benefits, raise the retirement age, and/or increase contributions, the adequacy of state-sponsored pension systems to meet future liabilities is doubtful. Thus, some attempt to shift the economic burden of retirement from the public to the private sector has been under way in most countries. The evolution of pension reform in several EU countries is discussed in brief in Appendix 3. **It is clear that the investment needs of Europeans will provide opportunities for well-positioned non-European asset managers.**

Increased Growth in Defined Contribution Assets

The problem of an aging workforce is not confounding governments alone. Companies are expressing dismay over the unsuitability of traditional defined benefit schemes to meet pension liabilities in a sluggish economy. Nor are they well-suited

⁷ *The Herald* (Glasgow), January 1, 1998, Pg. 19, "Golden years lie ahead for Europe's providers," James Salt.

Exhibit 15: Prime Savers and Dissavers as a Percentage of the E-4 Adult Population



Source: U.S. Bureau of the Census

for today's more transient workers. Thus, the trend in pension reforms is toward private pension schemes on a portable, defined contribution basis. InterSec estimates defined contribution assets outside of the United States will reach \$1.4 trillion by 2002, growing at a 16% annual rate. Notably, non-U.S. defined benefit assets, currently estimated at \$3.43 trillion, are expected to continue to dominate defined contribution assets by a wide margin. Defined benefit assets, however, are expected to grow at only 9%, reaching \$6.35 trillion by 2002. At yearend 1995, the EU accounted for some \$239 billion in defined contribution assets.⁸

Greater Exposure to Equities

The pension debate continues and European pension sponsors and individual investors will learn to appreciate the potential for equity-based products to hedge inflation risk and meet liability growth. The recent advent of tax-advantaged equity savings plans (such as the Personal Equity Plans, or PEPs, in the United

⁸ Pensions & Investments, July 7, 1997, News; Pg. 3, "Foreign DC Assets to Hit \$1.4 Trillion," Joel Chernoff.

Kingdom, and Plan D'Epargne, or PEA, in France) lend support to equities' rising popularity. Regionally, the ongoing shift toward riskier assets will have an enormous impact on European stock markets. A recent study by Pragma Consulting reported that domestic equity holdings by pension funds in most of Europe are insignificant, with German pension funds owning 1.33% of the stock market and France owning 1.52%. To lend perspective, United Kingdom pension funds account for 33% of the stock market.⁹

There is good reason to believe that a substantial portion of new equity investments will be directed toward international shares as well. Griffin presents a persuasive analysis of the worldwide aging trend and its effect on asset allocation. He argues that diversification via international equities is strongly correlated with international trade. The reason for the association is the impact international equities have on hedging imported inflation in open economies.

Increased Outsourcing of the Management of Pension Assets

The two aforementioned trends, along with corporate strategies refocusing on core competencies, will result in more companies outsourcing the management of pension assets. Among those companies that continue to manage pension assets internally, many will sub-contract parts of their portfolios requiring more sophisticated management expertise. **The growth in private defined contribution schemes will give a competitive advantage to providers capable of offering scale-intensive back office functions, such as custody and general administration.**

The Prospect of More Liquid and More Efficient European Capital Markets

The financial markets indicate a confidence that monetary union will proceed on time, and that short-term interest rates will converge among the first countries to join. The planned convergence in interest and inflation rates is a fundamental factor affecting the level and volatility of financial market activity. The immediate implication for the asset management industry is that monetary union will bring about a favorable interest rate environment supporting long-term investments. Market stability is important during a time when many European savers attempt to overcome their long-standing misgivings toward more aggressive investments. If pension plans pursue international diversification primarily through equities, as we believe they will, then EMU will require pension funds in member countries to reallocate the international equity portion of their portfolios to investments in countries outside of EMU. Investments in other EMU countries will have characteristics closer to domestic than international assets.

A secondary consequence of EMU is the creation of a more level playing field, especially between bank and non-bank financial

⁹ The Herald (Glasgow), *ibid.*

intermediaries. The Euro will offer the degree of liquidity necessary to create European capital markets that rival those of the United States. In the bond markets, the increased liquidity will provide depth not only to investment grade issues but support greater interest in higher yielding, non-investment grade credits as well. If so, the largest companies will likely experience decreases in their cost of capital while a greater range of companies will find it possible to bypass bank financing via the capital markets. All this will put additional pressure on banks' already slender lending margins. The possible disintermediation of the banks is no small consideration. Currently, banks' share of the corporate lending market is 56% in Britain, 73% France, 77% Germany and 78% Spain. By comparison, in the United States the figure is 22%.¹⁰

As cross-border capital flows grow, companies will become more accustomed to turning to the capital markets for their financing needs. Concurrently, investors will become more comfortable investing in riskier assets when expected returns are commensurate. In this environment, the large European banks will come under increased pressure to transform themselves in order to become effective intermediaries.

Prospects and Perspective

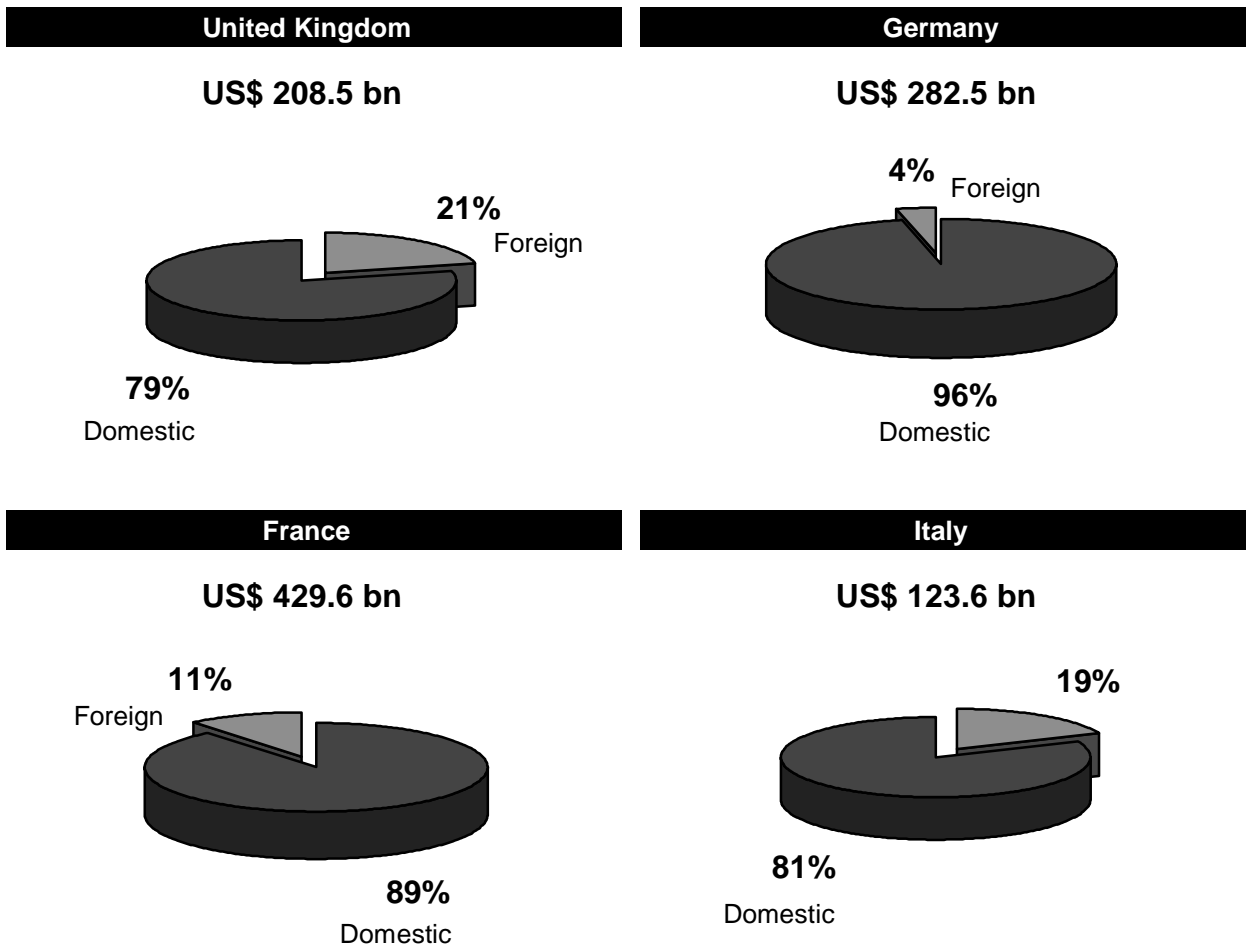
Today, it is too early to speak meaningfully of a single European asset management industry. The share of mutual fund sales attributable to foreign asset managers in each of the E-4 is still modest (see Exhibit 16), and domestic banks largely control the institutional segment, as well. Nevertheless, the idea of a developing pan-European market is a very real, although not yet realized, proposition (see Appendix 4 for a brief discussion of the evolution of the single market). And the conditions of competition in Europe make clear that there are substantial possibilities for future strategic transactions among even the industry's largest participants, as the recent UBS/SBC transaction suggests.

Prescription for European Banks and Insurers

For European financial institutions, pan-European expansion reflects the universal banking culture. Many large banks and insurers will view attempts at anything less than pan-European presence as an admission of failure. The universal banks will need to commit time and capital to build new business. We believe that developing product and a pan-European presence solely through organic growth will be a challenge. Even if the built-in risks of greenfield strategies are avoided, the adjustments necessary to compete in an intra-European market require prolonged investments. Moreover, branding of the product that we have touted to be so key in the United States will also be important but costly and time-consuming to build in the various local markets within the EU. Many of the asset managers who enjoy high brand recognition in the United States or in their respective local market

¹⁰ *The Economist*, January 10, 1998, U.S. Edition, Pg. 61, "Europe's Lovesick Bankers."

Exhibit 16: Domestic and Foreign Owned Mutual Funds



Source: Lipper Analytical Services

in the EU are facing serious challenges in trying to extend their recognition into other markets in Europe. How long can Europe's largest financial institutions defend their own markets while they try to penetrate others? **We believe that a resource-focused strategy where the core competencies of banks, insurers, securities firms, and asset managers are strategically combined to maximize value in new markets will be a common strategy, considering the time-sensitive nature of competition.** Indeed, the trends toward bancassurance and universal banking, which are more advanced in Europe than elsewhere in the world, are actually expressions of this general strategy. To be sure, cross-border integration presents managerial and cultural difficulties. Nonetheless, the first financial institutions to effect the greatest matches of product and distribution will become Europe's front-runners. Central to any successful endeavor will be a broad and successful asset management operation. Several notable transactions in Europe have already set the stage.

Prescription for Global Asset Managers: Several Alternatives

For foreign global asset managers, deregulation of European markets and circumstances favoring long-term investments do not guarantee sales. Distribution remains key. Still, the size and growth of the European asset management industry is so appealing that a legitimate player can hardly afford not to participate. In contrast to the universal banks, the asset management companies will consider a broader, less clear-cut range of strategies.

Direct Banking and Brokerage

One phenomenon that must be mentioned in the context of asset management development in Europe is the rise of direct banking and brokerage. Interestingly, however, the success of direct banking in Europe has been modest. In France, two fund supermarkets, Banque Cortal (an indirect subsidiary of Paribas) and Vega Finance (a subsidiary of CDC), have shown only moderate success. In Germany, where direct banking is most visible, the sector has shown little profitability. The rise of direct banking in Germany was prompted by the competitive prospects of U.S. entrants such as Fidelity and Schwab. To date, however, it seems direct banking operations are more an obligatory service than a means of attracting new customers. It is estimated that almost two-thirds of the segment's customers come from the parent's existing client base. Furthermore, direct banking sales account for only 1% of German fund purchases.¹¹ Estimates of the number of fund sales going through direct channels vary wildly. However, all fall well short of the market share found in the United States or United Kingdom. We believe that this is at least partly due to settlement systems that are ten years behind the state-of-the-art and a less technologically oriented customer base, and consequently, technology provides a smaller advantage to the more forward-looking discount distributors. If nothing else, however, the introduction of discount brokerage has resulted in a more price-sensitive investor base.

Outsourcer

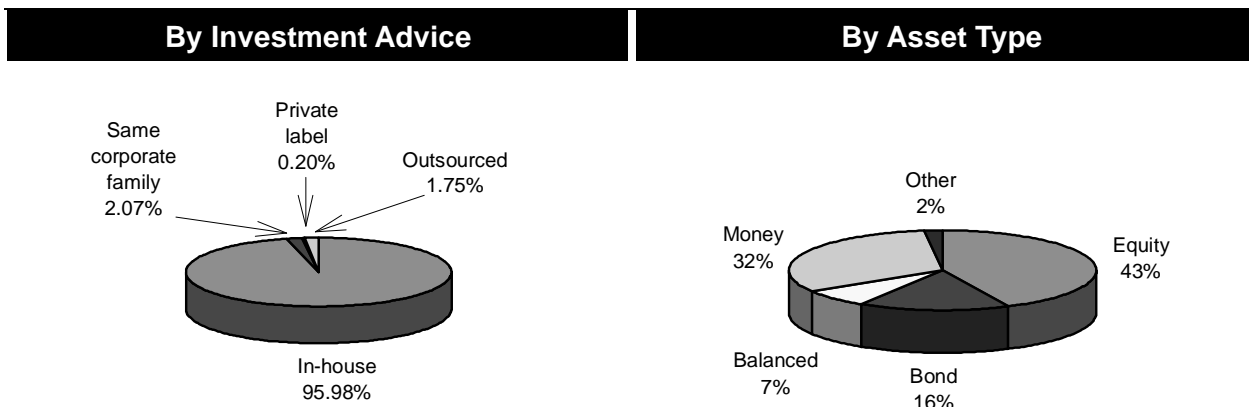
Another possible opportunity available to global asset management companies will be as specialist outsourcers. The opening here for retail providers has been limited to date but may show greater promise in the future. A recent study by Lipper of selected European markets (see Exhibit 17) found that outsourced mutual fund advisors account for a mere 4.02% of assets managed. Additionally, more than half the funds outsourced are mandated to companies within the same corporate family as the fund promoter.

The extent to which investment advice is outsourced varies across countries, with funds advised by third parties accounting for only 0.03% of the total in Germany, 1.0% in France, and 8.0% in the United Kingdom.¹²

¹¹ Direct Delivery International, June 1997, Pg. 9, "A DAB Hand."

¹² Lipper Analytical Services.

Exhibit 17: Outsourced Assets by Type of Investment Advice and Type of Asset



Note: Data compiled from Austria, Belgium, France, Germany, Luxembourg, and the UK
 Source: Lipper Analytical Services

Business scope and pan-European market share top the boardroom agendas of Europe’s largest banks. Currently, 59% of all equity funds (or 43% of all equity assets managed) are outsourced, which we believe is an encouraging statistic for asset managers as the emphasis on equities continues to grow. In contrast, only 10% of money market funds are outsourced.¹³ To many, outsourcing seems a clear means of overcoming the distribution problem and participating in Europe’s developing equity culture. It would be a sound strategy if the competitive landscape was static, but that it does not consider the strategic response of the European banks. **The more the market for equity products expands, the more likely it is that banks will perceive in-house expertise as an imperative.** In our discussions with the large banks and as demonstrated by their concrete actions, the European universal banks have already credibly shown their determination to assemble core business lines through strategic purchases as well as organic growth. This course of action is not only consistent with but fundamental to the universal banking concept. **Therefore, outsourcing should be seen as a temporary phenomenon, and a strategy solely relying on outsourcing will not be viable for any participant but the smallest niche asset managers.**

Independent Distributors

A third alternative is to make use of independent distributors. However, outside of the United Kingdom independent distributors control a relatively small fraction of fund flows. In France, the independent sector accounts for a mere 5% of fund sales. For the most part, the independents focus on higher commission insurance products. Foreign companies do account for a sizeable portion of the independents’ sales, however. In Germany, independent distributors account for 15% of fund sales, although the majority

¹³ *ibid.*

of such sales are attributable to pyramid-selling organizations (Strukturvertreibe). Far from independent, these organizations are tied to several fund companies and offer a limited choice of products. Still, they provide the greatest opportunity for foreign promoters to sell their funds.¹⁴

Both Fidelity and Flemings have made use of independent distributors as part of their pan-European expansion strategy. Fidelity's strategy has been to establish its brand by selling Luxembourg-based funds through independent distributors. Flemings has adopted an organic strategy, entering markets through sales of its Luxembourg-based funds via independent distributors, then gradually building a local presence as business developed. Both approaches, however, are capital intensive.

Institutional Business Shows More Immediate Promise in Europe

The retail distribution issue is so vexing that, in contrast to the United States, the institutional, rather than the retail sector, presents the most attractive opportunities for global asset managers to leverage their comparative advantage. First, it is sometimes noted that the institutional market is more performance-driven than the retail segment. BCG estimates that in Europe a 10 bp improvement in investment performance attracts 3% more institutional assets but only 1% more retail assets.¹⁵ Another attractive aspect of the institutional market is that it avoids the high startup costs associated with retailing across various markets. The hitch is that even the traditional institutional market favors the banks and insurers, which can leverage client relationships. But the status quo could change with demographic changes. For companies with book reserve arrangements, the approaching maturation of unfunded pension liabilities will have two profound consequences. First, sponsors will pay greater attention to the performance of externally managed assets. Second, companies will have to arrange external financing to replace depletions in working capital. **Thus, changes in the institutional segment will put additional pressure on the banks' traditional businesses, while offering an opening for the asset managers.**

Opportunities in Defined Contribution

We also see occasion for global asset managers to break into foreign markets via the defined contribution segment. Initially, the defined contribution market looks impenetrable to foreign asset managers: winning business would ostensibly require marketing first to sponsors and to participants. In Europe, however, employer paternalism and employee mistrust of pension reform makes it far from certain that defined contribution will take the same form that it has in the United States. European critics of private defined contribution schemes are concerned that unsophisticated investors will allocate the bulk of their funds, arguably imprudently, to low yielding money market and fixed

¹⁴ *ibid.*

¹⁵ *The Economist*, March 29, 1997, U.S. Edition, Business, Pg. 75, "Europe's Fund Phobia."

income investments. In response, many European sponsors are attempting to retain discretion over retirement assets by restricting participants' investment choice. Still, the schemes require comprehensive administration and service. Clearly, global asset managers have the investment expertise, service-orientation, and back-office capabilities to manage these 401(k) type schemes. In an increasingly competitive market, this is a meaningful advantage that will offset the banking industry's client ties.

Strategic Combination

We believe that one of the most attractive strategies for asset management companies with global ambitions is to form a strategic combination with a promising European universal bank, a strategy that has already yielded several success stories. **The synergies are clear: A universal bank provides the access and market intelligence to succeed in the new Europe while providing the resources necessary to compete effectively in the United States and exploit other international opportunities as they arise. The asset manager is empowered with independence and expanded authority to compete more aggressively in marketing a broader set of products.** Key to a successful strategy for an asset manager with global ambitions is to “explore global but secure local.” Remaining focused on the domestic business, maintaining growth, and strengthening competencies will make the company distinctive. These characteristics will ultimately be leveraged into any expansion abroad. Indeed, European partners seek those companies that have the scale and scope to act as a credible platform from which to build a global asset management capability. Many asset managers will seek a strategic partner in Europe over the course of the next several years. Maintaining a strong position in the United States — which remains the dominant asset management market — will ensure the broadest range of strategic options.

Japan: Sunrise, Sunset ... Sunrise?

History is replete with examples of well-thought-out ideas gone wrong or obsolete. Japan's downtrodden financial services industry is a case in point. Curiously, the separation of commercial and investment banking (pursuant to Article 65) failed to inspire the sort of financial innovation that its prototype, Glass-Steagall, did in the United States. In contrast to the United States, financial regulation in Japan was directed fundamentally at channeling funds to large corporations to fuel economic growth. The Finance Ministry's activist role in the development of the Japanese financial sector provided for a system in which banks recycled national savings into huge loans at low rates for industry and commerce. To its credit arguably, the system facilitated Japan's emergence as an economic superpower.

Currently, Japan's financial industry continues to resemble this post-War system. Unfortunately, its economy has matured and is no longer suited for micro-management by technocrats. The current-day infrastructure is an outdated financial system,

desperately ineffectual at allocating economic resources. At the end of February 1996, Japanese banks had outstanding loans of approximately ¥500 trillion. Comparatively, U.S. banks had loans of about \$2.8 trillion (approximately ¥340 trillion) despite a GDP that roughly doubles Japan's. Japan's capital-strapped banks present a serious problem for Japan's entire economic recovery plan.

Asset Management: A New Market

Until recently, there was little use for asset managers in Japan. Initially, only trust banks and life insurers were authorized to manage pension fund assets. Recently introduced pension reforms now allow investment advisors to manage pension assets, and until very recently, only securities firms could offer mutual funds. Now a few foreign promoters and insurance companies are permitted to offer funds, but the large domestic securities firms have distribution cornered. Distribution aside, mutual funds have never gained much popularity. One explanation is that policies restricting overseas accounts (e.g., the Foreign Exchange and Foreign Trade Control Act) make it difficult at best to invest in foreign securities and foreign-owned mutual funds. In the domestic arena, well-documented client biases and recurrent securities scandals have taken their toll on investor confidence.

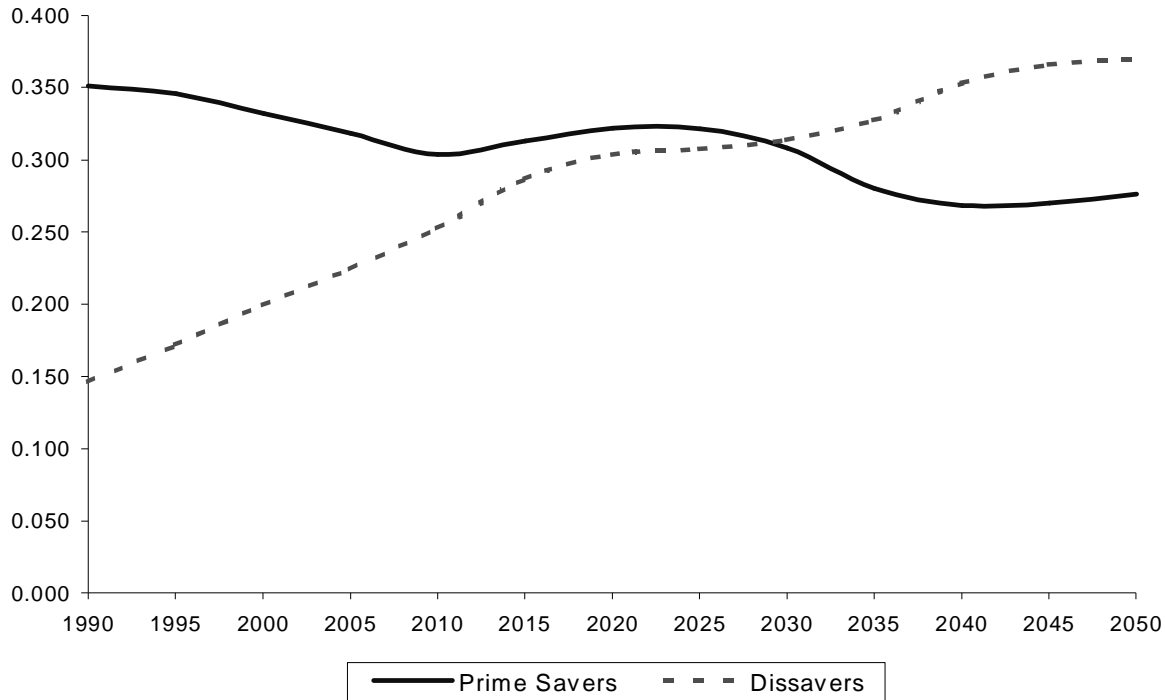
But all this is likely to change. Like the rest of the industrialized world, Japan is facing an aging population and large, unfunded pension liabilities. **Japan's financial system can no longer afford to offer its savers inadequate returns.** One obvious solution is pension reform. We believe that the ongoing changes to private pension systems are reason enough to notice Japan. Of course, there is another. So outdated is Japan's financial system that the government is forcing a complete overhaul. Japan's Prime Minister, Ryutaro Hashimoto, has dubbed the reforms slated to take place later this year as Japan's "Big Bang."

Japan's Pension Time Bomb

Japan's pension time bomb is ticking faster than any other country. As shown in Exhibit 18, Japan's working population has already peaked, and the dissavers ratio is actually expected to outstrip the prime savers ratio by 2030. Significant reform of the public pension system is already under way. Early in the next century, the retirement age for first-tier pension benefits will increase to 65 from 60. Further plans are in place to raise contribution rates gradually over the next three decades.

The private sector lacks the austere options of the public system. The size of private pension liabilities is difficult to assess because Japanese companies account for their schemes off-balance sheet. **But according to the European Business Community, a Tokyo lobby group, Japanese private pension costs are two to three times greater than those of U.S. or U.K. firms.** The burden of these costs in an increasingly competitive global arena underscores

Exhibit 18: Japan: Prime Savers versus Dissavers Ratios



Source: U.S. Bureau of the Census

the urgency with which Japanese companies must try to improve matters.

Historically, pension management was performed in-house. Generally, personnel departments allocated pension assets to their company’s trust bank, generally an exclusive relationship reinforced by the Japanese keiretsu structure. As mentioned above, only trust banks and life insurers were permitted to manage pensions assets. The funds were also subject to stern investment restrictions.¹⁶ Perhaps not surprisingly, the returns on pension assets were less than adequate. Frank Russell estimates that from 1985 to 1995 trust banks averaged a cumulative 59% return on pension assets managed, representing a 4.7% compound average annual return. In contrast, single-employer defined benefit plans in the United States returned 249% or 13.3% annually on a compound average basis.

Recently, the Health and Welfare Ministry has reformed Employee Pension Funds (EPFs). Similar reforms are in progress for a second type of basic pension scheme, the Tax Qualified Pension Plans (TQPP). In the early 1990s, investment advisers were authorized to manage new contributions to EPFs. Since then, investment advisory firms have been noticeably efficient at luring

¹⁶ Pursuant to the 5-3-3-2 rule, pension fund assets were required to be invested 50% in fixed income instruments, not more than 30% in domestic equities, 30% in foreign instruments, and 20% in property.

pension assets away from trust banks and insurers by offering plan sponsors better performance. The Japan Securities Investment Advisors Association estimates that, between March and December of 1998, the value of assets managed by investment advisers almost doubled to ¥13 trillion from ¥6.8 trillion. Foreign investment advisers account for a considerable part of this increase. For the year ending September 1996, pension assets managed by foreign investment advisers climbed 228%. The comparable figure for their Japanese counterparts was 117%¹⁷. Yet, foreign investment advisers account for only 20% of all public funds and EPFs managed by investment advisers. Independent managers' share of the entire corporate market is a mere 7%¹⁸. Competitive prospects, however, may be changing. Last April, EPFs were required to switch to market value rather than book cost accounting, bringing their underfunding to light. **It is likely that foreign banks and asset managers will meet a greater demand for their expertise once plan sponsors lose incentive to hold financial assets acquired before Japan's bubble burst.**

For Japanese Retail, a Big Bang

Big Bang has been a hot topic of late, for good reason. Not only are the remaining walls that separate banks and securities firms to be removed by the year 2000, but the now infamous hold of the Ministry of Finance on the financial services sector is slated for reform. Indeed, part of Big Bang involves the creation of a new independent body to oversee the supervision of banks and securities firms.

Beginning in April, several other measures will go into effect. A momentous reform, especially relevant to foreign asset managers, is the essential repeal of the Foreign Exchange and Foreign Trade Control Act. Japanese investors are currently prohibited from holding overseas yen accounts or converting foreign money with any institution other than a "foreign-exchange" bank. Thus, investments in foreign mutual funds are effectively proscribed. After April, however, Japanese investors will be permitted to invest abroad. Another important rule change allows banks to sell mutual funds. Currently, only securities firms are authorized to sell mutual funds directly. The introduction of banks into the market is certain to contest the securities firm's monopolistic distribution networks. A final change worth mentioning allows for banks and securities firms to only register with, not be licensed by, the Finance Ministry. This is no small matter. The Ministry's implicit guarantee of the institutions it licenses has contributed considerably to overcapacity in the financial system.

The most obvious result of Big Bang will be the flood of savings from low-yielding bank and postal deposits to

¹⁷ *Global Investor*, April 1997, No. 101 pg. 13, "Japan's 'big bang' is good news for foreign advisers," Preston, Claire.

¹⁸ *Ibid.*

investments offering better risk/return profiles. To be certain, Japanese banks will be intent on retaining as much of the funds moving out of deposits as possible with their own asset management operations. In fact, some Japanese banks and securities firms are attempting to preempt Big Bang deregulation by establishing new funds early through ventures with U.S.-based asset managers.

Entering into either a strategic transaction or a contractual relationship with a Japanese bank is the fastest method of gaining distribution. For the asset manager intent on gaining a long-term share in this market, however, we view the above approach more as a gamble than a strategy. The problem is that it is unclear which of the Japanese banks and securities firms will emerge from the inevitable shake-up that deregulation of the asset management industry is certain to bring. Already, a number of Japanese financial institutions have quietly attempted marketing themselves to foreign banks, and the recent collapse of Yamaichi securities demonstrates that no one is immune. Indeed, an asset manager cannot be sure the bank or securities firm they engage today will be viable a few years hence.

For a number of reasons, we believe that the better strategy is to enter the market directly, either through a physical presence, cross-border sales from an off-shore site, or cross-selling institutional product to retail customers.¹⁹ It is doubtful that the Japanese banks and securities firms will make a smooth adjustment from the nurturing guard of the Ministry of Finance to a financial market as open as that in the United States. It is equally unlikely that alternatives to deposits at rock bottom rates will be met with anything less than sober curiosity by Japanese retail investors in the near term. What's more, Asia's currency upheavals almost assure that zero percent real interest rates will persist for some time. Preliminary indications show that Japanese investors are purchasing foreign funds to the extent current rules allow. Japanese household investments in foreign securities have soared from practically nothing in 1993 to ¥10 trillion in 1996. And the U.S. Treasury Department reported that sales of foreign-managed funds rose 46% in the first eight months of 1997. All together, foreign asset managers doubled the amount of Japanese assets under management last year to a total of more than \$20 billion.²⁰ And Big Bang has only begun to take effect.

Latin America: The Next Generation of Opportunities

For asset managers seeking markets that offer the highest growth potential, the case for Latin America is compelling. Quite simply, increased economic stability anticipated to result from the

¹⁹ Fidelity recently opened counters in Japan to sell mutual funds to retail investors.

²⁰ *The New York Times*, February 1, 1998, Sunday, Late Edition - Final, Section 1, Page 1, "Worsening Financial Flu in Asia Lowers Immunity to U.S. Business," Kristof, Nicholas D.

Mercosur trade pact as well as pension reform programs already under way in the region's largest economies support opportunistic prospects for providers of institutional and "instividual" services.

Indeed Argentina, Mexico, Bolivia, Columbia, and Peru have already implemented or are in the process of setting up innovative pension systems modeled after Chile's Administradoras de Fondos de Pensiones (AFP), a defined contribution scheme. In Brazil, reform of the public pension system is a more difficult matter, both operatively and politically. So alarming are the actuarial deficits, however, that a number of private companies are offering voluntary pension schemes as a way of luring employees.

Of course, it is unlikely that the expectations for Latin America will materialize in the near term. The average pensioner lacks the capital markets mentality that spurs interest in both equity instruments and collective investment vehicles. What's more, there is much concern on the part of many Latin American governments that foreign asset managers will funnel pension assets out of the domestic market and into more liquid foreign stock markets. Hence, most AFP schemes contain stringent restrictions on foreign asset allocations, as well as direct limits on the participation of foreign providers. In Mexico, for example, there is a 49% cap on foreign investing in afores (i.e., asset managers authorized to manage pension assets), although the rule does not prevent a foreign entity from co-investing with its Mexican financial subsidiary for an effective controlling interest.

Despite the cultural and regulatory barriers facing foreign entrants, the need for non-domestic asset managers is apparent. Indeed, most Latin American countries are far from developing capital markets capable of channeling national savings into corporate financings. For example, Bolivia, which has no capital market, is almost entirely reliant on international investment. Moreover, foreign asset managers offer the service orientation and capabilities needed to manage the new defined contribution schemes. To be sure, expanding into Latin America and other emerging markets is a long road and generally a realistic option for only the largest, most stable providers. Still, such a move will, ultimately, prove rewarding for asset managers facing mature, saturated markets elsewhere.

Conclusion: ...Secure Local

The bottom line, however, is that most of these markets remain fraught with uncertainty and barriers, at least for now. As the barriers begin to erode, the uncertainty will begin to dissipate. Even while uncertainty exists, it is clear that the global markets represent breathtaking growth prospects for the asset management industry, and currently most of the expertise needed to tap those markets resides in the United States. What is certain, however, is that the market will grow to become so highly competitive that only firms that bring an advantage to the international arena will

be given a seat at the table. Generally, these firms will be the firms that have mastered the game in their home market. When this dynamic is coupled with the developments in the domestic marketplace outlined in the first half of this report, there is a clear mandate for investment managers: **Branding and distribution as well as product innovation will be key for firms that want to penetrate global markets.**

As mentioned previously, this industry is in the midst of a glorious era. The golden age, however long — or profitable — cannot last forever and it is certainly no time to be resting on one's laurels. **As we move into an uncertain future and its attendant opportunities and challenges, companies that act now to secure the future that will carry the day.** Naturally, every business has its strategic options refracted through the prism of its own goals, objectives, and strengths. Whatever the options, however, change demands adaptation, and we think it is only prudent to be proactive, while still in a position of strength than to take a wait-and-see approach and possibly become the victim of circumstance.

**APPENDIX 1 —
The Development of Defined
Contribution Retirement Plans**

1962 — Self-Employed Individuals Tax Retirement Act of 1962
Keogh (H.R. 10) plan accounts were authorized under this legislation for self-employed persons.

1974 — Employee Retirement Income Security Act of 1974 (ERISA)
Established the Pension Benefit Guaranty Corporation (PBGC)
Established IRAs to provide workers who did not participate in employment-based retirement plans.

1978 — Revenue Act of 1978
Permitted employers to establish 401(k) arrangements.

1981 — Economic Recovery Tax Act of 1981 (ERTA)
Made tax-deductible IRAs available to all wage and salary earners whether or not they were covered by employer-provided pension plans.

1982 — Banks allowed to offer IRA commingled accounts.

1986 — Tax Reform Act of 1986 (TRA '86)
Restricted the tax deduction among those with a retirement plan to individuals with incomes below specified levels.
Two new categories of IRA contributions were added: nondeductible contributions and partly deductible contributions.

1996 — Small Business Job Protection Act of 1996
Increased the amount that may be contributed on a deductible basis on behalf of a non-working spouse to \$2,000 from \$250.
Certain employers may establish Savings Incentive Match Plans for Employees (SIMPLE plans).

1997 — Taxpayer Relief Act of 1997
Section 301 of the Act increased the income limits applicable to deductible IRAs beginning in 1998 to \$30,000 for individuals and \$50,000 for couples.
Section 302 of the Act created the Roth IRA. Under the new back-loaded Roth IRA, individuals would be permitted to make annual nondeductible contributions in amounts up to \$2,000.
Created a new Education IRA that allows individuals to contribute up to \$500 annually to the IRA.

**APPENDIX 2 —
Regression Results and
Discussion**

In conducting these multiple regressions we are able to examine the effect of fund size and fund performance on net new sales while holding other variables constant. To conduct this study, we gathered quarterly data on all domestic equity funds listed on the Lipper Analytical Services, Inc. mutual fund database during the 1986-1996 period. From data on total net assets and quarterly returns data, we constructed net new sales by decomposing quarterly asset growth into a returns and a net new sales component. We used the natural logarithm of the net new sales as the dependent variable for all of the regressions. We then constructed several linear regression models to explain variation in net new sales to equity funds. We used several general classes of variables and several variables to measure the performance of the overall market using the performance of the S&P 500 index over various time periods. We constructed fund-specific performance variables by computing alphas over various time periods from a four-factor asset pricing model. This model employs returns on the S&P 500 Index, the Ibbotson Associates Small Cap Index, the Ibbotson Associates Corporate Bond Index, and the three-month Treasury bill rate to construct the time series model that estimates excess risk-adjusted returns.²¹ For a size variable we used the natural logarithm of total net assets of the fund. We use the size variable as a proxy for other less measurable qualities such as the size of the fund's distribution network, goodwill associated with brand name, and the quality of customer service systems.

As shown below in Specification 1, a two-variable model regressing the natural logarithm of net new sales on the lagged quarterly return on the S&P 500 Index and the lagged quarterly alpha for the fund found both variables highly statistically significant at the 99.9% confidence level. The 1.739 coefficient on the lagged return on the S&P 500 Index implied that a 1% increase in the S&P 500 return in the prior quarter led to an estimated 1.7% increase in net new sales for the fund. Similarly, a 1% increase in the prior quarter's alpha led to a 4% increase in net new sales. Interestingly, however, the R-squared for this regression model is quite low at 0.66%. In Specifications 2 and 3, we continued to add additional lagged values of the S&P 500 return and the fund's alphas and found that they were all statistically significant at the 95% confidence level. Nevertheless, the R-squared for these regressions remained low, never exceeding 3.99%. In Specification 3, we also included a dummy variable for load funds and an interaction term with the lagged alpha variable. We found that the load dummy variable was highly statistically significant and negative, load funds attracted less new sales, all other variables held constant. On average, load funds attracted 15.4% less funds than a comparable no-load fund. In Specification 4 we examined the influence of longer run fund performance on

²¹ The methodology is similar to one employed by Martin Gruber in "Another Puzzle: The Growth in Actively Managed Mutual Funds," *Journal of Finance*, July 1996, pp. 783-810.

fund flows. We regressed net new sales on 1- and 3-year alphas. We found similar results with regard to statistical significance.

In Specification 5, we introduced a simple regression of (the log of) net new sales on the log of total net assets at the beginning of the quarter. We found that this size variable is also a highly statistically significant at the 99.9% confidence level. We estimated that a 1% larger fund attracts 0.8% more net new sales, all other variables held constant. Moreover, we found that the size variable alone has vastly more explanatory power than any of several dozen regressions (most not shown) we ran employing only performance variables. The R-squared for our simple regression was 50%, an order of magnitude greater than any specification we ran with only performance variables. Specification 6 combined performance and size variables in a fuller model, which found many of the variables statistically significant and the R-squared higher than any prior model.

Regression Estimates

	Specification 1		Specification 2		Specification 3		Specification 4		Specification 5		Specification 6	
	Coefficient	p-value > t	Coefficient	p-value > t	Coefficient	p-value > t	Coefficient	p-value > t	Coefficient	p-value > t	Coefficient	p-value > t
S&P500 Return 1 Q Lag	1.739	0.000	1.874	0.000	2.168	0.000	-	-	-	-	1.613	0.000
S&P500 Return 2 Q Lag	-	-	-	-	1.370	0.000	-	-	-	-	0.720	0.000
S&P500 Return 3 Q Lag	-	-	-	-	1.078	0.001	-	-	-	-	0.615	0.004
S&P500 Return 4 Q Lag	-	-	-	-	0.808	0.008	-	-	-	-	0.558	0.007
S&P500 Return 5 Q Lag	-	-	-	-	0.649	0.019	-	-	-	-	0.244	0.199
S&P500 Return 6 Q Lag	-	-	-	-	-0.620	0.023	-	-	-	-	-0.719	0.000
Fund Alpha 1 Q Lag	3.996	0.000	2.469	0.000	2.378	0.001	-	-	-	-	3.825	0.000
Fund Alpha 2 Q Lag	-	-	4.445	0.000	4.313	0.000	-	-	-	-	5.540	0.000
Fund Alpha 3 Q Lag	-	-	5.545	0.000	5.631	0.000	-	-	-	-	5.347	0.000
Fund Alpha 4 Q Lag	-	-	4.926	0.000	5.180	0.000	-	-	-	-	5.212	0.000
Fund Alpha 5 Q Lag	-	-	4.237	0.000	4.385	0.000	-	-	-	-	4.251	0.000
Fund Alpha 6 Q Lag	-	-	4.462	0.000	4.687	0.000	-	-	-	-	3.571	0.000
Fund Alpha 1 Year	-	-	-	-	-	-	3.101	0.000	-	-	-	-
Fund Alpha 3 Year	-	-	-	-	-	-	1.184	0.000	-	-	-	-
Log of Total Assets	-	-	-	-	-	-	-	-	0.812	0.000	0.871	0.000
Load Dummy	-	-	-	-	-0.154	0.000	-	-	-	-	-0.064	0.011
Fund Alpha 1 Year * Load Dummy	-	-	-	-	-0.009	0.986	-	-	-	-	0.872	0.010
Constant	2.115	0.019	2.151	0.000	2.092	0.000	1.087	0.000	-2.087	0.000	-2.729	0.000
	R-squared = 0.66%		R-squared = 3.42%		R-squared = 3.99%		R-squared = 3.36%		R-squared = 50.17%		R-squared = 54.97%	

APPENDIX 3 — European Pension Reform Evolution in Brief

Italy — Private pension reform is well under way with formal implementation of recently approved legislation authorizing the creation of large-scale pension funds expected during the course of 1998. ANIA, the insurance trade organization, projects new pension fund assets to reach U.S.\$49 billion under management by the year 2000. The extensive promotion of funds by banks and the expertise of asset management companies in managing large-scale portfolios ensures that fund providers will acquire a considerable proportion of this business. Assogestioni, the trade association for asset managers, estimates net sales of funds in 1996 topped U.S.\$40.6 billion, representing more than one-third of that year's total household savings.²²

France — The government approved legislation to establish a private pension scheme in March 1997. However, issuing regulations to implement the new pension law has resulted in political delay. The proposed scheme would work on a voluntary-defined contribution basis, with employers permitted to match an amount up to four times that contributed by employees.

Germany — The government is expected to introduce Pensions-Sondervermogen, a special savings vehicle designed as a supplementary pension scheme early this year. The Pensions-Sondervermogen have significant advantages over the traditional systems of company pension provision. For example, the set-up costs for the Pension-Sondervermogen are considerably less than those for the traditional schemes, making the new schemes affordable to smaller businesses. Furthermore, companies will be permitted to set up Pensions-Sondervermogen on a more attractive defined contribution basis, with existing pension reserves transferable to the new vehicles.

Of consequence is whether the financially pressed German government will offer adequate tax incentives given its need to meet fiscal targets for EMU. Critics argue that, without tax benefits, the new savings vehicles are no different from Pensionskassen (pension funds) and Unterstutzungskassen (maintenance funds) already set up in large German companies. The debate highlights an important issue. The fiscal targets necessary to join EMU do not address mounting pension liabilities. EMU requires that public sector deficits are not to exceed 3% and that the public sector debt to GDP ratio is not to exceed 60%. These criteria do not take into account the financial burden unfunded pension liabilities have already placed on future GDP. If Germany were to pay interest on its unfunded pension liabilities, a 10% interest rate would require 21.3% of GDP in taxes simply to pay interest on its debts. And, of the largest EU economies, Germany remains best suited to address its pension time bomb.

²² Lipper Analytical Services

APPENDIX 4 — The Evolution of Europe's Single Market in Brief

The nearly materialized single market concept has Europe's largest financial institutions seriously considering whether competing globally is cost effective, or even possible. Certainly, some companies will enjoy the benefits that market liberalization brings, while others will fall victim to the costs.

In mid-1993, the Council of the European Union adopted Directive 93/22/EEC, commonly referred to as the Investment Services Directive (ISD), a measure designed to facilitate the cross-border distribution of investment services. The ISD provides a single passport for European Economic Area (EEA) investment firms to take up business, either by a direct physical presence or on a cross-border basis in another member state without local licensing. The ISD permits investment service firms to avail themselves of access to the host states provided the firms comply with local business conduct rules and are duly authorized by their home state. Investment services are defined broadly to include third-party order execution and asset management, underwriting and placing of new issues, and dealing for one's own account. The ISD implicitly allows for intra-European offerings of units in coordinated collective investment undertakings, (i.e., funds falling within the scope of the Units Directive), but, host states reserve the formalistic authority to restrict the provision of non-coordinated collective investment funds.

Ostensibly, the ISD seems certain to open protected markets to vigorous competition. Actually achieving the Directive's intent, however, has been another matter entirely. There are two issues. The first is the considerable delay by member states in implementing the ISD. The ISD provided for its implementation into law by the member states by yearend 1995. For most countries, however, implementation of the ISD has been a matter of extensive debate and protracted delay. Italy enacted legislation incorporating the ISD in July 1997, removing the arduous requirement that foreign distributors set up complex *Societa di Intermediaione*. The legislation is subject to conduct of business regulations recently released after months of delay. Similarly, the French parliament approved legislation enacting the ISD in June 1996. The implementing legislation arising from the directive has yet to be finalized, however. Conduct of business rules, required by the ISD, are expected to be issued by the *Commission des Operations de Bourse* in early 1998. For other countries, the process has been even slower. In 1997, the EC referred Germany, Spain, and Luxembourg to the European Court of Justice for failure to implement the ISD on January 1 when the policy went into force. Germany has since amended the *Securities Trading* to formally adopt the ISD. Spain and Luxembourg have similarly moved to pass enacting legislation.

A second issue is that some EEA countries are using the ISD to discriminate against non-EEA companies. So far, the ISD applies

only to EEA investment service providers, which has many American and Japanese companies complaining that EU countries are exploiting the ISD to reintroduce protectionist measures. The EC has recently issued guidance to member countries cautioning that new regulations could still be introduced should protectionist policies appear. Clearly, the EC means for the ISD to introduce Europe as the model open market.

The recent fuss may be taken up by the World Trade Organization (WTO), as well. The WTO reached an agreement last December committing more than 70 countries to open their financial services sectors to competition by March 1999. Unlike the ISD, the WTO omits direction on the discrepant host of local business conduct rules. Given the vague policing powers of the WTO, it is difficult to guess the extent to which the acceding countries will meet the agreement.

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