Investments & Wealth Monitor asked James McCaughan and Nora M. Everett in July 2008 to describe current trends in the asset management industry. Mr. McCaughan is president and chief executive officer of Principal Global Investors, where he oversees all global asset management activities, including developing global strategies and identifying market opportunities. PGI manages $244.4 billion in assets. Ms. Everett is president of Principal Funds, Principal Financial Group’s family of mutual funds, and senior vice president of the firm’s retirement and investor services division.

1&WM: What are your thoughts about consolidation in the investment industry—the creation of more large firms, independents, specialization, and companies offering one-stop shopping?

James McCaughan: The consolidation is basically about seeking distribution economies of scale, and I believe this will continue. In the asset management area, on the other hand, investment managers are increasingly focusing on where they can achieve added value—the search for alpha. When you examine investment strategies, you see, surprisingly, diseconomies of scale at fairly low levels. I think this happens for two reasons: One is illiquidity in the market. Many strategies have limited liquidity, and so they have capacity constraints. If you throw too much money at a strategy, you end up hurting the investment return, which is partly why boutique structures are attractive. A second reason for the lack of economies of scale is that investment managers tend to work in small entrepreneurial groups. One of the lessons we can glean from the 1990s is that big all-singing, all-dancing research and portfolio management groups, in the end, often turn bureaucratic and fail.

I see two divergent paths, with distribution achieving economies of scale through consolidation and growth and with investment managers having to handle things carefully in order to keep performing. I think the multi-boutique structure addresses both these elements.

1&WM: What are your thoughts about investment banks and commercial banks combining?

James McCaughan: The problems of Bear Stearns have highlighted the fact that if you don’t have a big balance sheet, your staying power for over-the-counter derivatives and long-term commitments becomes questionable. One implication of the crisis is that investors will think carefully in the future about the firms with which they enter into long-term contracts. I think some of the specialist investment banks that are active traders will need to have balance sheets comparable to those of commercial banks or, alternatively, the use of exchange clearing houses for derivative transactions will increase. In a way, these two trends are competing. We’ll see more integration of trading into firms with strong balance sheets, or we’ll see greater use of exchange clearing houses. Which way things will go is unpredictable, but from an investor’s point of view, the question is how do we make sure the value created in these long-term derivatives and futures is secure?

1&WM: How will demographic changes affect the asset management field—for example, the baby boomer generation, the transfer of wealth, immigration?

Nora Everett: Lifecycle funds will continue to dominate the asset management field because people are seeking “do-it-for-me” solutions. Consumers are interested in advice—not products. We’re not “product pushers.” We provide an array of options that don’t necessarily focus on specific products. For example, retirees are looking for income—whether it comes from an insurance product with an annuity feature or a mutual fund with a targeted rate of return. In fact, retirees need three income streams: guaranteed income, targeted income, and a long-term growth plan. When you look at these three options, you’re looking at a total solution. We’re seeing a huge interest in bundled products aimed either at target risk or at target date funds. Because our firm operates as a wholesale distributor of funds, we can create solutions that work in multiple channels. We’re putting together diversified solutions that can be bundled or unbundled but are ultimately aimed at addressing the retiree’s need for these three types of income—guaranteed, targeted, and growth.

1&WM: What short-term or long-term effects do you anticipate as a result of the political landscape? How might a change in administration affect considerations such as the estate tax or the way people save for retirement?

James McCaughan: A number of factors have made markets pretty prosperous over the past 25 years, despite
the odd period of turmoil caused by the bursting of the Internet bubble or the recent problems arising from the bear market. A period of cross-party consensus has resulted in policies that have really worked for the economy and the markets—these include free trade and modest taxes. If we began to see protectionism, as opposed to just some form of anti-globalism rhetoric, that would be worrisome for markets and would actually go against the trends of the rest of the world. But I don’t expect that from either of the leading presidential candidates. As a market observer, I am cautiously optimistic about the market whatever the outcome of the presidential election.

Nora Everett: Those of us in the fund industry right now are staying actively involved with regard to any changes in federal regulations.

I&WM: Will asset management become more global?

James McCaughan: My answer is an emphatic yes—almost regardless of any political change in this country. The asset management field has received healthy flows of new business for a while, but the nature of those flows has changed quite a lot. What’s dominating right now is global equities—shares in both large-cap and emerging companies—for clients in all parts of the world. From sovereign wealth funds to private investors in the United States to pension plans from across the globe, we’re seeing a big increase in cross-border investments. The investment managers who are well placed to capture these investments will be the winners over the next few years.

I’ll give you two current examples of the industry’s globalization. First, in July 2008, the California State Teachers Retirement System announced that in the future all of its equity mandates will be measured against a global benchmark. Over the past five years, U.S. mutual funds have had large capital flows into global products and net zero flows into U.S. products, so a purely U.S. equity manager is in a vulnerable position right now. Client behavior and the market structure are mitigating pretty strongly against traditional U.S.-only equity managers. U.S. firms need global capability, and firms that don’t recognize that the business is becoming global are endangering their long-term future. Second, our firm has just entered into a new asset management venture with our existing joint venture partner CIMB, one of the largest banks in Malaysia, to build global investment products that comply with Shariah, the set of religious and ethical principles governing the daily lives of Muslims.

I&WM: How does asset management differ in various regions of the world? Can a set of best practices be applied universally?

James McCaughan: Mutual funds in the United States are still governed by the Investment Company Act of 1940, and a lot has happened since then. I expect some elements of the structure of U.S. mutual funds to come under stress over the next few years, especially compared with undertakings for collective investment in transferable securities (UCITS) funds whose rules allow more active use of derivatives and hedging in registered investment companies in Europe. Compliance rules in Europe have been liberalized in a way that hasn’t happened in the United States. The growth of exchange-traded funds (ETFs) and separately managed accounts (SMAs) is partly an attempt to bypass the structure of U.S. mutual funds. Looking forward, an area in which best practices might change is that some of the innovations introduced in UCITS funds may find their way into the U.S. industry. For example, Japanese institutional investors are now using our Dublin Funds. If you talk to investors outside Europe—say in Asia or Australia—they’re often interested in buying UCITS funds; they’re not at all interested in buying U.S. mutual funds. The U.S. market has always been innovative, but it might want to look at some of these trends to avoid being left behind.

Nora Everett: I agree that structural trends are occurring here in the United States. Some of these trends are simply cosmetic; the same underlying investments come in different wrappers—SMAs, ETFs, collective investment trusts at the high end of the qualified plan market. I believe there will be a place for all of these structures—mutual funds alongside these newer structures where we’re seeing the growth on a relative basis. I have no doubt that the fund industry will stay front and center in the United States, but we need to stay focused on structure and on the best way to deliver the underlying investment, whether it’s through retail investments, qualified retirement plans, or institutional investments. Our firm is open-minded with regard to structure. Our ultimate goal as financial professionals is to deliver investment performance in the most cost-effective, flexible manner possible.

I also agree with Jim’s perspective on best practices globally versus in the United States. We’re trying to make sure it’s a two-way street with regard to the borrowing of best practices.

I&WM: Many companies in the United States are shifting employee pension plans from defined benefit to defined contribution plans. What’s going on with corporate retirement programs in the rest of the world?

James McCaughan: In the United Kingdom, the shift has happened even more rapidly than here because accounting rules there have made it painful for corporations to have defined benefit plans. In the United States, corporate balance sheets are required to recognize deficits. The United Kingdom is moving in the direction of recognizing income state-
ments, so there’s a big move toward defined contribution plans and toward liability-driven investing in existing defined benefit plans. The same is true in Japan. In the emerging markets, pension plans are being invented, and many regions—for example Mexico, Hong Kong, and Brazil—are bypassing defined benefit plans and going directly to voluntary or compulsory defined contribution plans. One of the defining elements of this trend is participant choice, which puts pressure on mutual fund providers to offer clear information and attractive choices, not only for fund sponsors but also for fund participants.

**I&W: What keeps you awake at night when you think about influences that might cause big changes in the asset management industry?**

**James McCaughan:** The changing nature of boutique firms—in combination with investors’ desire for income products and absolute return products—means that client demand will drive investment managers to approaches that are not easy to provide in 1940 Act funds. Globalization and the proliferation of investments resulting from the desire for diversification, combined with some degree of financial turmoil, could make this a time of radical change comparable to that of the early seventies. The challenge lies in how to be on the right side of that change.

Emerging markets investing remains very attractive, but because of the radical change involved in the addition of billions of new investors to the system, I suspect the process of change isn’t over. There is the likelihood of a global economic slowdown in the next year or two. Europe is suffering because the high value of the euro is affecting exports. The United States is suffering because of deleveraging and the problems in the housing market. But that slowdown won’t change the longer-term opportunities that will result from the opening up of the system.

Contact James McCaughan and Nora Everett at swalwell.rick@principal.com.