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INCREASINGLY, BANKS AND INSURANCE COMPANIES ARE SEEKING TO DIVEST THEMSELVES OF THEIR SUB-SCALE MUTUAL FUND BUSINESSES.

AH, THE 1990S. BULLS WERE RUNNING, RETURNS WERE FLYING, AND SARBANES AND OXLEY WERE JUST TWO POLITICIANS ON OPPOSITE SIDES OF THE AISLE WHOSE NAMES HADN'T YET BEEN JOINED BY A HYPHEN. Then came the new millennium and with it the diminished returns, Spitzer investigations and legislation that have altered the investment management landscape.

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For banks and insurance companies in particular, the events of the last several years have caused a strategic reconsideration about the previously accepted logic of offering in-house investment products to the same consumers who had checking accounts or life insurance policies. What went wrong?

At heart, these companies discovered that running mutual funds is tough work. The bull market masked that reality for many years, as investors focused on the double-digit returns offered by just about any mutual fund, as opposed to studying relative returns. Although many underperforming funds endured weak inflows, existing customers from captive distribution channels were largely content to stay put, while the rising stock market ensured that assets under management (AUM) and related fees continued to rise. As a result, these companies did not consider it imperative to build third-party distribution to supplement internal growth. (In fact, within banks, many funds began life as commingled trust products that, historically, did not need to meet rigorous performance thresholds.)

This agreeable arrangement ended when the bulls retreated, AUM declined, and stunned investors began doing their homework and demanding Morningstar's top performers. This included scrutinizing fees, which had been an afterthought during the bull market but grew increasingly important in investors' calculations as returns dropped to low single digits or worse. At the same time, regulators, politicians and the media began zeroing in on the conflicts within firms that acted as both manufacturers and distributors.

The problems were compounded by the inability of many banks and insurance companies to attract dynamic fund managers in what is for them a non-core business, with that issue heightened at mid-size firms. Not surprisingly, underperforming funds have also become a hard-sell in the distribution network, at the same time banks and insurers face demands from customers for open architecture.

Last year, Citigroup made the most definitive statement to date about the changing nature of the fund management business by swapping its funds and other investment products for Legg Mason's brokerage operations, $2.3 billion in Legg's common and preferred stock, and $500 million in cash (total deal value: $4.4 billion).

Profitability pressures include:

- Rebates often required on trust assets
- Undeveloped third-party distribution
- Internal assets under pressure from open architecture
- Higher compliance costs

The result of the industry's upheaval is a clear-cut hierarchy, with well-regarded fund companies at the top and banks and insurers at best struggling to hold on to market share. In 2005, for example, **Capital Group Companies** (American Funds) and **Vanguard Group** accounted for nearly half the industry's net fund flows, while only three bank- or insurer-owned complexes were among the top 20 fund groups by net flows (**Barclays Global Investors Funds**, **John Hancock Funds** and **Principal Financial Group**), according to Financial Research Corp.

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Citi was joined on the divestiture road by two smaller banks, **AmSouth Bancorporation** of Alabama and **Amcore Financial** of Illinois. In selling their funds to major mutual fund operations, the firms cited their reasons as being associated to either the impact of increased costs or conflicts. In the larger of the two deals, AmSouth sold 23 mutual funds with $5.5 billion in AUM to **Pioneer Investment Management**, for $65 million. In a common maneuver in such deals, Pioneer wrapped most of the funds into its existing portfolio of similar offerings while rebranding the rest.

Amcore, based in Rockford, Ill., sold its three equity mutual funds (AUM: $142 million) to **Federated Investors**, and separately divested its fixed-income institutional manager. As explained in Amcore's shareholder letter by Kenneth Edge, chairman, president and CEO: "During 2005, we strengthened our role as a trusted financial advisor to customers. In a series of carefully planned steps, Amcore became a provider of a broad range of high-quality investment products rather than a developer of a few proprietary investment vehicles."

Within the insurance industry, **Northwestern Mutual** last year sold most of its **Mason Street**

Advisors fund business (AUM: $1.7 billion) to another major fund manager, **American Century Investments**, while **St. Paul Travelers** sold off its majority stake in **Nuveen Investments** in a secondary offering.

The same confluence of pressures–new regulations; lack of growth and a squeeze on margins; underperforming funds; and the inability to attract top talent–is expected to lead other banks and insurers of varying sizes to divest their fund operations (often immaterial contributors to earnings) in the years ahead. To date, several types of deals have prevailed:

- If a bank or insurer's portfolio is made up of underperforming funds, buyers generally seek to merge them into their own better-performing funds, with the AmSouth-Pioneer deal being a good example.
- In situations where the bank or insurer's funds are strong performers, the seller may remain on as a subadvisor, allowing the firm to preserve the more lucrative investment management function while exiting the distribution and administration side. A good example is the recent strategic alliance between **Harris Investment Management** and **The Phoenix Companies**, under which Harris became the largest subadvisor to PhoenixFunds, a family of wholly owned asset managers and subadvisors. In turn, Phoenix became the advisor, distributor and administrator for the Harris Insight Funds, which were rebranded under the Phoenix name.
- A third deal type involves selling a fund business in return for a stake in what tend to be richly valued asset managers. A prime example of this was the $9.8 billion **BlackRock-Merrill Lynch** deal announced in February of this year, in which Merrill sold its mutual fund business to BlackRock for a long-term shareholding in that firm. Initially, the Citi-Legg deal appeared to follow that model, until Citi filed an offering this year to sell its shares.

The pricing and structure of deals depend on a variety of factors, including distribution sources, management fee levels, type of investment (i.e., equity, fixed income or money market). Significantly, a material portion of total consideration is often paid on a trailer basis pegged to the "stickiness" of assets, a key issue in deals involving bank trust funds, where pooled investment dollars can account for half or more of AUM.

With the mutual fund divestiture wave gaining momentum, banks and insurers with subscale fund complexes need to assess if and when to participate.

And who are the buyers? Primarily, large investment management firms with distribution and administration capabilities that are seeking to consolidate assets into their existing funds and bulk up their operations.

With the mutual fund divestiture wave gaining momentum, banks and insurers with subscale fund complexes need to assess if and when to participate. But even those firms with critical scale must weigh the benefits and risks of remaining in the mutual fund distribution business. This is particularly true for those with the desire and track record to remain as subadvisors to the funds, as there are a limited number of buyers using the subadvisory model. For those without strong performance, it is imperative to evaluate the financial, operational, regulatory and reputational risks of retaining a non-core, though potentially profitable, fund distribution business. ❖