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Norges Bank Investment Management

Developments in the international market for investment management services

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The international market for the production and sale of investment management services is characterised by mergers and acquisitions. Large companies are expanding, both in order to enhance their sales network and to benefit from economies of scale in production. The largest companies have assets of about NOK 10 000 billion under management. At the same time, there is a trend towards specialisation among smaller investment management companies. Over the past few years more than 6 000 enterprises specialising in various types of investment management services have been established. As a large purchaser, Norges Bank closely follows developments in the market for management services. This article presents a summary of developments observed over the past few years. It also provides an assessment of the Bank's future purchases of products from external managers.

The interaction of many different forces explains the strong dynamics of the market for management services. Economies of scale play an important part among the largest operators. It is costly to maintain and develop a brand name internationally. Larger asset management volumes result in lower marketing costs per unit. Production is also marked by large cost components that are not dependent on volumes. Investment in technology is one example; the development of analytical expertise that tracks different market segments is another.

Important changes are also taking place in distribution, with a sharper dividing line between distributor and producer. Traditionally, the dominant form of distribution in many countries, including Norway, has been that banks and insurance companies sell their management products directly. The current trend is for clients increasingly to be offered products from other suppliers as well. More sales are channelled through financial advisers, whose advantage is that they provide advice independently of the various producers.

A more distinct dividing line between distribution and production permits specialisation of production. Whereas producers used to have to maintain a broad product range in order to meet all needs in a distribution channel, they can specialise more now, and sell their products through several channels. This particularly applies to the retail market. In the asset management market for institutional investors the emergence of index management in particular has contributed to increasing the demand for specialist products.

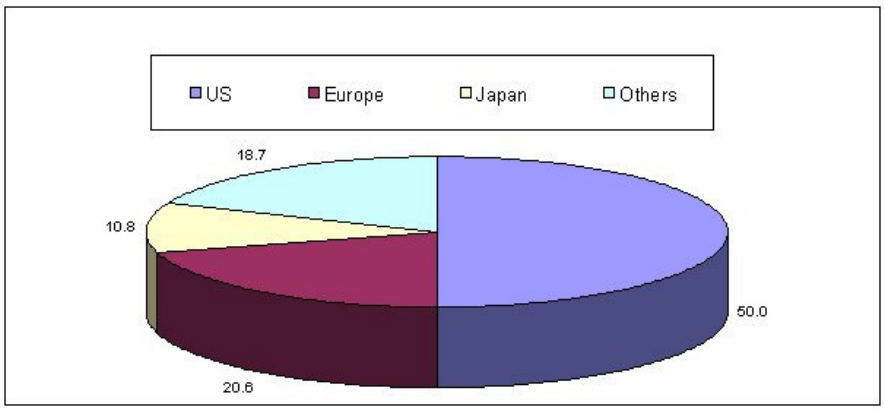
Economies of scale in investment management are not unconditional. Large operators run the risk of having market impact when they trade securities. If precautions are not taken, this drawback can outweigh the advantages associated with size. Large companies have also been found to have problems in retaining talented employees. In recent years, many capable employees have moved to hedge funds. In the course of just a few years, more than 6 000 such funds, on the whole fairly small operations, have been established. With the start-up of new operations, competent employees in large investment management companies have seen opportunities for both higher pay and greater influence over their own work. The largest investment management companies have increasingly been faced with a choice between an efficient and industrial structure, on the one hand, and retaining key personnel who demand extensive opportunities for professional development, on the other.

Another factor that also helps to explain the growth of hedge funds is that low returns in several markets have shifted investors' focus to other investment vehicles providing a higher return. Changes in distribution channels have provided greater opportunities for specialising and for small enterprises to sell their products.

Structural changes in the investment management industry

There are two main types of product in the global market for investments in securities: mutual funds and life and pension insurance. They are almost of equal size. Total assets under management for these products amount to USD 35 600 billion (NOK 320 000 billion). Chart 1 shows that the US accounts for more than half of this market. Japan accounts for 11 per cent, while most of the remainder is found in Europe.

Chart 1: The global market for saving in securities, by region.

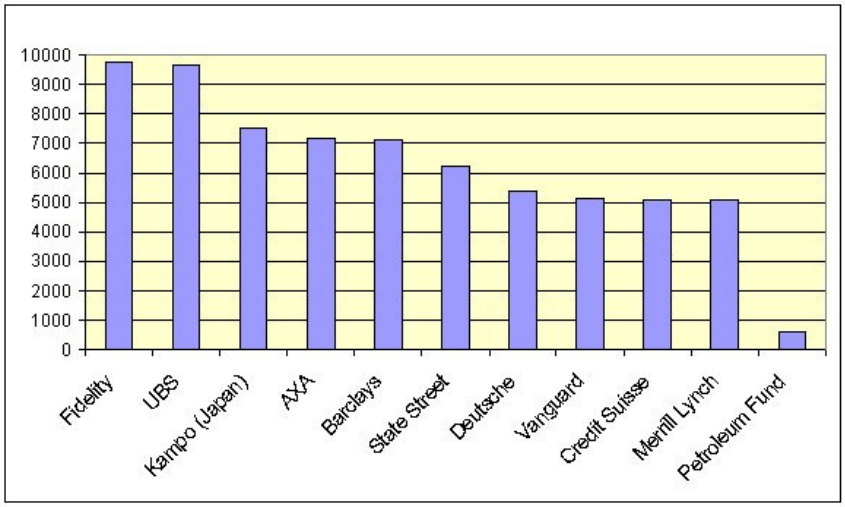


Source: Fox Pitt Kelton

Between 1992 and 1999, the number of annual mergers and acquisitions in the field of international investment management rose from 44 to 148 (source: Goldman Sachs). According to McKinsey & Company, 50 of these transactions involved investment managers with more than USD 1 billion under management in the period 1998-June 2000. Total assets under management in companies that changed owners came to USD 970 billion. In the first ten months of 2001, there were 83 acquisitions or mergers, representing a total of at least USD 829 billion, according to Salomon Smith Barney. The same source puts the number of transactions in 2000 at 120 and the assets involved at at least USD 1 244 billion.

Chart 2 shows the world's ten largest investment managers measured by assets under management at the end of 2000. For the sake of comparison we have also included the Government Petroleum Fund at the end of 2001. The largest investment manager in 2000 was the US company Fidelity, which managed NOK 9 800 billion (USD 1 074 billion). The 100th largest investment manager on the list had assets of NOK 810 billion under management, which is considerably more than the Petroleum Fund's capital today. A typical feature of the world's largest investment managers is that they have expanded through acquisitions and mergers. Four of the ten largest are index managers.

Chart 2: The world's ten largest investment managers, according to capital under management at 31 December 2000. In billions of NOK



Sources: Institutional Investor/Fox Pitt Kelton

Fidelity is a highly successful US investment management organisation. Growth has primarily been organic (without acquisitions of other companies) and based on both sales of fund products in the retail market and sales to institutional investors. Despite its size, Fidelity decided not to produce its own index products for the market. This task was assigned to the then Bankers Trust (later Deutsche Asset Management) in 1997.

Barclays and State Street are contenders for the position of the world's largest index managers. At its head office in London, Barclays Bank has extensive index management operations focused primarily on the UK market. With the acquisition of the US company Wells Fargo in the early 1990s, considerable volumes were also secured in the US market.

In contrast to Barclays, State Street has achieved its high volume more through organic growth. The company has carried out a number of acquisitions, but none of significance compared with the volumes achieved through its own operations. The latest acquisition was from the British company Gartmore. In 2001, State Street acquired the index portfolios of Gartmore, which at that time was a prominent index manager, particularly in the UK market.

The third index manager among the world's largest investment managers is Deutsche Asset Management. Unlike the others, however, Deutsche also has extensive operations in many other types of investment management services. Deutsche secured its position as a large index manager through its acquisition of the US company Bankers Trust, which was the world's fourth

largest index manager. The acquisition took place at the beginning of 1999. This is only one of several acquisitions Deutsche has carried out in the past decade in its deliberate strategy to become one of the world's largest investment managers. Deutsche's latest major acquisition, in 2001, was Zürich Scudder Investments, which at the time managed USD 345 billion. At the end of 2001, Deutsche's total assets under management came to about USD 970 billion.

Vanguard is by far the largest index manager in the US mutual funds market, and has concentrated more than the other index managers on index products in the retail market. Growth has primarily been achieved organically (without acquisitions).

The list of the world's largest investment managers also reflects another typical feature: European banks and insurance companies have to a large extent acquired investment managers in the US. This is necessary in order to enter the US market, which is by far the largest in the world. Some of the acquisitions have probably also been based on the desire to buy expertise. On the whole, US managers have considerably more experience than European managers in modern portfolio management.

Deutsche's acquisition of Bankers Trust is one such example. Another large acquisition was Union Bank of Switzerland's (UBS) acquisition of the management organisation Brinson in 1995. An example in the opposite direction was Merill Lynch's acquisition of the British manager Mercury Asset Management in 1997.

Structural changes among Norges Bank's managers

Since Norges Bank started to use external managers, several managers have been involved in ownership changes. Each time such a change occurs, the Bank has to reassess the management organisation in question. Important questions in this reassessment are whether changes take place in the company's investment philosophy, line responsibilities, or in the part of the organisation that manages portfolios for us.

The following changes have taken place in the Petroleum Fund's portfolio of external managers:

Gartmore: was sold in 1999 by the British bank National Westminster to the insurance company Legal & General. Gartmore has a mandate for active equity management in Europe excluding the UK. Earlier, the company also had a mandate for index management in the UK. In 2001, Gartmore sold its index operations to State Street.

Bankers Trust: has been an index manager for the Petroleum Fund since 1998. Became part of Deutsche Bank through an acquisition in 1998/1999.

Mercury: British manager with a mandate for active equity management in the UK. Acquired by the US company Merill Lynch in 1997/1998.

Zürich Scudder Investors: mandate for management of Japanese equities. Acquired by Deutsche Bank in 2001.

Factors behind consolidation and structural changes

A variety of structural changes has been taking place in the international market for investment management services and there is a complex set of factors behind them. The most important are described below.

Growing importance of index management

One striking feature of developments over the past 10-20 years has been the growing importance of index management in the market for investment management services. The share has now reached about 30 per cent in the US and slightly lower in Europe and Japan. Index management is most widely used in the market for institutional investors, but Vanguard is an example of a manager that has been highly successful in the retail market.

In index management, the manager attempts to achieve a return that is close to the average in the various markets, as reflected by representative indices. This management can be carried out inexpensively by taking advantage of economies of scale (see below). The expansion of index management has contributed to a general downward pressure on margins in the market for investment management services and made consolidation necessary.

Index management involves the transfer of part of the value added from managers to clients. Generally speaking, the value added generated by a manager consists of two parts: one due to exposure to a specific asset class, and one that is specific to a particular portfolio of securities and provides a positive or negative differential return in relation to general exposure to the asset class. Take, for example, a client who wants exposure to the stock market by buying units in a unit trust. The client knows that, over time, equity exposure provides a higher return than, for example, bank deposits, and may be willing to pay fairly high fees to the manager. With the emergence of index products, the client now faces new choices. General exposure to equities can be purchased inexpensively as an index product. The client then keeps a higher portion of the return because of her willingness to take risk by buying equities. If the client wants to increase the risk by having the manager select securities that deviate from the average in the market, she can buy active management products. Then, however, her willingness to pay will often be linked to the manager's ability to make a genuine contribution to value added in excess of that resulting from equity exposure.

In general, the emergence of index management and the division of the investment management market into two has strengthened the position of clients and exerted pressure on the traditional investment management industry. In terms of structural changes, this is seen in both the enormous growth recorded by specialists in index management and the emergence

of clusters of smaller niche operators that offer specialist products.

Norges Bank has always been a client that has promoted this dichotomy in the market. We can buy market exposure in the various asset classes reasonably as index products or do it ourselves with a limited use of resources in relation to the size of the portfolios. When we buy active management products in the market, the payment is linked to the manager's genuine contribution to value added.

Economies of scale

Investment management places considerable demands on IT systems. The more markets and instruments that are covered, the more important it is to have a technical infrastructure that automates trades, registers and records positions, settles trades, measures and analyses risk and measures the return. The systems must also be able to deal with the accounting of the various funds separately and with reporting to clients.

Rapid developments are taking place at international stock exchanges and in clearing, settlement and custodian functions. This provides managers with additional opportunities for automation, but also places demands on ongoing investments in order to upgrade the technical infrastructure. Sectors of the investment management industry are still characterised to a surprising extent by paper-based trading and settlement routines. The transition to automated systems will in most cases mean a noticeable improvement with regard to operational risk and possibilities for control and transparency.

A high proportion of IT investment is independent of the volumes under management. A large volume is often a precondition for it to be profitable to invest heavily in an efficient technical platform. On the other hand, the volume can be increased at small marginal costs once the platform has been established.

The high cost of developing and maintaining a brand name has been another important force driving consolidation in the industry over the past decade. The costs are particularly high when operations are to be expanded from a national market to additional markets.

There are also economies of scale associated with analyses and the development of an informational edge. If managers are to be able to deliver net excess returns that are higher than the level achieved through low cost index management, they must have an advantage with regard to the collection and analysis of information. Once a solid analytical system has been developed for the various capital market segments in which the company operates, volumes can be increased without a corresponding increase in the costs of analyses.

But there are also diseconomies of scale

There are many examples of unsuccessful mergers and acquisitions in most industries, and the investment management industry is no exception. It is very demanding to merge organisations that may have very different cultures and that have had different philosophies on how to create value. There is probably a greater need for direct manager involvement in merger and acquisition processes in the investment management industry than in many other industries because investment management depends so much on complex interactions between human and technological factors.

One clear disadvantage of size is that a large manager can run the risk of "moving the market" when he takes positions. Any trade that is executed has an impact on prices in securities markets. The larger a single trade is, the greater is the risk of moving market prices in an unfavourable direction. This negative effect may in some cases be so great that it eliminates the information advantage a large manager may have accumulated.

Many large organisations attempt to solve this is by developing their own "shops within the shop". They can use the advantages of size to develop an organisation of analysts who are available to the managers responsible for making portfolio decisions. When there are different groups of managers who may respond differently to the information that is available in the organisation, there is less risk of the organisation executing large transaction volumes in the same security on a single day or within brief periods. There are different practices with regard to whether these organisations centralise the execution of trades in the market. Centralisation may be important in permitting systematic use to be made of techniques to keep transaction costs low.

There is also a danger that large investment management organisations will avoid taking risk in investment decisions. Large investments in infrastructure and marketing may result in a fear of making investment choices that deviate substantially from the market average. In general, it is conceivable that increased size combined with large investments in distribution and a brand name may cause the return to approach the market mean.

This challenge is addressed in several ways. One common response is to define various products with different risk and focus and market the products under different names, but under the umbrella of a common brand name. Another response in the market for institutional investors is to allow clients to choose between different groups of individual managers.

Increased size and an emphasis on the industrialisation of management organisations have contributed to the flight of talented employees from a number of organisations to small specialist firms. Job changes may be partly due to an employee's perception that he does not have enough freedom to make investment decisions because the risk limits have been reduced. It may also be due to the structure of fees. In large companies, fees are often independent of results. In small companies, the fee structure is closely linked to performance. This provides greater opportunities to pay high bonuses to employees who make a large contribution to value added.

Changes in the pattern of distribution

In Europe, the way in which the distribution of saving products is organised varies considerably. In the British and Dutch

market, independent financial advisers account for a large part of the market. In countries like Germany, France and Italy, banks and insurance companies handle most of the sales, as is also the case in Norway. Differences in the pattern of distribution reflect differing degrees of deregulation and competition in the various countries' financial markets. Given the deregulation that is now taking place, particularly of the pension market in the EU, the ties between producer and distributor will most likely be more disjoined. There is a clear tendency in this direction even now. Another driving force is that clients often want to receive financial advice independent of the individual producer. There seems to be a trend for a larger portion of the management fees to accrue to the distribution stage and a smaller portion to the "factory" that is responsible for investment management.

A sharper dividing line between distribution and production allows production systems to specialise. Instead of supplying a complete product range in a sales channel owned by the organisation, specialist products can be developed and sold through several channels. The future structure in Europe may well be the same that has been observed in the US for a long time: clients can choose from among both index products at a low price, produced by organisations that make use of economies of scale, and specialist products in many types of active management. The growth of index products in the European market will probably contribute to squeezing margins. The authorities in countries that are deregulating the pension market will probably take precautions to prevent excessive margins and administrative costs in both distribution and production.

Other factors

The international financial services market has generally been characterised by excess capacity and intense competition. New technology, deregulation and new forms of distribution are exerting pressure on margins. For banks, investment banks and other operators, investment management is perceived as an attractive business segment, both due to high expected growth in the market and because revenues are often more stable.

New hedge funds

The number of hedge funds has increased sharply in recent years. There are now more than 6 000 different funds with total assets of more than USD 1 000 billion. Most funds are small; 80 per cent have less than USD 100 million under management.

Hedge funds are a collective term for fund products whereby managers attempt to take positions in different directions in order to avoid one-sided risk exposure in the portfolio. Management is often based on exploiting different types of inefficiencies in markets. The funds are generally closed-end, have a partnership structure and are not offered to the general public. They have therefore not been subject to as strict regulation by the authorities as ordinary securities funds.

A hedge fund that operates in the stock market may have a risk profile that is entirely different from general market developments. While an ordinary unit trust buys a number of equities, a typical hedge fund will combine these equity positions by also having a number of "negative" positions implemented through the sale of borrowed equities (short positions). The total value can fluctuate independent of the general trend in the stock market. If the fund is very successful in short selling equities that drop considerably in value, it can achieve a high return even in a negative stock market. However, if the ability to select the right equities is poor, the fund can also lose a great deal even in a rising stock market.

Most associate a hedge fund with high risk. A number of these funds with both a large capital base and high profile have performed very poorly in recent years. The most well known example is the US fund Long Term Capital Management (LTCM), which in 1998 had to close down after many clients had been exposed to considerable losses. Even though the fund was thought to have a very balanced portfolio, massive debt-financing of the portfolio meant that even small changes in the risk outlook could have a sizeable impact. Market developments in autumn 1998 were more unusual than even very advanced risk models had allowed for.

The performance of hedge funds in recent years generally confirms that many of them have maintained low risk and therefore lived up better to the designation hedge fund than LTCM. Further studies of actual risk in hedge funds show, however, that the return distribution properties may be very different from those in connection with traditional investment methods in equity and bond markets. The distribution of returns is often skewed, ie there is an excessive frequency of extreme returns. Adjusted for such factors, investments in hedge funds do not appear to be so obviously favourable as they would when we only consider average figures on returns and standard deviation. The substantial growth in the number of types of funds, with considerable assets under management, implies that it is more difficult to find special features of markets that can be used to achieve a high return in relation to risk.

Norges Bank's purchases of management services from external managers

The Government Petroleum Fund started to invest in equities in January 1998. Up until then, management was handled internally in Norges Bank. Through 1998 and into 1999, external managers were responsible for all equity management. In 1999, internal equity management was started and mandates were also awarded to external managers for the management of fixed-income instruments.

When setting up in equity management, it is natural to begin with index mandates. In order to achieve broad market exposure, most of the portfolio should closely mirror the market average, cf the section on the growth of index management above. In addition, Norges Bank needed more time to build the department that was to select and follow up managers engaged in external active equity management. Such mandates were announced in February 1998, and the first were awarded from the end of that year.

When a substantial share of the market pursues an index strategy and trades fairly mechanically on the basis of additions and deletions in the indices, the pricing of these equities is influenced. The manager pays too high a price when he trades on the day a company is added to an index and sells too cheaply when he sells equities in a company on the day it is deleted from the index. In other words, an investor who follows the index slavishly gives away money to other investors. Norges Bank

has therefore decided to move away from buying ordinary index products. An external manager has been given an enhanced index management mandate, and Norges Bank has also initiated this type of management internally. This is the main reason why about 50 per cent of the equity portfolio is now managed internally.

Norges Bank's organisation of internal and external management is on a par with that considered best practice among large institutional investors internationally. The strategy is documented in a number of articles in earlier annual reports and in Norges Bank's submission to the Ministry of Finance of September 2000 which presented the Bank's strategy for choosing between internal and external management.

The changes Norges Bank is now implementing in the equity portfolio, with the selection of specialist managers for different sectors, is still fairly uncommon among large funds. In the section below, we discuss the background for this way of organising investment management.

Economies of scale in investment management primarily apply to index management and other products that provide broad market exposure. However, a manager does not necessarily have to be among the largest in the world to do well in the competition over specialist products for institutional investors. A large operator may well be at a disadvantage in this segment (see above).

Many hedge funds are not of interest to Norges Bank, given the current limits applying to the management of the Petroleum Fund. Some of the techniques used by these managers may nevertheless be used in other types of management, also in Norges Bank's internal management. According to the Regulation on the Management of the Government Petroleum Fund, securities must be registered in Norges Bank's name, ie the Bank cannot buy units in funds. However, many of the old, established hedge funds also offer discretionary management to institutional investors.

In recent years, we have seen examples of large pension funds, such as the US Calpers and the Dutch ABP, that have themselves contributed to the establishment of new management organisations, because they wanted specialised management services that were not adequately covered by the market. Contributions to start-up have consisted partly of equity capital and partly of future management contracts.

Allocation of specialist mandates for specific sectors

In the latter part of 2000, Norges Bank announced for the first time mandates for specialist mandates for stocks in specific sectors. The sectors in question were financials, telecoms, healthcare and technology.

The size of the Petroleum Fund poses special challenges to management. If Norges Bank only awards management mandates that cover regions, we will have to choose between allocating large portfolios to a few managers or less capital to a large number of managers. There are drawbacks to both these solutions. On the one hand, Norges Bank does not want to have excessive exposure to individual managers. On the other hand, a large number of active managers in one mandate segment would probably mean that the sum of the managers' transactions would approach the benchmark portfolio, and the excess return would converge towards zero even before the additional costs of this management were taken into account.

With specialist mandates for specific sectors, many new, non-overlapping assignments can be allocated to external managers. The Petroleum Fund can thereby achieve a considerable diversification of total risk without overlapping mandates that neutralise the equity-specific risk that each manager contributes.

Equity management is based on the analysis of individual companies and an analytical understanding of the factors that determine earnings in specific sectors. This is the reason that most management organisations have developed research groups responsible for analysing sectors. The valuation models that are used are often more appropriate for assessing investment decisions within a sector than between companies in different sectors. Investment decisions across sectors must to a greater degree be based on the managers' views concerning developments in macroeconomic conditions, structural developments and the rate of change in various sectors. By confining the management mandates to sectors, it is possible to make more direct use of managers' information advantage. Moreover, the return in the mandates will to a greater extent reflect the managers' ability to evaluate company-specific risk than in the alternative with regional mandates.

Selection of external specialist managers for specific sectors

The selection of managers has taken place in several stages. In the first round, candidates were screened on the basis of their replies to a very comprehensive questionnaire. An important focus here was the organisations' stability, investment focus, analytical capacity and historical investment performance. Interviews and reviews of the most interesting candidates were then conducted in order to identify the professional quality of the analysts, managers and other key decision-makers, the quality of information processing and the investment process as well as the quality of the operational structure surrounding management. Against this background, an evaluation was made of the potential each manager had for generating excess returns in the future.

About 90 applications were submitted for the mandates announced. The applicants were primarily well-known management companies, but also some smaller niche operators. These are operators that have large specialist analytical organisations at sector level. Relatively few applicants had a Nordic registered office. A list of the managers selected so far is provided in the annual report section.

In the period ahead, Norges Bank will look for managers in sectors other than those now being covered by specialist mandates. The search will then take place in sectors where few managers have established products. A greater degree of adaptation on the part of managers will then be necessary in order accommodate the Petroleum Fund's requirements.

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