Institutional Investor Domestic Edition

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INSIDE II

Picture perfect

In a typical month Michele Hadlow, our resourceful photo editor, reckons she must secure 40 to 50 different photographs just for the bylined articles that appear in the two editions of *Institutional Investor*; we need an additional 25 on average for the People sections that open the magazines. This month's issues were even more photo-intensive than usual: For March we sent Hadlow in search of more than 90 images in all.

And not only to boardrooms on Wall Street and in the City of London: In a ten-day window in the production process, Hadlow had to have photos assigned and shot in a dozen countries, from South Korea to Mexico to Russia. Some tasks proved easier than others; getting nine busy J.P. Morgan executives to pose in the same room at the same time, for example, turned out to be less difficult than tracking down the right news photos for a collage of disgraced South Korean corporate chieftains and politicians.

Gary Spector

At the monthly art meeting, Hadlow works with designers and editors to determine how photography can help meet the objectives of each article. Considerations like overall design, the tone of the story, how much space has been allocated and the use of other art elements will affect "the look" Hadlow wants for her photographs.

Probably the toughest part of her job, she says, is protecting "the integrity of the photograph." Therefore the photographer is often her most important collaborator. Photography can be very subjective, Hadlow points out, and it's not unusual for the subject of a photo, his or her public relations department and the photographer all to have different notions of what the end result should be: "We must try to remain true to our vision or intent while being open to other visions." This is why the choice of photographer is so important, Hadlow adds: "It has to be someone we can trust to interpret the situation and location in a way that best fulfills our design objectives."

What is Hadlow's own objective? "A photograph must draw a reaction," she says. "It must catch your eye, make you want to read the story and ultimately help you relate to the subject." We think readers will agree that she's succeeded again this month.

— David Cudaback
Editor

Felix and the Fed

By Kevin Muehring

By Monday afternoon, February 12, **Felix Rohatyn** had accepted the inevitable. After consulting with former Republican minority leader Howard Baker, a close friend, and senior Clinton administration officials, the Lazard Frères managing director drafted a letter to Bill Clinton formally requesting that the president withdraw his name for consideration for the Federal Reserve vice chairmanship left vacant in mid-January by the departure of Alan Blinder.

Clinton was livid, blaming intransigent Republicans on the Senate Banking Committee and reportedly flinging papers across the Oval Office.

Clinton went on, of course, to reappoint Alan Greenspan to a (rare) third term as Fed chairman and also to nominate White House budget director Alice Rivlin as Fed vice chairman and respected Washington University economist and ace forecaster Laurence Meyer as a Fed governor. All three should easily win confirmation from the Senate Banking Committee this month.

But in the financial markets, the rise and sudden demise of the Rohatyn candidacy is sure to resonate for some time in this election year. The nomination of the articulate and outspoken investment banker has firmly placed on the nation's political agenda the question of just how quickly the economy can grow without triggering inflation. Rohatyn has championed the notion that the Fed in particular can foster more-rapid GNP growth without risking an upswing in inflation. Whether monetary policy should be systematically adjusted to promote such stepped-up growth has in fact become the key question around which Fed Open Market Committee policy decisions will revolve over the next year or so.

Clinton receives scant political credit for the stock and bond markets' long rally. Yet the markets' upbeat mood is in part traceable directly to the administration's economic policies and its determination to maintain smooth relations with the Fed. The latter stance has in large part succeeded because Treasury Secretary **Bob Rubin** has been dogged in suppressing the deep-seated instinct of administration officials, not least the president, to lash out at the Fed when it tightens monetary policy or eases it only slightly at politically awkward moments.

Nevertheless, Clinton is known to be frustrated by what he regards as Greenspan's excessive caution on monetary policy, which the president believes may have unnecessarily choked off growth — and thus job creation. Clinton is well versed in the contentious issue of whether sweeping corporate reorganizations and other fundamental structural changes in the U.S. economy have raised the so-called speed limit for growth without inflation. He believes it has.

It was this frustration that led Clinton to Rohatyn, who has long argued that the economy can, and must, grow at a brisker pace. "You cannot deal with any of the major issues today, whether balancing the budget, resolving our social problems, generating a higher level of public and private investments, or achieving a higher standard of living, without getting additional growth in the economy," Rohatyn remarked recently.

The president has long been familiar with Rohatyn's thinking and considered him for Treasury secretary after the 1992 election. (The position went instead to veteran politician Lloyd Bentsen.) Early last year Rubin asked Rohatyn if he would be interested in the presidency of the World Bank — he wasn't, and the job went instead to a fellow investment banker, Jim Wolfensohn.

Although Rohatyn has always expressed a keen interest in public service at the national level, his acquaintances in New York financial circles were baffled by his interest in the Fed job. "I just

can't imagine Felix sitting through hours upon hours of debate over monetary aggregates, this or that statistic, or feeling comfortable with that whole Fed culture," muses one friend.

Just the same, Rohatyn lobbied hard for the position. His ambitions and Clinton's pressing need to find a Fed candidate who shared his views on growth and could serve as an intellectual counterweight to Greenspan — a skeptic on the growth argument — neatly dovetailed. Administration officials began focusing on how to "package" Rohatyn, whose perceived liberal cast was bound to rile some Republican Senate Banking members.

Within the administration, political advisers and campaign strategists got behind the Rohatyn nomination, whereas the economic policy advisers in general were less enthusiastic. Rubin, who was said to be concerned over how Rohatyn would get along with Greenspan, nevertheless lent his support.

However, Rohatyn would face a stiff "technical" hurdle in becoming a member of the Fed, since he couldn't be said to represent the Fed's New York district — Greenspan already did. (Each Fed governor must represent a different one of the 12 Fed districts.) The administration's gambit to circumvent this complication — arguing that Rohatyn's ownership of a tract of land in Wyoming made him eligible to represent the Kansas City district — would be legally, not to mention politically, dubious.

It would be up to the committee; if they agreed to Rohatyn, they could sidestep the residency issue. But if they were opposed, they could easily use it to torpedo the nomination.

In the vacuum left by weak administration lobbying, Connie Mack, the supply-side-minded Florida senator who is close to Greenspan, mounted a preemptive Republican attack on the nominee that quickly coalesced around the residency issue and, above all, Rohatyn's reputation as a big-government liberal. By mid-February Howard Baker was telling Rohatyn that the Republican majority on the committee was firmly opposed to his confirmation. It was then that Rohatyn drafted his letter and faxed it to Clinton. White House chief of staff Leon Panetta called him back to ask that he hold off on withdrawing his name for another day, but by then the damage had been done.

Clinton was incensed. The same sort of Republican political mugging had felled another Clinton Fed appointee — Alicia Munnell — the year before, even before the economist had been formally nominated. He dismissed out of hand suggestions that he quickly consider substitute appointees, saying he'd take the matter up again only after he'd returned at the end of the week from touring the flood-ravaged Northwest.

The president's eventual stand-in for Rohatyn — Alice Rivlin — had in fact been one of his earliest picks to succeed Blinder when the Princeton professor expressed his reluctance last fall to serve out the remainder of his term as Fed vice chairman. It was Rivlin who at the time was dead set against being nominated to the Fed. A founding director of the Congressional Budget Office in 1975, she, along with Panetta and National Economic Council deputy assistant Bowman Cutter, is one of the most knowledgeable administration officials on budget arcana, and she was determined to see the budget battle through. "Battered and bloodied though I may be, I can still make a good argument," Clinton joked in explaining how he got Rivlin to change her mind about the Fed job.

But the president is doomed to disappointment if he thinks he has faster-growth proponents in Rivlin and Meyer. Both are mainstream economists who probably have more in common with Greenspan's thinking than Clinton's. Rivlin is a fierce deficit hawk who has been a clear-cut conservative voice in shaping administration economic policy. A former staff economist at the New York Fed, Meyer counts the Washington Fed among the subscribers to his economic forecasts. And as one who is said to be happiest analyzing the reams of data spewed out by his computer models, Meyer certainly shares the Fed chairman's love of statistics.

It's no small irony that a Democratic president who's leading in the polls during an election year — in which stagnating wages caused in part by slow growth have become an explosive issue — winds up appointing Fed nominees who are unlikely to sympathize with the faster-growth-without-inflation notion. Perhaps the best the White House can hope for is that three Democratic members of the FOMC — Rivlin, Meyer and earlier Clinton appointee Janet Yellen — may tilt the Fed toward a greater willingness to probe just how fast the economy can grow without igniting inflation. But this becomes a question not of the direction of monetary policy but of degree: Greenspan is, in fact, already chipping away at short-term interest rates, in what he described as "monetary insurance" against a recession, to see just how low unemployment can be pushed without inflation — albeit much more cautiously than a sitting president in an election year would prefer.

But if short-term interest rates are to come down further, it will still be Greenspan who decides.

Where Richard Holbrooke learned to negotiate

Former U.S. special envoy **Richard Holbrooke**'s success at brokering the Bosnian peace accords can be traced in part to his experience in another war zone — as a Lehman Brothers managing director from '85 to '93. "People used to talk about my yelling and screaming," says Holbrooke of the Bosnia talks. "But you have to match your methods to the situation. These people were very rough, and there were things I learned at Lehman Brothers that I used in the negotiations. One was the drop-dead date. It's very rarely done in diplomatic negotiations. But we used it in Dayton [Ohio, site of the negotiations] on the last day."

Having calmed (at least somewhat) centuries-old rivalries in the Balkans, will Holbrooke — who last month joined CS First Boston as vice chairman — be able to bring harmony to the ever contentious relations between his new firm's bankers and traders? "Do they have that problem here?" he asks, ever the diplomat.

Joel Leff's art for Wall Streeters

Just what Gotham's art fanciers needed: another glitzy gallery. Ah, but the Langham Leff Gallery on East 71st Street happens to be situated — metaphorically, if not geographically — at the intersection of Madison Avenue and Wall and Orchard Streets. Money manager **Joel Leff**, a collector for 30 years, wants to bring downtown prices, and financial sophistication, to the snooty uptown art scene. "We're egalitarian," proclaims Leff. "We apply 20th-century managerial techniques to an archaic enterprise. We can't quadruple prices and wait ten or 20 years for the inventory to sell. A lot of dealers do that. But that's investment, not trading."

He and his partner, former private art dealer **Sarah Langham**, feature such eclectic items as an 18th-century Persian

Dick Jenrette catches spring fever

It happened on an April day two years ago. **Dick Jenrette** was standing in the garden of his Pinewood, South Carolina, plantation. "The wisteria was blooming, the dogwood was out, and so were the azaleas," he wistfully recalls. "I wondered, 'How many more springs am I going to have where I feel [so] good?'" The upshot: On that idyllic spot the chairman of Equitable and co-founder of Donaldson, Lufkin & Jenrette began planning his retirement. He stepped down on Valentine's Day this year. Of course, retirement for the 67-year-old Jenrette won't mean sipping mint juleps among the azaleas. His plans include finishing one book (a management tome called *The Contrarian*) and working on others about the histories of his six historic houses, as well as consulting for DLJ. "I don't want to work less hard," explains Jenrette. "I want to work when I want to."

astrolabe, a 19th-century Zairean bronze (once used to buy brides), a Ming dynasty calligrapher's table, a 1920s Baccarat decanter and a pen and ink drawing of a dancing bear by Pierre Bonnard. The pair hope to cultivate a clientele among young upper-middle class New Yorkers (read Wall Streeters) who are developing an appreciation of Monet to go with their appreciation of money. Prudently, though, Leff remembers to stay in touch with the market via laptop when he's at the gallery. He still treasures the art of the deal.

Al D'Amato says thank you, his way

People who contribute to Senator **Al D'Amato**'s campaign coffers usually hope for something special in return — say, a tête-à-tête with Senator Pothole to discuss, oh, the repeal of Glass-Steagall. But now the Senate Banking Committee chairman wants to give those supporters an unexpected little thank-you present: a copy of his 1995 autobiography, *Power, Pasta and Politics*. D'Amato's reelection committee just got permission from the Federal Election Commission to purchase "up to several thousand copies of the book" to donate to contributors. Does that mean the $24.95 tome is selling so poorly that its famous author has had to give it away? And in that case, is the senator using campaign money to boost sales? D'Amato's office wouldn't comment, but his lawyer's letter to the election commission indicated that as of December at least, the senator still hadn't earned back his $225,000 advance. His publisher, Hyperion, insists, however, that sales of the book — now in its third printing — have been "great." Still, campaign donors would probably prefer a nice little banking bill.

A wonderful, wonderful career move for Steve Bollenbach

Steve Bollenbach *liked* being CFO of Disney. "I had a wonderful, wonderful job," he says of his ten months running the exchequer of the Magic Kingdom. Nor was he miffed, he insists, that Hollywood powerbroker Michael Ovitz had been named Disney president, thwarting Bollenbach's own aspirations along those lines. "I just loved everybody there," he swears.

Nevertheless, he and his longtime friend Barron Hilton had been having breakfast together every week or so almost since Bollenbach moved to California to take the Disney post, and when Hilton offered the CFO a *job* as CEO of his hotel chain in early February, Bollenbach jumped at the chance. It's "a wonderful, wonderful opportunity for me," exults Bollenbach, who before Disney had been CEO of Host Marriott and Southwest Savings and Loan as well as CFO of Trump Organization. He philosophizes: "Being the chief executive is better than *not* being the chief executive."

Fannie's and Freddie's tax politics fall flat

Few organizations can match the political savvy and muscle of Fannie Mae and Freddie Mac, the quasi-government agencies that dominate the multitrillion-dollar U.S. secondary mortgage markets (*Institutional Investor*, July 1995). Lately, though, some of their tactics have stirred ill will among top Republican lawmakers, which may cast unwanted light on the special benefits they lobby so hard to maintain.

The latest aggrieved party: House majority leader **Dick Armey** from Texas, who last month sharply criticized the agencies' role in backing political ads during the Republican presidential contests in Iowa and New Hampshire. Sponsored, in fact, by a self-styled Coalition to Preserve Home Ownership that included Fannie, Freddie and the national trade associations for realtors and homebuilders, the ads attacked the concept of a flat tax without a mortgage deduction, likening the idea to the homewrecking done by termites and tornadoes. The group spent some $270,000 on radio and newspaper ads and targeted mailings.

Armey, a staunch flat-tax advocate, decried the involvement of Fannie and Freddie as inappropriate partisan politics. (He had no qualms about the role of the realtors or the homebuilders.) Only GOP candidates are campaigning for a flat tax, Armey noted. And among the GOP challengers, the sole advocate of a flat tax without a mortgage deduction is Steve Forbes. Fannie and Freddie say they were motivated not by partisan interests, but by a desire to protect homeowners.

The coalition argues that the loss of the mortgage interest deduction would cause housing prices to fall. Flat-tax advocates counter that a decline in interest rates would offset the impact of the demise of the deduction. "The absence of the mortgage interest deduction would harm homeownership. We have an absolute obligation to be an advocate on this," says John Buckley, Fannie senior vice president for communications.

The coalition, which had planned a 1997 educational campaign, was surprised by the strength of flat-taxer Forbes. "What unnerves [Fannie Mae chairman] Jim Johnson is the loss of control of an issue," adds one longtime Fannie Mae watcher. "The idea of someone else shaping the housing finance message is unacceptable."

The flat tax's merits aside, Armey's camp is raising broader questions about the political activity of the two government-sponsored entities. Armey asked the General Accounting Office for a review of government-sponsored enterprises' benefits as well as a clarification of any executive branch restrictions and disclosure requirements regarding lobbying, political contributions and other activities that might be applicable to them. "My concern is the extent to which these GSEs receive substantial benefit from their affiliation with the government and then abuse their position by engaging in political activities," Armey wrote to the GAO. Adds an Armey spokesman: "There's a presumption that there's something that doesn't smell right here. We'll reserve final judgment until the GAO report comes back."

GSE supporters insist that they are in fact private companies, and that any benefits they derive from their quasigovernmental status is passed on to homeowners in lower mortgage interest costs. "The problem now [for Fannie and Freddie] is that Armey is a zealot. Armey is unrelenting. If you're in his scope, he's going after you," adds one longtime Washington Republican operative.

Armey isn't the only Republican taking aim at the two agencies. Last spring Fannie incurred the ire of GOP Representative and budget chief John Kasich when it quashed his effort to tag them with substantial user fees. House Banking chairman Jim Leach, a longtime critic of the concentration of power in agency hands, seemed to be warming to their public mission last summer — until Fannie helped defeat Leach's effort to pay for part of the recapitalization of the savings association insurance fund through a GSE user fee.

Even some of the GSEs' Hill friends are wagging their fingers at the agencies, mostly at Freddie Mac chairman Leland Brendsel. In January he suggested that the current $207,000 ceiling on mortgages the agency purchases be eliminated eventually, allowing Freddie to purchase the jumbo loans that finance the homes of wealthier Americans. This brought a sharp response from Representative Richard Baker, chairman of the subcommittee that oversees the GSEs. He blasted Freddie's "poor record" of complying with congressionally mandated goals for supporting mortgage lending to low- and moderate-income families. Freddie says it met its 1995 housing goals, except for the so-called central cities lending target, which has been redefined.

Separately, Baker and Rick Lazio, chairman of the housing subcommittee, in January asked the Clinton administration to push forward long-overdue reports from Treasury and HUD on the merits of privatizing the two entities. The reports are due this month, and hearings likely in April.

Still, both GSEs have powerful friends, including House Speaker Newt

Gingrich and New York's Al D'Amato, chairman of the Senate Banking Committee. Nevertheless, as Charles Gabriel, Prudential Securities' Washington political analyst, points out, "adding Armey to the list of malcontents is something politically astute Fannie Mae officials, in particular, would probably have liked to have avoided." — **Michael Carroll**

Barclays picks a winner

After three tumultuous years in Tokyo, where, as chief executive of Japanese operations, he was instrumental in refocusing the Barclays group's activities on investment banking, **Callum McCarthy** has moved to New York to become CEO of BZW in North America. His move coincides with a radical restructuring of BZW's U.S. operations, where Barclays has retreated from its old commercial and retail banking operations. It will be McCarthy's task to pick up where his predecessor, Richard Webb, left off. Webb, who returns to London as deputy chief executive of the European retail banking group, "did a remarkably impressive job clearing up the provisions left over from the retail and commercial banking disposals," says McCarthy, but "it's a question of horses for courses."

Data vendors' digital dilemma

By Maureen Nevin Duffy

For a decade the financial data industry has been suffering through a severe bout of creative destruction. In the mid-1980s more than 20 separate vendors provided screen-based news, market data and research to E.F. Hutton & Co. brokers and traders, recalls that now-defunct firm's former computer systems chief, Bernard Weinstein (who went on to found data vendor ILX Systems). Today most firms get by with just five or six electronic data providers.

Why the shrinking numbers? Cost-cutting on Wall Street, combined with the increasing power of today's trading room screens, which have evolved away from page-based video technology and toward fully digital systems. "Once data is converted to ones and zeros, you can do anything with it," says Raymond du Tremblay, executive vice president of Interport Financial, a Montrose, New York, trading room consulting company. The triumph of digital has enabled vendors to pipe data from ever-larger pools of information — including those belonging to their competitors — through their own screens. Thus vendors can match rivals' systems feature for feature, producing lots of overlap between once-discrete systems.

Indeed, the financial data industry is littered with firms that failed to make the investment required to update their technology. Bunker Ramo Corp. and Quotron Systems, for example, were eventually swallowed by competitors (Automatic Data Processing and Reuters Holdings, respectively). And Knight-Ridder recently put its financial information unit, Knight-Ridder Financial, up for sale rather than pour more money into it.

The result: consolidation. Currently, Reuters, Dow Jones Telerate Systems and Bloomberg account for 85 percent of the total sales of on-line brokerage information services ($7.3 billion for 1995), according to Simba Information in Wilton, Connecticut.

But that's not the whole story. While the destruction was going on, the technology was "creating" new competitors. The culprit: so-called client-server systems that spawn the desire for "open systems," that is, systems that allow users to pick and choose among the offerings of rival data vendors. This is fortunate, because more-sophisticated trading strategies mean desk-traders frequently follow more than one market.

Sensing this shift, some up-and-coming vendors have offered access to a wide variety of digital data through multifunction "killer workstations," which in some cases can be hooked up to a firm's existing, in-house network. This is a tack shared by such multiproduct firms as Waltham, Massachusetts–based Primark Corp., which owns Disclosure and I/B/E/S International among others; Thomson Corp.'s Thomson Financial Services unit (which also owns Weinstein's ILX); and Global Financial Information Corp., a group assembled by buyout specialist Welsh Carson that includes MarketVision, Bridge Data and EJV Partners. These companies don't mind doing business with a rival as long as they can give clients everything they want or make extra revenue off a competitor's client.

Some of the old guard appear to be resisting the trend. Michael Bloomberg, the ex–Salomon Brothers trader whose mastery of the fixed-income data business has rocketed his company into the market data industry's front ranks, last year told a gathering of clients and journalists, "We're in the business of leasing terminals." The data-selling business by contrast, he groaned, is "just not a great business." Nonetheless, Bloomberg this year unveiled plans for an "open" system that will enable customers to manipulate Bloomberg data from any PC or Sun Microsystems workstation. The catch: the PC or workstation must be connected to an existing Bloomberg terminal. For example, if a client creates calculations using Bloomberg data, he can only send the results of that effort to another PC that has another Bloomberg terminal. (Institutional Investor's Derivatives Monitor service is carried by Bloomberg.)

How much longer can Bloomberg keep the data genie in his box? To be sure, users are still willing to put up with "closed" formats to get information they can't find anywhere else. And though some types of market data have become commoditized — leading to lower costs for users — the digital revolution has hardly shifted the balance of power in users' favor completely. Even if the ranks of trading floor vendors have thinned, Wall Street hasn't managed to cut its market data bills significantly. Indeed, Simba Information projects that market data sales will nearly double, to $11 billion, by 1999. The lesson: Don't cry for the market data vendors quite yet. ∎

FRANS LUTTMER OF HEIDEMIJ

Cleaning up

The CEO of this Netherlands-based environmental-engineering group describes how acquisitions have enhanced its worldwide business prospects.

Dutch engineering and environmental-consulting group Heidemij has come a long way from the days when its primary occupation was building dikes in Holland. Today it is active in some 80 countries, having expanded largely through acquisitions. The company has averaged nearly five deals a year in recent times, including U.S. groundwater specialist Geraghty & Miller. In an interview with Assistant Managing Editor Hilary Rosenberg, CEO Frans Luttmer, who became chairman of the executive board last May, talks about how the company finds and integrates its acquisitions.

Institutional Investor: Trace Heidemij's evolution as an international company.

Luttmer: Looking at Heidemij's development, you have seen Heidemij started as a purely Dutch company. Geraghty & Miller is a purely U.S. company, and the two are now allied. We are accomplishing our network in Europe, which is why we acquired [engineering consulting firm] Antea in France and [engineering firm] Eptisa in Spain. And the next step will of course be East Asia and Latin America.

How do you absorb so many acquisitions?

We have a lot of what we call cohesion programs to make sure that the companies reap the benefits from the mergers. Nothing happens automatically; you have to wrestle to get those [benefits] out.

First, we install what we call international account management. That means that for an international [client], we appoint someone inside the company as the person who should know what that client, wherever in the world, is confronted with as far as environmental issues are concerned. Second, we have technology exchange programs and committees in the company. Third, we have developed our own management development course together with a university in the Netherlands, and Heidemij people from all over the world are participating. We do a lot of internal communications as well.

So at the moment of closing a deal, we already have a postacquisition program. Otherwise we get a postacquisition depression.

How do acquisitions help you win new business?

The new capital of Germany is going to be Berlin, so Berlin needs an airport that suits the capital of Germany. The government of Germany invited us to advise them on the best location for such an airport, taking into account all the infrastructural aspects and all the environmental concerns regarding noise, air emission and other pollutions. Never would we have had the opportunity to get this assignment if we were purely a Dutch company. Only because we now have a great outfit in Germany, Trischler und Partner, and we know all the German rules and regulations can we do this type of thing.

Another example of a job we couldn't do before is the remediation of the area where the World Exhibition Fair in Lisbon will be in 1998, which was once an oil-tank storage facility and a refinery. We could only do this with the know-how we have both in the U.S. at Geraghty & Miller and in the Netherlands. We did a wonderful job there, and it was a very profitable job as well.

What other opportunities has Geraghty & Miller brought you?

Geraghty & Miller was, I think, one of the best, if not the best, worldwide in groundwater, and environmental problems are always reflected in groundwater problems. So the know-how of Geraghty & Miller as far as groundwater is concerned is applied every-

where in the company.

And there are certain things we can now do because of the commercial relationship we have with multinationals. Geraghty & Miller could not deal with questions of their American clients outside the States. U.S. companies now have to publish their potential environmental liabilities in their annual reports. Companies want to get rid of those potential obligations because they don't like to publish those things, so they want the problems *to be solved.* They also want to get rid of those potential problems in faraway countries, because they also have to report them on their U.S. annual reports. A major car manufacturer from the U.S. asked us whether we could solve those problems in Europe. And so we are working for them in the U.S., and now we are working for them in Finland, Poland and Germany.

So with Heidemij's acquisition of Geraghty & Miller, clients were then able to turn to one source for their needs?

Exactly. We see now on a lesser scale that European companies that are in*vesting in the U.S. are also confronted* with U.S. environmental regulations, and they are very happy that they can use a European partner — Heidemij — with a U.S. outfit to [help them meet the rules].

Why are so many acquisitions available in this industry?

Each acquisition has its own story. For instance, we had been courting Eptisa for four years, but it was not for sale, because the single owner was Banco Central Hispano. Now there is new legislation that Spanish banks have to divest industrial holdings. So together with the management, we are accomplishing this deal. Antea is a totally different story. France wants to reduce its public sector, and Antea was part of a government agency. They were al*ready operating as a private-sector com*pany, but it was still in the hands of the French government. We are not interested in going into markets that are in a consolidation phase.

What is the reason for that?

Because then you take your position into a flat market from the outset. That's also the reason we haven't done an acquisition in the U.K. We started a green-field operation there four years ago that is doing very well. Lately, we have been offered major U.K. firms, but so far we have thought it better to keep our pockets closed. The market is still too flat, too much consolidated.

"We are not interested in going into markets that are in a consolidation phase."

Until two months ago there was no environmental law on soil pollution. That also means that a lot of companies in the U.K. have not developed environmental capabilities. And U.K. companies are losing their strength because they cannot intertwine environment and infrastructure into their plans.

What kinds of work have you been doing around the world?

In the U.S. we see the environmental market coming together with the infrastructure market. That has already happened in Europe. In the '80s and early '90s, the U.S. was a regulation-driven market. It is now develop*ing more as an economically driven* market, in which both the private sector and the public sector are going to find solutions for problems instead of doing investigation after investigation just to satisfy the lawyers and the courts.

Look at, for instance, what we call in our slang brown fugues, those parts of cities that have deteriorated, been neglected and where with a redevelopment you can give new value to the existing piece of land. On those occasions you both solve an environmental problem and create a new real estate *development in your neighborhood.*

For example?

In the southeastern part of the U.S., we are working with a city where one section has been neglected for many, many years. There's a lot of pollution, and the town says, "Okay, we want to renovate this area. But then of course we have to solve the environmental problems as well." And to be able to do so, you need both infrastructure know-how and environmental know-how.

That is the reason we acquired Piedmont [Olsen Hensley in South Carolina]. Piedmont is an infrastructure-engineering company. And you see the same [pattern] with what our competitors are doing. The purely environmental industry has to be enriched with engineering capabilities, and especially civil engineering capabilities.

What other major projects bring this combination into play?

Cellular and mobile telephone systems are popping up now in *all* parts of the world. We are working for BellSouth Corp. in South Carolina, North Carolina and Tennessee to set up about 600 antennae. We are doing all the engineering, all the zoning, all the regulatory compliance for those antennae *in this area. We are doing a similar* project in the Netherlands. This is also environmental work, because environmental is not only emissions, it is also visual — we don't want to see those things.

Are developing countries attuned to environmental concerns in their infrastructure projects?

The developing countries have a higher environmental awareness than we did, let's say, 25 years ago. What we have seen in the countries where we are working — including Indonesia, China, Thailand and Vietnam — is that this is moving pretty fast. Of course, [in setting regulations] they always start with the multinationals, and then, after some time, the local companies have to abide by the same rules. ∎

A 401(k) without the fuss?

Even President Clinton has endorsed simpler plans for small companies, but they may be too pricey for many employers. • **By Portia Richardson**

Two-year-old Electric Classifieds, a San Francisco–based provider of classified advertising services on the Internet, has been growing so fast that chief executive officer Jordan Graham has begun recruiting a few senior people from top Fortune 500 companies. The only catch: Executives of big corporations naturally expect a decent retirement plan — a 401(k) at the very least. Confides Graham, "We're looking at 401(k) plans, but the out-of-pocket costs, as well as the administrative burden, are significant." And his venture capital funds are earmarked for growing the company, not administering retirement plans.

Electric Classifieds' 16 employees have a salary-reduction simplified employee pension, basically just a collection of individual retirement accounts loosely administered by the employer but funded by the employees. What Graham would really like is a 401(k)-style plan, but without the stiff administrative costs.

Why can't there be some kind of retirement vehicle for small companies that, though perhaps less generous in its benefits than a conventional 401(k), is also less bureaucratic (and expensive) to administer? Some important people — including President Bill Clinton in his State of the Union address — are calling for just that sort of pension reform. The upshot is that bills to simplify pensions for small companies face their best prospects ever.

Republicans and Democrats have detached themselves from each other's throats long enough to agree on one basic principle: For companies with fewer than 100 employees, certain onerous administrative rules, particularly regarding discrimination against low-paid workers, should be eliminated in return for a mandatory employer contribution. The Republican budget package would simply amend ERISA to facilitate this trade-off. President Clinton and his potential Republican challenger in the presidential race, Senator Bob Dole, have both proposed entirely new small-company pension vehicles.

What's prompted the unusual bipartisanship is the daunting prospect of a bulge of baby boomers hitting the retirement rolls early in the next century. If they don't have sufficient private pension savings, as many experts think likely, the federal government will come under overwhelming pressure to provide pension assistance of some sort. Thus deficit-conscious Washington has ample incentive to promote private pension saving.

However, the pending reforms could create their own problems. Mandatory employer contributions could make plans too costly for many employers. Most proposals' caps on employee contributions aren't sufficient to guarantee workers much of a pension. Eliminating too much regulatory red tape could open the door to abuse.

Ohio Republican Congressman Robert Portman, deputy House GOP whip, has proposed amendments to ERISA that would repeal the family aggregation rule, under which spouses working for the same employer must be counted as one person — at their combined salary — for discrimination-testing purposes. Repeal of this provision would especially benefit so-called mom-and-pop companies. (Ninety percent of small

companies are family-owned.)

Another Portman bill provision simplifies the definition, for discrimination testing, of highly compensated employees. He would crunch the current confusing seven-step standard into three clear-cut alternatives: a person who earns at least $80,000, is among the top 20 percent of the firm's employees in pay or owns 5 percent of the company.

George Taylor, president of third-party administrator National Retirement Plan Services in State College, Pennsylvania, contends that Portman's red-tape slicing, coupled with investment companies' making a bigger effort to push SEPs and SarSEPs, obviates the need for a whole new pension vehicle for small companies. But others, including Clinton and Dole, believe it will take something more dramatic to tempt additional small companies into setting up retirement plans.

"Repeal of the 'aggregation' rule would especially benefit mom-and-pop companies."

Last June the president announced a pension-reform proposal, the national employee savings trust, that is modeled on the federal employee thrift and savings plan, which has a 78 percent participation rate. Employers would initially put in 1 percent of the company payroll. Then they'd match 100 percent of employees' contributions up to 3 percent of their salaries and 50 percent up to 4 or 5 percent, to a maximum of $5,000. The money would be tax-deferred until the employee retires, as early as at age 59½. Vesting takes place with the first payment. This would ease the existing rules on discrimination testing and cut back on ERISA's paperwork, creating savings for employers on administrative costs.

Dole's quite similar savings incentive match plan for employees calls for a dollar-for-dollar match on employee contributions up to 3 percent of salary, combined with an easing of discrimination-testing rules. Taxes would also be deferred under his plan. However, employees would be able to chip in $6,000 per year, and employers wouldn't have to make the Clinton plan's initial contribution of 1 percent of payroll. Employees would become eligible for Simple after two years and be vested immediately. Whether to include regular part-time and merely temporary workers would be up to the employer.

The critical difference between the two plans is that Simple includes an escape hatch for employers, whereas NEST doesn't: If a company's profits are poor (or nonexistent) two out of five years, it can cut the match to 1 percent of salary for the lean years (though not retroactively).

Simple has already passed the House and Senate and is included in the budget reconciliation bill. Yet NEST remains very much on the table. The eventual law will probably combine parts of NEST and Simple, sources say.

Small businesses are intrigued but cautious. Consider Performance Edge, a 12-person shop in Berkeley Heights, New Jersey, that provides custom technical, sales and leadership training for Fortune 500 companies. Right now Performance Edge has a profit-sharing plan, but president Russell Johnson says he believes in the concept of a 401(k) and wants to move toward it. Yet such a scheme is too rich for Performance Edge's pocketbook now. Johnson likes Simple's promise of low administration costs.

Electric Classifieds' Graham finds Simple's rejection of discrimination testing attractive, since he has trouble convincing younger, lower-paid workers to participate in a retirement plan at all. But his company would be hard-pressed to swing the 100 percent match, and Graham balks at assuming so burdensome an obligation.

Indeed, for all their savings in administrative costs and hassles, the big catch with proposals such as Simple and NEST is that their mandatory employer contributions make them too pricey for many small companies. Patrick Byrnes, president of Actuarial Consultants in Torrance, California, says that even with a cap of $6,000, Simple comes in way above most small businesses' budgets. Many small concerns, after all, offer no match whatsoever, or at best 50 percent, when they launch a 401(k).

Suppose a company can manage the maximum match. That may still not build enough of a retirement kitty for most employees. "The assumption is that Simple will be done properly and include the right number of people, but employers have no responsibility to contribute [an adequate] amount of employee compensation or see that workers save enough money," says NRPS's Taylor. The bill does not set up a regulatory apparatus to ensure that proper contributions are made.

For many small companies and their employees, 401(k)s and SEPs, with their higher maximum contributions, will remain the preferred options. Alan Towers, president of the New York public relations firm bearing his name, ought to be a prime candidate for Simple: He can afford the match, since he already contributes 3 percent of each of his eight employees' total compensation — voluntarily — to their SarSEP account. And he likes Simple's lack of discrimination testing. But Towers wouldn't consider using Simple to replace his firm's $350,000 SarSEP, because he thinks its $6,000 cap is too low. The SarSEP limit — 15 percent of salary — usually works out to more for his staffers.

For some critics Simple's chief selling point is also its most worrisome aspect: deregulation. Employers would be required to file only an abbreviated, one-page tax form with the Internal Revenue Service. As NRPS's Taylor and other skeptics note: With SEPs, cases of employers' failing to make promised matches are rife.

Nevertheless, most pension experts say the pluses of NEST and Simple outweigh the minuses. Fidelity Investments pension counsel John Kimpel sees the proposals as a matter of trade-offs. A company with 70 or 80 employees is better positioned to vie with larger rivals if it has a retirement plan, he notes. But if it's going to be forking over $40,000 for this competitive edge, it doesn't "want $10,000 or $20,000 [of it] going to lawyers and accountants — employers want to maximize the effectiveness of the money." Belatedly, politicians appear to agree. **ft**

A security issue

CFOs seem to be more secure in their jobs, their staffs decidedly less so.

Christopher Steffen's resignation last December as chief financial officer of Citicorp made other CFOs a bit nervous. Although the high-profile Steffen is one of the premier corporate cost-cutters — and there's been no slackening of demand for that sanguinary skill — he was reportedly forced out of his job.

CFOs have no real cause for concern, however. According to this month's survey, only about 15 percent of the companies polled report hiring a new CFO within the past year, and just 14 percent of that group say the previous CFO had been fired or was asked to resign. That's down from the 20 percent forced out in our December 1994 poll.

Forced departures may have declined simply because more CFOs are switching firms of their own accord. In this survey more than one quarter of the CFOs left to become CFO at another company, up from just 12 percent in 1994. In fully 40 percent of the cases last year, the CFOs retired.

CFO compensation remains stable. On the high end of the pay scale, some 5 percent of the CFOs surveyed now make more than $1 million in total compensation, down slightly from 6 percent in 1994. Nearly 40 percent of the CFOs make less than $300,000 a year; in the 1994 survey about half of the respondents earned less than $350,000.

Many CFOs may find their workload increasing as some of their staffers are forced out. About 43 percent of the CFOs in this month's survey said their staffs had decreased in the past year, virtually the same as the previous poll. But in both surveys some three quarters of the CFOs said the staff cuts were less than 10 percent. ii

How long has your current CFO been in office?

Less than 1 year	13.5%
1 to 3 years	30.5
4 to 6 years	19.9
7 to 10 years	17.7
More than 10 years	18.4

Has your company named a new CFO within the past 12 months?

Yes	14.8%
No	85.2

If so, why did your previous CFO leave the position?

The previous CFO was promoted within the company	13.6%
Was asked to resign	9.1
Was fired	4.5
Took a new assignment within the company	4.5
Left the company to join another as CFO	27.3
Retired	40.9

How long was the tenure of your previous CFO?

Less than 1 year	3.1%
1 to 3 years	27.7
4 to 6 years	21.5
7 to 10 years	20.0
More than 10 years	27.7

How many professional staff members report to your CFO?

Fewer than 20	34.0%
20 to 50	19.9
51 to 75	9.2
76 to 100	9.2
More than 100	27.7

Has the staff increased over the past 12 months?

Yes	25.0%
No	75.0

If so, by how much?

Less than 10 percent	71.4%
10 to 25 percent	22.9
26 to 50 percent	2.9
More than 50 percent	2.9

Has the staff decreased over the past 12 months?

Yes	43.1%
No	56.9

If so, by how much?

Less than 10 percent	74.6%
10 to 25 percent	22.0
26 to 50 percent	1.7
More than 50 percent	1.7

Has a CFO in your company ever been promoted to:

CEO?	63.6%
COO?	47.7
Vice chairman?	38.6
Chairman?	38.6

What is your CFO's total compensation?

Less than $300,000	39.1%
$300,000 to $449,999	29.7
$450,000 to $599,999	10.9
$600,000 to $749,999	7.2
$750,000 to $1 million	8.0
More than $1 million	5.1

Is your CFO's compensation linked to:

Savings on corporate tax bill?	6.3%
Increases in cash flow?	18.9
Attaining cost-cutting goals?	19.7
Improvements in productivity?	16.5
Annual corporate performance?	100.0

Has your CFO previously held line or operating positions?

Yes	39.0%
No	61.0

Has your CFO held international financial positions?

Yes	25.5%
No	74.5

What percentage of your CFO's total compensation does a bonus represent?

Less than 25 percent	21.0%
25 to 49 percent	45.7
50 to 74 percent	25.4
75 to 100 percent	8.0

Does a portion of your CFO's total compensation consist of stock options?

Yes	71.4%
No	28.6

If so, what percentage of your CFO's total compensation comes from stock options?

Less than 25 percent	64.3%
25 to 49 percent	27.6
50 to 74 percent	7.1
75 to 100 percent	1.0

How much time does your CFO spend charting corporate strategy?

Less than 25 percent	37.1%
25 to 49 percent	56.4
50 to 74 percent	5.7
75 to 100 percent	0.7

What is the most difficult part of your CFO's job?

Staying informed about financial markets	5.4%
Staying informed about corporate performance	34.6
Evaluating subordinates	7.7
Planning and budgeting	30.0
Negotiating with commercial and investment bankers	5.4
Management of finance function	16.2
Other	21.5

The results of CFO Forum are based on quarterly surveys of a universe of 1,600 chief financial officers. Because of rounding, responses may not total 100 percent.

Prefunding prime time

Long-term interest rates are low, short ones relatively high. Companies facing refinancings ought to consider prefunding. • **By Lyn Perlmuth**

The bond market rally of 1995 and early '96, which was marked by a conspicuously flat yield curve, should have created an opportunity for corporations to issue long bonds and also to extend their debt maturities through prefunding transactions. Perhaps because so much debt has already been refinanced, however, or perhaps because corporations are hoping for still lower rates (or narrower spreads), there's been no rush to the market.

Last year corporations brought $15.9 billion worth of 30-year bonds to market; the long bonds constituted just 6.2 percent of total corporate debt issuance, according to Securities Data Co. The volume was less than half the $33 billion in corporate long bonds — 11 percent of the total — that were issued in the bond rally of '93, when the yield curve was stubbornly steep. For much of that year, the spread between one-month LIBOR and the benchmark, 30-year Treasury bond gaped wider than 300 basis points, and throughout the year it never dipped below 200. By contrast, this past January the spread was less than 50 basis points (and that was up from 25 in December).

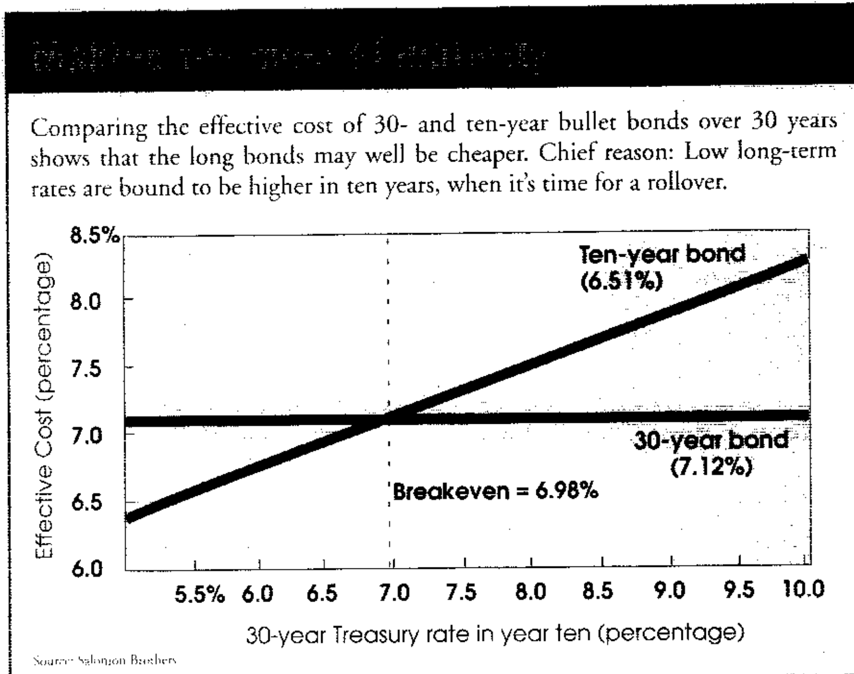
Salomon Brothers calculates in a recent study that issuers seeking long-term financing would do better with 30-year bullet bonds than with ten-year notes refinanced at maturity with a 20-year issue. Assuming no change in corporate spreads ten years from now, a 30-year bullet maturity with an all-in cost to an issuer of 7.12 percent would be a cheaper proposition than a ten-year note with a lower, 6.51 percent all-in cost but which had to be rolled over in ten years.

Cheaper, that is, unless the 30-year Treasury yield happens to be below 6.98 percent in ten years (see graph). The likelihood of that? Based on data from the past 25 years, says Salomon's "CFO Quarterly," the odds of so low a yield work out to a mere 7 percent.

Issuers that face refinancing over the next year can prefund — offer long-term debt now and put the proceeds into short-term instruments — to take advantage of low long rates and relatively high short rates. Prefunding offers protection from an unexpected rise in rates or a potential Federal Reserve Board easing that could leave the long end of the market largely unchanged but would pull down short rates.

Here's how prefunding works: A company with debt maturing or (if it has a relatively high coupon) becoming callable in a month issues a long bond today at 7.25 percent and invests the proceeds in one-month LIBOR at 5.88 percent. On an annual basis, the company is paying 1.37 percent more than it is earning (or 11 basis points a month). Using present-value calculations, this works out to an extra cost for issuing a 30-year bond of 0.9 basis points, says Niso Abuaf, a director in the financial strategy group at Salomon. Using the same assumptions (for the issuance and investment of proceeds), the extra cost for prefunding debt maturing in 12 months would be about 14 basis points a year for the life of the 30-year bond, only half the cost for a similar prefunding in October 1993.

Defeasing outstanding bonds through the purchase of Treasury bills is a refinement of the prefunding strategy. It avoids adding debt to the company's balance sheet, even temporarily. From an accounting perspective, the outstanding bonds are retired (and thus removed from the balance sheet) through the establishment of a defeasance trust (also off balance sheet), consisting of a Treasury portfolio that pays down the principal and interest. ♜



Comparing the effective cost of 30- and ten-year bullet bonds over 30 years shows that the long bonds may well be cheaper. Chief reason: Low long-term rates are bound to be higher in ten years, when it's time for a rollover.

Lyn Perlmuth is Editor of New Product Development in Institutional Investor's Newsletter Division.

The Emlico enigma

When GE's captive insurer moved to Bermuda, its liabilities promptly shot up and it collapsed. Reinsurers cried foul.

By Jan H. Schut

Last July General Electric Co.'s 70-year-old liability insurer, Electric Mutual Liability Insurance Co., relocated from Beverly, Massachusetts, to Bermuda. Regulators in both locales had readily okayed the move, which appeared to be fairly routine.

Yet within four months Emlico was insolvent: GE's essentially captive insurer turned out to be $500 million in the hole, largely from an estimated $750 million reserve increase for environmental and asbestos liabilities recognized *after* the move.

When Massachusetts insurance commissioner Linda Ruthardt heard the news, she called Bermuda's new registrar of companies, Kymn Astwood, and demanded to know what was going on. He told her that he had no answers either. "We did due diligence," the registrar notes, "but nothing really surprises me in insurance."

They weren't the only ones wondering what had happened to Emlico. Some of its reinsurers now charge that the move to Bermuda and the subsequent insolvency filing were all part of an aggressive strategy by GE to collect hundreds of millions of dollars from the company's 100 or so reinsurers to cover GE liability claims that the reinsurers otherwise might not have been responsible for. (Emlico insured lower levels, up to $5 million and $10 million, and passed most of its risk to its reinsurers, keeping only the first $70,000 to $80,000 per occurence, reinsurers note.)

General Re Corp., in a memo to the Massachusetts Superior Court in a subsequent suit against the Massachusetts Division of Insurance, declared: "Massachusetts law gives Gen Re the right to investigate and defend against policyholders' claims as if it stood in the shoes of Emlico. The insolvency clauses in the contracts between Gen Re and Emlico adopt the Massachusetts rule. Under Bermuda insolvency law, however, only creditors and contributors have rights in an insolvency proceeding. In addition, under Bermuda law Gen Re will be saddled with estimated contingent liabilities for which it could not be held liable under Massachusetts law."

A Bermuda-based insurer also has the right to claim reinsurance payments before the insured claims are paid. "Enlarged and faster recoverables in Bermuda increase the insurer's estate," notes the general counsel of another of Emlico's reinsurers. Moreover, in Bermuda the creditors — in this case, GE — can choose the liquidator. In the U.S. the receiver for an insurer in liquidation is appointed by the state insurance department. And in Bermuda, filings regarding Emlico are more limited and are available only to regulators, not to the public; in the U.S. more information would be available to the public.

"GE can control the liquidation process better in Bermuda than in Massachusetts," says John Snyder, a senior vice president at A.M. Best Co. "In Massachusetts they would substantially lose control."

Reinsurers are concerned that GE may have laid a blueprint for other environmentally overburdened captives to follow. Emlico doesn't see its behavior as different from that of other environmentally burdened insurers. "In 1995 Aetna and Fireman's Fund were posting sizable additions to reserves. People were beginning to look at [environmental liability] differently," says Emlico president David St. Laurent. "We decided to get [together] with our advisers to explore looking at things differently."

Emlico was not, strictly speaking, a captive. Yet for all practical purposes, it was. The insurer wrote commercial general and other liability insurance exclusively for GE, along with commercial lines for GE customers and such personal lines as home, car and workers' compensation for nannies and household workers of GE executives. Unlike a captive, however, Emlico was structured as a regulated mutual insurer owned by policyholders — 99.79 percent GE — making it a regulated entity. Thus it needed regulatory approval for any material change in its status.

Emlico's move to the more private and relaxed regulatory environment of Bermuda was part of a larger restructuring. The insurer split into a so-called good bank consisting of healthy policies, which will continue to issue new GE liability policies

(among others), and a so-called bad bank consisting of old environmental liability policies, which it will run off, collecting from reinsurers to pay claims. (The concept and the nomenclature come from the good bank–bad bank method of disposing of bad loans.) In recent years Talegen Holdings, Home Holdings, Cigna Corp. and Lloyd's of London have done similar splits (*Institutional Investor*, November 1995). But this appears to be the first time that a captive has done one.

A "bad bank" insurer is not supposed to be insolvent. Regulatory approval of such reorganizations assumes there will be sufficient funds to pay claims. Emlico's regulatory filings in Massachusetts and its testimony to regulators never showed the sort of large numbers for GE's incurred-but-not-reported claims that would suggest impending insolvency. "Like many insurance companies, you get into disputes [with insureds] over whether there is coverage or not," Emlico's St. Laurent explains. "Part of the lower IBNR was this interpretation of coverage."

Massachusetts approved the bad-bank strategy. Bermuda did as well, contingent on Massachusetts' approval and based also on GE's considerable assets. As Emlico's St. Laurent testified to the Massachusetts regulators, "There is no doubt that General Electric has the financial strength to pay claims, should they come due."

However, the Securities and Exchange Commission changed the ground rules on disclosure of environmental liabilities by requiring companies to estimate their total such liabilities, beginning with 1995 financial reports. Previously, many companies like GE had either assigned a total to prospective environmental claims net of expected insurance recoveries or had revealed claims on a pay-as-you-go basis. GE has said in the past that it expects to pay $80 million to $110 million each year in environmental costs for the next few years, exclusive of insurance receivables. So where did Emlico get its ballpark estimate of $750 million in asbestos and environmental liabilities in October?

"GE may have laid a blueprint for other environmentally overburdened captives to follow."

That figure shouldn't be so surprising. After all, Emlico insured nearly 70 years' worth of liabilities related to GE's heavy manufacturing, including building and operating nuclear reactors, manufacturing aircraft engines, producing engineering plastics, including the silicone used in breast implants, and building industrial transformers — the last of which contain the suspected carcinogen polychlorinated biphenyl. Before the problems involving silicone, PCB-linked claims were probably the worst of GE's liabilities. They include multimillion-dollar suits by several towns that allege that their aquifers were ruined by dumping of PCBs by GE going back to the 1950s. (GE is contesting many of the suits.)

GE has always insisted, however, that its environmental liabilities are not material to the company.

On February 21, 1995, Emlico applied to Malcolm Butterfield, then registrar of companies in Bermuda, to move there. That same month Emlico also had preliminary discussions with Massachusetts.

By June 12, the day Astwood took over Butterfield's post, Astwood signed Emlico's letter of acceptance and sent it to the Massachusetts regulator. Also on June 12, Emlico met again with the Massachusetts Division of Insurance about its proposal to reorganize and move. (Butterfield says he can't comment now because his current employer, KPMG Peat Marwick, is GE's and Emlico's auditor.)

Emlico's proposal called for a "good bank" to be created out of its stock subsidiary, Electric Insurance Co., plus a capital infusion of $75 million. Electric Insurance was to remain in Massachusetts initially as part of a Delaware trust, to wall it off from bad bank Emlico. (GE has since asked to buy Electric Insurance for roughly $125 million, pending regulatory approval.)

Emlico, meanwhile, was to be stuck with all of GE's environmental claims. Reinsurers contend that Emlico's surplus and capital were reduced from a presplit $255 million to $180 million (after the policy transfer to Electric Insurance). Emlico says, however, that its surplus was not reduced, because it continues to carry the $75 million as an investment in a subsidiary. Emlico was to be packed off to Bermuda to begin paying off claims. But there was no indication that it wouldn't remain solvent.

Why bother to move at all? To regulators the strategy seemed to be a simple matter of GE's cash management. After all, no individual policyholders were affected. And Emlico wasn't the first captive to move to Bermuda; for most, the driving force is tax considerations. A GE spokesperson says simply that "Emlico made the decision, which GE consented to."

Emlico persuaded Massachusetts to approve the reorganization quickly and waive the usual 20-day waiting period before a public hearing, arguing that it would be convenient to do the deal before the end of the quarter. The hearing was scheduled for June 20, and Emlico ran a small notice about it in *The Boston Globe*. The state insurance regulator didn't require Emlico to notify its reinsurers of either the reorganization or the hearing itself, but then it didn't expect Emlico's rapid demise. And Emlico didn't formally notify its reinsurers, even though, as some reinsurers point out, the company was sitting across the table from many of them in connection with other suits Emlico had filed against them over the same environmental claims.

The hearing lasted 37 minutes. On June 28 the Massachusetts regulator approved GE's plan, and three days later Emlico was established in Bermuda. The company had been on the island for barely four months when KPMG presented a new actuarial report, which disclosed a new set of incurred-but-not-reported claims for GE environmental and asbestos liabilities. The new reserves dwarfed Emlico's $250 million surplus, creating a huge shortfall. On October 20 Emlico filed for voluntary insolvency with the Supreme Court in Hamilton, Bermuda, the same day Coopers & Lybrand was named provisional liquidator. The matter is to be reviewed by the court on April 12.

Lack of etiquette

Within days of the liquidation filing, four reinsurers — Kemper Reinsurance Co., Allstate Insurance Co., General Re and a group of Lloyd's syndicates — had filed suits of their own against the Massachusetts Division of Insurance and com-

missioner Ruthardt. Their primary demand: That Ruthardt reverse her decision approving Emlico's move to Bermuda. They argued that the move changed their contractual relationship with Emlico because it placed the insurer in a different regulatory environment.

"What's clear," says A.M. Best's Snyder, is that "the creation of this bad bank and the movement of assets out of Emlico were done without the consent of many of the parties involved. There doesn't seem to be nice corporate etiquette here." Best had renewed Emlico's A– rating two weeks before the insurer moved offshore and downgraded it to D when the new numbers came out. In fact, Emlico moved so quietly that reinsurers only found out when tipped off by a lawyer on October 1 and had only a few days to respond before the period for filing objections was to elapse.

"Emlico had to have known they were insolvent. It didn't take a genius to figure out that GE's environmental liability exceeded Emlico's surplus," says an insurance analyst who asks not to be identified. "There wouldn't have been any other reason to move to Bermuda." St. Laurent insists that "what I viewed in February was a contingent event. I didn't know when it would hit — 1995, 1996, 1997?" Reinsurers don't believe that the events leading up to Emlico's failure were any accident, either. Indeed, they see themselves as victims of an "elaborate shakedown," says the corporate lawyer of an Emlico reinsurer. "It was brilliant, in a negative way. We never saw it coming."

Reinsurers see the "shakedown" occurring in three stages. The first was a four-year period (1987–'91) of nonbinding arbitration between Emlico and its policyholder GE over whether Emlico's commercial general liability policies covered pollution or not. Emlico has a fiduciary obligation to represent its reinsurers. But since the insurer is also controlled by GE, the notion of arbitration was somewhat artificial. "You would think that GE could just say, 'We always intended that our policies should cover pollution liability. Period,'" notes a reinsurance lawyer representing one of the reinsurers in litigation with Emlico.

Emlico's attorneys for the arbitration "fought such a good fight for Emlico that GE got scared it might actually lose the arbitration and wind up with no coverage," says the general counsel of one of Emlico's reinsurers. "They got almost to a ruling when GE came in and offered a compromise: that coverage would be individually negotiated, site by site. That was the setup [to suing reinsurers]. Then Emlico went around to some of its reinsurers and said, 'We've entered this compromise, and this is what you owe.' They offered a bargain. If $25 million was owed, they would take $10 million." They tended to settle with smaller and troubled reinsurers, such as the Home. Emlico says the arbitration is "frozen. It's at a standstill."

Some better-heeled reinsurers say they were offered no deals. Starting in September last year, they were just presented with claims "considerably more than what had showed on previous filings," says a reinsurer. "They wanted a sky-high amount for a commutation [canceling the policy]. In any discussion like that, GE's lawyers came along." These reinsurers say they suspect that GE restructured, moved Emlico and declared insolvency to facilitate collection.

St. Laurent says the move and restructuring were just a contingency plan. "It appeared that if events would go south, Bermuda has a structure in place to deal with insolvencies. Their business atmosphere and processes allow for quicker resolutions [of insolvencies]."

"GE may have felt it had almost outsmarted itself by being so involved in its own insurance and cleanups that it had actually hurt itself," a reinsurance expert speculates. "In all fairness, if they had had stock commercial policies all those years, they would have collected on them." Instead, GE would pay into Emlico; Emlico would pay out checks for cleanup costs. "GE may have seen its competitors winning big insurance recoveries from insurers. Maybe GE thought there ought to be a way to get something here too" out of their reinsurers.

One indication that GE knew what was in store for Emlico comes from the closing remarks at the Massachusetts hearing. The hearing officer, Daniel Judson, asked Emlico, "Why Bermuda?" St. Laurent answered, "If something should go wrong," the move to Bermuda would enable GE to handle its claims in a more efficient regulatory environment. "More efficient than Massachusetts?" the regulator asked. St. Laurent's lawyer cut him off and told him not to answer the question. ■

Finally, a safe harbor

New legislation not only gives companies that disseminate earnings projections greater protection, it also removes the main excuse for not doing so. • **By Mary Lowengard**

Six years after its 1987 initial public offering, Clean Harbors, a Boston-based environmental-services company, began issuing forward-looking, segment-by-segment statements to the investment community. Such candor with investors is unusual: Only 20 percent of companies responding to a National Investor Relations Institute survey last summer indicated that they "routinely" or "occasionally" forecast quarterly or annual results. It's not difficult to understand their reticence. Approximately 300 securities lawsuits are filed every year, some based on little more than a sharp drop in the price of a stock. In 1994 U.S. public companies paid an average of $8.3 million to settle these suits.

But fear of frivolous lawsuits began to abate at the end of December, when Congress overrode President Bill Clinton's veto of the Private Securities Litigation Act. And now, under the "safe harbor" provision of the act, a company is protected from lawsuits so long as its forecasts are identified as "forward-looking" and accompanied by cautionary listings of factors that could cause actual results to differ materially from those projected. "It's a whole new ball game," asserts Skadden, Arps, Slate, Meagher & Flom partner Thomas Dougherty, who wrote a nine-page memo deciphering the legislation for clients. "You're going to see changes in press releases, in printed forecasts, as well as in CEO speeches and in how IR people interact with analysts."

Indeed, with the safe-harbor provision, there are now few reasons companies can give for *not* issuing forward-looking statements on earnings. Skadden Arps's Dougherty sums it up this way: "There are companies that give no guidance, there are those that give guidance, and then there are those that say they don't but do." Under the new law the first and last categories may well disappear.

Most affected by the new protection, predicts NIRI chief executive officer Louis Thompson Jr., who helped to establish the provision, will be small-to-mid-cap companies that have virtually abolished voluntary disclosure for fear of inviting litigation. (NIRI was instrumental in demonstrating to Congress the effect that frivolous lawsuits were having on the willingness of corporations to voluntarily disclose information to the investment community.) These include companies in the volatile high-tech, biotech, pharmaceuticals and finance industries, which have been especially susceptible to lawsuits. Information never before released — let alone put in writing — will now reach a wide audience of shareholders. "The way is cleared for companies to reach out and give the investing community more and better information, which will improve the efficiency of the capital markets," contends John Ingalls, director of corporate finance and IR at Clean Harbors.

Similarly, the dialect spoken between investor relations executives and the analytical community will be transformed. Traditionally, a major preoccupation of IR departments has been helping analysts and investors generate earnings estimates that are close to the mark while avoiding any overt statement of what those earnings are projected to be. (Of those that do reveal internal financial forecasts, according to the NIRI survey, 75 percent present them only in broad and general terms.) Admits EMC Corp. IR manager Polly Pearson, "Now we can say it like it is."

Not every company can find shelter in the safe-harbor clause, however. NIRI's Thompson points out that the protection does not apply to forward-looking statements made in connection with a tender offer, an IPO or a going-private transaction, such as a leveraged buyout. It also does not apply to penny-stock companies nor to cautionary statements that misstate historical facts. In an article in the *National Law Journal*, attorneys Harvey Pitt and Karl Groskaufmanis of Fried, Frank, Harris, Shriver & Jacobson call the safe harbor a "welcome change," but they note that it is "pockmarked with exceptions."

For the majority of companies, the safe-harbor provision will result, at the minimum, in a reexamination of present disclosure policy and practice. "What the new law does is twofold," observes Scott Brooks, director of IR at Westcott Communications. "It makes us more secure about putting our projections in print, and it gives us more latitude to discuss with optimism the company's prospects." **II**

INSTITUTIONAL INVESTOR
MARCH 1996

Mail aggression

The Postal Service has never delivered profits reliably. CFO Michael Riley is battling the system to change that. • **By Ida Picker**

"What if your daughter played on a soccer team? Would you tell her, 'Get out there and *tie* every game'?" Michael Riley, chief financial officer of the U.S. Postal Service, conjures up this analogy to characterize the goal the service set for itself in its 1970 Reorganization Act: break even. During years of mismanagement, the quasigovernmental agency just couldn't stop losing money.

But, for Riley and his boss, postmaster general Marvin Runyon, merely staying out of the red is nothing to write home about. They're determined that the $54 billion-in-revenues mail and package delivery enterprise earn respectable profits and do so consistently. In fiscal 1995, for the first time in six years, the post office made a profit (after losses in 17 of the 23 preceding years). The $1.8 billion in net income was in sharp contrast to 1993's $1.7 billion loss. A reduction in the post office's $9.9 billion in debt and increases in postal rates largely explain the turnaround. Prospects are for another year of debt reduction and, yes, continuing profits projected to be about $1 billion in fiscal 1996.

Still, the task confronting Runyon, who was appointed in 1992, and Riley, who signed on as CFO the following year, is monumental in scale. If the post office were a private company, it would rank as the nation's 12th-largest in annual revenue. It accounts for nearly 1 percent of the U.S. gross domestic product and processes 180 billion pieces of mail a year.

Commercial as well as political pressures bear down ever harder on the Postal Service. Its traditional niche businesses — overnight mail, package delivery and first-class mail — are threatened not only by United

Parcel Service of America, Federal Express Corp. and others but also by electronic mail and the Internet. It is trammeled in largely outmoded regulations designed for the days when mail delivery was a government monopoly. Eighty percent of the service's revenues go to pay salaries and benefits for its unionized workers; that contrasts with less than 50 percent at FedEx.

The U.S. Treasury Department, moreover, stands as an improbable but formidable obstacle to the Postal Service's achieving efficient debt management. Given its right of first refusal of USPS debt financing by the 1970 Reorganization Act, Treasury has stubbornly resisted the service's efforts to gain ready access to the public markets to finance capital expenditures for state-of-the-art automation, among other things. And because the post office must borrow mainly from Treasury, it has no freedom to maneuver swiftly in and out of the markets to capture low rates.

It's probably fitting that Riley, 51, is a former U.S. Navy survival school instructor. New Hampshire–born and bred, he graduated from the U.S. Naval Academy in 1965 and served a five-year hitch as a naval aviator and survival school instructor. Riley later picked up an MBA from the University of Southern California, then a doctorate at Harvard University in 1977. After a stint as an accountant for a Boston company, he became executive assistant to the CFO and CEO at Northeast Utilities Co., a Hartford, Connecticut, company on the verge of insolvency. His projections of construction tie-ups from antinuclear protests convinced top management to cancel two planned nuclear power plants, averting probably hundreds of millions of dollars of future write-offs.

Riley next took on the job of helping to revitalize Michigan Bell Telephone Co. as its treasurer from 1983 to 1985. Then he moved onward and upward, becoming CFO of United Airlines. Although he was able to arrange the financing for some major United deals, Riley was confounded, he says, by the belligerent pilots' union and by United Airlines CEO James Hardigan's shifts in strategy. Less than two years later, Riley (along with most of senior management) was forced out. He became CFO at $350 million-in-revenues Lee Enterprises, an Iowa newspaper publisher, television station operator and graphic arts company. But after Riley had been there seven years, a new CEO arrived on the scene who wanted to set up his own team, with a new CFO. Riley, meanwhile, yearned for a greater challenge — a poorly run, financially hard-pressed enterprise of the sort he found so intellectually engaging.

What better candidate than the post office? He was recruited by Runyon for the CFO job, empty ever since Comer Coppie retired in July 1992. "I wanted to prove to myself that I could do [a turnaround] again," says Riley of his decision to take a job that pays a paltry (for a CFO) salary of $148,000 plus bonus.

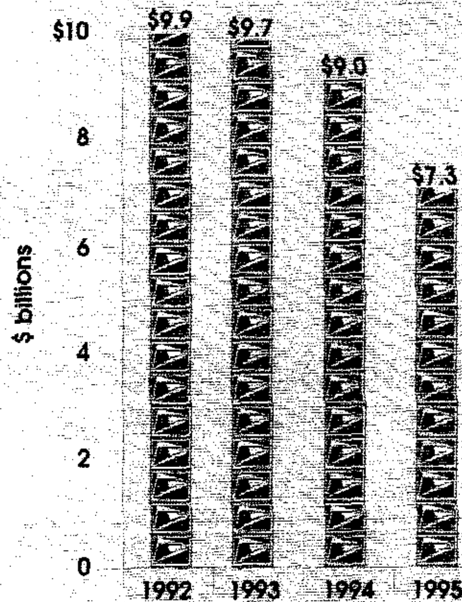
Riley arrived in the midst of financial upheavals touched off by Runyon. A former CEO of the Tennessee Valley Authority and senior manager of Ford Motor Co. and CEO of Nissan Motor Manufacturing Corp. U.S.A., Runyon was insistent that the post office be run like a business. Riley's "not impossible" task was to reduce debt and cut costs so that the post office could — of all things — earn regular profits.

Runyon's initiatives included reducing the Postal Service's interest expense by paying down debt with extra cash flow, primarily from refinancing debt and from the January 1995 postal rate increase, which Riley pushed for; slashing the 725,000-strong workforce by offering early retirement to 47,000 employees, resulting in the elimination of 23,000 middle management jobs (including 40 percent of finance staff positions) the year before Riley came; and wresting some borrowing flexibility from Treasury. In addition to making the case for the rate increase, Riley's brief has included installing stronger internal controls, setting up a management incentive system and making initial forays into Treasury negotiations.

Cash questions

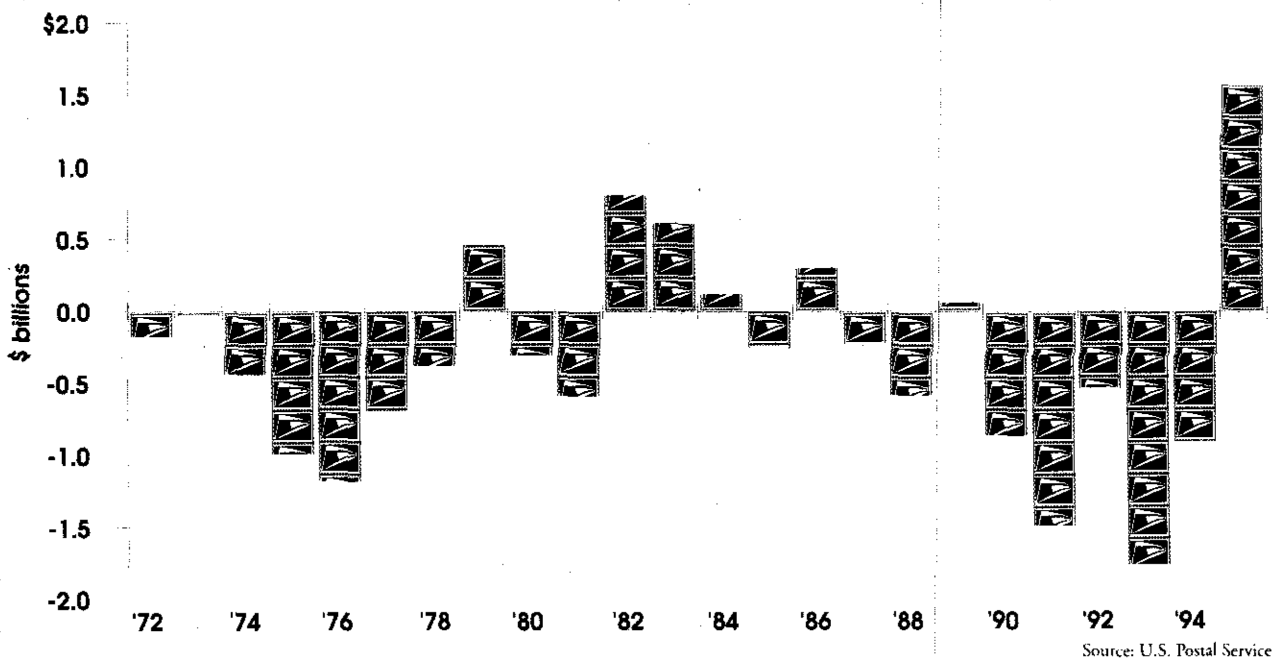
Right away Runyon asked Riley to figure out why the post office had to have cash on hand sufficient to cover three payrolls — at least $4.6 billion. To stockpile such a sum, the Postal Service needed to borrow at relatively high rates from Treasury. Riley recruited a chief financial forecaster to produce accurate cash projections and used those to persuade the Postal Service's board of governors to allow cash balances to be reduced to about one payroll's worth, or $1.3 billion to $1.4 billion.

Together Riley and Runyon have worked the total debt down from a high of $9.9 billion in September 1992 to



Figures are for the fiscal year ending September 30.

. . . while its losses have halted



Source: U.S. Postal Service

Jennifer Levi

$5.8 billion as of the end of January. Most of the increased cash flow from January 1995's postal rate hike has been put to debt refinancing. Long-term debt is now at a 1-to-13.4 ratio to revenues.

Riley has also begun tightening alarmingly slack management controls. Fearing that employees handling bulk mail and packages on loading docks were not keeping track of payments owed by customers, he began requiring senior managers to sign a simple form stating that they'd collected all the monies due. Riley recalls their initial reactions: "People said, 'I can't do that. I'm not sure we're collecting all the money we should be on the big docks.' I said, 'It's a success already.' "

Like Runyon, Riley is adamant that the post office draw on the public markets for financing. (At the TVA Runyon successfully battled Treasury for the right to tap the markets.) Riley concedes this might not save much compared with going cap in hand to Treasury but argues that it would provide critical financing flexibility and management discipline. Treasury can take weeks to okay even a short-term loan. Riley equates the Postal Service's transactions with Treasury with eating in a cheap restaurant: "When you walk in, they say they've got the lowest prices in town, and you say, 'Yeah, but your service is awful, I don't want to keep coming back here.' If you want something different from the menu, they say, 'We'll talk about it for the next six weeks.' "

The dealings between the Postal Service and the Treasury are a touch strained. Says Riley of the relationship, "We don't have one." Describing his introductory visit with Treasury undersecretary John Hawke, the Postal Service CFO comments: "To say I was unsuccessful is an understatement. They treat us as if we're a wayward child and they are the strict parent." Adds Runyon, the relationship "is not really grand." The Treasury's Hawke sees things differently. "I have no reason to think the relationship isn't very good," he says. "They're one of our valued customers."

Valued maybe, but also captive. The Postal Service must offer its debt to Treasury for first refusal before it can go elsewhere for financing. And as Postal Service treasurer Stephen Kearney notes, "They've taken their mandate [of first refusal] to prevent us from going to the public markets." Why? USPS folk suspect that Treasury wants to preserve the status quo: control of the Postal Service's financing, since the post office is the last horse in the barn — the Federal National Mortgage Association, Federal Home Loan Mortgage Corp. and other agencies all borrow in the public markets. (Technically, Treasury merely directs the post office to its Federal Financing Bank, which provides the actual funding, typically at 12 basis points over rates for comparable Treasury securities, plus an additional spread for call options.)

Treasury contends, however, that it offers the post office the lowest interest rates and, moreover, charges no transaction fees. "We haven't got any indication that we can't meet all of the Postal Service's needs," says Hawke. "So far the Postal Service has not to my knowledge tried to make a case that there's some reason why we should allow them to go out and borrow more expensively than the borrowing we can provide for them."

Postal Service treasurer Kearney is happy to make that case. "Treasury was not given authority to make business decisions for the Postal Service," he asserts. "As the cus-

tomers of the Treasury and as the business managers of the Postal Service, we're absolutely convinced we can do better in the market, as virtually all other agencies that used to borrow from the Federal Financing Bank decided in the past." In fact, says a Wall Street investment banker familiar with the standoff, "the Postal Service needs to be more nimble. [Treasury's position] really doesn't make any sense. It is oriented toward controlling the Postal Service."

Over the years, say post office officials, Treasury has provided little borrowing flexibility and has subjected the Postal Service to bureaucratic indignities. It has to wait for up to 15 days to find out if Treasury has approved a financing request — though it usually does. The Justice Department issued a memorandum last October stating that Treasury had to respond to the service's financing requests "within a commercially reasonable period of time." But it didn't define what such a period is, so the 15-day waiting period didn't change. According to deputy assistant secretary of the Treasury Mozelle Thompson, that's no problem. "Postal sometimes requires hundreds of millions of dollars at one time," he says. "We get that done very promptly. If they wanted to do that in the market, it could take several months."

"Treasury has tried to accommodate the post office in some matters, but only after serious prodding."

Post office officials say Treasury's stalling can be costly. Last June 2 the Postal Service, hoping to take advantage of a dip in interest rates and the availability of inexpensive call options, told Treasury that it wanted to issue two tranches of callable bonds. But it didn't hear back until June 14, and the Federal Financing Bank didn't get around to preparing the issues until June 21. The Postal Service then sent its notice of desired maturity and call dates, and on June 23 the FFB sent a draft promissory note back to the service. By that time, the call-provision pricing had more than doubled. "Each time the market changes, we have to weigh how long it will take [Treasury] to do a new note, and that distorts our decision," Kearney says. Thompson sees this episode in a different light: "They didn't inform us they had a time-sensitive request."

He goes on to say: "All of this would have been solved if they'd taken us up on our repeated request to do a shelf registration. What we've done over the past two years is an incredible amount of providing them with features that the market has." Responds Kearney: "We disagree with his characterization of Treasury's 'repeated request' to do a shelf registration. As a matter of practice the FFB doesn't request that the Postal Service do anything." Moreover, he adds, "we absolutely disagree with Thompson's characterization that they offer us a wide range of services."

Another point of friction is that Treasury doesn't know how much cash (from $1 billion to $2 billion) the Postal Service has on deposit with it every day, so it cannot automatically invest that money in a simple sweep account. Thompson concedes the point. "As with all federal agencies, the USPS funds are commingled with other agency cash receipts. We can't necessarily tell how much cash they have on hand to invest. They have to tell us."

The Postal Service has a sophisticated computer system to determine its exact daily cash on hand, which comes from 7,000 different accounts in 5,000 different banks from Alaska to Puerto Rico. Its chief investment officer must call Treasury every day to request that the money on deposit be reinvested. Treasury's Thompson comments: "This is a corporation that wants to be independent. They need to run their own accounts. That's a responsibility they have."

Treasury has tried to accommodate the post office in some matters, but only after serious prodding. In the fall of 1992, Runyon sent Treasury a letter stating that the Postal Service wanted to issue callable bonds. Treasury said it didn't want to buy them. "They absolutely stonewalled us," he recalls. So he announced his intention to use the public markets.

Morgan Stanley & Co. began making preliminary calls about the proposed issue, but Treasury reportedly bad-mouthed it, suggesting that the agency would not back it. More meetings ensued. Says attendee George Williams, a principal at Andrew Kalotay Associates, a Postal Service consultant, of one session: "That is the most antagonistic business meeting I've ever been at. These people at Treasury were acting like bullies: 'You want to play, you have to play by our rules.'" Runyon ultimately met with then–Treasury secretary Nicholas Brady, who agreed to let the Postal Service issue callable bonds that fall, but under unfavorable repurchase conditions and with no memo of understanding to permit similar borrowings in the future.

Last year Treasury joined with the post office in coming up with an innovative floating-rate note that resets every 91 days based on three-month Treasury notes. Treasury emphasizes its willingness to develop a shelf-registration process. It has also said that if the post office can agree on the terms of a note, it can take advances against it on two to three days' notice. The hitch: agreeing on the terms. Gripes Kearney, "They don't want us to compare what they can offer us versus what the market can." Runyon is hopeful about meeting with Treasury Secretary Robert Rubin to press his case but points out that with the budget crisis, Rubin cannot address the Postal Service's desires right now.

Perhaps the Treasury ought to be nicer to the post office. With its budget troubles, the federal government can use a profit-making mail deliverer. "If they'd only admit that they need our money," says Riley expansively, "we'll be glad to send them a dividend." ∎

Morgan

His predecessors began transforming this most traditional bank into a modern global powerhouse. Sandy Warner and his new generation of Morgan leaders are impatient to complete the task in their own way.

By Robert Teitelman

New York, January 24, 1996

It's a once-a-month ritual. Peter Woicke flies in from Singapore, where he oversees J.P. Morgan's Asia-Pacific region. Walter Gubert suddenly materializes from London, where he watches over Europe, Africa and the Middle East for the bank. Roberto Mendoza takes a break from defending Forte or helping Westinghouse buy CBS. Peter Hancock, Pilar Conde and Nicolas Rohatyn abandon their trading floors. Sandy Warner, his lieutenants from around the world in tow, pads down the lushly carpeted hall of the 20th floor of 60 Wall Street to the cool, English-oak cocoon of the credit policy committee room.

At J.P. Morgan they call this conclave of senior managers the House Arrest. It is something new under the Morgan sun, the brainchild of Warner, who has been chairman of the bank since January 1995. The numbers vary, but on January 24 roughly 20 of Warner's mostly direct reports were gathered at Morgan's stone-and-glass headquarters. The main subject of discussion: strategic systems, that is, the high-priced technology that ties the bank together. Why the name House Arrest? Attendance is mandatory. Warner accepts no excuses short of death or disease. "For this day they are mine," he says. "Hence the name."

The House Arrest is emblematic of Warner's first year at the helm of Morgan. It's a keystone of Warner's overarching drive to strip out management layers, flatten hierarchy and drive responsibility down to the business heads. It's an attempt to combat the centrifugal forces constantly threatening to rip apart a multiproduct, global firm. The session is both highly structured — schedules are set months ahead, and Warner himself often decides the agenda — and highly flexible. "It's not a group, it's a process," Warner likes to preach. "I'm not in favor of management committees and operating committees. I want agreement on the process by which we manage this place."

The House Arrest tackles issues that affect the firm as a whole. "We reserve discussion time for the big issues," Warner

enters the Warner era

says. "We try not to get into reporting and presentation. We want to get something moving. Beforehand I always ask those making the presentations to suggest what the outcome should be. We want to move things ahead."

Moving something. Getting it done. *Getting it right.* To Morgan insiders the burly, blue-eyed Warner has long been known as a manager with a bias for action, a visceral eagerness for decision making — sometimes, even he admits, to a fault. Warner's predecessor, Dennis Weatherstone, according to one senior Morgan executive, was an intuitive, sometimes opaque thinker, skipping from A to D to B. Warner is more linear, lining up the steps, explaining them clearly and marching his troops toward the foreordained conclusion. (He confided to one Morgan colleague that even his golf game was built around a goal: "I focus on par on every hole.") Warner argues that the task of transforming Morgan from a commercial bank into a global financial services provider — a long and complicated process kicked off in the late 1970s by then-chairman Lewis Preston — is all but complete, and that the focus (a favorite Warner word) is now swinging toward execution (another favorite).

Warner has ample time to work his will. Although he has played a senior management role for more than a decade — he served as president from 1990 through 1994 — he is just 49. With luck and good health, Warner could find himself running Morgan for as long as 15 years, longer perhaps than Preston, who reigned for a decade.

But Warner's ascension represents more than just a personal triumph. Over the past several years — accelerating with the Warner-led organizational revampings of the past year — a new, young, multinational generation of Morgan bankers has emerged. Indeed, Warner has bet his chairmanship on this cadre of managers: Woicke, 53; Gubert, 48; Americas chief Thomas Ketchum, 45; equities supremo Ramon de Oliveira, 41; Rohatyn, 35 (son of Lazard Frères & Co.'s Felix), who runs emerging-markets trading, foreign exchange and commodities; Hancock, 36, head of fixed income, capital markets, swaps and exchange-traded products; and credit chief Joseph MacHale, 44. This group — mostly Morgan lifers — represents a generation that could dominate the firm well past Warner's tenure.

What's missing from this picture? Left behind in the Warner era is a whole generation of Morgan commercial lending officers that failed to make the transition as the institution reinvented itself. The reasons for their departure vary, but the fact is that, with the exception of Kurt Viermetz, 56, a vice chairman with top-level client responsibilities in Europe, and Peter Smith, 61, who is charged with reviewing all potential conflicts — insurance against so-called reputation risk — there are few gray heads at the House Arrest (Smith died suddenly on March 2). This may be the reality of investment banking in the 1990s, but it is a profound change at the 135-year-old House of Morgan. Thus the story of the rise of one generation is, inevitably, also the story of the fall of another.

Washington, October 1994

"Dennis suggested it," says Warner, stretched out in a soft chair in his snug office, with its highly polished rolltop desk. "When I was first approached by the board to succeed him, he spent a lot of time with me working out what I planned to do. At one point, he said, 'Why don't you pay a visit to Lew Preston [who had retired from Morgan in 1990 and gone off to head the World Bank] in Washington and get his advice? It's a courtesy. You and he are close.' I thought to myself, 'He'll think a lot of this stuff is really radical.'

"I called, and he carved out a Friday afternoon. I felt I was asking a father for his daughter. I told him what we had in mind. About changing the psyche of the place. About a different management model. About driving more responsibility down to the operating guys. He smiled — and gave me his blessing. But he said, 'Remember, sometimes the hardest thing is to do nothing.' I kept the notes from that day. I'll keep them a long time."

Warner's story tells a lot about the stature of Preston, who died last year, and about the enduring power of Morgan tradition. Both Warner and Preston were deep believers in this one true faith — and Warner's pilgrimage to Washington smacks a bit of papal dispensation, just as the portraits of past chairmen lining the halls of the 20th floor resemble a sort of apostolic succession.

Such a deep-rooted culture inevitably contains paradoxical impulses. After all, it was those guardians of tradition, Preston and Weatherstone, who set out to remake Morgan well before most other big commercial banks realized there might be a problem with their customary franchise. Warner himself was a key shaper of the new vision. But what constitutes the indispensable, elemental core of the Morgan culture? What should be kept at all costs, what can be discarded? Can you engineer enormous change without losing your soul or, indeed, as Warner says, "blowing up the bank"? How hard do you march the troops?

Warner views his career through the lens of that Morgan culture. His style is very American, very Midwestern: blunt,

focused, with an energetic informality. He grins easily but does not easily indulge in personal revelation. As he recounts his early career, everything takes on a Morgan meaning — a lesson learned, an experience gained. He dwells on his luck (to have worked for such fine people) and on what he views as the almost providential wisdom directing his career. And behind every lesson lurks the ground of all meaning, The Client. "I felt in every one of my assignments that someone was saying, 'This is a dimension of your career, your background or portfolio that will better position you for the next challenge,' " he explains.

Douglas Alexander Warner III was born in 1946, the eldest son of a Cincinnati insurance executive. He grew up in the tony suburb of Indian Hills in a family with a certain social standing locally. His father served as a trustee of the Cincinnati Music Hall Association and Art Museum and chaired the United Appeal one year. His grandfather (and namesake) was also an insurance man — he ran his own firm — who was active in local golfing circles. Grandmother Warner was the daughter of a Cincinnati entrepreneur named J. Stacey Hill, the president of the Hotel Gibson, then a prominent local hotel.

Warner was packed off to boarding school — the Hill School in Pottstown, Pennsylvania — and then went, like his father and uncle before him, to Yale University. Intent on a medical career, he loaded up on math and quantitative chemistry and in the summers worked in hospitals and laboratories. "I was interested," he says, "in solving problems." In 1967 his father suggested that he try something different during his last summer at Yale, just so he would be certain that medicine was the right choice. Along with two classmates he ended up taking a job at Morgan.

It turned out to be a very special perch. Morgan rotated the summer interns through various areas, assigning them to the desks of vacationing partners on the big banking floor at the bank's old headquarters at 23 Wall. At the end of the summer, classmate and fellow intern Roland Betts, now a general partner of New York real estate venture Chelsea Piers, asked Warner how he liked the experience. "He said to me, 'I love it,' " says Betts. "And it was very obvious that he did — every single moment."

Warner agrees: "For me it was an exciting group of people to be around, diverse in interest and experience. Energetic. Thinking about things in a broad way." Before Warner returned to Yale, his supervisor suggested that he consider joining the bank after graduation. Warner took this as a job offer and spent months pondering his choices. It was a turbulent time for him. In February his mother died. The Vietnam War was raging, and the draft lottery was looming. "You really didn't know what you'd be doing a few years out," he says. He viewed the bank job as a sort of holding action. In the spring he called up Morgan's head of personnel to announce he was accepting the offer — an offer personnel knew nothing about. Nonetheless, Warner was persistent, and that summer he started at the bank. He also got married that June.

Fresh from the training program, Warner soon found himself calling on second-tier corporate clients in towns like Steubenville and Wooster, Ohio. "I got to call on the rubber companies in Akron when I was really doing well," he laughs. "But I never made it to Pittsburgh." As a better test of his potential as a banker — these companies, after all, had little need to borrow money — he was transferred to the New York region's metropolitan district, with its array of higher-profile companies, such as PepsiCo, J.C. Penney Co., American Express Co. and U.S. Steel.

Warner impressed the right people. In 1970 he was asked to serve as an assistant to the chairman, a mark of high favor. The assistantship had begun with chairman Thomas Gates, who based the practice on his experience as secretary of Defense in the Eisenhower administration. James Robinson III, later chairman of American Express, was the first assistant chosen; Warner, No. 4.

For three years Warner got a rare view of how Morgan chairmen — first John Meyer, then Ellmore Patterson — operated. He clipped newspapers, sat in on meetings, ran errands. He was thrown into daily contact with senior managers, including

share their secrets with you," he adds. "When you're at the core of a survival issue, you broaden the dialogue. Then you begin to understand the strategies, the cash flows, the structural issues. It was a corporate finance education."

In 1981 Warner was shunted to a job that others might have blanched at: operational services, a marketing unit that sold noncredit services, like cash management, to clients. Warner reorganized the unit and pushed hard to market an early form of the electronic check to Morgan's network of correspondent banks. There were larger lessons to be mastered here as well. "It was the first time I remember thinking about products and clients," Warner says. "Preston had thought about this long before, but I recall appreciating that as we evolved into a global financial services provider, the job would involve selling services that didn't have relationship responsibilities attached."

Despite his age — in 1981 he was only 35 — Warner was widely viewed as unusually mature in his outlook. A number of observers say that mounting family obligations had made a fairly serious young man very serious. His father had died in 1972, at 53, and Warner had taken on some of the responsibility for his younger brother and sister. For years the family had owned a summer house off Lake Michigan in a hamlet called Wequetonsing. Warner now expanded the house and became friends with a neighbor two houses down named John B. McCoy, now the chairman of the formidable Banc One. (Warner still receives encouraging notes from the McCoy family patriarch, 83-year-old John G. McCoy.) In the mid-1970s Warner's first marriage ended in divorce. In 1977 he married Patricia Grant, daughter of then-chairman of the New York Mets M. Donald Grant. Their first child, a son, was born a few years later, followed by a daughter. (Sadly, she was diagnosed as suffering from Down's syndrome.)

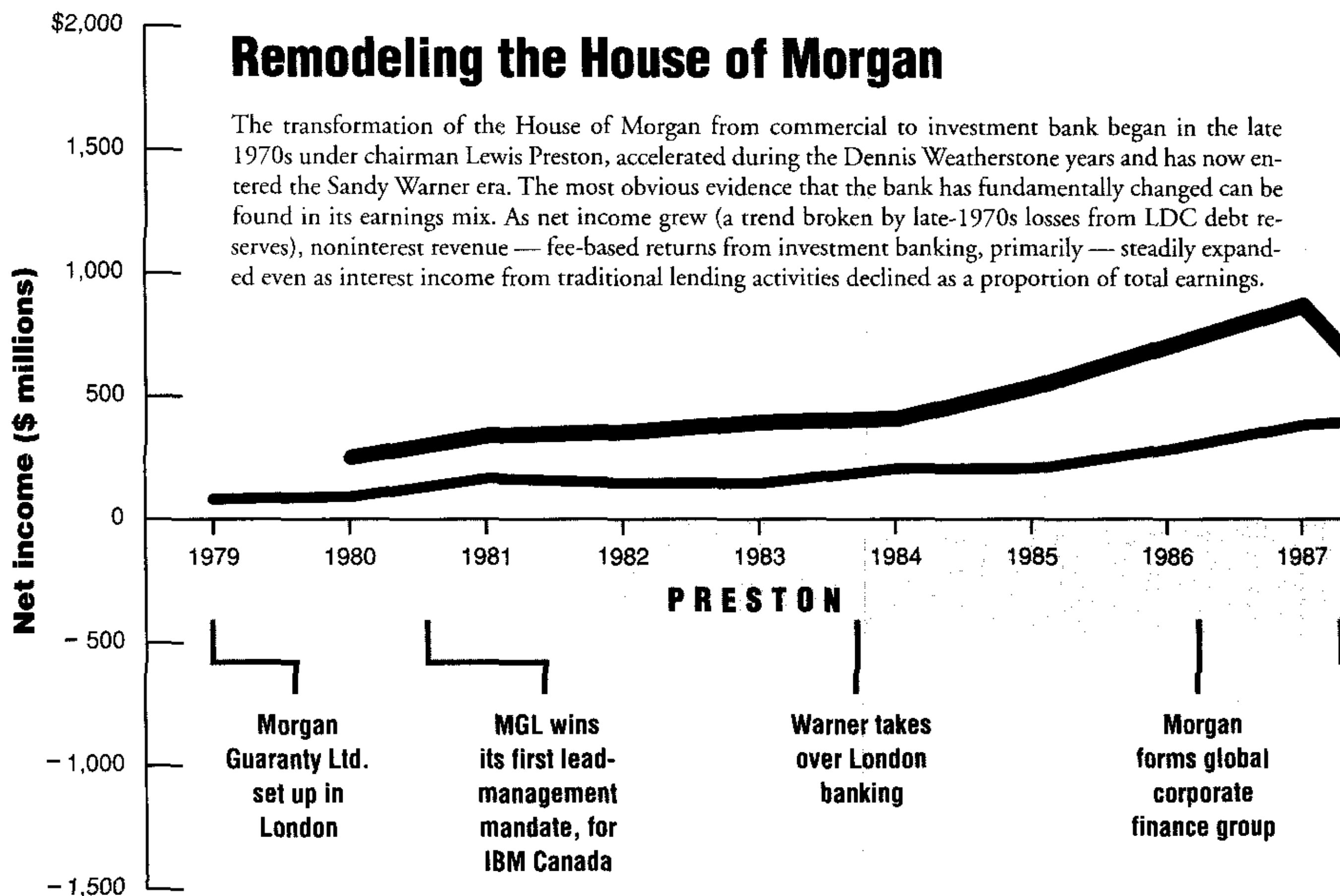
Around Morgan Warner's talents as an organizer did not go unrecognized. Weatherstone recalls debating with Preston over whether to send Warner next to London or Tokyo. Meanwhile, the head of banking in London, a Frenchman named Jean-Pierre Desbons, was stricken by what he thought was a back ailment but which turned out to be cancer; he died in 1983. "We decided that London would give [Warner] wider horizons," says Weatherstone. Peter Smith, then head of global banking, approached Warner, who quickly agreed to the move.

Preston asked him to stop by before he left. "He told me what he saw as the challenge," says Warner. "He said, 'You're going to the largest Morgan location outside the U.S., with roughly 10 percent of our staff and about $4 billion in loans. I foresee the possibility that that portfolio could disappear entirely over the life of your assignment, because the Euromarkets, Euro–commercial paper and technology could take us out

Preston, who was then running the rapidly expanding international division, and outside luminaries. One day Meyer dispatched Warner to fetch Federal Reserve Board chairman Arthur Burns from the airport. "You've got an hour with one of the great men of our time," the taciturn Meyer told him. "If you don't learn something, you've got rocks for brains." Warner chuckles: "Arthur Burns didn't need an escort. This was all about developing people."

In 1973 he was rotated to cover District 9, Chicago, then District 7 — the Far West — where he took long plane rides for two-week calling stints, mainly visting companies around Los Angeles. The lesson here: California was the preserve of the large local banks — BankAmerica, Security Pacific and Wells Fargo — forcing Warner to work hard to differentiate Morgan. "His predecessor was a fine banker but didn't do much in the way of new business," says William Barrett, then head of District 7 and now the firm's senior credit officer. "Warner brought in a remarkable amount of new business."

By 1979 Warner had entered management, this time running the Midwest region. Suddenly, rather than talk to clients who had little need for Morgan's basic product — credit — Warner found himself dealing with venerable Morgan customers, such as Ford Motor Co. and Chrysler Corp., that needed the bank desperately. But did Morgan need them? "The issue was always sponsorship," says Warner. "We're talking about amounts of money that if you got it wrong would be very significant." But the experience proved instructive. "Companies with double-A ratings didn't



of the business of intermediating investment-grade borrowers. You've got to figure out what the hell to do about that. So good luck — and don't screw up.' That's the way Preston could be in private: 'I've sketched the problem. I don't know the answer. Just don't screw it up.' "

London, September 1983

Warner's reputation preceded him in London. "He did Motor City — we knew that," says one veteran of the London office. "They were great clients, but we knew the difficulties of that assignment." At 23, Argentinean-born, Parisian-bred Ramon de Oliveira had worked with Warner on a complex loan, private-placement and real estate transaction for one of Warner's western clients, Southwest Forest Products, in the late '70s. "I was one of the few in London who knew him," he says. "It was obvious that he was somebody New York thought highly of."

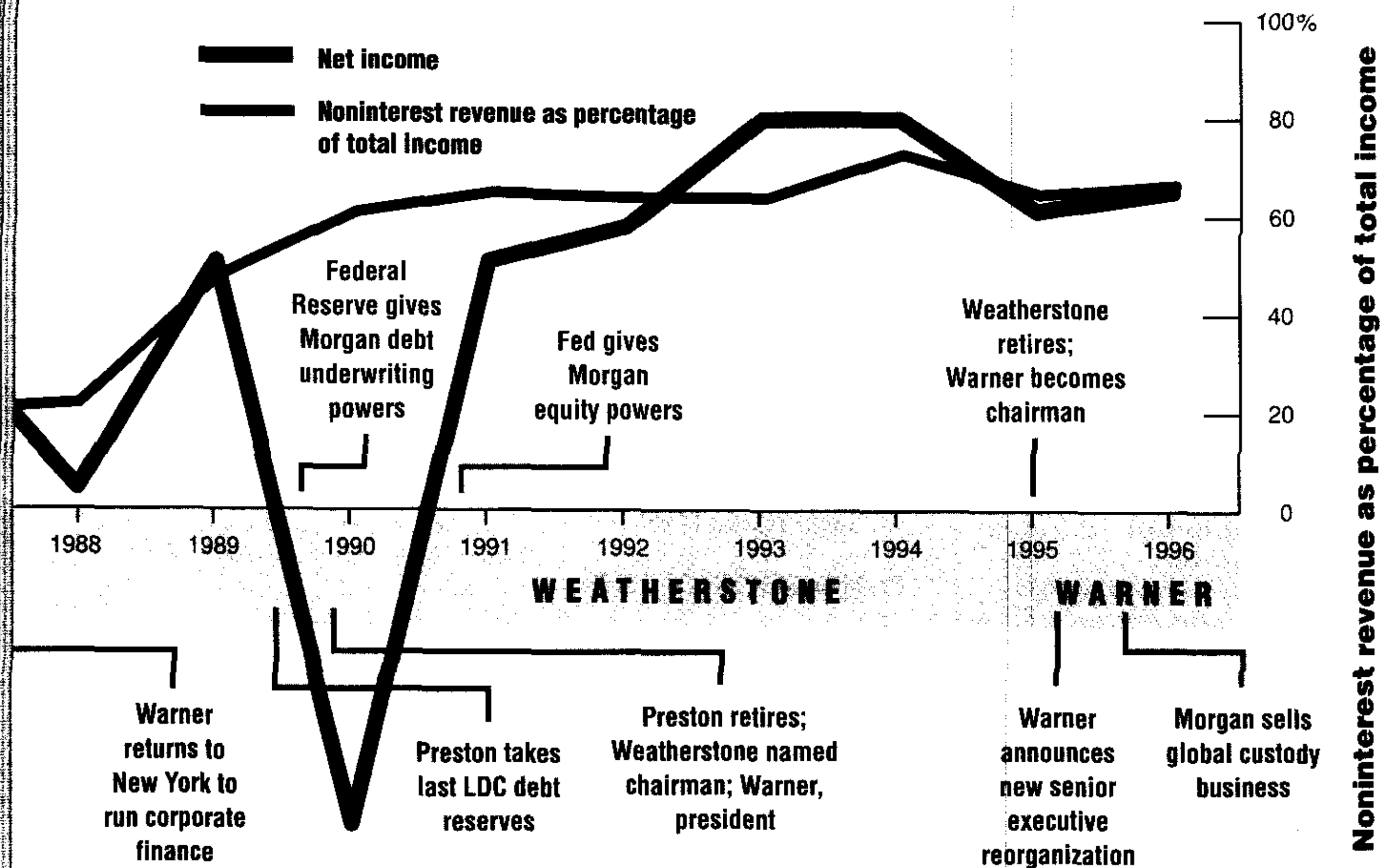
London had long been an important way station on the Morgan fast track. Preston had made his name through his leadership of the London office in the late '60s, and Weatherstone had begun there when it was still a Guaranty Trust branch. Since then rising Morgan managers were routinely rotated to London before returning to senior positions in New York.

London was also the firm's window on the Euromarkets. Since the '60s Morgan had had a major Eurodollar operation in London. This was the heart of the Weatherstone-led treasury and foreign exchange operation, the bank's first truly integrated global business. In 1979 Preston assigned then-39-year-old John (Tony) Mayer, who had run project finance, syndication and private placement in London, to set up Morgan Guaranty Ltd., the bank's first foray into corporate securities since the '30s. Mayer was assigned to learn how to tap the Eurobond market — to make Morgan a true Euromarkets player.

MGL was one of a flurry of initiatives hatched by Preston and Weatherstone. Years earlier the bank had started a small, specialized group called Territory 5 to deal with unusual, mainly cross-border, corporate finance situations for mainly U.S. clients (with a brief that ranged from currency hedging to wrestling with complex cross-border tax matters). About the time MGL was launched, Territory 5 was renamed international financial management and taken over by Roberto Mendoza, a brilliant, Cuban-born banker, educated at Yale and Harvard Business School, who had spent time in London before returning to New York. Mendoza, still in his early 30s, built an elite corporate finance team — it had only 15 to 20 people, many very young, and was always considered a cost center — and began to attract clients eager for sophisticated cross-border advice.

Thus MGL had two strategic purposes: to provide IFM with the means to raise money in the markets (something that Morgan, blocked by Glass-Steagall, could not do in the U.S.) and to build securities expertise, which it could then export to the U.S. when Glass-Steagall finally fell. Indeed, MGL's breakthrough Eurobond lead management — a 1980 swap from U.S. to Canadian dollars for IBM Canada — came through IFM.

Despite MGL, the Morgan branch was hardly a hotbed of



change. The bankers dominated, though organizationally it was a hodgepodge. Both the Eurodollar operation and MGL, which early on adopted an aggressive style that occasionally clashed with that of the branch's bankers, reported back to treasury in New York. And there were a handful of head-office extension groups, or HOEGs (pronounced "hogs"), which were filled with reps from New York businesses. London was also the booking center, though not the origination office, for Latin American syndicated loans.

The London general manager was a dashing international banker named Fred Vinton, an American who grew up in Argentina and had developed a keen appreciation for things British, including fox hunting. "It was very much an international banking outpost," says one London veteran. Adds another, "Like the rest of the City, the day started at 8:30 and ended at 5:30 — almost by law."

Vinton had his difficulties. By the early 1980s Preston had grown very annoyed at what he saw as London's high cost and declining profitability. Barrett, Warner's old District 7 boss, had been sent over in 1980 to serve as assistant general manager for operations. He arrived in time to get hit with two cost studies from New York, one from the controller's office, the other from a unit called management information and profit analysis, looking into the then-obscure subject of where money was actually made in banking. London had grown without much forethought, adding services wherever it seemed to make sense. Back-office costs were high throughout the City, and the trading operations made ever greater demands. More significantly, spreads on lending were steadily shrinking. And when the Latin American business hit the wall with the 1982 Mexican default, interest income and syndication fees evaporated. "The cost base wouldn't have mattered if revenues were growing," says Barrett. "But they weren't."

Says Weatherstone: "London needed someone who could establish a corporate banking organization. The kind of client approach that you had in the U.S. didn't exist in London. We needed an organized, managerial approach. And we wanted someone with not just a knowledge of the client, but also of the operations behind the scene." Warner, with his client perspective and operations background, fit the bill. He faced several interrelated challenges. He had to get commercial bankers to sell a more diverse set of products — investment banking products. He had to link costs more closely to real profitability. And he had to build relationships, beyond those with the subsidiaries of U.S. corporations, within the ranks of the established British companies — the kind of companies that had long used the U.K. clearers as their house banks.

The temperature was rising in London. Thatcherite deregulation was the rage, and the Euromarkets (and MGL) were responding. Battered and bruised, many U.K. companies began to reconsider their traditional relationships. "The merchant banks were not really involved in securities underwriting," says David Band, a longtime Morgan executive who's now chairman of BZW. "Morgan had the capability to do lending and securities. One of the keys to the Warner years in London was to focus tightly

on a small U.K. corporate client list."

Oil and gas lending was an entry point. IFM and MGL were doing new things, but for a mainly U.S. client base. In London, only the oil and gas unit had really broken through the relationship barrier to reach top U.K. clients. Even before Warner moved to London in September 1983, he and U.K. and Norway area head Neil Chrisman paid a visit to a key client, British Petroleum finance chief (now CEO) John Brown. A decade earlier, Morgan's petroleum team, led at the time by Band, had pioneered, along with Lazard Brothers, the financing for BP's Forties Field in the North Sea. It was then the largest private bank loan in history. "Brown at BP was a very sophisticated finance guy," says Chrisman, who had run the U.S. oil unit in the 1970s and who retired in 1993. "But Sandy really got to know the company. We were already talking M&A, capital markets — not just traditional banking services."

"Some bankers simply could not handle the demands of the new products."

Chrisman was impressed by Warner. "He could really focus. Over and over he would say: 'What drives this? What makes this so valuable?' " However, Chrisman adds, Warner may have come across to some U.K. clients as too American, too brusque: "He was a no-nonsense guy, and the English could be very procedural. And he was *very* young."

In fact, oil and gas lending had already been pulled into the force field set up by IFM and MGL. When he staffed IFM, Mendoza had attracted such young oil and gas tyros as Maureen Hendricks, who recently moved to head Morgan's new business development unit. It didn't take Warner long to recognize the talent base in London. London oil and gas was run by James Berliner (who retired in 1994), but it was driven by Ketchum. It included de Oliveira; Hancock; John McColloch, today Morgan's municipal bond chief; Rodney Peacock, now co-head of M&A for Morgan in Europe; Charles Stonehill, now Morgan Stanley & Co.'s European equities head; Alexander Catto, the son of a former Morgan Grenfell & Co. chairman who ran Lazard Brothers' capital markets unit before he left the firm last year; and Olav zu Ermgassen, a German who now runs his own boutique merchant bank in London. Late one night Warner paid a visit to the group. "What we've got here is the equivalent of the corporate finance department of Goldman, Sachs & Co.," Stonehill recalls Warner saying. "And I'm going to let people know about it."

What was so valuable about oil and gas? The Forties Field had led to a host of similar financings as companies stampeded to exploit spiraling oil prices. The business gushed money for Morgan. "Petroleum was one of the highlights of my career," says Asia-Pacific chief Woicke, who ran the London unit from 1978 to 1982. "We were in almost all the big, nonrecourse deals, and we just dominated sectors like Norway, Denmark and the U.K."

In those years oil and gas was about as sophisticated as bank lending got. It used production financing, in which loans were collateralized not by the actual oil in the ground but by the rights to produce that oil from the field. The business was complex, global and threw off the kind of tax, hedging and currency issues that demanded a high level of expertise and analytical skill. Production lending made it possible to finance massive development projects around the world, but getting deals done required handling sophisticated clients, recalcitrant governments, a jumble of production partners. "They were projects of NASA-like size, with ten-to-15-year horizons," says fixed-income chief Hancock. Not surprisingly, both the U.S. and London oil units had spun off separate project finance groups in the 1970s.

"The oil companies were big users of IFM services," says Chrisman. "They had major issues of repatriating income and financing projects through thinly capitalized subsidiaries. They had cash flows indigenous to wherever they had businesses: refineries, gas stations, shipping, pipelines. Or they had big investments without cash flows, as in the early days of the North Sea."

The demands of the business subtly altered Morgan's role as banker. "We were doing securitizations as far back as 1973 and 1974," says Hendricks. "These were skills we had as a principal rather than just an arranger. Those clients didn't need Morgan as a lender. They needed us for hedging or to access international capital markets. These businesses generated fees, not interest income."

Today Warner argues that oil and gas was important not because it was so sophisticated, but because the bank tended to send its best young talent to such a money-spinning unit. In 1985, with oil prices falling and business drying up, Warner downsized the London unit. But by then he had already begun to lobby for the strategic placement of its key members, weaving together banking and securities. In 1984 he talked to Ketchum about moving to Hong Kong, where he went on to run Asia-Pacific. He then helped to place de Oliveira and Hancock at MGL, working the Eurobond syndication desk (oil and gas had been one of the few banking units to do its own syndication). De Oliveira then began his plunge into equities, running London's equity operation in 1987 before moving on to manage high-yield in New York.

Hancock, an Oxford University grad who had grown up in Asia, worked as a young number-cruncher and modeler for oil and gas in the early 1980s, quickly migrating from mainframes to PCs to networks. He used syndicate as a platform to leap into swaps — a lot of Eurobond deals, he notes, had derivatives attached — and then moved to New York to run a fixed-income, multicurrency portfolio and eventually, the swaps group. Like oil and gas, the swaps group was an important crossroads, with veterans moving into other gestating businesses, particularly those involving risk management.

For all its significance, oil and gas was only one narrow aspect of the London scene. The branch, which had relocated to larger quarters at Angel Court in the City in 1980, was handling a flood of business; the old "banking" hours no longer applied. Head counts soared. Indeed, units were deliberately overstaffed in preparation for expansion into U.S. markets. Early on Warner had sent negative signals to some bankers by cutting back their compensation; a number quietly left. He then began to hire from the outside and stepped up recruit-

ing. The bankers who remained began selling an ever growing menu of sophisticated products to major U.K. clients. Meanwhile, as interest rates fell, MGL exploded, driven particularly by its swaps and options business.

The bodies really began to fly around, and reporting lines blurred. Barrett returned to New York in 1984, Berliner in 1985. In 1986 Band switched jobs with Mayer, who wanted to return to New York. Band had succeeded Mendoza as the head of funding services, a sort of umbrella group that included IFM and other "specialty" advisory services, such as private placements, tax counseling and swaps. After a year of running MGL, Band decamped for BZW, reportedly after pushing hard — and failing — to induce Morgan to make a Big Bang acquisition in London. Gubert, who had been running the IFM part of funding services since 1982, replaced Band at MGL. Vinton also left that year, to take the No. 2 spot at Sir Evelyn de Rothschild's N.M. Rothschild & Sons (he's now the chairman of Electra Fleming, a U.K. investment firm).

"What constitutes the indispensable, elemental core of the Morgan culture?"

Meanwhile, Preston had asked Mendoza to build a global mergers and acquisitions business, another piece of the investment banking puzzle. After a short time at funding services, Mayer joined Mendoza in M&A.

If this merry-go-round seems confusing from the outside, it was chaotic and anxiety-provoking from within. Everyone appeared to be doing something new. "With all those changes, the one permanent fixture in London was Sandy," says de Oliveira. "He was the center of stability." He was part cheerleader, part mentor, part client man par excellence. He spent much of his time out of his office, either visiting clients or chatting up the troops. His late-afternoon strolls around Morgan's Angel Court quarters — from 3:00 to 4:00 — became famous. "He was immensely approachable," says MacHale, who worked under Warner in London banking before bouncing to IFM in 1984, then back to the U.K. in 1986 to run Eurobond underwriting. "He was a good listener. And he would often tell you things that other senior managers wouldn't share at your level." Warner worked hard to articulate what was to be done, where the place was going, what was expected of people. Although he was technically under Vinton and Band, Warner dominated the branch, London veterans say. For the last eight months of his tenure, he held the title of general manager, though he downplays the promotion. With the emphasis on building functional specializations, power was fragmenting. "I was really general manager for about eight minutes," he quips.

Arguably, the most important thing Warner did was keep London from splitting into antagonistic camps. Preston and Weatherstone were acutely aware of that danger — and of Warner's success at avoiding it. "It wasn't easy," says Weatherstone. "What you wanted was a little conflict, but not warfare. It's like the relationship between sales and trading; if you don't have a little friction, it's not working." Warner talked up the idea of one firm and labored to make the tension and ambiguity work for him, to find that magic balance point.

In late 1986 Preston and Weatherstone decided they needed Warner in New York. The preparatory stages were complete; now the real transformation would begin.

New York, August 1987

"Lew [Preston] could be rough on people he thought were unprepared or wasting his time. But he could also be kind, smart and witty, particularly in small groups. He listened very carefully. He played a close game, and he was very patient. Dennis [Weatherstone], on the other hand, was very nice, very kind, particularly in personal relationships. He was a little more open than Lew. But don't think that Weatherstone couldn't make decisions very coldly. He's a trader. It is a misreading of him to say he's just a nice guy. He knew where he wanted to go, and he got there.

"Much of the rap that Warner was tough stems from the late 1980s, when he reorganized corporate finance in the U.S. People saw Warner. He was in the middle of it. They didn't see Weatherstone as much. But he was there. And he would make the tough decisions."

— Recently retired Morgan vice chairman
Rodney Wagner

Warner returned to New York in mid-1987 to take over what the bank now called North and South American corporate finance — consisting essentially of the traditional relationship bankers. His timing was good. Just as he was leaving London, the Japanese invaded the Eurobond market, spawning losses at MGL. In New York Warner reported to Robert Engel, a longtime colleague of Preston's who, besides setting up the management information and profit analysis group, had served as London chief, CFO and, during much of Warner's London tenure, head of treasury. Insiders say that though Engel and Warner worked closely together, Warner, with the enormous U.S. banking group under his leadership and his achievements in London to build on, clearly drove the process. In early 1988 Warner was named head of global corporate finance; Engel, then 56, took a strategic-planning staff job before retiring in 1991 (he died in 1993).

It was, as Weatherstone admits with an impish smile, "an impossible job I asked Sandy to do." London was smaller, looser, and the bankers there were closer to the markets. The U.S. banking group had long been the cultural motherland of Morgan Guaranty, the repository of the fabled Morgan corporate relationships, the revenue engine. From 1988 to 1995 Morgan would shudder through one and sometimes two reorganizations a year, as it struggled to create an organizational matrix that effectively balanced functional specializations, clients and regions.

It was a complex process. In effect, Morgan diffused IFM and funding services throughout the bank. Every banker would now be an investment banker. Moreover, these bankers would have to deal with more than just loans and cash management services. They would have to be the contact on securities — mostly, in 1987, still out of London, though the buildup of the

U.S. securities effort was under way — as well as on derivatives and M&A. They would have to master the broad corporate finance picture.

On September 22, 1988, Warner sent a memo to the corporate finance group describing the revolution he was initiating. Several points are significant. First, he opened with the mantra that the mission was "to understand each client's business, management objectives and financial needs." The competition, he pointedly wrote, was Goldman Sachs and Morgan Stanley; he did not mention Citicorp or BankAmerica. And, he argued, "we must leverage our resources to achieve greater profitability."

He then announced a reallocation of resources "to create a more concentrated group of client specialists at the center of an expanded, flexible, integrated network of product specialists." He mandated the creation of 14 client teams, each headed by a senior banker. Both client teams and senior bankers would have responsibility for their traditional relationships, though they would sell far more than credit alone. Indeed, given that credit was such a large, important and complex product, a special credit group was set up independent of the client teams, a credit services group.

"Warner concedes the difficulties of reconciling transactions with relationships."

This was just the beginning. To make these traditional bankers into investment bankers, compensation had to be rethought. Morgan needed to become more competitive with Street firms and to provide incentives in the form of stock. As the pace of change accelerated, Morgan relaxed its pension plan to allow earlier retirement (at age 50, with 20 years of service). To protect against conflicts in an increasingly broad product line, a commitments office was started up under Peter Smith. The catalyst: the storm that blew up when Mendoza's M&A group advised Hoffmann–La Roche in its 1988 hostile bid for Sterling Drug. Both companies claimed to be Morgan clients. And to ease the transition into investment banking, the bank offered basic courses in everything from capital markets to valuation to organizational management, the latter run by an Egyptian-born pyschologist named Moneim El-Meligi.

It was a high-stress time. Preston was wrestling with LDC debt and various bank crises, and Morgan was shaken by the Anthony Gebauer embezzlement scandal. Meanwhile, bankers who had successfully practiced their craft for years struggled to adjust. Some bankers simply could not handle the demands of the new products. Others found that, at 50 years of age, they simply didn't want to take on the increasingly travel-heavy demands required to compete with peripatetic 30-year-old Goldman bankers. Experienced bankers began to take early retirement in waves. Into their places swept younger replacements more attuned to technology, to the raft of new products, to the heightened rigors of the job.

There was bitterness, but it was muted by traditional Morgan rectitude and steadfastness. "People saw that the process was rational," says one now-retired banker. "It was obvious that some were ill-prepared and ill-equipped. You had the yuppies pushing up from below. It was hard." Warner, he says, was "essentially pretty sensitive but very realistic. It was defined in the compensation plan. You have to know your skills and not hide behind the unpleasantness. The process wasn't without logic and full disclosure. You have to go through the logic, or you're just putting your head in the sand."

By the late 1980s, with the securities buildup going at full steam in the U.S., Morgan (and the securities analysts following the firm) became concerned by the growth in overhead and head count. The bank hired McKinsey & Co. to recommend cuts. In late 1989 Morgan launched a broad-based cost reduction effort, trying to shrink head count through attrition and push for productivity gains. At one meeting for all managing directors held in the atrium of 60 Wall, McKinsey, led by banking consultant Lowell Bryan, presented its findings. Morgan, said the consultants, had overlaid the flat, high-compensation investment banking structure on top of the traditional pyramid of the commercial bank. As a result, the balance between managing directors and associates was out of whack. There were either too many managing directors in relation to associates or too few associates per managing director.

The squeeze came over the next few years. The bank ramped up recruiting while making it more difficult to attain managing director status. In a meeting with managers around this time, Warner articulated the new realities. The bar had risen, he said. With bankers now expected to deal with CEOs — not just CFOs and treasurers — about a broad range of products, merely solid performance wouldn't be good enough. No one was talking layoffs, but compensation and promotion would reflect the new competitiveness.

Warner admits that the transition was difficult, but he is hardly apologetic about implementing it. "You're seeing now the people who run the place," says Warner. "Every one of these people grew up in the new J.P. Morgan with the new capabilities. Some of them learned the hard way. We've had some tough times together. As we complete this transformation, it's critical that people with these skill sets lead the place. It's not that we've gotten rid of an older generation. It's that they didn't participate to the same degree in the development of the businesses."

Still, Warner concedes the difficulties of reconciling transactions with relationships. After all, Morgan purports to be different — to offer employees a career, not just an opportunity to grow rich; a chance to serve, not just to feed off, clients. "It's not just a young man's game," he insists. "The client part of this equation values continuity. And we're trying to give those clients that continuity. You can't do it without skills. But as people with skills and experience grow in this place, I hope we'll keep them engaged in the client part of the business until they don't want to work anymore."

In November 1989 Preston, taking the final reserves on the LDC debt, announced he was retiring. Weatherstone was named to succeed him; Warner, a relative unknown outside Morgan (particularly compared with the flamboyant Mendoza) became president. Weatherstone and Warner worked easily together. But it was a difficult year for the new Morgan president.

Several years earlier Warner's second daughter had been born with a heart defect. In 1990, while he was wrestling with cost, compensation and reorganization issues, Warner and his wife were struggling to save the child. That June she died.

It was also in 1990 that the new generation began to assume real power. Mayer replaced Warner as head of corporate finance. Gubert was running the London office, Hancock was overseeing global swaps, Ketchum was heading up Morgan's Euroclear operation. Woicke presided over J.P. Morgan Securities, the U.S. Section 20 subsidiary, and MacHale was in charge of U.S. capital markets. (In June 1989 the Federal Reserve had, momentously, given Morgan permission to underwrite debt.) And de Oliveira was named head of JPMS's equity underwriting and trading business when the Fed gave the go-ahead for that business in September 1990.

"I was flying back from Tokyo when I heard the news: Preston's retiring and Sandy's becoming president," recalls de Oliveira. "It hit me: Whoa, that's a change. One of ours is becoming president."

"Morgan now has information systems to break down every business along three axes: by function, region and client."

New York, January 26, 1996

At the Millenium Broadway Hotel conference center on West 44th Street in Manhattan, Warner stands before some 420 managing directors — the largest such gathering in Morgan history — at least a third of whom have flown in from overseas. The House Arrest group met two days ago, but for this more inclusive gathering, Warner reviews the results of the past year and then launches into his New Paradigm motivational speech.

Warner is on — and he delivers a performance that takes some of his senior managers by surprise. "It's tremendous how this guy has grown," says Woicke, about to jet off to India before returning home to Singapore. "He's developed charisma." Gubert, who's rushing around to meetings before he, too, leaves that night (for London), expresses similar sentiments: "He seems like he's really enjoying it." Indeed, even his friends comment on how Warner seems to thrive at the top. When Warner was younger, says Banc One's McCoy, he would arrive at Wequetonsing so wound up that McCoy would kid him that no one wanted him in a foursome. "Now he seems a lot more relaxed, more comfortable," McCoy says.

It doesn't hurt that Warner has good news to report. For much of last year, Morgan was still having to cope with the fallout from the Fed-rate-hike-induced fixed-income disaster of 1994 — not to mention the Mexican meltdown and the collapse of Banco Nacional de Credito, the Spanish bank that Mendoza had invested in for the firm's Corsair Fund. Trading profits and underwriting revenues had slipped in 1994, though the firm was bailed out by taking profits on proprietary investments and — irony of ironies — by a strong credit environment.

In 1994 Morgan had earned a modest, for it, $1.2 billion, or $6.02 a share, down from $1.7 billion, or $7.80 a share, the year before. But now things were picking up nicely, Warner told the assembled managing directors. Net income in the fourth quarter of '95 was up some 62 percent over the year-earlier period — and full-year profits had advanced 7 percent over 1994's, to $1.3 billion, or $6.42 a share. Trading, corporate finance and investment management all showed strong gains, with momentum picking up as the year progressed.

Even better, Warner's cost control program seemed to be having an impact. True, operating expenses were running 8 percent over those of 1994, but one quarter of that was accounted for by a weakening dollar, and the expenses included $55 million for severance. At year-end 1995 Morgan employed 15,613 people; 12 months earlier the head count had been 17,055. Like earnings, cost reduction accelerated as the year progressed.

Warner's first year had been a trial by fire. The cost reduction program had put to an end the notion that Mother Morgan would not lay people off. Moreover, Warner had sold off the custody and processing businesses, with their commodity pricing and sky-high development costs; reorganized global research; and shrunk the firm's mortgage unit after big trading losses. In addition, discussions had begun about a major technology outsourcing deal — another break with traditional Morgan practice. Perhaps most trying, however, had been the introduction and implementation of the new management structure, which shook up reporting lines in the senior ranks and, in some cases, reshuffled senior executives.

Warner and Weatherstone had been discussing plans to strip out a layer of senior management and reorganize the so-called corporate office for some time. The purpose: to adjust to increasingly specialized, fast-changing businesses. This was the "radical" idea Warner had proposed to Preston. Instead of a corporate office that directly supervised business along hierarchical lines, Warner interposed himself as the direct report of some 11 business heads, including co-heads of proprietary trading Conde and Michael Corey, asset management chief Keith Schappert and private banking head John Olds. Most strikingly, he named no president, though he surrounded himself with a buzzing cloud of senior bankers — Mendoza, Viermetz and the recently retired Wagner — and advisers: CFO Mayer, chief counsel Edward Kelly (who recently became co-head of the financial institutions investment banking group), Stephen Thieke and Smith on risk; Nicholas Potter on strategic planning; and former chief counsel Michael Patterson (son of the former chairman), who serves as the chief administrative officer and, by all accounts, Warner's No. 1 consigliere. Instead of being given fiefdoms to rule, the members of this group preside over more ambiguous "spheres of interest."

No traditional organizational chart can begin to capture this system. It's like going from 19th-century physics, with its lines of force, to 20th-century quantum mechanics, with its fields. To add to the ambiguity, this high-level matrix is overlaid on a global matrix that has been evolving since Warner's early London days. "Ten years ago in, say, Italy, you'd add up all the locally booked businesses — all the forex, all the loans — and you'd say,

'We have *this much business, and this is what it costs to run* these businesses, so here's the profit,' " explains Warner. As globalization sped up in the late 1980s, Italy still had a general manager who was responsible for all Morgan business in that country, although the local reporting lines were extensions of the global functions. "Now," says Warner, "we have a head guy in Italy who's responsible for doing anything we do with an Italian client anywhere in the world. *Within that office, functions remain* global, but he's judged on how much business his clients do."

In discussing the new system, Warner leans forward and gestures animatedly. "The management challenge is to marry global products — say, equities — with the desire to serve clients well throughout the world." The demand on the relationship manager — in Italy or *in the* U.S. — is to be able to deal intelligently with clients on the one hand and on the other, to be nimble enough to deliver Morgan capabilities anywhere in the world. "From 1985 to 1993 or so, we were building Morgan product capabilities," he concludes. "Now we're rebalancing, reorienting along a client dimension."

"Warner can't be constantly settling disputes; he can't micromanage."

Although he doesn't call it that, Warner has embraced that ubiquitous management notion of the 1990s, the web — the ultimate matrix. A precondition for such a network is global, real-time information systems that provide the communication necessary to operate locally with a global reach — and the control, particularly in terms of risk management, that makes a flatter organization possible. Nearly everyone at Morgan, from Warner on down, now uses e-mail. And Hancock mentions how internal webs have begun spontaneously appearing in places like the fixed-income trading floor. What's more, says Warner, Morgan now has the information and accounting systems to break down every business along three axes: by function, region and client. (Ironically for Morgan, the investment *bank, the system is the result of efforts in the early '80s to es*tablish the profitability of commercial banking products.)

All this communications paraphernalia comes at a cost, of course. Morgan has traditionally been a big technology spender, last year shelling out about $1 billion. And the firm has struggled with all the usual problems of incompatibility, of gold-plated systems and sheer waste. Thus it's no surprise that *the January House Arrest focused on the subject (probably re*lated to the outsourcing deal). Yet as one high-level Morgan competitor concedes, if the firm really can drill down to the client or the regional level for accurate data, it would gain a significant competitive advantage. Merrill Lynch & Co. analyst Judah Kraushaar argues that even more significant is what that technology suggests — "that Morgan is now shifting from a product focus to a profitability focus."

However, all the computers in the world won't make maneuvering within this organizational web simple. The dilemmas are particularly apparent for the three regional heads Warner named in March — Woicke, Gubert and Ketchum. "I had two choices when I got the job," says the Italian-born Gubert. "I could have pounded the table and demanded authority or tried to make my way in quietly. Sandy gave me the authority, but it will only work when [the individual *business lines] believe it." Gubert says he has tried to be a fa*cilitator, dealing with people, promotions, compensation, cross-selling and, of course, clients in Europe, the Middle East and Africa. "Is there tension?" he asks. "Sure, it's a constant give and take. But if we waste time worrying about who's senior, we're in trouble."

Woicke agrees, but he argues that traditionally underinvested *Asia requires* a slightly different rebalancing than Europe or the U.S. — a "defunctionalization." But the spirit is the same. "You can be very entrepreneurial here as long as you have people's trust and confidence," he says. "If you don't, nothing will happen."

Indeed, it is a weakness of such a system that outsiders (whom Morgan has never pursued in large numbers) might find it completely baffling to work at the firm. To negotiate through the complexities and ambiguities of such a matrix — to fully release its creativity — might require an almost familial understanding born of years of service. Would someone like investment banking star Joseph Perella, formerly of First Boston Corp. and Wasserstein, Perella & Co., fit in as well at J.P. Morgan as he has at Morgan Stanley?

Many of these questions quickly come down to what one senior manager refers to as the "touchy-feely issues" — the culture, the incentives, the leadership, the morale. For a "flat" organization to work, and for Warner to survive at its center without being run ragged, more decisions, more conflicts have to be resolved horizontally, not vertically. He can't be constantly settling disputes; he can't micromanage. His business heads have to be mature, apolitical, team-oriented, *Morganesque*. And they have to pass those traits down the line. They don't have to like one another — some don't — but they do have to deal with each other professionally as colleagues. They can't be consumed by politics.

The House Arrest is thus a high-level testing ground — a sort of parliament — for Warner's constitutional monarchy. "People in the organization want to know there's a cohesive group at the top," says Gubert. Early House Arrest meetings, according to several business heads, were stilted, uncomfortable, with everyone representing, as one said, "their own business, the most important business at the bank." *Warner, however, has continued to proselytize for the con*cept, and the meetings have loosened up. Now business heads are cautiously optimistic about making it work. "Reactions are sometimes predictable," says Woicke, "but if everyone has good arguments and brings them to the table, we're okay." More important, he says, "I don't think we're avoiding problems now."

Ultimate responsibility, of course, comes back to Warner. It is the kind of balancing act he's long worked to master. He is both giving up power and shouldering responsibility. He can act autocratically, but at the risk of undermining the decentralizing impulse that makes his scheme work. Only by winning his troops over by his own actions can he earn what Preston and Weatherstone — men of a different generation — expected automatically: allegiance. It is a complicated and difficult world, but it is one Warner has been preparing for his whole career. ■

Secrets of the style switchers

They swear rotating between growth and value guarantees outperformance. Yeah, say skeptics, if only you can define styles and get the timing right.

By Miriam Bensman

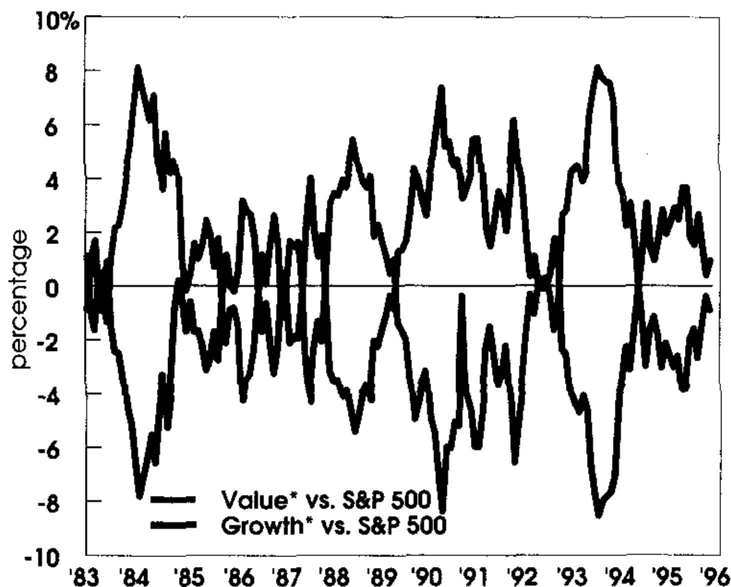
The Florida State Board of Administration prides itself on its rigor in analyzing investment style. "Everything we do is style management: It's our mission in life," declares Lan Janecek, equity chief for the state's $50 billion in pension plans. For the past eight years, Florida has labored to define the styles of its many managers to maintain a static mix of large- and small-cap, growth and value stocks in its domestic equity portfolio.

Last summer, however, Florida made a tentative move in the opposite direction: The fund set up a $250 million portfolio that will try to profit from the *cycles* in style returns. Janecek's approach differs radically from recent efforts by many of his peers to eliminate style risk from their portfolios (*Institutional Investor*, February 1996). At less than 1 percent of Florida's $28 billion in domestic equity, the fund's new, in-house style-tilting portfolio is just a test. "But if we find value in tilting and we are good at it," Janecek says, "we could take the $6 billion in our internal passive portfolios and overlay a tilt on it."

Proponents hail the strategy as far beyond managers' traditional reliance on scarce stock-specific risk. Declares Robert Arnott, president of Pasadena, California, style manager First Quadrant Corp., "We've moved from a world in which style was used to categorize managers to a world in which style is viewed as an appropriate tool for active management."

Out of sync

When growth stocks outperform, value underperforms — and vice versa — in cycles that can last for years.



* Standard & Poor's 500/Barra value and growth indexes: 12-month rolling returns relative to the S&P 500.
Source: Goldman, Sachs & Co.

Indeed, active equity style management — also known as style tilting, style rotation and style switching — has become one of the hottest new areas in equity management. More and more managers are hunting for signals to tell them when to switch in and out of growth, value, large- and small-cap stocks for maximum gains. All told, up to $15 billion in equities may now be invested in such strategies, suggests a quick count of style managers, and these managers boast that their superior returns will pull in far more.

That remains to be seen. The current enthusiasm notwithstanding, style managers have yet to prove their predictive abilities. And critics claim that style bets are at best a risky reliance on statistical patterns, at worst a dangerous form of market timing.

Harbor Capital Management in Boston lays claim to having started the first style management fund, in 1979. "We operated on the theory that growth stocks do well over time and value stocks do well over time, but not necessarily at the *same* time," explains managing di-

rector Lawrence Marks. Harbor's returns average 1.3 percentage points more than the Standard & Poor's 500 index for the past 15 years (despite 6 percent underperformance last year when it tripped up on technology stocks).

About a decade after First Quadrant, Jacobs Levy Equity Management and Trend Capital Management followed Harbor into style management. A host of other managers have since joined the ensuing rush. Among their clients: Florida, GTE Corp., Ameritech Corp., Georgia-Pacific Corp., Thiokol Corp., Nynex Corp., IBM Corp. and the Carnegie Institute. Several other pension funds, including GTE Service Corp., manage style-tilting strategies in-house.

It's not hard to see why style management appeals to these investors: It looks like easy money. Wilshire Asset Management, for example, shows potential clients what startling results they could achieve by applying a simple rule to Wilshire's growth and value indexes: Stick with whichever style is in favor until it's been out of favor for two quarters and then switch entirely to the other. "This would miss the first six months after a turn and still capture 300 to 400 basis points above the Wilshire 750," says David Borger, director of equity products. "That tells you how much return could be gained by picking it up earlier."

Awareness of style — identifiable segments of the market with distinguishable patterns of returns — has been growing for some time. Studies in the 1970s demonstrating the long-term outperformance of value stocks (mainly utilities, oil, some retailers, financials, auto-related and steel stocks) persuaded many institutions to overweight them. Unfortunately, a ten-year boom for growth stocks (pharmaceuticals, food, high-tech and some retailers) began shortly thereafter — to the dismay of those investors (and the value managers they fired).

Managers began wailing that it wasn't fair to can them for underperforming simply because their style was out of favor; as a result, pigeonholing managers by style became consulting firms' bread and butter. Led by Nobel Prize-winning economist William Sharpe (then working with Frank Russell Co.), consulting firms concluded that, yes, style does drive returns. Plan sponsors began routinely categorizing managers by style and judging them against style-specific benchmarks or peer groups.

But some savvy managers started to reason that if style drives returns, why not bet on style? Why be stuck with a value or growth label when you could reap the benefits of both? Most cite a 1992 study by Sharpe showing that just as asset allocation drives broad portfolio returns, style drives equity returns. Up to 90 percent of the average equity manager's returns, and considerably more than 95 percent of the returns in most multimanager funds, are driven by style, Sharpe found.

"This is a macro issue the consulting community needs to grapple with," says Thomas Schwab, executive director at First Madison Advisors, who, with his partner Bruce Westervelt, launched an active equity style management program in 1993. "Everyone's shooting for the 2 percent of the pie that comes from stock-specific risk. I'd rather shoot for the 98 percent."

Certainly, the returns attributable to style are appealing (see chart). First Madison, in a study published last year, showed that in the 15 years from

1980 through 1994, perfectly timed shifts between passive baskets of large-growth, large-value, small-growth and small-value stocks would have delivered average annual returns of 29.67 percent — more than twice the 13.98 percent average gain of the Wilshire 5000 equity index.

Of course, no manager can time tilts as perfectly as a 20-20 hindsight study. In addition, transaction costs are significant, and most active managers don't shift from all growth to all value (Twin Capital Management and Trend Capital are among the exceptions). Still, active style managers have so far turned in impressive results. First Quadrant has added 3 percent on average to the S&P 500 (with a 4 percent tracking error) in its long core strategy since June 1990. Jacobs Levy's core strategy has outperformed the S&P 500 by 3.3 percent on average since June 1991; its insight-weighted strategy did still better. Trend's Large Cap Fund has outperformed the S&P by 2.15 percent since 1990.

Style managers achieve these returns in different ways. Harbor implements trades in stocks; Trend trades style index funds. So, for large accounts, does Stratford Advisory Group; it trades no-load mutual funds for accounts with less than $50 million. First Quadrant and PanAgora Asset Management have both been trying out the new, S&P/Barra growth and value futures to ease implementation and lower transaction costs.

First Quadrant, PanAgora, Jacobs Levy and Harbor all juice up their style bets with individual stock picks. Columbine Capital Services breaks up mid-cap value and growth stocks into groups that react differently to given conditions. Managers also vary a lot in how often they trade and how stringent their risk controls are.

Spotting signals

Despite their different approaches, for all these managers the keys to the kingdom are the signals that tell them when to switch styles. It's no good knowing that style should be rotated, without reliable forecasts to bet on. So for the past decade quantitative managers have been combing the data for robust indicators. The signals they've lit upon are familiar; most have long been used by so-called stock pickers (often themselves unconscious style rotators):

• **Seasonal indicators.** Perhaps best known is the January effect: Value stocks tend to outperform in January (as do small-cap stocks). "It's a housekeeping issue," notes PanAgora research head Peter Rathjens. To dress up their year-end list of holdings before they are audited, mutual funds buy winners and sell losers in December. In January they buy back the losers in hope of a rebound. All that buying and selling, of course, creates a nice blip, and style rotators buy value stocks in late December to catch it.

Value stocks tend to beat growth in the first quarter; growth beats value in the fourth. Neither has the edge in the middle quarters. Investors willing to stand high turnover could buy the value index at year-end, return to neutral on March 31 and on September 30 shift to a maximum growth position. The purely seasonal strategy works only two years in three, cautions Geoffrey Gerber, president of Pittsburgh's Twin Capital, which has been running a style-tilting strategy using this and other signals since 1991. Last year growth stocks did better than value in the first quarter, and value beat growth in the fourth.

• **Technical indicators.** One simple strategy assumes that stock prices will revert to their mean: If large-cap growth stocks usually sell at 1.3 times the price of large-cap value but are now selling at 1.1 times, growth must be cheap, says First Madison's Schwab. PanAgora makes this mean-reversion play after a market overreaction: "If the universe of growth stocks has great profits in February, you want to underweight those stocks in March" when the euphoria dissipates, Rathjens says. Price series is another technical indicator.

• **Fundamental and economic indicators.** Key among these are interest rates: Rising rates hammer growth stocks far harder than they hit value stocks. "Think of it as a present-value problem," says Eric Sorensen, managing director and head of quantitative equity research at Salomon Brothers. A growth stock is a long-duration asset that investors buy for growth in earnings; a value stock is a shorter-duration asset they buy for cyclical gains or dividend yield. And when interest rates rise, long-duration assets suffer more than shorter-

Beyond growth and value

Critics have started to attack not just the way stocks are classified (story) but the whole premise that every stock must be labeled either growth or value. "When you divide the world in half, you end up with many stocks that are neither growth nor value in each index," says Ivan Stux, a principal in equity analytical research at Morgan Stanley & Co., who advises pension funds and money managers and provides style signals. "It's better to list the characteristics of each and throw out the middle."

That's precisely what Wilshire Asset Management does. "We think lots of stocks are neither growth nor value, so we classify as much as half the large-cap universe — and more than half of the small — as neither," says David Borger, Wilshire's director of equity products. "When you buy a growth-index product from us, it has clear-cut growth stocks in it, not just stocks that are a bit more growth than value. That's important if you're making a big bet that growth will outperform."

Salomon Brothers goes still further: Its large-cap growth and large-cap value indexes leave out so many betwixt-and-between stocks that only 50 are left in each index. The result, predictably, is returns that differ widely between the two. In 1995 the Standard & Poor's 500/Barra growth index returned just 113 basis points more than its value index; Salomon's beat its value counterpart by 516 basis points. "Ours is a more extreme bet," says Salomon managing director Eric Sorensen. "It's a gauge of what's working and will likely work, not an index product we market."

Frank Russell Co., too, is moving away from the bi-

furcated approach it previously advocated. "The problem is that huge stocks like IBM, Exxon and Kodak keep moving across the break point [between growth and value] because they are close to the median," explains John Christopherson, senior research analyst at Russell. And when such stocks shifted across the divide, their huge capitalization weighting pushed many other stocks across the break point, too. The result: significant turnover in index composition that created huge transaction costs for those running index baskets.

Yet the old method is also intellectually unsatisfying, Christopherson notes: It just doesn't sit right to say that IBM Corp. is 100 percent growth, like Motorola, one year or 100 percent value, like Exxon Corp., another.

Russell's new methodology — already used in several indexes, such as those for Canada, Japan and U.S. small-cap value and growth — computes the first- and third-quartile break points as well as the second. Stocks below the first-quartile break point are judged 100 percent value; those above the third-quartile break point are judged 100 percent growth. Stocks at the median get a 50 percent weighting in both indexes. Other stocks get a weighting that depends on their distance from the median toward the first- and third-quartile break points. "You get two different tilt fund indexes that overlap," Christopherson explains. "This mimics what managers do." That will likely make the indexes more useful as benchmarks for active managers or for new, passive funds.

For active style managers that control how much they tilt their funds toward value or growth, the new Russell indexes will likely be of less use because they don't provide a pure enough representation of either style. They'll also be less useful as a basis for futures contracts than the simple method behind the new S&P 500/Barra growth and value futures. (Barra simply labels stocks on the basis of the book-value-to-price ratio.)

That's because the S&P 500/Barra growth and value indexes offer a key advantage: Their lists of stocks and capitalization weighting add up to the S&P 500. Thus traders can use the existing S&P 500 futures hedging infrastructure to manage the risk of the new futures, notes Michael Kelly, a vice president of equity derivatives research at J.P. Morgan Securities. So traders should be able to provide liquidity to the market at a low price as soon as demand picks up.

That's no small consideration for style managers. The excess returns picked up through style rotation are irrelevant if transaction and market-impact costs gobble up the gains. Since liquid futures remain the cheapest way to execute big trades, they'll likely be the key to growth in style rotation strategies.

duration ones.

Likewise a steeply positive yield curve bodes ill for growth stocks; their earnings are discounted by long-term rates, whereas value stocks' earnings are discounted by short-term rates. On the other hand, "if the curve is relatively flat, as it was early this year, it's an indicator to buy growth stocks," says Warren Johnson, president of Johnson Portfolio Group in Boston, a research firm that has been selling style-tilting signals since 1993. (Last year the firm began a money management joint venture with Marshall Plan, L.P.) "An inverting curve *really* favors growth stocks," Johnson adds.

Other business cycle indicators: "When profit expectations and consumer confidence are falling, we move to growth," says Harbor's Marks. Both Brinson Partners and PanAgora measure corporate stress by the default premium on bonds. "If you're worried about defaults, you want shorter-duration stocks — value stocks," says PanAgora's Rathjens.

The change and rate of change in the dividend yield differential between growth and value and the flow of funds are also used as switching signals. If money is pouring into growth funds, it's probably time to sell growth, says David Kudish, president of Stratford Advisory Group. Last, style managers use the old rules of thumb: When stocks are cheap relative to bonds, growth stocks tend to do well; when stocks get beaten down, growth stocks get hit hardest. Style managers betting on capitalization rely on similar measures. Paul Samuelson, chief investment officer at PanAgora, notes that large value stocks pick up earlier than mid-cap value in a business expansion. A ballooning risk premium for small stocks also warns managers to shift into large caps, Twin Capital's Gerber notes. And large companies benefit from a falling dollar, adds First Madison's Schwab: Many are exporters or multinationals with non-U.S. operations.

All this sounds pretty logical. But Ivan Stux, a principal in equity analytical research at Morgan Stanley & Co., who provides style signals to institutions, warns that cap-size-tilting can be treacherous. In his opinion the growth-value play is safer to forecast, because it is more likely to be driven by economic fundamentals. "But what drives large and small cap? The technol-

ogy cycle? Periods of high rates of innovation?" Stux asks. "We have clients who want information on large versus small, but the signals are less reliable."

If such signals are wrong, they'll inflict far more pain on a manager than a wrong growth-value bet, Stux cautions; the large-cap, small-cap cycle is generally longer, and differences in performance can be more extreme. And investors can run into liquidity problems. Consider a pension fund with $3 billion in equities: 70 percent in large-cap, 20 percent in mid-cap and 10 percent in small-cap stocks. Moving 10 percent from large to small cap shrinks the large-cap portfolio by only about 15 percent but doubles small-cap investments. The cost of the shift — in bid-ask spreads and market impact — will eat into returns.

And as with most quantitative techniques, managers must wrestle with the old problem of whether historical data has much predictive power. Value stocks raced ahead in the 1980s, thanks to an unprecedented plunge in interest rates. Rates are now so low, compared with the past 20 years, that any analysis based on data from this period may well be suspect, Stux notes.

"Sometimes style signals play nasty tricks on would-be style tilters."

Sometimes style signals play nasty tricks on would-be style tilters. Large-cap, small-cap cycles are long and very volatile, for example. "When it goes wrong it's hard to know if the strategy isn't working or it's just interim volatility," says Stux. In 1988, for instance, small caps lagged in an otherwise straight run of outperformance from 1984 to 1990. Managers that got out lost the last two years' gains. "This can be nerve-racking — and requires real confidence in the strategy," Stux points out.

Sound familiar? That's the same warning managers give their tactical-asset-allocation clients. "Any contrarian strategy has the potential for being uncomfortable," says First Quadrant's Arnott. "TAA and style management fall in that camp. They are best suited to organizations with patience." Inevitably, active tilters will sometimes be too early; at other times they may give their clients a rough ride through a temporary reversal. However, Arnott notes, this is less of an issue for style management than for TAA because a growth-value tilt (if well managed) has a higher correlation to the S&P 500.

As more and more managers embrace style rotation, skeptics focus their criticism on the basis of the style definitions used by managers and consulting firms (see box). "What's growth? What's value?" Salomon's Sorensen asks. "A financial dictionary might define a growth company as one with investment opportunities or rates of return on investment that exceed their cost of capital." Value, by contrast, simply means that a company is cheaper than it ought to be. Measures differ according to who's labeling the stock. That, of course, makes a crucial difference to an investor placing a big bet on growth or value.

Barra, for example, lists 13 different components of growth in its models. But when Barra splits the S&P 500 into growth and value, it relies on the book-value-to-price ratio as the single measure of value; growth stocks, by default, are simply those with below-average value. Salomon Brothers, by contrast, looks at book-to-price, past and forecast earnings growth, whether a stock pays dividends — and whether it trades like other growth or value stocks. Acadian Asset Management looks at earnings yield and normalized (that is, adjusted for the business cycle) earnings yield, as well as book-to-price value.

As for Jacobs Levy, "We seek more refined equity characteristics than the terms usually suggest," says principal Bruce Jacobs. "There are many more pervasive forces in the market than growth or value, large or small." His firm looks at multiple factors — value, industry, stock-price momentum and reverse momentum — in a proprietary system it calls "high-definition style." Others pooh-pooh this approach; Jacobs Levy, they say, is simply placing multifactor bets, as it had done for years before relabeling the strategy "style analysis" to join the current vogue. (That may be true, but style is, after all, a simplified form of factor analysis.)

Clearly, style management is more than just the latest investment fad. But managers still need to do more research on what moves individual stocks and market segments. To get cleaner, more robust switching signals, Morgan Stanley's Stux advises money managers and pension funds to pay closer attention to individual industry sectors. "You could tell me that small-cap stocks were undervalued last fall, but what about the tech stocks?" he asks. Stux advises large institutions first to define what they mean by style and then to build a benchmark and a strategy based on that definition.

That's just what GTE Service does, using its own models and signals from Jacobs Levy. GTE concluded that no single stock among more than 1,000 in its $7 billion domestic equity portfolio would have much impact on portfolio returns, explains Britt Harris, vice president for pension fund management. "So we developed key driver portfolios and developed valuation models for them, the same way that people typically do for individual stocks," Harris says.

GTE ended up with portfolios of anywhere from 50 to 250 stocks that share certain characteristics (valuation, exposure to macroeconomic variables, such as interest rates, and technical measures). Several are industry-based: consumer nondurables, oil, utilities, technology. GTE simply underweights or overweights these portfolios according to the appropriate signals.

Last year, Harris notes, growth and value stocks performed within 1.5 percent of each other. Managers that switched from one to the other would mostly have wasted their time — and their clients' money. Many missed one of the most lucrative style bets of the year: Consumer stocks outperformed cyclicals by almost 20 percent. Harris's blunt conclusion: "The literature on style management is too simplified."

That will change, thanks to new research and more players. But only when this new discipline has been severely tested by the market will its predictive powers be proved. ■

The trouble with Guillermo Ortiz

The finance chief's part in Mexico's bungled bank privatization may make him a political liability in '97 — even as his policies revive the economy. • **By Michael Tangeman**

Guillermo Ortiz would have been content handling Mexico's ports, railroads and a satellite or two. "Actually, I was very happy at the [Secretariat of State for Transport and Communications]," says Ortiz, the memory of less-stressful times bringing a smile to his face. "To privatize the ports, railroads, deal with infrastructure, advance the modernization of telecommunications — that was a really challenging and interesting job. I wish I had spent more than the 28 days [doing it]."

But by the 28th day of the new administration of President Ernesto Zedillo — December 28, 1994 — Mexico wasn't the country it had been four weeks earlier. The December 20 peso devaluation had sent Mexico into a financial tailspin, forcing the president to sack finance secretary Jaime Serra — whose unprecedented ouster saddled him forever in Mexico with the derisive nickname "El Cete," for having had exactly the same term as Mexico's bellwether 28-day Treasury certificates. Ignoring investors' pleas for the return of former finance secretary Pedro Aspe, Zedillo called on Ortiz, who'd been undersecretary of finance during the administration of president Carlos Salinas, to rescue the country.

Since then Ortiz has masterfully implemented an economic program that — once a $48 billion international bailout saved the country from bankruptcy — has provided the underpinnings for economic recovery. Although that recovery has yet to begin, with GDP having contracted 6.9 percent last year (the country's worst decrease in GDP since 1932), the financial market's developing revival indicates that investors believe it may do so at some point soon. "Ortiz was able to bring Mexico back to borrowing in international markets, he had some creative financing packages during the year, and he showed strength within the Mexican government," says David Malpass, Bear, Stearns & Co.'s director for international economics. "All of that helped Mexico during a very difficult period." In the process, Ortiz's efforts have also helped to stabilize other Latin American markets that were buffeted by the peso devaluation's "tequila effect."

While Ortiz is riding high on his current success, however, his future in government is in question as rumblings about his political past grow louder. Within Mexican political circles and in the press, there is mounting criticism of his role in the 1991–'92 privatization of Mexico's banks, which lies at the root of their continuing crisis (*Institutional Investor*, November 1995). With the approach of next year's midterm congressional elections, scrutiny of that role could make Ortiz a liability for a party struggling to

maintain dominance after six decades in power.

Ortiz was the best candidate for finance minister as much for what he was not as for what he was. He was not a threat to Zedillo in the way that the powerful Aspe might have been. And he was not particularly tainted by the devaluation, having shelved his misgivings and publicly supported former boss Aspe's decision not to devalue, which left that dirty work to Zedillo's first finance minister, Serra.

What Ortiz was, was an experienced economist with a solid understanding of domestic and foreign debt issues. And he was loyal to the reigning system. The son of an army general whose rise through the officer corps began with service in Mexico's 1910–'17 revolution, Ortiz, at 17, joined the ruling Partido Revolucionario Institucional, membership in which has been de rigueur for government officials during the PRI's 67-year iron grip on power. Moreover, Ortiz could be counted on for personal loyalty to Zedillo, his longtime friend from their days working together at the central bank in the early 1980s.

He was also the only undersecretary of finance to have served a full six-year tour of duty under Aspe. Ortiz had been a dissident voice in favor of a peso devaluation as early as 1993, when it probably would not have caused a market backlash. But when Salinas and Aspe overruled Ortiz's devaluation proposal, the undersecretary decided to honor their authority and not make his position public or resign his post. Still, his early advocacy of a devaluation suggests just how capable an economist he is — trained at the National Autonomous University of Mexico and then at Stanford University, where he earned a Ph.D. in 1977 with a thesis called "Capital Accumulation and Economic Growth: A Financial Perspective on Mexico."

During the past three decades, Ortiz has worked, in addition to the Finance Ministry, at the central bank and, in the mid-1980s, as Mexico's representative to the International Monetary Fund. "Upon Guillermo Ortiz's arrival in the post, there was a perceptible sense of relief both abroad and in some Mexican circles that we now had a finance secretary who had some experience in handling financial markets," says Enrique Quintana, an economist and financial columnist for Mexican daily *Reforma*. And the extensive international contacts he'd made at the IMF certainly seemed useful for hammering out the terms of a financial bailout of the magnitude Mexico would require.

As it turned out, Ortiz had little to do with whether or not Mexico would get emergency aid. The country's needs were so desperate at the beginning of 1995 that, because of its strategic importance to the U.S. and to U.S. investors, a rescue was inevitable, says Jeffrey Sachs, director of Harvard University's Institute for International Development. "Even if Pancho Villa had been president of Mexico, they would have been bailed out," echoes Rudiger Dornbusch, a professor of economics at the Massachusetts Institute of Technology and onetime mentor to Aspe. Ortiz did, however, put his contacts to good use, working the halls of the U.S. Treasury and the IMF to secure as much assistance as possible as quickly as possible and under terms that were fairly amenable to Mexico.

Ortiz has successfully implemented the Zedillo administration's financial stabilization policies, including imposing tight reins on the money supply and slashing government spending. The result: a reversal of the current-account deficit of $29 billion in 1994 to a surplus of $200 million as of last September; a reduction of the galloping annual inflation rate from triple digits in April to just under 52 percent by year-end; a curtailing of growth in net domestic credit from 53.2 billion pesos predevaluation ($15.2 billion) to less than N$10 billion ($1.5 billion); a stabilized currency and interest rates; and a stock market rebound, with record highs in nominal terms reached earlier this year, as investors moved back into Mexico. At the same time, Ortiz was instrumental in loosening restrictions on foreign investment in the banking and financial services sectors — a liberalization that went beyond what he as undersecretary had negotiated for the North American Free Trade Agreement. He also led the charge on reform of the pension system, which is expected to swell Mexico's savings pool and fuel the growth of domestic capital markets in coming years.

Since last July Mexico has raised more than $6 billion on foreign markets in a series of strategic offerings that Ortiz himself orchestrated. Attesting to his familiarity with foreign debt instruments was one particularly novel offering last November: $1.5 billion of one-year bonds at optional rates designed to protect investors against exchange risk. Holders could choose to cash in the bonds at the 12-month LIBOR rate, the 28-day cetes rate minus 6 percentage points or the peso-dollar rate of exchange on the date of redemption. More novel offerings could be forthcoming this year.

Ortiz's triumphs have been bittersweet, however. The government's policies have failed, thus far, to restart the

economy. Millions of Mexicans are unemployed or underemployed, factories and businesses are shuttered, and the nation's private banks are drowning in nonperforming loans. Ortiz has found it "somewhat frustrating" that political missteps, such as the bungled arrests of alleged Zapatista rebel leaders and the massacre of 17 unarmed peasants by security forces in Guerrero state, have shaken the markets, undermining his financial engineering efforts. It has also been difficult, he concedes, to restore the confidence of the Mexican people in their own economy. "Expectations were shattered in December [1994], and 1995 was supposed to be a good year," he says. "But the very abrupt change in expectations that took place after the devaluation and the ensuing adjustment had a very big effect on people's confidence." Even so, Ortiz now believes that both confidence and the economy will grow. For 1996 he projects 3 percent growth, led by strong exports, and 20 to 25 percent inflation.

But doubts about the administration's ability to restart the economy run deep in the public mind. What's disturbing to many is that Ortiz and other key Zedillo administration officials — including the president himself — were among the economists under Salinas who wreaked such havoc on the economy. "Their policies failed," charges Ifigenia Martínez, an opposition politician of the center-left Partido de la Revolución Demócratica, who was Ortiz's undergraduate economics professor.

As Martínez sees it, Ortiz and other Salinas-era technocrats returned to Mexico from U.S. universities having learned "inapplicable" economic theories, then "were appointed to undersecretariats for which they had neither adequate training nor the necessary experience." Economist Quintana says that within the private sector, Ortiz is considered by many to be the Zedillo administration's "clearest example of a technocrat, with no contact to the real economy, to the productive sector." After last year's economic debacle, Martínez says, the technocrats "think that they just made some miscalculations, and if they try again, they'll get it right."

Ortiz lightly dismisses the criticism leveled at him by "*mi maestra* Ifigenia." Nevertheless, the disdain of his old professor, and now political opponent, for foreign-trained technocrats is shared by many. And Ortiz's inability to recognize that, says Quintana, reflects a "political insensitivity" for which the finance minister is known.

Ortiz admits to mistakes by the Salinas administration, such as the overencouragement of foreign portfolio investment, which contributed to the current-account deficit and subsequent devaluation. But he sidesteps any personal responsibility. "It is easy to see now with the benefit of hindsight that these [foreign] funds actually had a greater [than expected] degree of volatility," he says. Acute hindsight, however, is of little consolation to owners of businesses that failed as a result of the crisis, many of whom are irked when they hear administration officials like Ortiz fall back on the discredited claim that "at the end of 1993, the Mexican economy was on track" and that 1994's political turmoil is to blame for the current crisis. Private-sector leaders beg to differ, clearly recalling their mid-1993 warnings to Salinas technocrats about structural problems in the economy. "We told them that there were red warning lights that needed to be dealt with," says Hector Larios, president of the powerful Business Coordinating Council. "But they paid no heed."

The finance minister's efforts to rebuild confidence in the economy could be hobbled by political concerns as the 1997 elections loom. In most Mexicans' minds, the links between the discredited policies of Salinas and those of President Zedillo are strong. Moreover, Ortiz is held suspect because of his longstanding friendship with Salinas' former top aide, Joseph Marie Córdoba, who is the target of press allegations of involvement with drug traffickers and in the assassination of former presidential candidate Luis Donaldo Colosio. Particularly troublesome for the finance minister, though, could be growing questions about his role in the privatization of the banking system.

Ortiz was responsible for the technical and operational side of the privatization process, and detractors say that on orders from Salinas, Córdoba and Aspe, he overlooked crucial guidelines set by the Finance Ministry. Economist Quintana says that Ortiz showed negligence "in not demanding that the evaluation of the groups that were interested in the banks be more rigorous, both in terms of their experience and the [strategic plans] that the would-be buyers had to present for each bank." Corrupt and inept businessmen took over some Mexican banks, while at others, loan portfolios deteriorated at a rapid rate.

"Guillermo Ortiz was taking orders in all this, but his role was more than that of the good soldier," contends Quintana. Former majority owner of Bancomer Manuel Espinosa Yglesias, who lost the No. 2 bank in the 1982 expropriation and tried unsuccessfully to buy it back in 1991 during the privatization drive, is one of the disgruntled private-sector leaders. Although he agrees that Córdoba and Aspe were running the show, Espinosa Yglesias says that when he told Ortiz at a 1991 meeting that the banks' troubled loan portfolios did not justify the high prices being paid for the institutions, Ortiz turned to central

bank governor Miguel Mancera and chortled arrogantly: "Get this! He says we don't know what shape the banks are in."

Ortiz admits to mistakes in the banking privatization. "If we had to do it over again," he says, "I think the main change would be that we would have set much higher capitalization standards for the banks." But he denies even a hint of any wrongdoing. The speed at which the privatization was carried out — one bank every third week, on average — made it difficult to foresee potential problems, Ortiz maintains. And he adds: "When the privatization process was over, it was thought in Mexico and abroad that it had been a big success. [And] it was very transparent."

Not entirely, says Antonio García Villa, a legislator from the opposition conservative Partido Acción Nacional and head of the finance secretariat oversight committee in Mexico's lower house of Congress. According to García Villa, there are numerous "key documents" missing from the voluminous "white book" that records the bank privatization process. Among them are records of how evaluations of some investors' bids were carried out and the process by which investors' groups received sharp discounts on banks after their bids had already been accepted by the government.

García Villa's committee does not have a mandate to examine the books on transactions that took place before 1993, but the PAN legislator says that a special commission to probe the bank privatization may well be formed if the opposition wrenches majority control from the PRI in Congress in 1997, as polls suggest it may. "In that case, we would have the possibility of going back to investigate the entire process," he says. Says PAN Senator Norberto Corella, "If [Ortiz] were to be appointed today, with all that is now known of his role in the banks' privatization, there would certainly be a fight in Congress."

One prominent Mexico City economic analyst says that in the windup to midterm elections, "Ortiz is going to be walking on extremely thin ice." Because of the banking sector's problems, says this economist, the finance minister "may even become a political liability" to Zedillo — and the president may be forced to dismiss him despite their long friendship. Should that occur, says Quintana, there are at least two possible replacements: MIT-educated economist Luis Tellez, director of the office of the presidency — Córdoba's old job — and newly named Energy Secretary Jesús Reyes Heroles, a respected economist and also an MIT graduate, who served as a finance undersecretary during the Salinas administration but then distanced himself from Aspe.

Dornbusch and others believe that both Mexico and Ortiz will weather the current banking storm. "They're going to bail out all the banks and all the big companies, so in that sense they are avoiding a crisis at the expense of building up a significant public debt," says Dornbusch. But with a special commission investigating charges of fraud by Salinas' brother Raúl and legislators threatening to form a special commission to investigate supposed fraud in the privatization of Teléfonos de México, political considerations could overwhelm economic ones, jeopardizing Ortiz's position. No one can blame the finance minister for being nostalgic about his 28 days at the ministry of communications. **II**

Home-run hitters of 1995

The Internet propelled several stocks to the top last year.

By Debbie Galant

The stock market was kind to investors in 1995, giving even passive participants a good ride. The Standard & Poor's 500 index had a total return of 37.59 percent for the year. But, for those who picked well, the stock market was more than kind. The home runs of 1995 returned to investors approximately twice as much as the stocks on the previous year's list. Ascend Communications, 1995's top performer, had a total return of 696.3 percent, compared with the 317.9 percent return for 1994's leader, Stratacom.

As always, *Institutional Investor's* list of home runs provides a distillation of the year's big trends. Technology stocks accounted for nine of the ten home runs in 1994, for example, proving that investors will always be excited by the new and shiny. Last year several themes prevailed. For one thing, the hottest stocks on Wall Street were more often than not initial public offerings. They also include a host of

major turnarounds, including a company whose suspicious balance sheet once caused investors to exit en masse. And there was nothing like the Internet to fire up investor enthusiasm.

Besides Ascend, Security Dynamics Technologies and Sun Microsystems all benefited from Internet mania. And among the major turnarounds last year, none was more dramatic than that of Northwest Airlines Corp., which practically went bankrupt in 1993. Former NatWest Securities' airline analyst Michael Derchin (now a managing director at Tiger Management Corp.) not only singled out Northwest at liftoff but also picked the perfect moment to back the entire industry. Derchin's call — controversial at the time — subjected him to ridicule.

The medical devices industry rebounded with a vengeance from worries about health care reform. Two companies in the field, Boston Scientific Corp. and Guidant Corp., captured sufficient support to make this roster.

But five of this year's standouts — Ascend, Apollo Group, C-Cube Microsystems, Security Dynamics and Guidant — are recent initial public offerings. There could be no more apt demonstration of how important investment banking has become in the life of securities analysts. "You've got to underwrite the right companies," emphasizes Thomas Erickson of Wessels, Arnold & Henderson, who was one of three analysts to single out Ascend.

Picking the analysts who hit home runs was a difficult task. We started, as in the past, by having each company compile a list of several analysts who were early or vociferous champions of their stocks. Close calls were broken by asking buy-side portfolio managers and analysts who first alerted them to the stocks' potential. Further research was conducted using Investext Group's I/Plus Direct on-line service. In the case of IPOs on which two or more analysts initiated coverage and maintained positive ratings throughout, ties were awarded. In all other cases, we attempted to pinpoint the analyst with the earliest relevant call or with the best timing on the stock.

One analyst narrowly missed being a home-run hitter in two instances. Prudential Securities' Laura Conigliaro, who made last year's list for her advocacy of Autodesk, was an early champion of both Structural Dynamics Research Corp. and Sun. Yet for reasons revealed below, other analysts captured the laurels. Still, Conigliaro served clients well by identifying not only those two stocks but also Cadence Design Systems, another high-flying technology stock.

Assigning the home run for Northwest Airlines was particularly agonizing. CS First Boston's Paul Karos deserves credit for being an early booster of this once-troubled airline. But NatWest's Derchin displayed impeccable timing.

Edward White Jr. of Lehman Brothers has the distinction of being a home-run hitter for two years in a row. In 1995 he was cited for earmarking Tencor Instruments; this year he makes the list for C-Cube. Lehman was involved in underwriting both companies.

As in past years, FactSet Data Systems in Greenwich, Connecticut, provided the list of winners and the technical support necessary for this project. The top performers are divided into two groups: high-growth stocks — companies with market capitalizations between $75 million and $1 billion as of January 1, 1995 — and large-cap stocks, companies with market caps greater than $1 billion at the beginning of last year. As in previous years, stocks trading below $5 at the year's start were excluded. Percentages used indicate total returns, with dividends reinvested and compounded daily.

HIGH-GROWTH STOCKS

Ascend Communications

(ASND/NASD)
+696.3%

When Ascend Communications was taken public in the summer of 1994, the Internet was barely a blip on the national consciousness. In fact, not one of the three analysts who helped in the IPO even highlighted the Internet in their initial reports. But it was Internet mania that catapulted Ascend to the top in 1995, making it the finest performer in our investable universe.

Ascend, which was first touted as a play on videoconferencing, makes equipment that connects users to wide area networks — including the biggest network of them all, the Internet. It also provides remote access to local area networks, enabling workers to dial into their company's computer systems while they're away from the office. Neil Danzger, the telecommunications equipment analyst who helped shepherd the company through its IPO for Morgan Stanley & Co., the lead underwriter on the deal, points out that "the company, right out of the box, was consistently able to beat analysts' expectations. As quickly as we raised our price target, the company blew past it." Danzger follows Ascend jointly with George Kelly, who covers data networking equipment companies.

Sharing the honors with Danzger is Thomas Erickson of Wessels, Arnold & Henderson, who also worked on the IPO. Like Danzger, Erickson has been astounded by the stock's surge. He points out that nobody could have anticipated the growth of the Internet — and of the Internet access providers that buy Ascend's most important product, called Max. "Nobody saw this,

not even the company," he says.

But Paul Johnson of Robertson, Stephens & Co., the third underwriter, who was assigned to Ascend on his first day of work — at the request of the company's CEO — says he was first to grasp the importance of Max. "I didn't think that [the company] could tell the story very well," he remembers. "They were in the middle of a product transition. Max is the product I identified early on."

2 APOLLO GROUP (CLASS A)

(APOL/NASD)
+558.9%

The company that turned in the second-best performance in 1995 doesn't fabricate microchips or make it easier to surf the Internet. Apollo Group is in the relatively low-tech business of granting college degrees. The two analysts who split home-run honors — Peter Appert of Alex. Brown & Sons and Gerald Odening of Smith Barney — may be the only Wall Streeters to specialize in education. So when Apollo was looking for underwriters to take the company public in December 1994, Alex. Brown and Smith Barney were the obvious choices.

What makes Apollo so appealing, both Appert and Odening say, is its market niche. Apollo-owned University of Phoenix only takes individuals who already work; a typical student is someone who has been in the workforce for a decade and earns $55,000 a year. Some want to finish their college degree after having taken time off to get married or serve in the military. Others are eager to freshen their skills or retrain for an increasingly competitive job market. In good times University of Phoenix will draw students eager to move up in the world; in bad times it is the choice of students who fear being downsized. "I don't know which is more powerful a motivator," submits Odening. "That's why I say the demand is noncyclical."

Appert, who also monitors textbook publishing and educational software, points out that Apollo not only identified a good market niche, but it has also made it work better than anyone dreamed. "The key is execution," he says. "This is one of the strongest fundamental stories that I've come across as an analyst."

Look for Apollo's success to educate investors to the potential of for-profit education providers, a field that may be comparable to HMOs in the 1970s. And expect demographics to boost the trend, given the vast progeny of the baby-boomers and strained state budgets. "The concept of for-profit education is fairly radical for a lot of people and somewhat controversial," acknowledges Appert. "People like me and Gerry are educating investors on the business of education."

3 C-CUBE MICROSYSTEMS

(CUBE/NASD)
+557.9%

Taken public in the spring of 1994 — smack in the middle of all the hype about interactive media — C-Cube Microsystems was positioned to enjoy the multimedia revolution. No matter what medium ultimately would triumph — telephone, cable or broadcast satellite — C-Cube, which makes chips that can compress and decompress video images, had the right technology. Its chips could be sold to telecommunications companies, cable companies and satellite operations alike.

But just after C-Cube's IPO, the multimedia story began to fizzle. The proposed merger between Tele-Communications Inc. and Bell Atlantic Corp. collapsed, a much-vaunted telecommunications bill in Congress failed to pass and people started to think of computers — not television sets — as the locus of the great interactive future. C-Cube shares languished for months, barely maintaining their IPO price.

Then, in mid-1995, digital video found a new market. One of C-Cube's products was a chip that could turn an ordinary CD player into a video-CD player. And in countries where intellectual property rights are weak, particularly China, a new video-CD market took off in mid-1995 — taking C-Cube stock along with it. In a move that began last spring and accelerated in the fall, the stock attained its early promise.

Two of the three analysts who helped in the original underwriting — Andrew Kessler of Unterberg Harris and Ed-

ward White Jr. of Lehman Brothers — stuck with C-Cube long enough to savor the victory. (The third, Eric Jansen of Alex. Brown & Sons, became neutral too soon.) "The unexpected development was that consumers in China started to pick up on this," says White, noting that the video-CD player experienced "the fastest ramp-up of any consumer electronics product in history." As for Kessler, he too failed to fully appreciate the China video-CD story at first. But he took "a pretty big leap of faith" in mid-1994 by predicting that C-Cube's sales would hit $100 million the following year. (Sales for 1994 were estimated at $40 million.) "This is a bet on digital video," he informed clients.

Even Kessler was astounded when sales for 1995 turned out to be $125 million and C-Cube was more than twice as profitable as he envisioned. "I'm surprised as everybody else about the magnitude of the thing," Kessler confesses. "It just exploded."

4 SECURITY DYNAMICS TECHNOLOGIES

(SDTI/NASD)
+485.2%

Like several other home runs this year, Security Dynamics Technologies got a huge boost from the Internet. The company, which was taken public in December 1994 by Alex. Brown & Sons and Robertson, Stephens & Co., is involved in network security. Its specialty is authentication, ensuring that someone accessing a network from a remote location is really the person he or she claims to be. Security Dynamics offers a unique technology involving special cards on which a personal identification number is generated by a computer algorithm and changes every 60 seconds or so. Software back at the central office, generating the same number series, verifies the temporary PIN and, with a password known only to the user, allows access to the network.

John Dean

Security Dynamics' product is popular because it protects a network without unduly frustrating its users. "Whenever you can win or tie the battle in terms of level of security, and do it with an easier-to-use solution, you're going to win," says Robertson Stephens analyst John Powers.

Although computer network security was bound to become a big concern because of the growth of networking, the Internet pushed it to the fore. "The Internet absolutely raised security from a consideration of a low-level [management information systems] guy to an issue for everybody in the organization," emphasizes Alex. Brown analyst James Wade. Noting the "paranoia that's grown up around the increasing use of the Internet," Robertson Stephens' Powers points out that salespeople for Security Dynamics began in 1995 to pitch their product to higher levels of management, which enabled them to close deals faster.

Ironically, Security Dynamics still sells most of its systems for use in private corporate networks, not for the Internet. "We're nowhere near significant penetration," avows Wade.

5 STRUCTURAL DYNAMICS RESEARCH CORP.

(SDRC/NASD)
+446.5%

Wall Street is slow to forgive companies that mess around with their numbers. So when the balance sheet of Structural Dynamics Research Corp. began to show signs of financial hanky-panky several years ago, analysts who follow computer-aided-design companies fled the stock en masse. Fortunately, customers were more faithful. The mechanical engineers who use Structural Dynamics' software to design and test products remained loyal — which helped to sustain the company during its period of financial distress.

Lawrence Rauch

When a new management team arrived at Structural Dynamics in late 1994, it faced a formidable challenge: restoring the market's badly tested faith. Two analysts were quick to recognize that new management had things under control: Laura Conigliaro of Prudential Securities and Russell Crabs of SoundView Financial Group, both of whom reinstated coverage of Structural Dynamics with buy ratings last May. A disappointing quarter sent the stock stumbling again in summer and influenced Conigliaro, whose price target was never as high as Crabs's, to remove her buy signal. Crabs held on during the turbulence — and therefore is credited with the home run. "I remember watching the stock get pummeled," he says. "We stuck with the buy and reiterated it and that price point."

In addition to recognizing that the company had stalwart

customers, Crabs saw other big positives for Structural Dynamics: important new products in the pipeline and the potential for a large contract from Ford Motor Co., which finally came through late in the year. It was the Ford contract, ultimately, that brought back the rest of Wall Street. "It's a great example of the shift in psychology in the marketplace," says Crabs. "Once the contract was announced, the stock started rallying." Thus one of the worst-performing technology stocks in 1994 became one of the best in 1995.

LARGE-CAP STOCKS

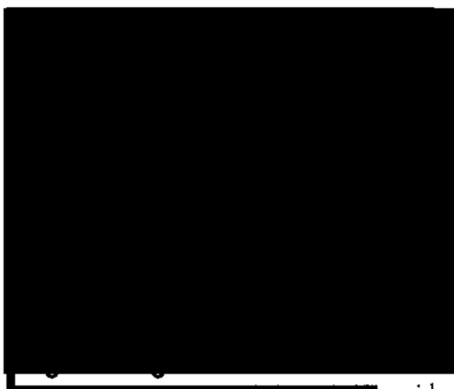
1 NORTHWEST AIRLINES CORP.

(NWAC/NASD)
+223.8%

The airline industry has been troubled in recent years. But in late 1994 Michael Derchin, who has been watching the airlines since the 1960s, began a series of meetings with airline managements. The then–NatWest Securities analyst and research director detected a change. "One by one, each management was laying out a strategy of containment," Derchin recounts. The airlines were grounding planes they couldn't make money from, taking "hundreds of millions of write-offs," he notes. "And second, they were getting out of each other's way" — ceding weaker markets to competitors and concentrating on the corridors in which they were strong. "For the first time in decades, these guys were poised to make a huge amount of money," Derchin says.

In January 1995 Derchin made a major bet on the airline industry, a bet so exposed that on the cover of his January 23 report, "Spotlight on the Airlines," he included a cartoon showing a naked man sitting behind a desk, calling home and asking, "Honey, did I leave the house this morning with or without clothes on?" In the commentary, Derchin admitted to feeling like the guy in the cartoon. "I know I'm the only analyst who is really this bullish on the airline industry," he wrote. "But I'm still very comfortable with my call."

Derchin's biggest bet was on Northwest Airlines Corp., a company that had almost gone belly-up in 1993. He was convinced that new CEO John Dasburg could ably pilot the company to profitability. And the market's disenchantment with Northwest — which had reversed an LBO by going public again in 1994 — made the stock even cheaper: "The more levered the turnaround, the bigger the outperformance," Derchin points out. In a 44-page report of early January, he wrote, "Northwest Airlines is one of the most dramatic airline turnaround stories in recent history." In February, March and April, Derchin issued updates, raising his earnings estimates and price targets and urging investors to accumulate Northwest on any pullbacks.

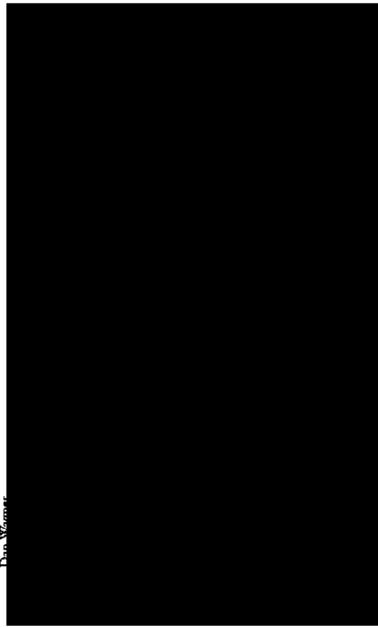


Derchin, who left NatWest in midyear for Tiger Management Corp., where he tracks transportation and travel, was not alone in being bullish on Northwest. CS First Boston's Paul Karos, who helped Northwest with its 1994 IPO, was actually earlier. "I'm the only one on the Street who has stuck with it since the IPO," Karos says. But the stock performed erratically during 1994, actually declining after a Halloween note in which Karos endorsed it. The drop enabled Derchin to launch his buy campaign at a lower price. And while Derchin went out on a limb in early January with a $28 price target for the stock, Karos — though he still had a buy — modestly lowered both his earnings estimate and his price target. Home run: Derchin.

2 HFS

(HFS/NYSE)
+208.5%

Morgan Stanley & Co. lodging analyst Neil Barsky thought he'd found a winning formula when he put a buy recommendation on HFS, the world's largest franchiser, last May. HFS, which owns such brand names as Days Inn, Ramada and Howard Johnson, collects license fees from the individual hotel operators in its chains, thus avoiding the real estate risk of actually owning the property outright. "We saw tremendous free cash," recalls Barsky, who also suspected that HFS had a major plan to diversify its franchise business. He couldn't guess what the new business might be. But "I loved the cash," he says.



Just two weeks later HFS, formerly Hospitality Franchise System, announced its acquisition of Century 21 Real Estate Corp. The stock initially declined in reaction to the news, but Barsky figured that real estate was an excellent business for HFS — and said so in a brief note. Just to make sure, however, he began calling real estate brokers around the country. Barsky uncovered "pervasive dissatisfaction" with Metropolitan Life Insurance Co., Century 21's former owner, which would predispose the brokers to work well with HFS. Second and even more important, the realtors were receptive to the idea of using their real estate operations to cross-sell mortgages, which would be a major HFS strategy. Five days later Barsky raised his rating on the stock to a strong buy.

Although other analysts, notably Michael Mueller of Montgomery Securities, gave the nod to HFS earlier, Barsky pulled

the trigger at precisely the right time. He not only endorsed HFS right before the stock took off, but he also organized a massive campaign after the Century 21 deal to make sure investors got the message. "We did everything. We organized luncheons. We made a lot of noise," says Barsky, a former reporter for *The Wall Street Journal.* "We stayed maximum bullish."

3 Boston Scientific Corp.

(BSX/NYSE) +183.4%

It hasn't been easy to cover the health care industry in recent years. In addition to the normal contingencies — such as waiting for the Food and Drug Administration to approve new drugs and devices — there have been a host of other intangibles to deal with. They include Hillary Rodham Clinton's health care reform crusade and strong public sentiment against the industry.

But PaineWebber health care analyst David Lothson managed to pinpoint some hairpin turns in market psychology. For one thing, he astutely predicted in May 1994 that Congress would not do anything to further hurt health care stocks — and raised his rating on nearly all hospital supply and medical device companies. He also called the second leg of the device rally in March 1995. Since Lothson's first call nearly two years ago, hospital supply stocks have advanced 91 percent and medical device stocks 125 percent, compared with a 35 percent rise for the Standard & Poor's 500.

The best stock in the lot has been Boston Scientific Corp., which is up 195 percent since Lothson featured it in May 1994. He reiterated his buy that October and, significantly, in November, right after Boston Scientific decided to purchase SciMed Life Systems.

The acquisition was controversial. "SciMed was perceived by many as a damaged company in an undesirable segment of the industry," says Lothson. But he told clients that the acquisition would give Boston Scientific a presence in the cardiology device market and also add market capitalization and liquidity, making the stock much more attractive to institutional investors.

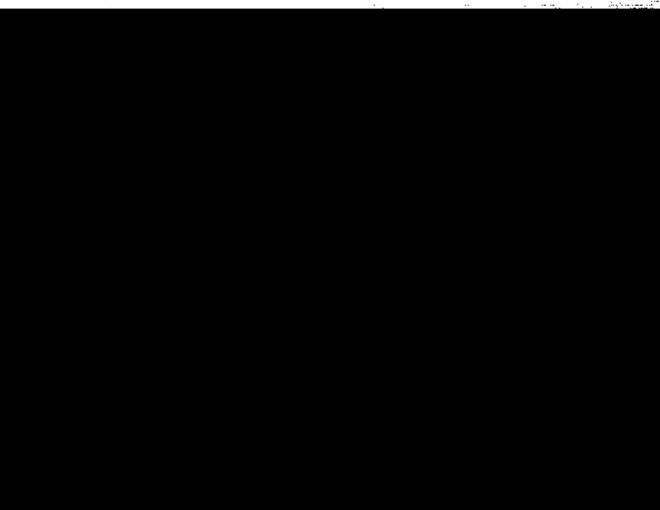
Not until the following March did Lothson's closest competitors, Frederick Wise of Bear, Stearns & Co. and Kenneth Abramowitz of Sanford C. Bernstein & Co., jump on the bandwagon. The stock exploded in April, when the first quarter of combined results for the two companies far exceeded Wall Street's expectations.

One buy-side fan says that Lothson's work on Boston Scientific was all the more important because its product line is difficult to understand. "It's a little bit of a stealth company in terms of the products it makes," this client says. "Dave did his homework. He really hit it out of the park."

4 Guidant Corp.

(GDT/NYSE) +164.8%

Guidant Corp. went to market in December 1994 as a spin-off of Eli Lilly & Co.'s five largest medical device companies. Like most IPOs that come at the end of the year, it was a tough sell; institutions are reluctant to assume major new positions in December. Moreover, the U.S. health care system had endured several years of intense scrutiny, which put pressure on



medical stocks. And if that weren't discouraging enough, the five companies that make up Guidant operated at Lilly as separate fiefdoms and had grown lazy and weak under the corporate umbrella. Investors wondered what synergies they would find on their own.

"People had poor impressions of the company," acknowledges Glenn Reicin of Morgan Stanley & Co., which acted as lead underwriter on the IPO. Nevertheless, Reicin sold Guidant as "a cultural revolution in the making." He pointed out that management, loaded with stock options, had the incentive to create value. "This, we believe, offers outstanding opportunity for upside surprise," he said in his initial report on Guidant.

Reicin was on target. Guidant achieved the overhead efficiencies the spin-off was supposed to generate, and its scientists collaborated to make their products more competitive in the marketplace for cardiovascular devices. The company was also lucky. "The whole pace of FDA approvals came much faster than even the company anticipated," says Reicin. In June Guidant got approval for a new generation of pacemakers.

Late last summer the Lilly spin-off was completed and the remaining Guidant shares were made available to the public. Morgan Stanley was the chief banker for that transaction, so Reicin was unable to publish on the stock. Guidant's most enthusiastic supporter during this period was Michael Weinstein of J.P. Morgan, who adjusted his 1996 earnings estimate on the company to well above the consensus. "It was a big table-pounding call," he says.

Still, Reicin came back in early October with an aggressive endorsement of his own. Rating the company a strong buy, he noted that his initial prediction on Guidant had indeed

come true. "*Guidant is, in fact, undergoing a cultural revolution as management fosters a more entrepreneurial environment,*" Reicin wrote.

5 SUN MICROSYSTEMS (SUNW/NASD) +157.0%

For years Sun Microsystems has been touting the importance of networking among computers. But for most of the 1990s, investors were interested in virtually everything *else* connected to computers: the microprocessors inside them, the operating systems that run them, the dazzling educational offerings available on CD-ROM. While the stocks of Intel Corp. and Microsoft Corp. soared, Sun's shares behaved erratically, gathering no momentum at all. But in 1995, the year of the Internet, the stock became a star. The company famous for workstations introduced Java, a new operating system designed for use on the Internet. It woke up Wall Street with a jolt.

Back in 1990 when Wall Street was shunning Sun, Prudential Securities' Laura Conigliaro sensed its potential. "There always seemed to be exciting things that were fomenting under the surface," she relates. Although the company "ran into an extended period of execution stumbles," Conigliaro resisted sounding a sell. "Picking a bottom for technology stocks, particularly highly popular ones, is sometimes a crapshoot," she explains.

One sell-sider *did* pinpoint Sun's bottom, however. First Albany Corp. networking analyst Gina Sockolow — who was then at Josephthal, Lyon & Ross — has conducted a regular survey of Sun distributors since January 1994. She spends four days each month contacting value-added resellers and other Sun distributors, reaching 25 percent of Sun's customer base. The Friday before the July 4th weekend in 1994, Sockolow discerned a momentous change. "Customers were too busy to talk to me," she recalls. A week later Sockolow slapped a buy on Sun, trumpeting the beginning of a "strong new product cycle." She caught the stock's bottom exactly.

Sockolow had another bold stroke last August, when she put out a report entitled, "Sun Micro as an Internet Play." At the time, Netscape Communications Corp., last year's hottest IPO, was trading at 55 5/8; no one even suspected it would surpass 100 and take every other stock linked to the Internet along with it. Sockolow followed up the call in October by having Hal Stern, a top Sun engineer specializing in the Internet, address a group of clients. She believed that Sun's management held the key to the technological future. "The management of Sun, for all the knocks they take, does have a devotion to technology for technology's sake," she sums up. ■

Labor force

Unions have awakened to pension assets' power not only to get recalcitrant companies to do social good but also to do well.

By Jinny St. Goar

Last November 21 a clamorous group of protesters were arrested in front of the Royal Dutch/Shell Oil Co. building in Washington, D.C. They were demanding that the company stop operations in Nigeria, whose heavy-handed military junta had hanged nine environmental activists 11 days before. Among those booked for unlawful congregation and assembly: AFL-CIO executive vice president Linda Chavez-Thompson.

That's one form of union activism. Chavez-Thompson, as it happens, was actually picketing in a dual capacity: as a representative of Shell's unionized workers, yes, but also on behalf of AFL-CIO pension funds that have invested millions in Shell stock. "We had been trying to get the oil companies to be more responsive before the situation became the crisis [that Lagos created with the execution of the activists]," says William Lucy, secretary-treasurer of the American Federation of State, County and Municipal Employees and chairman of the Coalition of Black Trade Unionists. "Acting in international solidarity, irrespective of boundaries, we understand pension plans to be the deferred wages of workers. The [pension] plans' power should be used — not inconsistently with sound business practices — to improve economic conditions, workers' rights and human rights."

Flexing pension muscle to push a socioeconomic agenda is not exactly a new exercise for big labor. But in recent years the effort has intensified: Unions accounted for almost one fifth of all shareholder resolutions in 1995. And — strikingly — this flourish of shareholder activism is geared as much to goading companies to perform financially as it is to advancing workers' interests. It may be capitalism with a conscience, but it is capitalism nonetheless.

Now, the new AFL-CIO president, John Sweeney, who's a pension expert with an activist bent, is sure to step up shareholder activism. On a broad front

the goal will be to boost returns through both activism and more sophisticated investment strategies. Installed last fall, Sweeney has placed pension investment issues high up on his list of priorities. At his behest the AFL-CIO's executive council has created a task force on pension issues that has already proposed establishing an "ownership institute" to develop pension policy relating to investment and corporate governance as well as to worker ownership through employee stock ownership plans. The council acts as the advisory body to AFL-CIO unions representing some $300 billion in pension assets.

The pension thrust is only natural, given Sweeney's background. He has direct, in-the-trenches knowledge of pension issues. As president of the New York City local of the Service Employees International Union in the late 1970s, he negotiated union salary-and-benefits contracts. And throughout his 15 years of leading SEIU, whose membership consists of poorly paid maintenance workers, he stressed the importance of making solid pension investments to deliver on pension obligations. From mid-1990 to mid-1995, the SEIU pension funds, organized into a single master trust, posted an annual average return of 10.36 percent. AFL-CIO treasurer Richard Trumka, formerly president of the United Mine Workers of America, has also been outspoken on pension issues.

"We [in organized labor] were already heading in the direction of more research on pension issues — both investment strategies and corporate governance activities," says Marvin Hrubes, director of field services for the United Food & Commercial Workers International Union, which has $24 billion in aggregate pension assets. "Sweeney will only enhance those initiatives." Adds Landon Butler, White House liaison to organized labor in the Carter administration, who now runs an investor relations consulting firm: "John Sweeney knows the private pension system inside and out. He will be both a knowledgeable trustee [as adviser to all AFL-CIO affiliates on pension issues] and a progressive, forceful voice."

Several forces at work in recent years have persuaded labor to pay more heed to asset management. First is the phenomenal growth of large multiemployer plans. According to the Employee Benefits Research Institute, large multiemployer plans, those with more than $60 million in assets, increasingly dominate the market. In 1983 they represented 69 percent of all multiemployer plan assets (or $59 billion); as of mid-1995 these large plans accounted for 80 percent of total multiemployer plan assets (or $262 billion). As these pools of money have deepened, union officials have had to devote more time and thought to considering how the money should be invested, and that has brought the matter of corporate governance strategies to the fore.

At the same time, the unions feel compelled to generate higher returns now because of increasing anxiety about long-term investment prospects. Like many other investors, the funds fear that the outsize returns offered by the stock and bond markets over the past 15 years probably can't be sustained. And with a declining base of union members supporting a growing contingent of retirees, the pressure is also on to take calculated risks to boost returns. Then, too, as plan contributions are fixed at the bargaining table — where organized labor wields less and less clout — higher returns are crucial to offsetting lower contributions. Last, unions have had to direct a greater percentage of workers' contributions toward health and welfare funds because of soaring health care costs, adding still more urgency to the need to enhance the returns on pension assets.

Staying in shape

On the whole, multiemployer pension funds have maintained a healthy surplus in recent years.

	1990	1991	1992	1993	1994
			($ millions)		
Investment and other income	$ 13	$ 38	$ 27	$107	$ (46)
Total assets	190	238	283	407	378
Net position*	182	163	169	276	197

* Assets less liabilities.

Source: Pension Benefit Guaranty Corp.

Conveniently, multiemployer plans are well funded: They've raised funding levels from 77 percent of liabilities in 1980 to 97 percent in 1993. Thus union officials believe the plans can afford the risk of lightening up on fixed-income investments and pouring more money into equities. Throughout the '80s, union funds' equity allocations barely inched upward, from about 28 percent at the beginning of the decade to 32 percent at the end. "Our Taft-Hartley clients had typically focused more on preserving capital or principal than our corporate clients had," notes David Schilder, the principal at Weiss, Peck & Greer responsible for marketing in the Chicago office. But after the bloodbath in the bond markets in 1994, he says, "the safety of principal in fixed-income accounts just wasn't so sacrosanct."

The bond-bashing, moreover, was followed by last year's roaring equity market. Rising prices automatically pushed up union equity allocations in '95, while also luring more assets out of fixed income into stocks. As a result, union equity commitments have soared to about 42 percent, according to EBRI. "At least one third of my 40 Taft-Hartley clients are in the process of increasing their equity exposure by 10 percent, from, say, about 35 percent to about 45 percent of their portfolios," says Weiss Peck's Schilder, whose firm manages $2 billion in Taft-Hartley assets.

Indulging a greater appetite for equity, Taft-Hartley plans also began sampling different varieties, such as foreign and small-cap stocks and venture capital. In investment guidelines issued in 1993 for affiliates' pension plans, the AFL-CIO's executive council strongly recommended such diversification.

"Five years ago a Taft-Hartley fund would not even have

considered our Re/Enterprise Partners [Fund]," a $170 million pool that's invested in corporate restructurings, says money manager Martin Sass of MD Sass Group, which manages about $600 million in union assets out of the firm's total $7 billion. "But one medium-size local just recently inquired about it." Almost half of the $63 million in Poland Partners, a venture capital fund supported by the Overseas Private Investment Corp., comes from union plans. The fund counts among its investors the pension plans of the SEIU, the International Union of Bricklayers & Allied Craftsmen, the UMWA, a New York local of the International Brotherhood of Electrical Workers and the Communications Workers of America, according to consultant Butler, who is the fund's vice chairman.

In 1994 Cigna Retirement & Investment Services launched the Cigna/America Fund expressly to make private-placement investments for union pension funds. The fund considers investments that create or maintain union jobs to be a priority — but strictly a secondary one. "Our first objective is to provide a competitive return for union pension funds," declares portfolio manager Henry Wagner, who oversees the investment of some $120 million in 29 companies whose workers are at least 25 percent unionized. For the 12 months ended last December, the fund was up 21.28 percent, 204 basis points more than the return on the benchmark Lehman government/corporate index.

Among the investments — which are made in tandem with other Cigna-run funds to reduce the risk — is a $3 million, 25 percent stake in a pork-processing plant run by members of the UFCW and a $2 million, 16 percent stake in an aircraft plant staffed by members of the United Auto Workers and the International Association of Machinists & Aerospace Workers. "This fund sets out to make a difference, to create opportunities that would not otherwise exist," says Jack Moore, international secretary of the IBEW, whose pension plan has approximately $5.5 billion in assets.

Unions have been somewhat slower to embrace international investing. The AFL-CIO's guidelines propose forthrightly that union funds try foreign stocks. Unions had shunned them as undermining jobs for U.S. workers. William Patterson, corporate affairs director of the International Brotherhood of Teamsters, favors selective international investing, that is, in foreign enterprises that don't threaten U.S. jobs or even better, that buy U.S. exports. But he concedes that few Teamster funds have shifted assets overseas.

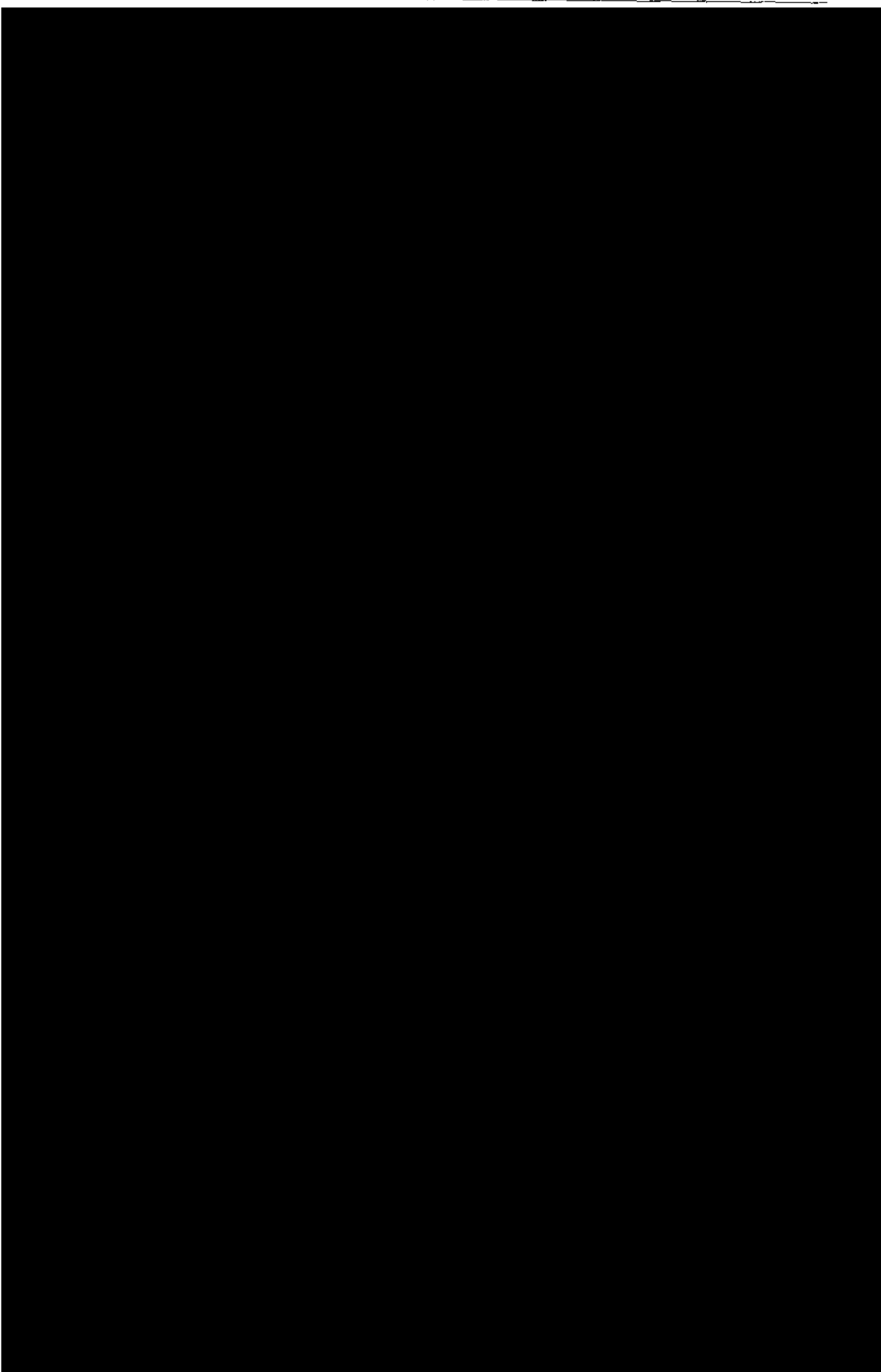
A growing number of union pension officials have concluded, like their public-fund counterparts, that good investment management requires throwing some weight around in the boardroom. Last year was a high-water mark for Taft-Hartley corporate governance activity: Unions filed 80 out of a total of 460 shareholder resolutions in 1995, according to the Investor Responsibility Research Center. So far this year unions have filed 73 resolutions, 17 percent of the total (like last year).

Among the active drafters of resolutions is the LongView

Collective Investment Fund, an index fund pegged to the Standard & Poor's 500 index that actively votes its proxies. The brainchild of the Teamsters' Patterson in his former capacity as director of financial strategies at the Amalgamated Clothing & Textile Workers, the fund was launched in August 1992. As of year-end 1995 it had more than $1 billion in assets from 32 investors, primarily Taft-Hartley funds but also a handful of single-employer and public funds. For the coming annual meeting season, LongView's administrators have drafted 19 proposals on such initiatives as scrapping poison pills, eliminating staggered terms for board members, canceling directors' pension benefits and creating "high-performance workplaces" that promote training, incentive-based compensation, communications systems, teamwork and morale.

Labor doesn't shy from corporate battles. "We are getting involved in the decision making in corporate transactions, not just responding to shareholder resolutions at annual meetings," says Edward Durkin, director of special projects at the United Brotherhood of Carpenters and Joiners. In the recently settled shareholder battle at Chrysler Corp., Taft-Hartley investors joined with public plans to oppose Kirk Kerkorian's takeover bid. "In this case, we were wearing our shareholder hats," says Patterson, who worked closely with Durkin of the UBCJ as well as with activists from the California Public Employees' Retirement System. These three institutional shareholders made their opposition well known to Kerkorian as he tried to rally support for his bid in a vote that would have taken place at the company's spring annual meeting. "We were concerned primarily that Chrysler under Kerkorian would be weakened — with its cash reserves depleted for shareholders' short-term gain — for the next downturn in the business cycle," explains Patterson.

The Teamsters speak with all the authority of $46 billion in pension assets. Last summer the union notified Chemical Banking Corp. of its intention to submit a shareholder resolution opposing the bank's long-standing poison-pill provision at this year's annual meeting. On January 18 Chemical, whose shareholders had approved a merger with Chase Manhattan Corp. the month before, issued a terse press release: On the first dividend payment date after the merger, the bank announced, it would effectively neutralize the pill. "We make recommendations on how all [Teamster plans] vote their stock," says Patterson, "and historically, we have delivered." For all union funds the pressure to deliver in the future will be even greater. ■



The coming fracas over fees

Vendors are hiking 401(k) costs — and plan participants are footing the bill. Expect a backlash when this hits home in a down market.

By Mary Rowland

Last year a company with $10 million in 401(k) assets approached Trisha Brambley, an independent retirement plan consultant in Horsham, Pennsylvania, for advice on selecting a new 401(k) vendor. To Brambley's distress the client chose a mutual fund company that charged an asset management fee of 100 basis points on top of the funds' expense ratio. That fee — as well as the funds' expenses — was paid by plan participants.

Why would a company saddle its own employees with such crippling fees? "The company chose it because the recordkeeping was free to them," says Brambley, who was so disgusted that she dropped the client.

The 401(k) marketplace is, of course, increasingly competitive, and ferocious competition ought to mean plunging costs for buyers and shrinking margins for sellers. But anyone who peeks under the rug of the 401(k) business is in for some surprises. Competition has resulted in higher, rather than lower, fees.

This hasn't been such bad news for plan sponsors. Most have simply passed the costs on to plan participants, partly because it's the participants who must foot the bill for mutual funds and partly because some sponsors haven't bothered to try to negotiate lower fees on behalf of participants. This has allowed fund companies to charge more or less what they please. "Mutual funds are stacking high administrative fees on top of high asset management fees, and the participants are taking it in the shorts," contends Steve Hensley, vice president for pensions at financial services company Principal Financial Group.

However, the trend is likely to boomerang, warn Hensley and other experts, who note that once plan participants grasp what's going on, they will simply begin to resist plans with high asset management fees. A market downturn could hasten the awakening. "When you come off a year like 1995, Johnny Lunchbucket is thrilled," Hensley says. "He got 35 percent. He doesn't think 200 basis points is too high a price. But how happy will he be when 30 percent of his return goes to fees?"

One reason high fees have not yet registered on participants is that the fees are layered in a manner that is far too complex for employees — and even for many sponsors — to understand. Some vendors bill the sponsor; others collect asset management fees from employees. Most rely on both methods, making it extremely difficult to compare the cost of two plans. Comparisons are especially tough because the billed expense is expressed in

dollars and the management fee as a percentage of assets.

Brambley says she sees three distinct types of pricing emerging: mutual funds with deferred sales charges; mutual funds with wrap fees or asset management fees of 65 to 165 basis points on top of the funds' expense ratios; and funds with special classes of shares for 401(k) plans that add annual 12(b)1 fees of 25 to 65 basis points for recordkeeping and distribution. "With these shares, you can never transfer to a [front-end loaded] A share, so you pay the fee forever," Brambley says.

The emergence of mutual funds as leaders in the 401(k) market helps account for the trend. "Mutual funds took the lead sometime in late 1994," says consultant Glenn Casey at Cerulli Associates in Boston. "Until that point, insurance companies were the leading investment managers." In 1995 mutual funds accounted for about 37 percent of 401(k) assets, compared with 30 percent for insurers and 25 percent for banks, according to a 1995 Cerulli study.

"The management fee component in mutual funds is typically higher than in bank trust funds or insurance company managed accounts," Casey points out. What's more, the employer is not allowed under ERISA to pay the expense ratio, of which the management fee is a component; the individual participant must pay it. (Sponsors are permitted to pay asset management fees to bank trust departments and insurers, however.) Nor is the fund company permitted to rebate any portion of the fee to the employer.

So the participants pay, and the longer they stay in a plan, the more they pay. Principal Group's Hensley has worked out what he says is a typical pricing example. Suppose a sponsor that has a 5,000-person, $32.5 million plan with $7.5 million in annual contributions is looking for a bundled vendor. Vendor A proposes an annual fee of $100,000 with an asset management fee of 150 basis points, for a total first-year fee of $587,500. Vendor B offers a $240,000 annual fee and 50 basis points of investment management fees, for a total first-year fee of $402,500.

But as Hensley points out, Plan A increases dramatically in cost as the plan assets grow. Assuming an investment return of 7.5 percent, Plan A costs the sponsor $13 million cumulatively after ten years, compared with $7 million for Plan B. After 20 years total costs are a whopping $51 million for Plan A, compared with $22 million for Plan B. "In the long run asset-based fees are one of the most significant differences between providers," Hensley points out.

Whatever happened to economies of scale as assets under management grow? "You would think that as the big mutual fund companies have generated so many assets from 401(k) plans, it would bring the expenses down," says Cerulli's Casey. But the reverse has happened: Expenses are going up.

Vendors naturally argue that they are justified in charging more (although many interviewed for this article did not want to be quoted on the subject of fees). Providing 401(k) services is increasingly expensive, they insist. "The issue here is, Are people like myself going to be forced into a 20-basis-point business and still provide voice-response units, daily pricing, asset accounting, hand-holding?" asks the head of retirement marketing at one of the top half dozen fund vendors. "The way we're currently structured, I cannot do it."

Fund companies have also had to make huge technology outlays to keep pace with the competition as well as ante up fees themselves to distribute their 401(k) products. The dozens of funds that participate in distribution alliances, such as those formed by Hewitt Associates and William M. Mercer, Inc., find that they must rebate 15 or 20 basis points to an alliance. Ethan Kra, chief actuary for retirement services at Mercer in New York, explains the alliances' reasoning this way: The funds that participate shouldn't be collecting the full retail prices, because they aren't doing the recordkeeping. "So," he says, "they rebate 15 or 20 basis points to the recordkeeper."

Some funds pay this recordkeeping tariff out of the fees they've already collected. But more and more funds are creating new share classes to generate additional fees. Such groups as Neuberger & Berman Management and Warburg, Pincus Counsellors, both in New York City, have developed a special — and more expensive — class of shares to be used for 401(k) plans.

In 1991 Warburg Pincus created its adviser shares and assigned them a 12(b)1 fee of 50 basis points for "a combination of administration, recordkeeping and distribution," says Steven Plump, vice president of the institutional marketing group. That means participants in two different 401(k) plans might be offered the very same Warburg Pincus fund, the only difference being that one group has 50 basis points shaved from its return every single year. "There is a growing trend in the marketplace toward funds that have these types of fees," says Plump.

Neuberger uses a hub-and-spoke structure to distribute the same investment management product through different channels with different pricing. The company has created a pricing

structure for 401(k) plans with slightly higher fees than those for retail investors. "We created a spoke just for pension administrators about a year ago," says Neuberger & Berman Management president Stanley Egener. "That spoke pays a pension administrator 25 basis points as an annual administrative fee." But Egener did not want to charge a full 25 basis points to pension participants, so he capped the differential between expenses for the two types of funds at 10 basis points. "Anything more than that, the management pays," he says.

An obvious parallel exists between those extra fees and the 35 basis points that Charles Schwab & Co. charges fund families to distribute their products through its OneSource program. Funds happily pay up without creating a separate class of shares. (Schwab will not permit companies to offer funds through its brokerage unit that are structured differently from their retail funds.) "Most of us pay that out of our fees," says Warburg Pincus's Plump. "So if our management fee was 75 basis points on our growth fund, it shrank down to 40."

Why can't funds be made to eat the costs of 401(k) recordkeeping and distribution in the same way? The truth is that plan sponsors simply lack the incentive to push fund providers as hard as Schwab does. Moreover, the fund industry isn't as squeezed by cost increases as it claims to be. "The fund industry tends to greatly overstate the cost of providing basic services," says Don Phillips, president of Morningstar Mutual Funds in Chicago. "You hear all this talk, and you look at the bottom line, and they're making 30 percent. It's an argument that wouldn't hold water in corporate America."

It is possible to deliver low-cost mutual funds. Even the competition acknowledges that Vanguard Group has done an amazing job of delivering retail funds as well as funds for 401(k) plans with minuscule expense ratios. With other vendors averaging 95 basis points and above, Vanguard averages 47 basis points for funds in the 401(k) market. Counters one large 401(k) vendor, "We respond to that by saying that that's what you pay for indexlike returns."

Not all plan sponsors stand by complacently while their participants get fleeced. Consider Winn-Dixie Stores. Charles Thompson, the southern supermarket chain's investment officer at the time, rejected actively managed funds because he didn't believe managers could beat the index and because they cost too much. Thompson argued that the 401(k) participants in mutual funds were subsidizing the fund companies' retail customers. "There is too much waste being laid on the table," he declared.

So Winn-Dixie installed a customized 401(k) plan in 1993 with seven passive investment options. Winn-Dixie participants get daily valuations and have daily-switching privileges. The total cost to Winn-Dixie? Twenty-two basis points, paid by the plan's participants. "Your cost really ends up in your yield, and that makes a big difference over a long period, so we wanted to keep it down," says Rick McCook, Winn-Dixie's financial vice president.

Steven Zients, head of pension marketing for T. Rowe Price Associates, the vendor to Winn-Dixie, adds that "the 22 basis points includes the audit fee, everything." In the past two years, T. Rowe has set up similar low-price common trust funds for other large institutional clients. "Now 25 percent of our 401(k) assets are in these funds," reports T. Rowe vice president Steven Norwitz.

Many consulting firms, too, are wresting good deals for big-company clients. It was the rebate to recordkeepers in the alliances, in fact, that opened the door for fee negotiations, notes Richard Koski of Buck Consultants in New York City. Consultants like Koski, seeing that recordkeepers could get rebates of 15 or 20 basis points, began asking for something else on behalf of their clients. "Now we say, 'You get the full institutional expense ratio, but what will you give me for free?' " says Koski. "I have cooked up some deals where the institutional investment management fees pay for all custodial, educational and other fees." Getting one fund family to pay the bill and add funds from another family is also possible, he said. Adds Cerulli's Casey, "The bottom line is that pricing in this market is a moving target."

Some standardization in the way providers present fees to plan sponsors would no doubt help, Principal Group's

Hensley argues. This would at least allow plan sponsors to understand what they are paying — and what they are asking employees to pay. He suggests expressing all the costs, including the annual administration fee, as a percentage of assets under management.

Vendors have every reason to be concerned about what will happen when employees get the message that they are shelling out more for the mutual funds in their 401(k) than outside retail investors pay for those same funds — or perhaps more than other 401(k) participants whose employers drove a harder bargain with the fund providers. It shouldn't take them long to find out. Morningstar's Phillips says participants might have been led to believe that they will earn 10 percent a year on their 401(k). Now they are being asked to give up 10 to 20 percent of profits — and that is inching up to 30 percent. "It's an enormous cost," Phillips says. "This is an industry that is grossly overcompensated for the benefits it brings." Phillips argues that funds for 401(k) plans are "overpriced by two thirds" but that "few plan sponsors have the courage to step up and pierce the veil and find out what is really behind the fees."

More-modest investment returns will make high fees stand out further, of course. But other concerns loom for 401(k) providers. The "American dream" IRA, which is likely to be part of whatever budget bill is passed, is an extremely appealing alternative to the 401(k) for lower-paid workers. Although contributions to the American-dream IRA are not deductible for tax purposes, no tax is due on earnings from the account. More significantly, money that stays in the plan for five years can be withdrawn for a number of purposes, such as buying a first home.

In such an environment, hiking 401(k) costs and passing them on to participants in the form of high asset management fees is likely to be a losing strategy in the long run. "Mutual funds want to be in every distribution avenue possible, but they approach it as if their profit margins were sacrosanct," says Phillips. "And no one is calling them on it." That may soon change, as employees start pressing plan sponsors to wangle better deals. ♜

American Express Pla
Prompts McGraw Sui

Time Warn
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In Probe of the Munic

Gershon Kekst, the hidden persuader

Image buffing is more crucial than ever to companies, and this self-effacing confidant of CEOs is still the master.

By Suzanna Andrews

No trophies adorn Gershon Kekst's office. No Lucite-encased tombstones or silver platters commemorate his role in some of the most celebrated deals of the past decade: the monster buyout of RJR Nabisco, the merger of Time and Warner Communications, Paramount Communications' marriage to Viacom, IBM Corp.'s acquisition of Lotus Development Corp. On one wall of Kekst's 19th-floor Madison Avenue aerie are black-and-white photographs of a dancer; prints hanging on another wall betray no discernible mood or theme. Conspicuously missing are snapshots of Kekst with his clients, who constitute a who's who of America's CEOs.

Sitting in a corner armchair, wearing a simple, blue V-necked sweater, his glasses sliding down his nose, Kekst is at pains to downplay the extent of his influence. In a soothing, barely audible voice, he flatters a visitor, trying to deflect any talk about himself. Kekst smiles as he insists he has never had an "aptitude for anything serious or worthwhile." Why else, he suggests, would he be doing what he does? "I mean," he says with a shrug, "here I am in the public relations business."

His remarks reveal the possibilities of self-deprecation as an art form. Today, in the field of financial public relations, investor relations, corporate image making and crisis management, Gershon Kekst is a consummate artist and the undisputed king. Ten years ago "being in PR" may well have had pejorative connotations as a career that ranked somewhere in public disdain with politics or law (or journalism). But the world has changed. The proliferation of the financial press and its growing influence; the popularization of investment information, especially on public companies; the painful, often job-destroying restructuring of many industries; and the quasitabloid tenor of much business news coverage — all these forces have compelled companies and their CEOs to embrace aggressive public relations to manage both outright disasters and controversial strategies.

Of the small army of PR firms that give advice on how to handle everything from layoffs and bankruptcies to mergers, product recalls and rogue traders, none is as influential as Kekst and Co., the firm Gershon Kekst has run for the past 25 years.

Kekst himself has the kind of clout on Wall Street and in corporate boardrooms that is rarely seen among outside advisers. When Lazard Frères & Co. needed help in handling the fallout from a municipal bond scandal, it turned to Kekst. Chrysler Corp. turned to him to help fend off Kirk Kerkorian's unwanted bid for the carmaker. Kekst represented both General Electric Co. and PaineWebber in their deal to dispose of the remains of Kidder, Peabody & Co.; he also advised both parties in the Walt Disney Co.–Capital Cities/ABC merger.

But no list of deals alone can begin to explain Kekst's influence. In the past few years, he has elevated the stature of the outside public relations counsel and, in the process, become a trusted power broker and confidant to a galaxy of corporate chieftains. "He occupies a unique position in this country," says Wachtell, Lipton, Rosen & Katz attorney Marty Lipton, who himself knows something about high-powered advisory work. "I don't think anyone has the relationships he does with CEOs and investment bankers." Kekst is not simply a PR adviser but a counselor, "a rabbi," as one CEO puts it. Says former Lotus CEO James Manzi: "I talked to Gershon about the most serious problems and issues and challenges I faced when I ran Lotus, not just PR. Gershon helps people with probably the most thorny issues that they face."

No one will ever accuse the 61-year-old Kekst of upstaging a client. Unlike chattier, flashier competitors — Linda Robinson,

for example, who has been profiled in *Vanity Fair*; or John Scanlon, who handles celebrity clients like Ivana Trump as well as corporations and who is currently at the center of a controversy over smear tactics used by his clients, Brown & Williamson — Gershon Kekst has an aura of mystery. His firm does not trade on its roster of clients or even talk about them. Even competitors who have worked opposite his firm on deals know little about Kekst. "Have you *seen* him?" one asks. "What does he look like?"

What, others wonder, does he *do*? "I've worked on deals with him," says one top M&A banker, "and I've never understood what he does. People hire him because he makes them feel safer, but I've always thought the whole thing was B.S." Says another banker, "Basically, you could say what he's good at is understanding the insecurities of powerful, difficult people." For which solicitude they're willing to pay a hefty premium: Kekst and Co.'s fees are thought to be the highest in the business; the firm requires clients to sign on for a minimum annual retainer — before hourly billings — estimated to be more than $100,000. Kekst himself bills at a rate of close to $500 an hour.

He is the grandmaster in a business that, at heart, is about manipulating information to shape perceptions of reality. The question about Kekst is whether, ultimately, he is his own greatest creation. "When you think of Gershon Kekst," says a competitor, "think of the Wizard of Oz."

Just how important public relations has become to corporate America is illustrated by the experiences of two companies, Bankers Trust Co. and Prudential Securities, that failed to give PR its proper due. "Any PR adviser would have argued heavily against fighting [Procter & Gamble Co.] in court," says one practitioner, referring to BT's handling of its acrimonious dispute with P&G over a derivatives deal. "It's very risky to fight a client." In fact, the bank consulted not one but two PR advisers and went to court only reluctantly, insists a BT spokesman.

Prudential Securities was oblivious to the PR dimension of its limited-partnership scandal. Not only did the firm play legal hardball with thousands of brokerage customers who felt they had been cheated, but it also hung tough with regulators and its own top brokers, hundreds of whom quit the firm in the wake of a tidal wave of bad press. Prudential eventually hired Robinson

Lerer/Sawyer Miller, whose first piece of advice was to get rid of top executives perceived to be in any way associated with the radioactive partnerships and to institute greater candor. "PR 101," says one PR adviser: "Contain the story in one day. You don't want a story with a long tail — like Watergate — which is why you want to tell the truth on the first day and apologize."

One of the best examples of effective public relations is the media campaign conducted on behalf of Michael Milken in the two years before his 1990 sentencing. In a carefully orchestrated barrage of interviews, photo opportunities and op-ed pieces, Robinson Lerer added a completely new dimension to the public debate about Milken. With the firm's help, Milken, accused white-collar criminal extraordinaire and avatar of Wall Street greed, suddenly became Milken, "national resource," someone who had helped build small American companies and create jobs and, in his spare time, took inner-city kids to baseball games and talked urban renewal with Jesse Jackson.

Corporate public relations has undergone a profound evolution. Twenty years ago press releases, if they were issued at all, heralded minor executive promotions and touted new products. Investor relations consisted of communiqués written by lawyers and handed out to the press without further comment. Things began to shift in the early '70s as corporations came under greater scrutiny. Ralph Nader and his campaign for corporate accountability had a particularly significant impact.

But the most dramatic development, the one that boosted the fortunes of people like Gershon Kekst, was the growing power of institutional investors. "There did not use to be a lot of thinking about how do you use the communications process to strengthen the relationship between the management of a company and the owner," says Kekst. "It was evolving through the '50s and '60s, but mostly, it really [took] shape as a by-product of the acquisitive [1980s]."

What the era of hostile takeovers did was upend the attitude then prevailing in corporate boardrooms that investors would happily accede to whatever management wanted as long as the stock price continued to rise, no matter how sluggishly. The wave of bust-up takeovers exposed management's flank. "When those takeovers started to thrive, the managements turned to their shareholders for support — and as often as not couldn't get any, because it was the first time they were seriously turning to them," says Kekst. "They had not done a good job of communicating year in and year out, in bad times and good, what their strategies were. It was: 'Trust me. I'll send you an annual report once a year.' The companies were sitting ducks."

This notion of the importance of relationships has shaped Kekst's work. "Public relations for me is communications," he says. "A company has to have a business strategy that says: 'We are at Point A. In five years we want to be at Point X. And here's what that will mean.' A CEO has to ask: 'What's in it for my shareholders, my lenders, my customers, my employees? What do I need *them* to do for me to go from A to X?' There are all kinds of dimensions — legal, manufacturing and finance — but the most important is communications. It's, 'How do I get my constituents, upon whom I depend 100 percent for my strategy, to do what I need them to do?' "

Interrupting an interview, an investment banker takes a call from a Kekst and Co. executive. His firm has Kekst on retainer and uses it for help on M&A deals. "I talked to the reporter at the *Journal*," the banker says. "Yeah, I told him ours was the best bid, that we were bidding a lot and the company wasn't going to get a better deal." The reporter was just beginning to explore the story, but Kekst and Co. had advised the banker to get the bidder's point of view out to the press first — and fast. It was important, the Kekst executive told the banker, to stress how the bid would benefit the target company and its investors; Kekst would itself follow up with the reporter.

In the 1980s many public relations firms, lured by huge fees, tried to move into M&A, or transaction, PR. The field was crowded with such stalwarts as Edelman, Adams & Rhinehart, Howard Rubenstein and

Jonathan Levine/Onyx

Hill & Knowlton. But today a Big Bang of sorts has left only a handful of top players in this sector of the business: Abernathy MacGregor Scanlon, Robinson Lerer, the relatively new Sard Verbinnen and, still at the top of the heap, Kekst and Co.

The number of players shrank in part because of the decrease in hostile takeovers. Today the fights for the hearts and minds of investors, regulators, employees and the general public are both fewer and less bitter. But the demand for the services of the best firms is still there. In the current environment of corporate consolidation, points out Steven Jacobs, a merger lawyer at Weil, Gotshal & Manges, "you have deals that are nonpremium, stock to stock, in which you want to see both stocks go up in value. PR has become very important in trying to make sure that happens."

Dominant firms have created a special infrastructure to handle transaction PR — tight teams of executives who work well together under intense deadlines. A lot of administrative work has to be done, mostly in the first weekend following a transaction: writing press releases, putting together documents, lining

up interviews and arranging press conferences. But the critical work is much more subtle. What message will make the client look good? Which reporters will be skeptical and in need of extra stroking? What will hook investors, who are already overloaded with information? Sums up James MacGregor of Abernathy MacGregor: "How do you create an *idea* that transcends this avalanche of bits and bytes?"

Effective corporate PR injects a perspective that is often lacking in corporate and Wall Street boardrooms: How do other people think? "I was in a meeting at one company," recalls a PR adviser, "and the lawyers and bankers wanted the press release we issued to say that this merger would not result in the loss of jobs. Well, it was going to result in the loss of thousands of jobs. A good PR counsel has to have enough authority to be able to tell his or her clients, 'Guys, that is about the stupidest thing you could do' — and also enough clout to make them listen."

Lawyers and bankers have their own agendas and often have to be persuaded to change course. CEOs also need to be handled firmly. "Especially if there's a crisis," says one adviser, "you may have a CEO who is completely cowed. These guys are terrified of the press. They live in a world where they control everything, and the press comes in from left field. It can't be controlled." Says Blackstone Group partner J. Tomilson Hill III: "Gershon is the kind of person who can say, '*Enough*,' and people listen to him. He has extraordinarily good judgment — about people and about business trade-offs. In the midst of strategic fights, proxy fights, he is always calm and has always thought through the trade-offs of how things are perceived."

Gerardo Somoza/Outline

One showcase of Kekst style is the work he did for longtime client Henry Kravis during Kohlberg Kravis Roberts & Co.'s takeover of RJR Nabisco. By quietly funneling information to reporters on background, Kekst was able to promote KKR's actions without ever putting Kravis himself out front. The press treated readers and viewers to portrayals of the bitter, childish squabbling of Kravis's opponents, but Kravis himself appeared to be above the fray, calm and measured. "We were the high bid, remember, and we lost," says a banker who was allied with RJR. "A lot of it had to do with this image thing." Missteps on the RJR side, which was represented by Robinson Lerer, helped — most famously the disastrous *Time* interview with CEO Ross Johnson that resulted in a cover story headlined "A Game of Greed."

Kekst refuses to discuss his role in the deal, but bankers say that behind the scenes he played rough. Several credit him with a leak to *The New York Times* suggesting that a controversial management-perk agreement that Johnson engineered was worth some $2 billion. So what if, as some bankers insisted, it would only have kicked in if all sorts of unrealistic assumptions had been met? Reality, in Gershon Kekst's business, comes in many shades — and the toughest man's wins.

In 1969, in one of the most controversial business moves of that time, computer-leasing impresario Saul Steinberg made a hostile bid for Chemical Bank. Steinberg was represented by Gershon Kekst, who was then working for Ruder and Finn, a small PR firm. Kekst was about to make his name.

The bid provoked a furious outcry from the business establishment: An aggressive *outsider* was not only attacking a blue-chip company, he was attacking a *bank*, one of the hallowed cornerstones of the American economy. Kekst's job was to convince investors and the public that Steinberg's bid was the best option for Chemical. It was a doomed proposition. But Kekst's willingness to represent Steinberg got him noticed by key lawyers and investment bankers, who would soon turn to him for help.

PR had not been Kekst's first choice of a career; journalism had been. "If you could have made me Edward R. Murrow," he says, "I would have paid anything." He worked nights as a news announcer for one local radio station while in the army in the 1950s and then as a reporter for another in Washington. Although he interviewed Fidel Castro and Eleanor Roosevelt, among other prominent people, Kekst says he knew he'd never be a Murrow. And so, like many frustrated (and financially ambitious) journalists, he went into PR.

"Why would anyone want to do a story on me?" he says today, his smile more a mask than an invitation to conversation. "It would be so boring." Kekst's early life may well have lacked much drama, but it helped to position him perfectly for the

cultural upheaval that would take place on Wall Street and in the corporate world during the '80s.

He was born in Salem, Massachusetts, to parents who were both Hebrew-school teachers. His father died when Kekst was 4 years old, but his mother continued to teach to support her two sons. The family, Kekst says, "had no means at all, no money." They later moved to Maryland, where Kekst wound up attending the University of Maryland and majoring in philosophy and psychology. While he was growing up, Kekst was in Hebrew school or in synagogue six days a week, and Judaism was — and remains — a profoundly important part of his life. Today Kekst is chairman of the famed Weizmann Institute of Science, a leading institution of scientific research based in Israel, and of the Jewish Theological Seminary, the prominent academy of the conservative Jewish movement.

In the early days of his career, say people who know him well, his background helped him to establish a trademark style. "He was poor, he was an outsider, and he was deeply religious," says one man. That combination, along with a BA in psychology, became Kekst's portfolio as a public relations counsel: his eye for the outsider in a situation — and his knack for making someone look like the outsider — and the moral tone that he often injected into takeover fights.

One of the first men to take note of Kekst after the Chemical fight was Skadden, Arps, Slate, Meagher & Flom's Joseph Flom. The prominent takeover lawyer urged Kekst to leave Ruder and Finn and set up his own shop. Four years later, in 1975, Flom brought Kekst the deal that established him in M&A PR. Sterndent, a manufacturer of dental equipment, had been targeted by an investment group led by the heirs of Julius Rosenwald, a noted Jewish philanthropist. Kekst quickly noted that the group also included some Arab partners, and he placed a newspaper ad calling attention to that fact. The bid was swamped by a flood of objections from Jewish dentists who were Sterndent customers.

The tactic won the moniker "the Jewish dentists' defense." Recalls Kekst with an amused smile: "The Jewish members of the investment group did not want to stand up. I guess they were very self-conscious about being in this group with Arabs." That perceptions of the reality of the situation had been recast — in this case to play on the vulnerabilities of the bidder — was simply astute PR. "I put forth the facts and the reality as my clients see it," says Kekst. "Different people see it differently."

During the 1970s Kekst built his business slowly. As hostile takeovers began to heat up in the latter part of the decade, Kekst demonstrated his talents for attack PR. In 1978 he successfully represented Mead Corp., the giant paper company, in its defense against Occidental Petroleum Corp., making sure that the financial community knew that an Oxy Pete subsidiary had been responsible for the Love Canal disaster. A year later he helped McGraw-Hill fight off an unwelcome bid from American Express Co., scripting an attack that questioned AmEx's "corporate morality and sensitivity" and portrayed the bid as an assault on the publisher's integrity.

Kekst hit his stride in the 1980s, a decade that proved to be the ideal stage for his morality plays. Separating the heroes from the villains has always been at the heart of crisis public relations, but in the '80s it took on a new urgency and aggressiveness. Many of the largest corporations could no longer rely on their size, their name or their standing in the business community to protect them. Suddenly, a new force had come into play, led by the raiders, who not only offered serious money to investors — or what passed for it then — but also challenged the performance of corporate managements.

Raiders, hardly angels, were in need of PR themselves to counter their image as amoral predators. Kekst represented a number of them, most notably Steinberg, T. Boone Pickens, Samuel Belzberg and, of course, Kravis. He was also on retainer to Drexel Burnham Lambert and helped guide some of that firm's clients. But the bulk of his work was for the defense. Throughout the '80s Kekst built a formidable store of contacts and information, which made him a daunting — some would say fearsome — adversary.

Kekst became the PR man of choice for the new *Wall Street* subculture of M&A bankers and lawyers. And as they brought him into more and more deals, Kekst's reputation grew; in time corporations were putting him on retainer defensively, as they did bankers and lawyers, in case they received an unwanted takeover bid. "He was so much in the deal flow," says one competitor, "that it didn't matter if he was good. He had information, he had contacts, he could trade. Investors and re-

A no-spin situation

Some stories just won't spin. One of these was Ace Greenberg's $15 million stock and compensation package, awarded to the Bear, Stearns & Co. chairman in the late 1980s. Aware that this might raise the hackles of investors and the public in general, Greenberg got Kekst and Co. founder Gershon Kekst on the phone. "How do we handle this?" he asked Kekst, according to an executive who was in the room. "You don't," Kekst reportedly told Greenberg. "If you don't want to take the heat, cut your pay."

"Nobody ever has," Kekst laughs, when reminded of this story. "[Former Time Warner boss] Steve Ross and I used to go around this every single year. He would ask, 'What can we do about my compensation?' And I would say, 'Would you like me to increase it for you?' And he'd say, 'No, I would like people to understand that I am worth it.' And I would say to him: 'I can't. Maybe someone else knows how to do that, but I don't.'"

porters relied on him because he had information. He could create perceptions."

What is most intriguing to his competitors is how Gershon Kekst came to be such a trusted adviser to so many CEOs and investment bankers. "It is not so much what Gershon says as how he says it," says one man who has watched Kekst at work. "He walks in looking very rabbinical, very calm, very confident. He tells the client what to do in a voice that is almost too hard to hear, and the client is sitting there mesmerized." Lazard managing director Felix Rohatyn describes Kekst as "extraordinarily at peace with himself, very spiritual. His ego and his ambition don't get in the way when he gives advice." Kekst really cares about his clients, insist longstanding friends and clients like former Paramount CEO Martin Davis.

"Drexel was the kind of PR crisis that Kekst has tried to avoid: the kind that has failure built into it."

"Gershon is as close to a psychotherapist to CEOs as you can get," says one prominent investment banker. Adds a man who knows Kekst well: "We all need people who tap into our psyches, into something beyond the bottom line. Gershon can comfort people in times of stress and need. He has an extraordinary bedside manner."

When Jim Manzi learned that IBM was moving on Lotus, he became extremely upset, say insiders. Overwhelmed by a feeling of having been betrayed by Big Blue CEO Louis Gerstner, he froze; no one could get him to act, to call Gerstner. Suddenly, Manzi agreed to the acquisition. But sources close to the transaction say it could have been a protracted battle if it hadn't been for the intervention of Kekst, who was the only person able to "get [Manzi] over his emotions and thinking about shareholders," according to someone involved.

Not everyone buys into this notion of the PR counselor's strangely intimate role in the life of the '90s CEO. "I am not a normal client of Gershon's," says one CEO, who has Kekst on retainer. "I don't need a rabbi. I can run my own company. There are people who have him on retainer just so they can ask him what he thinks. I am not one of those." Perhaps not. Yet as understandably difficult as it is for many of Kekst's clients to admit, what they really need from him is encouragement, the reassurance that their decisions will not make them look bad, especially to increasingly demanding institutional shareholders. The greatest strength of Kekst, who is himself described as "very shy" and "acutely sensitive," is "how good he is at understanding people's vulnerabilities," suggests one banker. There are those who scoff that Kekst has made millions off a cheap commodity: common sense. But if that's all he's brought to the table, why haven't more people done it?

By the middle of the 1980s, Kekst says, he became alarmed at how heavily dependent his business was on takeover PR, which accounted for some 80 to 85 percent of revenues. Kekst knew that the takeover craze would die down and was "very frightened," he says, that Kekst and Co. would die with it. He began to plot a new strategy for a business that would focus more on broader strategic issues for clients.

"What I've tried to develop has been a business of strategic communications planning, where I sit down with a client and help them formulate a program that is born out of a particular motivation," he says. "It may be prophylactic — preventing being vulnerable to a proxy context, for example. It may be the possibility of a restructuring or dealing with a strike or a product recall." Today Kekst says takeover work accounts for only 35 percent of his firm's revenues and that Kekst and Co. does "substantially larger gross volume." The bulk of revenues derives from such activities as IR and high-level, big-picture advice.

Kekst's guiding business philosophy? He speaks admiringly of the great PR men who worked around the time of the Depression — Ben Sonnenberg, Tommy Ross, Earl Newsome — men "who cultivated the art of being your closest friend." He has taken to heart the advice Sonnenberg gave him 25 years ago when he left Ruder and Finn that "the key to success is to tuck your client in at night every night and be the last person he hears. And in the morning be the first to rouse him, ever so gently."

Kekst's critics may be right. Much of the time he is simply dispensing common sense or offering friendship. But he does so in a way designed to maximize his revenues and his dominance in the business. There are, for example, clients Kekst will not handle — CEOs he can't relate to personally, for example, or CEOs who won't give him unfettered access to other executives at their companies. If Kekst is going to render a judgment, he demands total freedom to collect information. Kekst, says a former partner in his firm, "will not stick around where there is no money to be made" — which would be the case if he had less than complete control.

A former consultant to Viacom recalls a meeting in which Paramount's Davis announced that Kekst would be brought in to represent both Paramount and Viacom in their merger talks. All other PR firms — including Robinson Lerer, which was working for Viacom — would be let go. "We went out into the reception room," says this source, "and there was Kekst waiting to take possession of the client."

The fact that Kekst represented both sides of the Paramount-Viacom merger was widely criticized in the press, especially after QVC began bidding and effectively put Paramount and Viacom in opposing camps. Davis says today that Kekst was hired because everyone involved in the deal agreed that he was the best. After QVC entered the deal, Kekst offered to remove himself and continued in the deal only as Paramount's adviser. Competitors see the scenario differently, as the moves of a control freak with an ax to grind. "He hates Linda Robinson and Ken Lerer," says one competitor, who notes that Viacom eventually rehired Robinson Lerer after it acquired Paramount.

Kekst responds angrily to the criticism. "There is no conflict of interest in representing both sides of a friendly transaction. I withdrew when the Delaware court opened it up for auction," he says. "I was the victim of someone throwing a nasty stone." He believes the villain was a competitor, but he won't say who.

Heaving more stones, competitors contend that Kekst walked away from longtime client Drexel Burnham CEO Frederick Joseph because his status as PR counselor was being chal-

lenged. "We were very surprised," says a former DBL public relations executive. "He was working with us; we had him on retainer. Then we got into trouble, and he resigned the account. He told Fred that too many people were second-guessing him. My feeling was that he didn't want to be questioned by the [Drexel] bankers. He didn't like them."

That Kekst seemingly abandoned a client faced with arguably the biggest public relations crisis in the modern history of Wall Street astonishes many people. The charitable view is that Kekst objected morally to Drexel's business practices and did not want to be associated with the firm. A different view is that he objected to the fact that Robinson Lerer was being hired to represent Milken.

Kekst disputes both explanations. Donning his cloak of modesty, he insists that he was no longer competent to do the job: "I was never at Drexel. I was Fred's friend — I hope I still am. When they got themselves into a lot of trouble, [attorney] Arthur Liman was representing first the firm and then just Michael, and [Liman] wanted me to represent Drexel. I told Fred I couldn't because I didn't understand [the allegations against Drexel or the firm's responses], and I had to stay away from anything that I didn't understand. When Art wanted me to represent the firm, he told me Linda Robinson was going to represent Michael and he wanted me to work with them. I said I wouldn't do that — but it didn't matter, because I didn't want to represent the firm."

"When he retires, what will happen to the firm he has so carefully crafted in his own image?"

In some ways, Drexel was the kind of public relations crisis that Gershon Kekst has studiously tried to avoid: the sort that has failure built into it. No image makeover was going to change Drexel's problems, not after the firm's practices had brought down the wrath of regulators, law enforcement officers and politicians. Even the best PR in the world, says Robert Marston, CEO of the corporate PR firm Marston Associates, "cannot reverse an egregious blunder."

Kekst can be brutally frank with his clients. "I have no problem," he says, "if a man or woman comes in and says, 'I have destroyed my credibility, and I would like to understand what it takes to rebuild it.' But if you come in and tell me, 'I have a public relations problem,' that's a tough one. That's someone denying the possibility that there is a reality problem.

"I don't want to hear how the press doesn't understand you, or the securities analysts," he continues. "If you do your research, you often find out that the person got his point across very well to securities analysts; they just didn't buy it. Or it turned out to be the wrong point, and now he's trying to reconstruct his credibility."

Despite Gershon Kekst's success, Kekst and Co. faces one big problem. When he retires, what will happen to the firm he has so carefully crafted in his own image? Today Kekst and Co. is made up of some 30 professionals, 18 of whom are partners. Over the years, Kekst has assembled a team that many people consider top-notch. He has paid them a share of profits and thus some of the highest salaries in the business. He has studiously avoided hiring PR "pros," plucking his staff from the legal profession, academia and business. He has also made a practice of hiring the offspring of his friends and clients — on the theory, he half jokes, that the children of overbearing, controlling men will have been well trained in focusing on other people's needs.

According to people who have left the firm, Kekst runs the company without any visible hierarchy or chain of command. He rarely second-guesses his partners and delegates easily. The firm's top partners — Lawrence Rand, Kekst's No. 2; James Fingeroth, perceived as No. 3; Andrew Baer; and Robert Siegfried — have made their own names in the business, and younger stars, such as former attorney Lissa Perlman, are moving up. Nevertheless, says an ex-Kekst employee, "that business is based on his relationships, and I don't believe that anyone else there could sustain it." According to another former staffer, "He has hired a lot of people who look up to him, who are more passive than he is."

But the root doubt is whether Kekst's business will thrive with a new generation of clients. Kekst has been successful, it is said, in part because he has advised a certain kind of CEO — "white, older men who are most often Jewish," says one competitor. "Culture and generation and ethnicity," notes another observer, "have been a big part of Kekst's power."

When Republic New York Corp.'s Edmond Safra needed help in fighting what he believed was American Express' slander campaign against him, Robert Siegfried was his Kekst adviser on a daily basis. But Kekst himself played a huge role in that affair, as chronicled at some length by Bryan Burrough in his book *Vendetta*. In Burrough's account, to Kekst "what was happening to Safra was more than just another assignment. It was a fight against the most detestable form of anti-Semitism."

Kekst laughs at Burrough's characterization. "The people at American Express were Jewish," says Kekst. "That wasn't the issue at all." A man who knows him well also disputes this interpretation of the Safra case: "Gershon is too smart to be controlled by that kind of passion."

But the larger point is raised by many Kekst watchers, even if their phrasing differs from Burrough's. Will a younger generation of CEOs — men and women who didn't live through World War II, who may not be particularly religious, who are much less intimidated by the media and by image making than their elders — need or want to use Kekst and Co.?

"We have several clients who are third- or fourth-generation CEOs in a company," says Kekst. "What I worry about is, Will people here be developing relationships deep enough in a company so that we will have established relationships with new generations as they come along?" That the firm boasts such clients as Manzi, who is 44, suggests that Kekst's assertion that Kekst and Co. will indeed endure — "no question" — is no mere PR, as it were.

It's hard to imagine Kekst and Co. trying to emulate the hip, high-tech aggressiveness of Robinson Lerer or the open, easy, hyper-media-connected style of Abernathy MacGregor Scanlon. But when Gershon Kekst goes, the firm will have to change. Because Kekst is a huge force, the likes of which will not be seen again in corporate PR for some time.

Or at least that's one version of reality. **it**

Wall Street's no-name merger gang

They may not be as celebrated, but today's industry specialists get more deals done (quietly) than the high-profile deal makers of the excessive '80s.

By Michael Peltz

By the time then–Walt Disney Co. chief financial officer Stephen Bollenbach got around to calling merger banker Glen Lewy late last July, the major elements of Disney's deal to buy Capital Cities/ABC were already in place. Bollenbach's boss, Michael Eisner, had negotiated the terms directly with Cap Cities CEO Thomas Murphy (abetted by timely matchmaking by major Cap Cities investor Warren Buffett and kibitzing by Disney shareholder Sid Bass). Conspicuously not involved in the process: investment bankers.

Still, when Bollenbach flew back to New York on Thursday, July 27, for marathon bargaining sessions to hammer out the details of the impending $19 billion acquisition, he wanted Lewy — vice chairman of James D. Wolfensohn, Inc. — to be by his side. "I've worked with Glen and the Wolfensohn firm for a good ten years, and I've always found them to be extraordinarily helpful," says Bollenbach, in a framable endorsement. (His ties to the investment banking boutique go back to his days as CFO of Holiday Corp. and Marriott Corp. and will presumably continue in his new position as president and CEO of Hilton Hotels Corp.) For a fairness opinion on the Cap Cities deal, Bollenbach retained longtime Disney banker Bear, Stearns & Co.

Should the absence of investment bankers during critical price negotiations between Disney and Cap Cities worry Wall Street? Not really. The 1980s mystique of Wall Street's merger mavens as the

M&A's marathoners

First the legs go. What with its heavy travel, intense performance pressure and general demands on stamina, merger banking can be as grueling, and short-lived, a career as professional sports. Yet a few of the merger stars of the early 1980s and before continue to work their Rolodexes as deftly as ever.

Lazard Frères & Co. managing director Felix Rohatyn, 67, amazes competitors with how he manages to remain hip-deep in the deal flow after four decades in the business. This ultimate generalist in an age of specialists landed another big deal in January: the $10 billion sale of defense electronics company Loral Corp. to Lockheed Martin Corp. Rohatyn should continue to attract his share of high-profile deals now that his name has been withdrawn from the sweepstakes for the vice chairmanship of the Federal Reserve Board.

Deal maker Joseph Perella, 54, who built First Boston Corp.'s M&A operation in the early '70s and helped make it into a powerhouse in the '80s, has likewise impressed M&A insiders with his endurance. He has been reenergized, observers say, since he joined Morgan Stanley & Co. in 1993 after leaving Wasserstein Perella & Co., the M&A boutique he co-founded in 1988. A member of Morgan Stanley's operating committee, Perella has been less involved in the day-to-day mechanics of individual deals since he was put in charge of the firm's corporate finance operation last spring. He spends much of his time overseeing the firm's overall client relationships and deal flow, "a really big job given the strength of the M&A environment," says one banker.

Some other '80s M&A stars are still visible on the horizon. Perella's old sidekick at First Boston, Bruce Wasserstein, 48, recently made headlines for selling U.S. cosmetics company Maybelline in a fierce bidding war between France's L'Oréal and Germany's Joh. A. Benckiser. (L'Oréal prevailed, after upping its initial per-share offer of $36.75 to $44.) His merger boutique stands to make $200 million from its 29 percent stake in Maybelline.

Eric Gleacher also made news — and raised quite a few eyebrows — when he sold his M&A boutique to the U.K.'s NatWest Group for $135 million in October. Wall Street insiders say the 55-year-old former Lehman Brothers and Morgan Stanley deal maker got top dollar for Gleacher & Co. because of its impressive top-15 finish in 1994's league tables. This high standing was thanks mostly to the firm's advisory role in American Home Products Corp.'s $10 billion hostile takeover of American Cyanamid Co. that year. Representing AHP was a nice coup, all right, says one bulge-bracket M&A head, but "the sale to NatWest was clearly [Gleacher's] greatest deal."

Robert Greenhill, 59, should be cheered by Gleacher's good fortune. The longtime Morgan Stanley banker left Smith Barney in January, halfway through his five-year contract as head of investment banking, to open up his own boutique. Although Greenhill built a solid franchise among middle-market companies at Smith Barney, he had a hard time attracting the large, high-profile deals that made him famous at Morgan Stanley.

brazen but brilliant swashbucklers of American banking, who (for better or worse) were engaged in restructuring American industry from the foundation up, has long since faded. Yet as Wolfensohn's supporting role in the Disney–Cap Cities (parent of *Institutional Investor*) merger suggests, M&A advisers have not been relegated entirely to the wings.

"I chuckle when people question whether investment bankers will be needed," says Lehman Brothers co-head of M&A Steven Wolitzer. "We're advisers, and companies like to have an adviser, someone they think is smart and who will give honest advice. Our role may range from being consigliere to being just an insurance policy, but we've always been used in a variety of ways." Indeed, in one way or another, bankers were involved in most of the record $450 billion in announced transactions last year.

The M&A trade has changed dramatically since the '80s. Then financial raiders, greenmail, two-tiered bust-ups and takeover defenses were the norm. Merger bankers like Eric Gleacher, Robert Greenhill and Bruce Wasserstein were bigger celebrities than many of the CEOs whose companies they combined (see box). By contrast, the new generation of merger bankers toils in relative obscurity as highly proficient but low-profile industry specialists. This no-name gang of financial facilitators seems to be comfortable behind the scenes of '90s-style strategic acquisitions.

But within this rather self-effacing set are some relatively young bankers who have achieved a level of fame within their specialties. Among them: Bear Stearns' Dennis Bovin (technology); CS First Boston's Brian Finn (restructurings, spin-offs and hostiles); Goldman, Sachs & Co.'s Steven (Mac) Heller (industrial companies); Lazard Frères & Co.'s Steven Rattner (media); Morgan Stanley & Co.'s Gary Parr (insurance) and Frank Quattrone (technology); and Salomon Brothers' Michael Carr (industrial companies).

Gone, too, from the current merger scene are the outsize bills that the '80s M&A stars got to present for their own and

their firms' services (which often entailed merger financing as well as straight merger arranging). During the 1988–'89 height of the LBO boom, raiders paid their bankers a whopping $45 million in fees per deal on average. But today's deals — less complex in both tactics and financing — can't command that kind of premium. Overall, however, fees have certainly kept pace with the best years of the '80s (see table).

Most of the no-name platoon earned their stripes in the '80s. CS First Boston M&A co-head Finn, who played a lead role in Seagram Co.'s $5.7 billion purchase of 80 percent of MCA last year, began his career crunching numbers for Wasserstein and Joseph Perella during their heyday as M&A co-chiefs at First Boston Corp. The 35-year-old Finn looks back fondly upon those days. "It was an exciting, fun, intense experience," he says. "I was young, and they gave me great opportunities to get involved in many different levels of transaction work." Finn is one of several new-generation bankers at big firms who benefited when the stars of the '80s moved up to more senior management positions, left to form their own boutiques or simply opted out of the daily (and nightly) grind.

A star system was, to be sure, a wonderful marketing device for Wall Street in the '80s. CEOs and boards of directors were more than happy to fall back on the stewardship of the Street's big names to justify leveraging up their businesses to make what otherwise might have been perceived as foolish acquisitions (which, in any case, were sometimes carried out merely in the hope of warding off potential hostile suitors). Once companies took the plunge, they had little choice but to rely on the expertise of investment bankers to structure deals that were as highly complex as they were highly leveraged. The decade's arcane takeover rules made tactics critical, playing to the strengths of former lawyers like Wasserstein. "An enormous amount of the deals of the '80s had huge litigation issues," notes Cravath, Swaine & Moore partner Allen Finkelson. "Today even hostile deals are accomplished with less litigation."

The playing field has been plowed flat indeed. Securities and Exchange Commission and Delaware Chancery Court rulings now make it mandatory for any company that puts itself up for sale to deal equally with all potential suitors. Moreover, tax changes restrict financial buyers' ability to bust up a company. The widespread use of auctions has also helped to systematize the M&A process.

In what is perhaps the biggest about-face, most boards of directors have started to view hostile deals as an acceptable corporate strategy. IBM Corp. helped to legitimize the practice with its $3.5 billion takeover of Lotus Development Corp. last summer — after it had been spurned by the software maker.

"Strategic" acquisition has become the corporate buzzword of the '90s. But Perella, now head of corporate finance at Morgan Stanley, contends the hype is just that: "Everyone's saying that M&A deals are more strategic today, but I just think that it's a stage in the cycle." He argues that the deals that created the big conglomerates 30 years ago were just as strategically motivated as today's deals are. "It's the market that creates the mechanism for these things," Perella says. "Today focus is rewarded, but if the market were to put a premium on companies that are in 20 lines of business, then people would diversify."

One thing is certain: Corporations, though still a little wary of merger bankers, no longer view M&A as simply another fancy product being peddled by the Street. Instead, they see deal making as an essential part of their corporate-strategy kit, another way to improve the bottom line. And despite the fact that CEOs still play the dominant role in actually initiating deals, it's CFOs who often are the most closely involved in the decision making that prompts a merger or divestiture.

Companies are also more financially savvy. Says Lazard's Rattner, who heads up his firm's media and telecommunications coverage: "Ten years ago even the analysis we did was proprietary. Now most clients have a financial model for looking at acquisitions, and some of what we brought to the party can be done by the companies."

Large multinational companies have brought much of their M&A work in-house. To handle most deals, finance staffers don't need the expertise of investment bankers. Cheap bank financing and a buoyant equity market allow most acquisitions to be done with plain-vanilla financing: stock, cash or some combination. What's critical is valuing the business benefits of combinations or divestitures, and there companies may actually have an advantage over Wall Street. "In the '80s a lot of time was spent on the financial engineering of deals, but

What fee squeeze?

Some investment bankers grouse that their fees are being squeezed, but compensation for M&A advisory work has held remarkably steady since the 1980s.

Deal size	Average target fees	Average acquirer fees
	(Percentage of total deal)	
1988–1990*		
$250 million to $500 million	$2.36 million (0.68 percent)	$1.92 million (0.56 percent)
$2 billion-plus	$18.34 million (0.48 percent)	$13.96 million (0.29 percent)
1995*		
$250 million to $500 million	$2.82 million (0.81 percent)	$2.58 million (0.74 percent)
$2 billion-plus	$9.50 million (0.28 percent)	$8.67 million (0.27 percent)
LBOs**		
$250 million to $500 million	$2.33 million (0.72 percent)	$4.03 million (1.17 percent)
$2 billion-plus	$12.70 million (0.34 percent)	$45.35 million (0.89 percent)

** Hostile takeovers, leveraged buyouts and fairness opinions have been excluded.*

*** From 1988 to 1989, the height of the leveraged buyout boom.*

Source: J.P. Morgan, based on publicly disclosed filings.

today that's less relevant," says Lehman's Wolitzer. "Now the business analysis is extremely important, and the banker is somewhat less relevant there."

Companies tend accordingly to rely on fewer investment bankers, and competition for coveted mandates is intense. "You need to be in a company's inner circle of two or three bankers to do any meaningful M&A business," says CS First Boston's Chicago-based M&A co-head, Steven Koch.

Winning an assignment often depends on specific industry knowledge of the sort that takes years to acquire. Long gone are the days of the lone ranger M&A banker coming in with a wild idea to break up a company or launch a leveraged takeover. Says Merrill Lynch & Co. M&A co-head Jack Levy: "Bankers need to have a much more frequent level of contact with their clients. Knowing their clients' business is at the heart of a quality M&A dialogue." Companies are as eager as ever to hear innovative ideas. "Clients want your views on their industry — who the buyers and sellers are, what's going to happen," says Salomon co-head of M&A Carr. "But if you bring them obvious ideas you get thrown out pretty quickly."

"Firms have tried to better integrate M&A into their overall corporate coverage."

Most firms have by now redeployed their M&A bankers along industry lines. Rather than repeat their big '80s mistake of staffing up, only to cut back when the deal flow ebbs, firms have tried to better integrate M&A into their overall corporate coverage. At J.P. Morgan, says Joseph Walker, co-head of M&A for the Americas, his 50 professionals work closely with both the geographic-coverage bankers and the groups specializing in such industries as health care and technology. At Morgan Stanley M&A chief Bruce Fiedorek has instituted a "buddy" system: "The M&A officers work closely with their counterparts in corporate finance, much of it specialized by industry."

As companies have gotten more sophisticated, their demands have changed. They no longer need — or want — to be shepherded from deal to deal by Wall Street power brokers. "In the '80s you'd be hiring a particular guy as well as his firm," says Stephen Schwarzman, an M&A marquee name at Lehman before leaving in 1985 to co-found Blackstone Group. "Now it's the reverse, you're hiring the firm and then the individual."

The "firm first" approach has played to the strengths of Morgan Stanley and Goldman Sachs. The two firms have pulled away from the merger pack, together accounting for 53 percent of all announced transactions involving a U.S. target last year, up from 50 percent in 1994. "Goldman and Morgan Stanley have big lists of corporate clients, and the M&A business flows out of corporate client lists," says Schwarzman. CS First Boston, a solid No. 3 in deal volume last year, says it has been able to succeed with a much smaller client list by doing fewer but larger deals that require a more specialized expertise. Last year the firm advised a number of successful hostile acquirers, including IBM, Wells Fargo & Co., Union Pacific Corp. and Praxair.

Niche players and boutiques have made real inroads in M&A advisory work. "In the past you wouldn't have seen a firm like Wolfensohn in a Disney–Cap Cities deal," says Jones, Day, Reavis & Pogue partner Robert Profusek, a specialist in merger law for the past 20 years. Boutiques have attracted a lot of top-drawer M&A talent from the big firms, but they also have one clear-cut advantage over their bulge-bracket brethren: It's a lot easier for them to appear objective, since they essentially only do advisory work. With only one or two clients in a given industry, boutiques are much less conflict-prone. Wolfensohn is on retainer to only about 40 companies. Says vice chairman Lewy, "Our clients are willing to share with us their five-year business plans because they know they won't find us on the other side of the table." (Bulge-bracket bankers counter that it's more important to be a full-service provider.)

J.P. Morgan, the only "commercial" bank threatening the bulge-bracket firms' grip on the M&A advisory business, is in the midst of a generational shift in its merger department and, indeed, bankwide (see Cover Story). The 50-year-old Roberto Mendoza, the banker most identified with Morgan's merger effort, has taken on a more senior role as vice chairman and has been succeeded by Walker, 41, and Nicholas Paumgarten, 50, in the Americas.

Morgan's bulge-bracket rivals grumble that the bank lacks their ability to execute deals and accuse it of trying to buy market share by cutting fees. Walker flatly denies both the skill and the fee rap. "We wouldn't get hired if we couldn't do the execution," he says. "This is not a business where anyone is going to hire you solely on the basis of price. The cost of making a mistake in one of these transactions is too significant." At least one bulge-bracket M&A chief reluctantly admits that J.P. Morgan has become a formidable rival: "In the early '90s you'd only see them in certain pieces of the business, particularly in Latin America and Europe. Now they're across the board."

Absent the old star system, merger banks of whatever sort have a tougher time differentiating themselves from the competition on deal-making prowess alone. Cultivating relationships is therefore crucial. But for this exercise in sustained schmoozing, bankers need skill sets quite different from those of the sometimes-brusque master tacticians of the '80s. Charm isn't necessarily the key, though. The ability to execute is a given, but that must be combined with a thorough industry and business focus in a package with which CEOs, CFOs and boards of directors alike can be comfortable. M&A remains an intensely personal business. "When a company issues stock, it deals with a trading desk on matters of price and process," says Salomon's Carr. "M&A is very different. The relationship extends to matters of trust, so if they confide in you, you won't go tell their competitors."

For firms that earn a company's trust, the rewards in M&A and also ancillary business can be great. "One thing that is consistent over time is that there's a value inherent in being a confidant of a decision maker that transcends the day-to-day events of the Street," says Morgan Stanley's Perella. ■

The beat goes on

Germany moves up as global optimism continues to nudge sovereign creditworthiness higher.

By Harvey D. Shapiro

Amid broadly positive reviews from international bankers everywhere, a new leader has emerged in *Institutional Investor's* exclusive semiannual rating of sovereign creditworthiness. One banker surveyed suggests that "nostalgia for the deutsche mark, a currency that may soon disappear," helped push Germany's rating up slightly just as Switzerland slipped a bit, easing the Federal Republic into a tie for the No. 1 position. Germany goes to the head of the class after years of U.S. leadership followed by relatively brief reigns by Japan and Switzerland.

Though there may be some nostalgia underpinning Germany's rise, the bankers surveyed for this feature clearly were not looking to the past in their ratings of other countries; indeed, many formerly troubled credits moved up sharply. Thirty-five countries climbed a point or more in the past six months and only a dozen fell by that amount. Overall global creditworthiness climbed slightly — 0.4 points, to 38.9 — the fifth successive increase in the survey; it is now at its highest point since September 1990.

The ratings rise was paced by strong gains in Eastern Europe and Latin America. The Asia-Pacific region, however, seemingly every financier's favorite part of the world, actually had a small dip in its rating. In fact, there is a good deal of divergence in the views of respondents regarding individual countries, but the consensus is, decidedly, "Onward and upward." The reason is clear, says one British banker: "The economic outlook for the world is reasonably favorable, but the biggest changes are political. A lot of potential theaters of war are being changed by peace processes. This includes southern Africa and the Middle East."

The greatest regional improvement occurred in **Eastern Europe**, where the overall rating rose more than a point, to 26.1, the highest level in four years. Five of the top seven gainers in the survey were from Eastern Europe, where nine countries rose and only two fell by a point or more. "But you can't talk about regional performance," cautions one banker. "Each country has its own story." The region's biggest winner was Slovenia, up 3.5 points in six months, the second-largest increase in the survey. It has risen 25.5 points since it was first rated in September 1992. "Slovenia is potentially a little Switzerland on the opposite side of the Alps," says a German banker. The Czech Republic, up 1.7 points, and Slovakia, up

WINNERS AND LOSERS

THE ONE-YEAR RECORD (MARCH 1995 TO MARCH 1996)

Who's up the most? Country	Change in Institutional Investor credit rating	Who's down the most? Country	Change in Institutional Investor credit rating
Slovenia	6.4	Mexico	-5.7
Slovakia	5.4	Venezuela	-3.0
Poland	4.5	Hungary	-2.8
Croatia	4.3	Nigeria	-2.7
Czech Republic	4.3	Algeria	-2.0
Mauritius	4.3	Iran	-1.9
Jordan	4.2	Hong Kong	-1.6
South Africa	3.8	Afghanistan	-1.4
Chile	3.6	China	-1.2
Estonia	3.5	Switzerland	-1.0
Peru	3.5	Japan	-0.9
Cyprus	3.4	Taiwan	-0.8

THE SIX-MONTH RECORD (SEPTEMBER 1995 TO MARCH 1996)

Who's up the most? Country	Change in Institutional Investor credit rating	Who's down the most? Country	Change in Institutional Investor credit rating
Mauritius	3.8	Hong Kong	-1.6
Slovenia	3.5	Hungary	-1.4
Croatia	2.9	Algeria	-1.3
Slovakia	2.9	Venezuela	-1.3
Jordan	2.8	Iran	-1.2
Estonia	2.6	Nepal	-1.2
Poland	2.6	Pakistan	-1.2
Trinidad & Tobago	2.0	Singapore	-1.2
Barbados	1.8	Afghanistan	-1.0
Chile	1.8	Belarus	-1.0
Cyprus	1.7	Nigeria	-1.0
Czech Republic	1.7	Taiwan	-1.0

2.9 points, also benefited from solid economic performance.

Poland's 2.6-point rise, on the other hand, is attributed to politics. "The big worry was about the transition to a new president, but that seems to have worked out very smoothly," says a German banker. Similarly, he says, Croatia was upgraded by nearly 3.0 points because of "what seems to be an end to hostilities in that part of the world." In the Baltic States, Estonia was up 2.6 and Latvia 1.3 points, "because of the commitment of their governments to reform,"says this German banker. "Estonia," he adds, "is a star performer that has practically completed its economic reform in terms of privatization and removing the government from day-to-day economic life." Because Lithuania is seen as lagging its Baltic neighbors in the pace of reform, however, he says its rating has not climbed as fast.

The other two Eastern European countries that rose, Romania (up 1.2 points) and Ukraine (1.0), are seen as getting their economic houses in order as well. Not so with Hungary, down 1.4, and Belarus, off by a point. "Hungary has lost momentum," says one European banker, adding, "They were by far the leading candidate for membership in the OECD and so on, but now they're slipping. Their commitment to the reform process is wavering. The government is pragmatic, to put it politely, rather than being ideologically committed to putting through reforms." As for Belarus, he says, "it's getting too close to Moscow again. There is concern the government wants to rejoin a Soviet union of two countries, and forming monetary union with a currency that has the credibility of the ruble is a bit of a joke."

If each country in Eastern Europe has its own story, almost every sovereign in **Latin America** benefited from the same story; the region's slight rating improvement, just shy of a point, was the second-biggest in the survey. "There was a clearing out of the tequila effect, the worry that these countries would go the same way as Mexico," a New York banker says. Although 12 countries rose a point or more, he notes, "in terms of economic fundamentals, there is very little news that would push them either way."

Most of the gains were posted by the smaller countries of Central and Latin America, including Barbados, Trinidad & Tobago, Costa Rica and Bolivia; bankers even upgraded Cuba by 1.3 points. Among the major Latin credits, only Chile moved much — a smart 1.8 points upward because of favorable economic news. "We believe its current account was in balance in 1995 and will be so again in 1996," says a British banker. The region's only big loser was Venezuela, down 1.3 points. "They're hopeless," sighs this banker. "Except for Venezuela, everybody in Latin America is on a train moving in the right direction."

Many of the financiers surveyed are taking a similar view of the **Middle East**, which rose 0.6 points, to 41.6, the region's highest rating in 14 years. The peace process meant continuing significant improvement for Israel, Jordan and Lebanon; Egypt, however, failed to benefit because peace dividends were offset by internal political and economic problems. Cyprus rose 1.7 points, bringing its rise to 10.3 points in four and a half years; bankers continue to believe that it will prosper as a trading center for the expanding Middle Eastern economy. The region's big loser was Iran, down 1.2 points as a result of "worries about the power of fundamentalists over the government," in the words of one U.S. banker. "There's fear we're returning to the bad old days of the Ayatollah [Khomeini]."

Africa struggled to a 22-point regional rating thanks to an 0.3-point rise that, statistically, is only marginal; the rating is nonetheless the region's best in nearly a decade. Two countries fell significantly because of internal political strife — Algeria and Nigeria — while the ratings of seven improved. Mauritius remains the favored African credit, leaping an additional 3.8 points — the biggest change in the survey — because of what one U.S. banker called "its perky little economic engine." And the Seychelles climbed 1.5 points "because it is becoming a little Mauritius," he adds. This banker says the Seychelles has weaned itself from its Russian patron and is now building a diversified economy.

Meanwhile, continuing evidence of political stability boosted South Africa, southern Africa's strongest economy, better than a point. Stability "radiated good vibrations throughout the southern cone of Africa," observes a British bank economist. "That's why Zimbabwe is up 1.2 points."

Amid all these gains the **Asia-Pacific** region registered its first ratings decline since September 1992, although only by a modest 0.3 points. Despite continuing growth, "there's a feeling that some of the tigers are overheating," says one Dutch banker. "You're seeing rapid economic growth, but inflation is a concern. It's remaining relatively controlled, although it's high by Western standards. And there's a fear that if this continues, it may affect the current account and their international competitiveness."

That, he argues, has contributed to what happened in Singapore, Taiwan and Hong Kong; the crown colony's 1.6-point decline was the biggest drop suffered by any country in the survey. As for Pakistan's 1.2-point decline, he explains that "it's dawning on people that they have nuclear weapons." One of the region's two significant increases was recorded by the Philippines, up 1.3 points this time and 12.4 points over the past four years. "They had been lagging the rest of the region," one Los Angeles–based banker says, "but now there are foundations for reasonable economic growth over the medium term."

Although this survey was driven by lots of movement, with an average country rating change of 0.84 points, compared with 0.61 points six months ago, little of this change emanated from the industrialized world. **Western Europe** edged up 0.1 points as the result of a single significant improvement: Ireland was up a point because of better prospects for an enduring peace (the survey was conducted before the IRA bombing in London in early February). And in **North America** the minuscule uptick in the U.S. rating was offset by modest declines in Canada and Mexico, bringing the North American regional rating down 0.3 points.

The survey was clearly dominated by changes in the developing world, in which, says one European banker, "almost everywhere you look, the economic news is pretty good, and the political news is even better." But even in the developing world, he adds, the major countries were becalmed, with little movement in the ratings of such countries as China, India, Brazil and Mexico. "There was broad-based improvement nonetheless," he concludes, "and we're cautiously optimistic that it will continue." **II**

Associate Editor Kit Purcell prepared the statistical material accompanying this feature.

HOW THE RATINGS ARE COMPILED

The country-by-country credit ratings developed by *Institutional Investor* are based on information provided by leading international banks. Bankers are asked to grade each of the countries on a scale of zero to 100, with 100 representing those with the least chance of default.

The sample for the study, which is updated every six months, ranges from 75 to 100 banks, each of which provides its own ratings. The names of all participants in the survey are kept strictly confidential. Banks are not permitted to rate their home countries. The individual responses are weighted using an *Institutional Investor* formula that gives more importance to responses from banks with greater worldwide exposure and more-sophisticated country-analysis systems.

The 1996 All-Europe Research Team

This magazine's annual selection of the brokerage analysts who have done outstanding work covering Europe during the past year ranks analysts from 46 firms in 76 industries and investment specialties.

If at the start of 1995 London-based securities analysts had been asked to forecast their own market value for the following 12 months, few would have been bullish. Analysts were well aware of how heavily the costs of large-scale research, sales and trading operations were weighing on the investment banks that employed them. Nomura International seemed to be setting the tone when it laid off most of its U.K. equity researchers in early February. To many analysts, much-reduced bonus payments seemed the best they could hope for in the months ahead.

However, help was at hand. It came first in the form of Deutsche Morgan Grenfell (the name that Morgan Grenfell & Co., Deutsche Bank's U.K. operation, took on after the bank's other investment banking activities were merged into it) and then, as the year progressed, in the actions of Dresdner Bank, Swiss Bank Corp. and Merrill Lynch & Co. All of these foreign institutions set out last year to build through acquisition — or, in the case of DMG, to start from scratch — an equity operation in London. For that they needed analysts. Interviews for this survey — *Institutional Investor's* 11th annual look at the best analysts in the U.K. and the fifth in which analysts in continental Europe are included — reveal that this new source of demand not only secured the jobs of people at the houses involved but also raised the profile and value of analysts in general.

But City newcomers in 1995's Big Bang II (as it came to be known) were acquiring analytical expertise for reasons different from those that had motivated the purchasers nine years before. In the original Big Bang, banks bought stockbrokers and market makers; last year (with the exception of Merrill Lynch's purchase of stockbroker Smith New Court) attention was focused on the so-called integrated houses, which combine corporate finance and securities operations, that had been created out of the 1986 changes. The first Big Bang was mainly about building a role in secondary market trading; in the rerun, establishing a presence in the international primary equity market was often high on acquirers' list of priorities.

Small wonder. The 1990s have seen this market establish itself as one of the most active and profitable areas of investment banking. The rewards are especially great for houses that regularly win lead-management roles. When choosing a lead manager, issuers are naturally concerned about how effectively a securities house will be able to distribute its shares. Wheeling out an analyst who is highly rated in the relevant industrial sector vastly increases a house's chances of getting in on a deal.

This is the key reason well-regarded analysts have been able to command higher and higher pay over the past few years, even when the secondary markets have performed poorly. Says the head of research at one U.K. firm, "Remuneration has been squeezing upward, and competition gets intense in areas where there is short supply." Take last year's high-profile moves in the telecommunications sector, one of the most active areas in the international primary equity market. Paul Norris was reported to have secured a deal worth £1 million ($1.56 million) a year, setting a new benchmark, when he transferred to Lehman Brothers from BZW last summer. (Norris, who doesn't appear on this year's survey, was a third-teamer in 1995 in Continental telecommunications op-

erators and a runner-up in U.K. telecommunications operators.) Although a Deutsche Morgan Grenfell spokesman insists that the firm is paying a "market rate," there was speculation that it wrote a big check to lure the highly regarded Golob brothers — one an analyst, the other a corporate financier — from SBC Warburg (the investment banking entity created after SBC's acquisition of S.G. Warburg in July). James Golob shows up this year in both U.K. and Continental telecommunications operators as a runner-up and a first-teamer, respectively.

It was, of course, not only the Golobs who fled Warburg for Deutsche Morgan Grenfell. The shift was made so often last spring that Sir David Scholey, former chairman of S.G. Warburg Group, wrote to Hilmar Kopper, his counterpart at Deutsche Bank, to complain about the "targeting" of his staff. Certainly, DMG took good advantage of the turmoil into which Warburg, including its top-rated research department, had tumbled after the breakdown of merger talks with Morgan Stanley & Co. at the end of 1994. And departures did not stop with the May announcement that SBC was to be Warburg's new parent. Despite the defections, however, the old Warburg was so successful in entrenching itself in the market that the successor organization holds on to the premier position among firms (see table, next page). This is Warburg's fifth consecutive triumph.

By contrast, Kleinwort Benson's acquisition by Dresdner Bank last August seemed to go smoothly, especially as far as Kleinwort's analysts were concerned. That was chiefly because Dresdner had no existing research operation in London and made no attempt to interfere with what the U.K. house was doing in the field. Indeed, Kleinwort has staged a form of reverse takeover in that it has been given responsibility for Dresdner's Frankfurt-based equity and fixed-income research operation, which has been rebranded under the Kleinwort name.

Merrill Lynch's August 1995 acquisition of Smith New Court appears to have been more troublesome. Merrill already had an equity research department in London, even if it comprised only 25 analysts against Smith's 100-plus. Although Merrill gave Smith staffers prominent management positions, there have been rumblings of discontent from the Smith camp. U.K. research director Bruce Davidson concedes that the integration of Merrill analysts, almost all of whom cover industry sectors, with those of Smith, which traditionally divided up continental European companies by country, has caused some problems. "Some country analysts are feeling a bit bruised," he says, even though "management has tried to handle the integration as sensitively as it can." Management's motivation is clear: All of Merrill's 15 U.K. sector analysts who show up on the All-Europe team this year were formerly with Smith New Court.

Certainly, analysts who number among the 320 former Smith people on whom Merrill has placed "golden handcuffs," at a cost of £30 million, have something with which to console themselves. Beneficiaries have signed contracts that guarantee minimum bonuses. In return, Smith staffers are believed to have accepted extended notice periods and agreed not to entice away other colleagues for a certain number of months.

SBC also set up a loyalty incentive scheme when it integrated its investment banking unit with Warburg in July of last year; for many this involved a cash reward for staying on for 12 months. These steps have been crucial in buoying up the remuneration of City analysts generally, research heads say. As the Golobs' departure from Warburg clearly suggests, some people are worth so much to a rival house that they cannot be confined. But, alongside DMG's recruitment drive, the loyalty schemes have underscored the value of researchers to a newcomer to the London market.

A matter of intense interest to the market over the coming months will be what happens as the handcuffs start to come off. There are some SBC Warburg and Merrill analysts whom rival houses would love to lure away. At the same time, other analysts at these firms may be forced to move, as their new owners start a weeding-out process. Notes the head of research at one U.S. house: "The handcuffs were expensive, but SBC and Merrill were effectively buying themselves at least a year to evaluate whom they did and did not want."

If staffers do start shifting from these two key European research houses in 1996, it should spell some changes in our list of top firms. But during the past year this lineup has seen little alteration (after Merrill's absorption of Smith New Court, which helps to elevate the combined organization from No. 11 to No. 4, is taken into account). The most notable change has been the rise of UBS Ltd.; it jumps five places to reach the third position. Although UBS has not had any dramatic change of strategy, according to global head of research Nigel Lester, its recent hires include former Warburg chief economist George Magnus and Mark Cusack, a former BZW staffer who places third in U.K. diversified industrials. UBS has also been beefing up its European emerging-markets team with the recruitment of Maciej Radziwill of CS First Boston as the head of its Polish equity research. This is in tandem with similar moves made by other houses: Nomura Research Institute Europe, for instance, has added more analysts to its team for Eastern Europe.

Because there is so much that separates it from the rest of Europe, Eastern Europe is still being covered as a discrete geographical area by research departments. Elsewhere, however, the trend toward covering companies in industry sectors is

now firmly established. According to many research directors, the pan-European approach reflects business fundamentals and satisfies a growing demand from investors. However, even the U.S. houses, which spearheaded the trend, accept that the local market feel of a country specialist can be valuable, too. Many researchers talk about the "country-sector matrix," in which industry and country analysts cooperate to produce a fully rounded service. But research directors acknowledge that such teamwork can prove difficult to achieve — "We call it the country-sector Bosnia," jokes the head of research at one house.

Going pan-European may, in some instances, be a way of putting a positive gloss on a house's abandonment of an attempt to break into the intensely competitive market for U.K. company research, a field that remains dominated by the same handful of long-established British names (even if just two of them, NatWest Securities and BZW, are domestically owned). The research strength of these firms goes hand in hand with the substantial sales and trading operations they maintain; unlike the U.S. investment banks, for instance, their analysts are usually backed up by specialist salesmen. Yet investment banks are increasingly asking themselves if it is worthwhile to maintain such a significant investment in the secondary market. The problem is that the big investing institutions that dominate trading in U.K. equities continue to exert downward pressure on margins; some have now persuaded their brokers to let them deal net of commissions.

Concerns about this trend are believed to have been part of the reason Smith decided to sell out to Merrill. Of course, this squeeze on profitability might not matter if the U.K. houses could offset it with more lucrative primary market work. Yet, Warburg excepted, most have had little success acquiring lead-management roles in international equity deals, despite their strong relationships with U.K. investors.

That leaves the domestically oriented houses vulnerable to losing their analysts to the U.S. investment banks, which have a stronger primary market presence. However, points out Edmond Warner, head of global research at Kleinwort, "it's still a broad church: Some analysts are corporate financiers at heart, whereas others like to stick to pure stockbroking." Although U.S. houses may pay more, analysts may not be prepared to work the long hours demanded there. In addition, some still fear that their integrity will be compromised if they get too involved in primary market work.

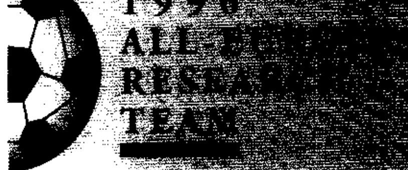
The U.S. firms, of course, vehemently reject any suggestion that their analysts are pressured by investment bankers. At Goldman Sachs International co-partner in charge of international research Robert Morris III insists that his firm does not neglect relationships with investors in the secondary market. "On a sustained basis you can't have a primary business unless you have a secondary business," he reasons, adding that when an analyst comes in for an interview, "out of the 15 to 20 people who see him, only one or two will be from investment banking."

Whatever the pros and cons of the different working environments, the international primary equity market will continue to play a large part in the fortunes of analysts. True, a number of privatization issues launched last autumn had to be scaled down. But European governments still need to place a great deal of paper over the next few years. That, and the strong appetite investors have demonstrated for some deals from nongovernment issuers, should underpin demand for highly rated analysts. In addition to those covering telecoms, specialists in media companies are much sought after, owing to the flurry of corporate activity in that area.

There are other reasons for researchers to feel optimistic. After a prosperous 1995 investment banks have become expansive; Salomon Brothers was recruiting equity staff in London toward the end of the year. And 1996 may bring further Big Bang II acquisitions. Although some experts expect a correction in the job market as the retention schemes that SBC and Merrill have put into place start to unwind, the correction may affect only the compensation level of analysts whose value was artificially inflated by last year's events. Agrees Keith

THE LEADERS

Rank 1995	Rank 1996	Firm	Total positions	First team	Second team	Third team	Runners-up
1	1	SBC Warburg	46	11	5	12	18
2	2	James Capel & Co.	37	3	13	8	13
8	3	UBS	33	6	5	12	10
11	4	Merrill Lynch	31	4	5	12	10
5	5	NatWest Securities	30	12	12	2	4
3	6	BZW	29	6	3	8	12
6	7	Kleinwort Benson Securities	28	7	7	4	10
6	8	Goldman Sachs International	20	10	1	5	4
9	9	Morgan Stanley International	18	7	4	1	6
—	10	Deutsche Morgan Grenfell	9	2	3	0	4
10	11	ABN Amro Hoare Govett	7	3	1	1	2
—	12	D. Carnegie	4	2	0	0	2
12		Lehman Brothers	4	0	0	3	1
16		J.P. Morgan	4	0	3	1	0
19	15	Robert Fleming Securities	3	1	1	0	1
19		ING Barings	3	0	2	1	0
19	17	Alfred Berg	2	1	0	1	0
16		CS First Boston	2	1	0	0	1
—		FIBA Nordic Securities	2	0	1	0	1
19		Fox-Pitt, Kelton	2	0	1	0	1
15		Paribas Capital Markets	2	0	0	1	1



Brown, co-head of European research at Morgan Stanley International: "The top footballers command high prices. The same thing applies to our business."

It's appropriate, then, that selecting the members of the All-Europe Research Team is such a painstaking task. To find out whom the largest institutional investors turn to for advice on Europe, *Institutional Investor* sent out a questionnaire covering more than 85 industries and investment specialties to the director of research or head of investments at more than 500 institutions in 29 countries. Respondents were asked either to reply themselves, to survey their money management colleagues or portfolio managers or to circulate the questionnaire through their own research departments.

After the questionnaires were returned, our reporters spent several months interviewing the institutional investors that replied to learn more about their choices. Investors that did not respond were contacted as well to determine if they would be willing to participate over the telephone. The names of those surveyed and the institutions they work for are kept confidential to ensure their cooperation and to protect those who spoke with us off the record. The opinions of more than 200 institutions in 18 countries are reflected in the 1996 All-Europe Research Team.

Since the voting in most categories was for both firms and individuals, each house's votes were combined. A numerical score was then produced by weighting each vote based on the respondent's European equity assets under management and on the rank it awarded to the house (first, second, third or runner-up). This year, for the first time, rankings were determined solely by using these scores. Only if the scores of two analysts were numerically identical to two decimal places did a tie occur (in certain rare instances in the past, ties were declared when scores were close but not in fact identical). As a result, there are no third-team ties, and, for the first time since this ranking was inaugurated, analysts share top billing in three categories and second-team status in one. Multiple runners-up occurred when the scores of more than one analyst were tightly clustered below the score of the third-place analyst. (In the past the range of scores within which an analyst could be considered a runner-up was wider.) This methodology makes the All-Europe Team an even more exclusive club. In contrast to 1995, when there were 359 analysts on the team, there are only 313 today.

Deciding who should be featured in each category is another major task. In cases where there is a strong favorite or only one analyst tracking a category, that individual is highlighted. But since many investment specialties in the U.K. and in continental Europe require teamwork, many of the write-ups contain evaluations of group efforts, and the head of each squad or the person chiefly responsible in that field is emphasized.

Following is a list of the first-place finishers from our ranking of the best brokerage firm analysts. It was compiled by *Institutional Investor* staffers under the direction of Assistant Managing Editor Laurie Meisler, who also edited the feature, and Staff Editor Barbara Bent. This overview was written by Staff Writer Clare Pearson.

THE OUTSTANDING ANALYSTS OF THE YEAR

U.K. SECTORS

BANKS/CLEARING
Richard Coleman
Merrill Lynch

BANKS/MERCHANT
Philip Gibbs
BZW

BREWERS & DISTILLERS
John Spicer and team
SBC Warburg

BUILDING
Jamie Stevenson and team
Kleinwort Benson Securities

CHEMICALS
Charles Lambert
Merrill Lynch

DIVERSIFIED INDUSTRIALS
David Ireland and team
ABN Amro Hoare Govett
Fiona Perrott-Humphrey and team
James Capel & Co.

ELECTRICITY
Simon Williams and team
Kleinwort Benson Securities

ELECTRONICS & ELECTRICALS
Robert Millington and team
BZW

ENGINEERING
Charles Burrows and team
James Capel & Co.

EXTRACTIVE INDUSTRIES
Alan C. Richards
BZW

FOOD MANUFACTURERS
Mark Duffy and team
SBC Warburg
Alan Erskine and team
NatWest Securities

GAS DISTRIBUTION
Simon Flowers
NatWest Securities

HEALTH CARE SERVICES
Steve Plag and team
NatWest Securities

HOUSEHOLD GOODS
Steve Plag and team
NatWest Securities

INSURANCE
David Nisbet
NatWest Securities

INVESTMENT TRUSTS
Philip Middleton and team
Merrill Lynch

LEISURE & HOTELS
Mark Finnie and team
NatWest Securities

LIFE ASSURANCE
David Nisbet
NatWest Securities

MEDIA
Richard Dale and team
Merrill Lynch

OIL/EXPLORATION & PRODUCTION
Fergus MacLeod and team
NatWest Securities

OIL/INTEGRATED
Fergus MacLeod
NatWest Securities

OTHER FINANCIALS
Philip Gibbs and team
BZW

1996 ALL-EUROPE RESEARCH TEAM

PHARMACEUTICALS
Steve Plag and team
NatWest Securities

PRINTING, PAPER & PACKAGING
Sonia Falaschi and team
UBS

PROPERTY
Alec Pelmore and team
Kleinwort Benson Securities

RETAILERS/FOOD
William de Winton and team
ABN Amro Hoare Govett

RETAILERS/GENERAL
Nicholas Hawkins and team
Kleinwort Benson Securities

SUPPORT SERVICES
Mark Shepperd
UBS

TELECOMMUNICATIONS OPERATORS
Mark Lambert and team
NatWest Securities

TEXTILES & APPAREL
Julia Blake and team
BZW

TOBACCO
Mark Duffy
SBC Warburg

TRANSPORT
Richard Hannah and team
UBS

WATER
Richard Smith and team
Kleinwort Benson Securities

CONTINENTAL SECTORS

AUTOS & AUTO COMPONENTS
Stephen Reitman and team
UBS

BANKS
Alan Broughton and team
SBC Warburg

BUILDING
Sandrine Naslin and team
SBC Warburg

CHEMICALS
Charles Brown and team
Goldman Sachs International

ELECTRONICS & ELECTRICALS
Angela Dean
Morgan Stanley International

ENGINEERING
John Longhurst and team
UBS

FOOD & DRINKS MANUFACTURERS
Sylvain Massot
Morgan Stanley International

INFORMATION TECHNOLOGY
Angela Dean
Morgan Stanley International

INSURANCE
Katherine Moynes and team
SBC Warburg

MEDIA & ENTERTAINMENT
Mark Beilby and team
Deutsche Morgan Grenfell

OIL & GAS
Fiona Nicol and team
Kleinwort Benson Securities
Gavin White and team
SBC Warburg

PAPER & PACKAGING
Mads Asprem
Morgan Stanley International

PHARMACEUTICALS
Mark Tracey and team
Goldman Sachs International

RETAILERS
Claire Kent
Morgan Stanley International

TELECOMMUNICATIONS OPERATORS
James Golob and team
Deutsche Morgan Grenfell

TRANSPORT
Mark McVicar and team
NatWest Securities

UTILITIES
Ricardo Barcelona
SBC Warburg

STRATEGY AND ECONOMICS

ASSET ALLOCATION/GLOBAL
Barton Biggs and team
Morgan Stanley International

BONDS/INTERNATIONAL
Andrew Bevan and team
Goldman Sachs International

BONDS/U.K. CORPORATE
Shira Cornwall and team
BZW

CONVERTIBLES
Peter Warren and team
Goldman Sachs International

CURRENCY FORECASTING
Terence (Jim) O'Neill and team
Goldman Sachs International

ECONOMICS/EUROPEAN
Gavyn Davies and team
Goldman Sachs International

ECONOMICS/INTERNATIONAL
Gavyn Davies and team
Goldman Sachs International

ECONOMICS/U.K.
David Walton and team
Goldman Sachs International

EQUITY STRATEGY/EUROPEAN
Richard Davidson and team
Morgan Stanley International

EQUITY STRATEGY/INTERNATIONAL
Andrew Garthwaite and team
SBC Warburg

EQUITY STRATEGY/U.K.
George Hodgson and team
SBC Warburg

GILTS
Martin Brookes and team
Goldman Sachs International

QUANTITATIVE ANALYSIS
Alun Jones and team
UBS

TECHNICAL ANALYSIS
Robin Griffiths and team
James Capel & Co.

CONTINENTAL COUNTRIES AND EMERGING MARKETS

AUSTRIA
Andrew Thomson and team
Kleinwort Benson Securities

BELGIUM
Jeffrey Taylor and team
Dillon, Read Securities

CENTRAL & EASTERN EUROPE
Xavier Rolet and team
CS First Boston

FRANCE
Henri Chermont and team
Cheuvreux de Virieu

GERMANY
Timothy Plaut and team
Goldman Sachs International

ITALY
Roberto Condulmari and team
Giubergia Warburg

THE MEDITERRANEAN
John Ferreira and team
D. Carnegie

THE NETHERLANDS
Wouter van der Veen and team
ABN Amro Hoare Govett

SCANDINAVIA
Bjorn Jansson and team
Alfred Berg

SOUTH AFRICA
Richard Jesse and team
Fleming Martin

SPAIN
Mark Giacopazzi and team
Carnegie España

SWITZERLAND
Hans Kaufmann and team
Bank Julius Baer

PRIVATIZATIONS

Gonzalo Santos' Philippine supermarket

There are a number of acknowledged heroes in the Philippine march toward economic health, starting with President Fidel Ramos and Secretary of Finance Roberto de Ocampo. Less well known, but following closely behind them, is Gonzalo Santos, who has played a key role in closing out an era of massive government inefficiency and protectionism.

Santos, 60, is chief executive trustee of the nation's Asset Privatization Trust, a 70 billion-Philippine-peso ($3 billion) trust fund established in 1986 to sell off private and public assets plundered by former strongman Ferdinand Marcos and properties foreclosed on by government financial institutions during the debt crisis of the 1980s. The APT's holdings range from whole companies to partial stakes to mortgages in a grab bag of industries, including manufacturing, mining, transportation and agriculture. Santos, in charge since 1994, is responsible for turning the little-known APT into a key revenue generator for the government and an important facilitator of foreign direct investment.

With the APT's help Manila chalked up its first back-to-back budget surpluses in 20 years in 1994 and 1995. The trust's fiscal role is now diminishing, as its assets have been reduced and the International Monetary Fund has cautioned Manila not to rely overmuch on asset sales to balance its budgets. Of lasting importance, however, are a series of successful APT sell-offs that have pulled in key overseas Chinese investments and set the stage for a new wave of deals. The APT recently had its mandate extended until 1999, and it is likely to develop an advisory role in future privatizations, including infrastructure projects.

Given Santos' record, the new mandate is no surprise. The sale of Paper Industries Corp. of the Philippines, the region's largest pulp and paper producer, to Malaysia's Hong Leong Group earned the APT P$2.4 billion in 1994. The sale of Philippine Shipyard and Engineering Corp. to a consortium led by Singapore's Keppel Corp. in 1994 pulled in a further P$2.1 billion. In Santos' first year at the helm, APT revenues for the government were a record P$5.4 billion; in 1995 its sales totaled about P$4 billion.

An attorney by training, Santos has a modest demeanor but a résumé tailored to his task. He has represented his country at the United Nations conference on trade and development and is a member of the American Association of Arbitrators and the International Chamber of Commerce's court of arbitration. He has served on the board of the Philippine Securities and Exchange Commission and has twice been its acting chairman. A more personal measure of the man is his legal defense in the 1970s of late democratic leader Benigno (Ninoy) Aquino during Marcos's martial-law era. Aquino, of course, was assassinated when he returned to the country in 1983 — the spark that led to the bloodless revolution of 1986 and the sweeping democratic and economic reforms initiated by Ninoy's widow, president Corazon Aquino, and by

her successor in 1992, Fidel Ramos.

Those reforms did not entirely transform the notorious Philippine bureaucracy. But Santos has worked hard with the tools at hand, persuading foreign and domestic investors to examine a range of privatization options, shortcutting the bureaucracy to close deals and helping foreign investors get past various barriers to majority ownership of companies in the Philippines.

"It's a supermarket approach to privatization," says Santos. Investors can browse through the APT catalogue and target likely investments, he explains, after which the APT goes to work directly with the investor to seal the investment. Santos offers a variety of buyout schemes, among them straight equity sales, debt-equity swaps, leases or build-operate-transfer arrangements for the refurbishment of government-owned infrastructure.

"Santos has 140 companies left to shed for the government, some of them unattractive."

One of the APT's key skills is its ability to arrange joint ventures in which it helps to find a local partner or contributes its own assets alongside a foreign partner's equity infusion and new technology. This latter approach has allowed foreign investors to exercise operating control over companies without exceeding various national ceilings on direct foreign investment. For example, the APT is a passive majority shareholder of Philippine National Construction Corp., a joint venture with Indonesia's Sitra, which is building the Manila Skyway, an elevated highway.

Inevitably, though, the deal making is getting harder. Santos has 140 companies left to shed for the government, some of them unattractive. Many assets still held in trust are the subject of litigation by former owners or are so dilapidated they cannot be sold at book value. But the trust fund is working on several sales in which investors will take an asset "as is" and then settle with the previous owners. Pacific Nickel, for instance, a consortium of Australia's Mimproc Engineers and the Hong Kong arm of National Westminster Bank, is in advanced negotiations to buy the Nonoc Nickel Complex for more than $400 million. Predicts APT associate executive trustee Teofilo Pilando: "In 1996 mining is likely to be where power was two years ago. A number of Australian and North American mining companies are expressing interest in the six mining assets we have."

The APT is also working to off-load assets in trust that have suffered terribly from lack of maintenance. Panay Railways (on the island of Panay), for one, may well go to an Australian-Malaysian consortium. Crumbling properties like this are pitched at fire-sale prices.

All this sales activity by the APT has contributed mightily to the Philippines' economic recovery during the past few years. The handsome budget surplus for 1994 of P$16 billion included privatization revenues from, among other deals, the P$25 billion sale of state-owned oil company Petron Corp. to Saudi Arabian American Oil Corp., on which the APT acted as an adviser. Those APT revenues of P$5.4 billion remitted to the central government in 1994 represented more than one third of the country's P$16 billion budget surplus.

Preliminary budget figures for fiscal 1995, however, show a much reduced surplus of P$4.7 billion, down almost 70 percent from government expectations of a P$15.5 billion surplus. A single, non-APT privatization in 1995 — the sale of Fort Bonifacio in metropolitan Manila to Hong Kong–based property developer First Pacific — netted P$38.2 billion, payable in two tranches in February 1995 and February 1996 (though the 1996 payment looks likely to be delayed). Without significant revenues from privatizations, there could be a fiscal deficit again in 1996. Santos concurs — and proudly points out that his enterprising approach to privatization may also yield future dividends for the government. In years to come, he says, the APT plans to sell its joint venture stakes to private-sector partners or list them on the stock exchange.

The APT's performance under Santos is helping the economy of the Philippines in another way, points out Romeo Bernard, the undersecretary of finance responsible for privatization. The smooth transfer of APT assets to the private sector has helped create an investment environment that attracts more foreign portfolio investment. This in turn has coaxed more local companies to declare their actual worth to attract foreign partners or to tap the stock market. Says Bernard, "These traditional family-owned companies are seeing the advantages of declaring their true worth, as the market rewards in ratio to earnings." Luring firms to declare their earnings to the public could boost the nation's dismal tax collection record.

Indeed, for tax and budgetary reasons, Secretary of Finance de Ocampo is keen to keep the privatization push going. In a November speech in Manila, he outlined the three waves of privatization he hopes will sweep through the nation. The first wave is the APT's current brief. The second is the privatization of major infrastructure, such as power generation and supply, which is now picking up steam. And the third wave foreseen by de Ocampo is the privatization of such public services as housing, the post office, education and pension funds, including the nation's social-security system, which has $4.5 billion in assets.

That's a lot of privatizing — more, certainly, than could be accomplished by 1999, when the APT's mandate expires. But a bill currently before the national legislature may give the APT a role in all this, as a permanent privatization agency and a facilitator of private investment in major government-run service industries. — **Julian Stargardt**

'Buffettish' on foreign bonds

Many investors treat international bonds as a covert currency play. Pimco's Lee Thomas looks instead for long-term fundamental value. • **By Miriam Bensman**

One afternoon in 1988 the head of Goldman Sachs International's global fixed-income strategy team called on an important client — bond market giant Pacific Investment Management Co., in Newport Beach, California. The strategist, Lee Thomas, had an unusual notion to sell: that diversifying U.S. bond market exposure through global bonds would provide real benefits. Pimco had begun buying global bonds tentatively, but it took Thomas two more visits to put over his concept. He was so persuasive that Pimco not only bought the idea, but it tried to buy him, too.

Thomas, who'd just settled in London, had no desire to move and stayed on at Goldman for several years before leaving to become head of proprietary trading for Investcorp, the Bahrain-based investment bank. Pimco, meanwhile, ran its global bond operation more or less as Thomas had advised it to. Early last year, however, the firm decided to make a push to be as dominant a player in global bonds as it is in U.S. bonds. It renewed its offer to Thomas, and this time he accepted, joining Pimco as their senior international portfolio manager in March 1995.

Persistence has paid off handsomely for Pimco. Last year its longest-running account earned an eye-popping 431 basis points over the unhedged Salomon Brothers world government bond index, and the $114 million Pimco Global Bond Fund earned 441 basis points over its benchmark. Morningstar recently gave Pimco's Foreign Fund, which pursues the same strategy as the global fund minus the U.S. bonds, its five-star rating. Wrote Pimco chief investment officer William Gross in his letter to clients: Thomas was "turning out to be one of the best acquisitions since the Lakers bought Kareem from Milwaukee."

(Pimco's international bond results, unlike the Lakers pre-Abdul-Jabbar, hadn't been flagging. Before Thomas took over, managing director John Hague ran the portfolios for three years while Pimco searched for a specialist and consistently turned in top-quartile numbers [see box].)

Thomas presides over $1.6 billion in dedicated global or foreign bond accounts. That's a puny sum compared with Pimco's $74 billion in U.S. domestic accounts. But when tactical opportunities arise, Pimco may allocate as much as 30 percent of certain domestic portfolios to foreign bonds. Thomas ended 1995 managing, in addition to his own portfolios, $7.6 billion that Pimco's U.S. bond managers had shifted into international bonds on his advice. Clients that permitted this foreign excursion did well: Their composite return beat the U.S.-only account composite by 55 basis points. (In 1994, however, these clients lagged U.S.-only accounts by 90 basis points.)

Some bond managers treat international bond investing as a tacit play on currencies. Not Pimco. "You should take your risk where the alpha is," says Thomas: Sometimes the biggest returns will be from currency, sometimes from country or curve selection, sometimes from relative-value plays or cash management. Last year the Pimco Global Fund owed just 100 basis points of its 400-plus basis points in outperformance to currency bets. (Some 70 basis points of the 100 came from a bet against the yen, the remainder from trading Finnish markkaa, Swedish kronor and Italian lire against the deutsche mark.) No matter how tempting an opportunity, Pimco never permits more than 10 percent of a portfolio to be exposed to a single currency. "For us," Thomas says, "10 percent is a lot."

An economist, Thomas wrote his dissertation at Tulane University in the late '70s on the effects of currency risk on corporations and investors with multi-currency exposures. After a stint as an exchange rate forecaster at Chase Manhattan Bank, he joined Goldman, where he was one of the first financiers to argue that U.S. investors should diversify into global bonds. Thomas took what even

today is an unorthodox tack. He explains: "To secure diversification from global bonds, you have to hedge."

When U.S. investors buy foreign bonds, they reduce their interest rate risk through diversification, of course. But they also add exchange rate risk, unless they hedge their foreign exchange exposure. Moreover, Thomas notes, "the point at which FX risk overwhelms interest rate risk is low — when foreign bonds are 15 to 20 percent of the total bond portfolio." Plan sponsors seeking foreign diversification would be wise to hedge, while allowing opportunistic currency plays, he advises.

Many Pimco clients, however, reject Thomas's philosophy, reasoning that forex gains are central to the whole notion of buying foreign bonds. "Yes, currency can be a powerful source of return" is Thomas's rejoinder. "But why take currency risk wherever the bonds look good?" Of course, it's their money, he adds. Accounts that ask to be run against an unhedged benchmark are accommodated.

Pimco enforces tough risk limits on all portfolios, hedged or not. Rarely does the tracking error of a portfolio exceed 200 basis points, and the risk can't be loaded in one country or currency. Consider last year's yen trade. With dollar-yen volatility at about 13 percent annually, taking a 15 percent position in the currency would produce roughly 195 basis points of tracking error. "That would pretty much exhaust my risk budget and leave no room to express other views," says Thomas. "We like to have much smaller exposures to a number of different ideas."

Pimco's yen bet was an easy trade in '95. In midyear the fundamentals pointed to a need for Tokyo to kick-start the economy; the failure of a major credit institution and the consequent run on banks in early August merely supplied the catalyst. The U.S., Germany and Japan lined up to take the yen down. The implications were obvious: The Japanese yield curve would steepen as short rates fell. "It was right out of the international finance textbook," says Thomas.

Even before the Bank of Japan's August 1 rate cut, Pimco was slightly underweight yen. On the central bank's announcement, Thomas sold all his ten- and seven-year Japanese government bonds and bought three-year notes. He also further underweighted the yen. "We figured that Japan, like the U.S. in 1991, would keep short rates low to bail out the banks. The banks would fund the three-year notes, which paid 1.4 percent, with one-month rates at 50 basis points. We did the same."

The Japanese banks, of course, would take no currency exposure. As a dollar-based investor, Pimco took an equivalent position: It bought the three-year note and hedged by selling the yen forward one month. Since yen interest rates were much lower than dollar interest rates, the hedge gave Pimco some 600 basis points in additional carry.

But what Thomas planned as a carry trade also turned into a capital gain as other players caught on to the gambit. They piled into three-year notes, pushing the yield down to 75 basis points. In just three months Pimco added 110 basis points to the global fund's returns. It closed out the position last November.

German bonds also provided Pimco with easy pickings. "Germany had an inflation rate 1 point less than the U.S. rate, but its long-term bonds were yielding 7.64 percent and its central bank had unusual credibility," says Thomas. In May and June Pimco started overweighting German bonds, picking up about 50 basis points over U.S. Treasuries on 30-year Bunds. The spread later widened to as much as 100 basis points. By year-end Pimco had made a total return of 4.2 percentage points on the trade, including 170 basis points from hedging the position (German short rates, too, were well below U.S. rates). This time, however, Pimco didn't take its gain: Germany remains a substantial holding for the firm (although it has shortened the position's durations).

Thomas also picked up returns in smaller markets. In January Finnish government bonds comprised 15 percent of Pimco's global bond portfolio — that's down from 20 percent in late November last year. The bonds don't figure at all in the Salomon world government bond index. "This is probably our single largest overweight position," Thomas says.

The Finnish move is in fact a strategy to goose Pimco's German returns. Finnish bonds correlate highly with Bunds and pay higher yields: 7.48 percent in February on the eight-year government bond (versus 5.97 on a comparable Bund). "The attraction of buying the bonds is the political consensus within the country to cut spending and keep inflation low," says Thomas. "[Finland has] a chance of meeting the Maastricht requirements for [economic] convergence" and thus for membership in the European monetary union in 1997.

Thomas started buying Finnish bonds last May, when they were at 200 basis points over German Bunds. He estimated their fundamental value to be only about 90 basis points over Bunds and expected the spread to narrow by 40 to 50 basis points within three years. This January the spread was down to 100 basis points, but Pimco had revised its estimate of the bonds' fair value to 80 over Bunds. So Thomas halved Pimco's position early that month, although it was still providing a pickup of 310 basis points (yield plus hedging gains) over Treasuries. Some of Pimco's German allocation is in other highly correlated bond markets, such as those of Denmark, Austria and the Netherlands. "We move it around, depending where the relative value is," Thomas says.

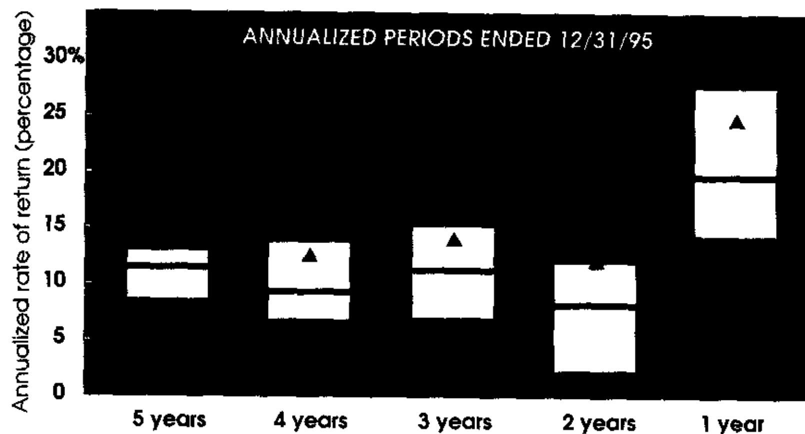
In his search for value, Thomas has ventured much further afield. In December 1995 New Zealand's yield curve was inverted as a result of the central bank's attack on inflation (which had risen above its 2 percent target). By mid-January the three-month bank bill was yielding 8.57 percent; the ten-year note, 7.07 percent. "That's good news if you

Lee Thomas: The fundamentals

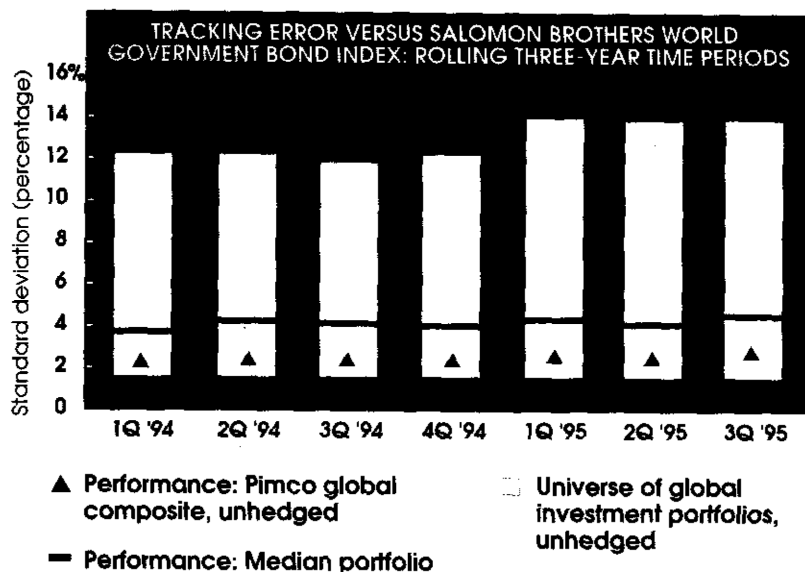
Title: Senior international portfolio manager, Pacific Investment Management Co.
Assets under direct management: $1.6 billion
Investment focus: Global (nondollar) bonds
Performance: Global bonds, unhedged: one year, 23.71 percent (Salomon Brothers world government bond index, 19.04 percent); three years, 13.53 (11.33); five years, 12.74 (11.02). Foreign bonds, hedged: one year, 21.23 percent (non-U.S. Salomon world government, 17.92); three years, 9.36 (8.68)
Age: 44
Education: BA and Ph.D. in international economics, Tulane University; MA in economics, University of New Orleans

How Pimco compares with its peers

High returns . . .



. . . and low risk



Source: Based on consulting firm reports provided by Pacific Investment Management Co.

expect they'll succeed at defeating inflation," says Thomas. The high short rates, however, made the cost of hedging the bonds unacceptable. "You'd have to hope the bond rallied fast enough so you weren't eaten alive by the negative carry if you currency-hedge," Thomas explains. Yet the alternative — leaving the bonds unhedged — would create unacceptable exchange rate risk.

Thomas came up with a novel solution. Instead of hedging the bond position by selling forward the New Zealand dollar, he sold forward the New Zealand trade-weighted currency index. This basket of U.S. and Australian dollars, yen, pound sterling and deutsche marks is used by the New Zealand central bank to guide its exchange rate policy. The trade substantially reduced the exchange rate risk. And as a bonus, because the weighted-average short-term rate of the currencies in the basket is below 5 percent, it "created a fat, positive carry," Thomas says. "Plus, if interest rates come down, the three-year should rally, giving us a capital gain." By late January the New Zealand dollar had rallied against the trade-weighted index, giving Pimco a 100-basis-point gain on its small, residual currency exposure. This, along with a 50-basis-point pickup on the notes, made for 1.5 points in just one month.

Despite Pimco's reliance on trading strategies, the turnover of its global bond portfolios is less than 50 percent a year. "Our approach is Warren Buffettish as applied to bonds," says Thomas. The firm looks for long-run fundamental value and is willing to hold until the market recognizes that value. When that happens fast, as with last year's Japanese trade, it's a happy surprise.

Unlike most global bond managers, who take bigger bets on duration than U.S.-only managers, Thomas sticks to Pimco's firmwide duration target. In January it was 0.7 years above the firm's various benchmarks' durations. (Managers can move 0.1 of a year around the target.)

Thomas tries to pep up returns with relative-value trades — between corporate and mortgage bonds or between bonds and futures. Such trades can provide a pickup of 5 basis points in the U.S.; in Japan, three times as much.

Pimco eliminates the leverage inherent in using futures by putting up the necessary margin on its positions and investing the remaining notional amount in cash instruments. Meant primarily to control risk, that strategy also allows the firm to exploit its prowess in cash management using such tactics as stretching out maturities to as long as one year and taking some credit risk by moving off LIBOR into investment-grade commercial paper. Says Thomas, "We hope to add 30 basis points or more a year to the global bond portfolios with similar cash management efforts."

At the end of January, the main account through which Pimco's domestic bond managers gain nondollar bond exposure was up 120 basis points versus its U.S. bond benchmark, thanks to substantial exposures in Europe. "Our basic forecast for Germany and France was slow growth and falling rates. It worked out," Thomas says.

Japan is currently Thomas's least-favorite market. As the economy turns around — albeit excruciatingly slowly — bond yields are almost certain to rise, he says.

It's in small markets that Thomas sees some of the best opportunities. "The markets you can gain advantage from covering are the Finlands of the world, the New Zealands and the Czech Republic," he says. "That's where undiscovered value lies." II

In the money at Castle Harlan

Investors in Castle Harlan's two buyout funds have every reason to celebrate, thanks to the firm's recent spate of portfolio sales. By next month Castle Harlan will have completed its third sale in a year, for a total of $1.1 billion. "We found that this year it was easier to sell things than to buy things," remarks chairman John Castle.

First to go was Delaware Management Holdings, sold to life insurer Lincoln National Corp. last April for $540 million — a seven-year investment that returned seven times its purchase price. Next out the door was Truck Components, which was bought last August by trucker Johnstown America Industries for $250 million in stock, more than five times the amount the buyout specialist spent 15 months earlier. Last comes the sale of Indspec Chemical Corp. to Occidental Petroleum Corp. for $300 million. Scheduled to close shortly, this transaction will deliver a fivefold return to Castle Harlan after a two-year commitment.

The Delaware sale was the last for the $125 million Legend Capital Fund, Castle Harlan's first fund, which posted compound annual returns in the mid-20s from 1987 through 1995. The other two deals came out of Castle Harlan II, a four-year-old, $250 million fund that so far has fared even better. At year-end 1995, CH II had racked up annual compound returns of a whopping 93 percent (including the Truck Components sale and a value placed on Indspec of close to the sale price).

CH II has made only one investment during the past year: the purchase of a property and casualty insurer for $60 million. The fund remains only 40 percent invested, but president Leonard Harlan reveals that there are a few deals "in the pipeline." With those, CH II will be about 75 percent invested, he says, and at that level the firm will probably start raising a third fund.

If Castle Harlan maintains its stellar returns on CH II — and Castle says there's "a good probability" that one or two more companies will be sold off this year — that new fund could be a hot item. — **Hilary Rosenberg**

Korea Inc. reforms: What a shame?

In recent years "Buy on the whiff of a scandal" has proved good advice — at least for some emerging-markets investors. Last fall's revelation that hundreds of millions of dollars were plundered from *chaebol* — South Korea's massive industrial holding companies — and channeled to two now-former Korean presidents had many long-term investors not fleeing for the exits but instead snapping up Korean stocks.

"The local market share price came down about 15 percent, while the share price of the Korea Fund went up," notes John Lee, manager of Scudder, Stevens & Clark's $800 million Korea Fund.

Why coolly hunt for bargains rather than clamor for corporate governance reform? Foreign fund managers are as aware as Koreans of how a web of mutual interests binds together Korean managers and bureaucrats. Minority shareholders may object to these cozy relationships. But insofar as they've helped companies to grow, they've provided real benefits for those same shareholders.

"When you own 60 percent of the stock and you've built up the company for 40 years from a bicycle shop to a $20 billion conglomerate, is some [minority] shareholder going to tell you you're making a bad business decision in currying favor with top leaders?" asks Stewart Kim, CEO of Los Angeles–based Pacific Gemini Partners, which manages $75 million in Korean equities.

Korea Inc. may be about to change, however — with direct implications for foreign investors. Next year's planned elimination of shareholding limits is predicted to unleash a flood of takeovers. Moreover, Korea is seeking to join the OECD and, to qualify, must liberalize its markets. As it is, Korean companies increasingly recognize the need to appeal to overseas investors, and large corporations now meet regularly with shareholders. — ***Chad Rademan***

Fair trading

Most pension funds now monitor transaction costs, and two thirds want to cut them.

A decade of paying more attention to transaction costs seems to have paid off for pension funds. Some three quarters of the respondents to this month's Pensionforum regularly monitor their equity transaction costs, and 84 percent indicate that they're satisfied with their overall costs. Nevertheless, 67.5 percent are trying to lower costs even more.

No doubt there is room for improvement. Judging by this survey, plan sponsors fix a less than eagle-eyed gaze on transaction costs. About 60 percent say they monitor such costs somewhat closely, compared with just 18.7 percent who categorize their monitoring as "very close." And the vast majority review transaction costs no more than once a quarter. Moreover, of those that don't do any monitoring, about 16 percent say they simply haven't gotten around to it yet.

Saving money isn't the only motivation for watching transaction costs. Other reasons include helping to evaluate managers, improving performance and implementing a total-quality-management program. Commissions are by far the most frequently followed indicator, but respondents are also interested in their managers' soft-dollar usage and portfolio turnover as well as the market impact of their trades.

How can costs be cut further? Among other things, respondents would like to see managers direct a portion of their business to discount brokers, employ more passive or semipassive strategies and use electronic networks. The best way to keep costs down? According to the survey, keep managers on their toes by continuing to watch them. ıı

Does your pension fund regularly monitor its transaction costs for equities?

Yes	76.6%
No	23.4

If so, have you stepped up your efforts on this front in recent years?

Yes	47.0%
No	53.0

How closely would you say you monitor your transaction costs?

Very closely	18.7%
Somewhat closely	60.6
Not very closely	20.7

For whom do you monitor these costs?

In-house managers only	7.2%
External managers only	77.2
Both in-house and external managers	15.6

Who monitors your transaction costs for you?

Master trustee	22.2%
Outside consultants	29.2
In-house staff	20.5
Some combination of the above	26.5
Other	1.6

How frequently do you review your transaction costs?

Daily	2.2%
Weekly	3.2
Monthly	14.6
Quarterly	52.4
Semiannually	14.6
Other	13.0

What components of transaction costs do you monitor?

Commissions	97.8%
Market impact	50.3
Portfolio turnover	48.1
Futures-trading costs	3.3
Soft-dollar usage	52.5

Why do you monitor these costs?

To save money	54.3%
To improve performance	45.1
As part of a total-quality-management program	45.1
In response to the Department of Labor's guidelines	17.9
As another way of evaluating our managers' performance	62.5
Other	2.7

If you don't monitor these costs, why not?

Don't believe they are significant to the bottom line	12.9%
Haven't gotten around to it yet	16.1
When a manager's performance is poor (including transaction costs), he should simply be fired	22.6
There is no accurate way to measure these costs	12.9
The trouble and expense of monitoring these costs is not worth any savings we could generate	25.8
Other	9.7

How would you characterize your current overall transaction costs?

Higher than we would like	16.0%
Satisfactory	84.0

Are you trying to lower your transaction costs?

Yes	67.5%
No	32.5

If so, how?

Working with managers to find ways to lower costs	51.9%
Asking managers to use electronic networks	17.6
Asking managers to direct a portion of their business to discount brokers	41.2
Limiting the size of full-service commissions that managers can pay	18.3
Putting more assets into passive or semipassive strategies	35.1
Believe that monitoring in itself helps lower costs	60.3
Other	12.0

Are your efforts to lower transaction costs paying off?

Yes	51.7%
No	0.0
Too soon to tell	48.3

The results of Pensionforum are based on quarterly surveys of a universe of 800 corporate and 250 public pension plan sponsors. Because of rounding, responses may not total 100 percent.

Trading real estate — on screen

Major firms have formed a clearinghouse to provide data on private deals to aid liquidity. Next: an electronic trading system. • **By Mindy Rosenthal**

Investors surfing their Bloomberg screens on January 18 had a chance to catch a piece of real estate history. Standardized data on private real estate investments flashed across their monitors, foreshadowing the first-ever electronic private real estate trading system.

In April the Institutional Real Estate Clearinghouse is scheduled to follow up on its new information exchange (*Institutional Investor*, July 1994) with a central trading market for such nonpublic real estate investments as unregistered limited partnerships, bank commingled funds, insurance company separate accounts, group trusts and private real estate investment trusts. The market is modeled after the National Association of Securities Dealers' Portals system for trading Rule 144A securities. It would permit qualified 144 and 144A investors to view investment descriptions and place bids and offers on screen, according to IREC chairman Blake Eagle. Cantor, Fitzgerald & Co., which will run the system, will act as an intermediary and help negotiate transactions, adds Cantor managing director Anthony Labozzetta.

The gathering of real estate investors under this electronic buttonwood tree will mark the culmination of an idea sparked five years ago by Eagle and Barbara Cambon, president of Institutional Property Consultants. The two and a few others formed IREC in the aftermath of the liquidity crunch that hit the private market in the early 1990s. With sellers unable to locate buyers, prices plummeted, Eagle notes. The idea behind IREC was to build a more efficient secondary market by delivering information to a broad audience and providing a central marketplace to bring buyers and sellers together. Says Aetna Realty Investors managing director Thomas Anathan, "It's the difference between calling up a friend, looking to sell shares of IBM, and calling the New York Stock Exchange and saying, 'I want to sell shares of IBM.'"

The clearinghouse, which was set up in April 1994, has 25 sponsors, including Aetna Realty Investors, Frank Russell Co., MetLife Realty Group and Prudential Real Estate Investors. IREC members have provided not only financial support but also ideas.

IREC now has data on 170 private issues (out of a universe of about 350) available on Bloomberg screens. Alternatively, would-be investors can call or fax IREC and have data sent directly to them. IREC data, similar to what's available on publicly issued real estate investments, typically include two or three years' worth of an issuer's annual reports plus private-placement offering material and governing documents as well as figures on dividend yield, price-earnings ratios and total returns. The package also includes descriptions of the underlying properties by type and location. IREC executive director Paul Saint-Pierre says real estate fund managers have been quite willing to provide data because they realize that if they want to sell investments, they "have to confront disclosure."

Why Bloomberg? Because the data service asked for it. "We want to see this happen, and when two parties are ready to go, let's go," says Saint-Pierre. Bloomberg already carries a host of real estate data, he adds, and although its audience is predominantly traders, they are important leads to investors. IREC is exploring other avenues for disseminating investment data, such as Reuters and Teleris.

Creating the real estate trading system has proved to be a tougher proposition than getting the information flowing. "The biggest hurdle has been [obtaining] a Securities and Exchange Commission no-action letter," says Cantor's Labozzetta. "We thought it would take six months." Instead, he says, Cantor has had to contend with complex regulatory hurdles resulting from the arcane nature of private real estate securities, the complexity of 144A rules and settlement questions. (A winter in which blizzards and budgetary politics have periodically shut down federal offices hasn't helped speed the process.) Though IREC hopes to start trading in April, it won't begin until it receives a response to its December 1994 request for an SEC no-action letter assuring it that the agency won't mount a regulatory challenge. ♜

The couch potato option

Balanced funds have become the most common 401(k) option. But are they more popular with plan sponsors than with plan participants?

Sophisticated investors may mock balanced funds, with their grab bag of stocks, bonds and cash, as the asset of choice for the hopelessly ambivalent. Nevertheless, increasing numbers of plan sponsors are dutifully adding balanced funds to their 401(k) menus to enhance selection and diversity.

Indeed, balanced funds have become the single most common 401(k) investment option, according to a recent study by Hewitt Associates. Sixty-six percent of the mainly large-plan sponsors the consulting firm surveyed offered balanced funds, up from just 48 percent three years ago. (Rival consulting firm A. Foster Higgins & Co. puts the percentage of plans with balanced funds at an even higher 72 percent.)

Why the tilt toward balanced funds? A growing awareness of the need to diversify, suggests David Graffagna, a research consultant with Hewitt. The common wisdom used to be that balanced funds were unnecessary. Participants could, after all, duplicate them by diversifying among their regular 401(k) options. But plan sponsors have seemingly caught on to a simple truth: Though participants know they need the diversification, they want a professional to make the asset allocation calls. "It's the couch potato option," says Michael Seidenburg, a principal at William M. Mercer, Inc.

For plan sponsors the attraction of balanced funds is that they bridge the gap between conservative fixed-income and aggressive equity funds. A participant generally earns a lower return than on an all-equity fund but also experiences less volatility because of the steady return from the fixed-income portion. For employees who don't have the time or knowledge to formulate their own portfolio mix, balanced funds round out the conservative side of the equation.

In balance

Balanced funds have become the single most popular 401(k) option with plan sponsors.

	Percentage of plans surveyed offering various options	
	1995	**1993**
Money market	51%	51%
Stable value	55	58
Diversified fixed income	19	18
Short-term bonds	16	14
Intermediate or long-term bonds	31	28
Bond index (debt index in 1993)	9	1
Balanced	**66**	**48**
Lifestyle (asset allocation)	**9**	**1***
Growth & income equity	52	45
Growth equity	58	42
Aggressive growth equity	40	25
Equity index	45	36
International equity	36	10
Global equity	10	4
Emerging markets	4	NA
Employer stock	36	40
Life insurance	1*	2
Self-directed (participant manages own brokerage account)	1	1*
Other (government securities, certificates of deposit, etc.)	10	5

* *Less than 1 percent.*
Source: Hewitt Associates.

Moreover, they're often seen as an easier sell. What with the advent of 404(c) rules promoting diversification, balanced funds have become a frequent addition, particularly for companies that already offer guaranteed-investment-contract and equity options.

Yet balanced funds may, overall, be more popular with plan sponsors than with plan participants. Opinion is decidedly mixed on whether cash is really flowing into balanced funds. Buck Consultants says balanced funds are still low on the employee popularity list, accounting for just 17 percent of 401(k) assets on average. In an *Institutional Investor* survey published last July, only 5 percent of plan sponsors cited balanced funds as the most popular investment option. Thomas Pipich, a principal at Buck, contends that although money is gradually shifting out of stable funds, it is going into equity funds more frequently than into balanced funds. "Participants tend to want a choice with a clear-cut pattern of returns," he says. "Balanced funds are a little more confusing."

This odd pattern could be

changing. Variations on the standard balanced fund — asset allocation and lifestyle funds — are catching on with 401(k) investors. The funds are still rare, offered by only 9 percent of plan sponsors, according to the Hewitt study.

However, William Landes, chief investment officer of the global asset allocation group at Putnam Investments, believes that asset allocation funds are the future of 401(k) investing. "This is the most natural option for participants who worry about a lot of things all day and think that the last thing they have time for is to worry about what their stock-bond mix is," he says. Employers, it seems, empathize. — **Lauren Dermer**

Labor launches a torpedo at the float

To Alexander Nelson, Putnam Investments' client-service director, it's a "nonevent." Declares Nelson, "It is totally unreasonable for [401(k)] plans to take longer than a day [to deposit employee contributions in a plan], and I think this is good discipline." But what he sees as an appropriate government rap on the knuckles for companies that stall on forking over employees' withdrawals is regarded by some other plan sponsors as a major imposition — one that will force them to expensively revamp their payroll systems.

The Department of Labor has proposed that small companies cut by half the time they allow for depositing employees' withholdings, from 90 to 45 days. For large-plan sponsors the new standard would be one day. (The DoL defines such sponsors as those that accumulate $100,000 or more in income and employment taxes on any single day.) Currently, all plan sponsors, regardless of size, have 90 days to deposit employee contributions. The proposed regulations are patterned on the maximum period allowed for depositing Social Security and other payroll taxes.

For large companies that have a single automated payroll system, complying with the new guidelines should be a nuisance at most. They typically transfer funds to a 401(k) plan trust after every payday anyway. All of Putnam's large-plan-sponsor clients have daily-valuation recordkeeping, says Nelson, and they're authorized to wire the assets to Putnam 24 hours after each payday.

But for even sophisticated companies having multiple payrolls, the one-day rule could be a burden, says benefits expert Richard Koski of Buck Consultants. Buck has one client with no fewer than 360 locations — and 360 payrolls — "and it's in a panic mode," he says. Hewitt Associates' Scott Peterson, who advises plan sponsors on outsourcing issues, calls the one-day rule "overkill." The new standard would require a number of Hewitt's clients to change their procedures and systems, he says. The ongoing charge for complying with the regulations is estimated at an additional 5 to 10 percent of plan administration costs.

Perhaps the least expensive, most hassle-free way to accommodate the new standards would be to transfer employee withdrawals to the 401(k) plan trust immediately but then hold off allocating the assets into individual accounts. Christopher Kearney, who heads Coopers & Lybrand's defined-contribution-consulting business, says this ploy passes muster with the DoL. Moreover, it would allow plan sponsors to avoid increasing the number of times that they have to reconcile deferrals with participants' allocation instructions, thereby saving on costs.

Participants' assets would be deposited initially into a safe account, such as a guaranteed-investment-contract portfolio or money market fund, and then allocated to individual accounts as frequently as the employer allocates those assets now. What's more, says Coopers's Kearney, plan sponsors could use the interest that accrues in the safe fund to pay plan expenses (as long as the plan document allows for this). The catch is that employees' contributions would not be invested immediately, and they'd forfeit the benefits of more frequent dollar-cost averaging.

But enhancing participants' investment prospects is not the point of the proposed regulations, which are scheduled for public hearings later this month. Olena Berg, assistant DoL secretary for pension and welfare benefits administration, explains that the goal is to make sure that deferrals are transferred to a trust in reasonable fashion, so as not to tempt employers that are strapped for cash. The DoL definitely doesn't want vendors using the existing 90-day limit as a selling point by telling plan sponsors that it amounts to a free three-month revolving loan fund. "We're not trying to create hardship," insists Berg. "We're trying to come up with a system that everyone can comply with." — **Carolyn Sargent**

Robin Laurance

New keepers in the Kingdom

Now that self-custody has become more burdensome — and perilous — outside custodians are all the rage in the U.K. • **By Paul Penrose**

Mounds of securities have languished, sometimes for decades, in the musty vaults of British merchant banks and investment managers. But more and more these pieces of paper are now finding new homes, as merchant banks, fund managers, life insurers and pension funds rush to outsource custody to major banks.

Global custodians have been sifting through requests for proposals from U.K. money managers and pension funds that want out of the custody business. In early January Prudential Portfolio Managers, a subsidiary of Prudential Assurance Co., ended a 15-month search by awarding custody of its £45 billion ($67.5 billion) portfolio of U.K. and international securities to a team from Mellon Trust Corp. and Midland Securities Services.

The next day Kevin Lee, operations director in the institutions group of Baring Asset Management, inked a contract naming Barclays Bank as preferred custodian for BAM's £10 billion in U.K. assets. "We've set a trend," says Lee. "There are going to be others following on behind us."

Prudential and Barings are among the most recent, and most celebrated, British institutions to abandon in-house custody operations in favor of third parties. Sun Alliance, Guardian Assurance, Henderson Administration and AMP Asset Management have also pulled back from internal custody. The ranks of those resorting to outsourcing are soon to be swollen by the investment arms of life insurance companies. Sun Life Investment Management Services, Commercial Union Investment Management and Clerical Medical Investment Group are among the outsourcers.

This bonanza of business has reawakened the U.K.'s troubled global custody market, hit hard in the past three years by spiraling technology costs and thumbscrew pressure on margins. The players that toughed it out as the market was abandoned by big names like J.P. Morgan, NatWest Markets and BankAmerica Corp. are now preening in anticipation of a monster payback.

The free-for-all represents a fundamental break with a proud tradition of internal custodianship among British investment managers. The custody of most overseas assets was outsourced years ago. But the administration of U.K. investments has long been tied to the British management of those assets. Now costly impending changes in the U.K. system for settling trades and an attack of the jitters since the collapse of Barings have prompted many institutions to rethink self-custody. The prospect of legislation to regulate custody has tipped the scales in the direction of outsourcing.

The immediate catalyst, though, is Crest, the Bank of England–inspired system for "dematerializing" U.K. share certificates: It replaces pieces of paper with a book-entry system. Due to go live in July, Crest is the stripped-down successor to the London Stock Exchange's doomed Taurus

system. "Many of these companies would have been macho enough to take on Taurus themselves, but Crest is a different matter," says Terry Pearson, head of external relations at Royal Bank of Scotland's securities services division. "They would have to do a lot of work in their own shops to build in the links and get the sophisticated reporting capabilities most funds now require."

The up-front costs of linking to Crest are estimated at £250,000 to £500,000 for each institution. If that's not sufficiently daunting, there will also be substantial indirect and ongoing expenses: costs of credit for settlement-processing disaster-recovery systems, high insurance premiums and considerable telecommunications charges. "We did some calculations and quickly realized that it would make more sense for us to outsource," says Kelvin Meade, head of investment administration and accounting at Clerical Medical. Meade is assessing five custodians' bids on the group's £5 billion U.K. portfolio.

The expense of adapting to Crest comes on top of rocketing costs for providing custody. "The biggest custodians are now investing on the order of $40 million to $50 million a year in systems development just to keep ahead of the game technologically," says Roger Fishwick, group treasurer at Prudential Portfolio Managers. "As a fund manager our investment needs to be in improving the way we manage money, rather than in improving the custody side of our activities."

British money managers are eager to reassure clients that their assets are secure. Rogue publisher Robert Maxwell's looting of his companies' pension funds heightened interest in splitting off custody from investments, and the Barings failure dramatically intensified it. Says Prudential Portfolio's Fishwick, "We can see distinct advantages for our clients in making it quite clear that the fund management carried out by PPM is completely separate from the custody of the assets resulting from that activity."

BAM has gone further. It is offering its money management clients a new contract that names Barclays Bank as its "preferred" custodian but requires the bank to contact BAM's entire client base and sign up individual funds directly. BAM, whose in-house custody operations were actually run for it by S.G. Warburg Group, will reduce its own management charges in accord with the fee negotiated between the client and the bank. "It's a novel twist," says BAM's Lee. "We felt we had to demonstrate to our clients [the] totally best practice if the custody was outside the house." The firm is not doing this to save money, he insists. "Our primary concern is to make our clients feel comfortable that we have got ourselves in the very best position in terms of risk reduction."

The Securities and Investment Board's plans to make custody an "authorizable" activity would impose a new regulatory burden on the industry and could force many of the integrated houses to quit the business. "Most of the merchant banks use one computer system to run the two businesses, with both custody and asset management running on the same database," notes Lee. "But if the regulators insist on a split, and if the two sides have to be definitively separated, many firms will find it very hard to continue with in-house custody."

The use of outside custodians may soon extend to the Continent. A drive to disengage pension fund assets from bank balance sheets seems destined to provoke a major shake-up in Germany. Says Chase Manhattan Bank vice president Aidan Dennis, "Pension funds in Germany are growing fast, and whereas in the past a local bank might have provided fund management, custody for broking and all the cash management banking activities for a particular firm, there are those who see that a division of responsibilities may be beneficial for all concerned."

In December Chase took over custody of the Dm3.4 billion ($2.3 billion) in assets of Hoechst in what Dennis claims is the first such custody deal between a domestic German fund and a non-German custodian. "Hoechst represents a potentially major change, pointing a way forward in Germany that maybe five years ago we would not have contemplated ever happening," says Dennis.

Easing of restrictions on foreign investments undertaken by pension funds in Finland, increased outsourcing activity among sophisticated institutions in Holland and Denmark and prospective pension reforms stirring the slumbering Italian and French markets have convinced custodians that their industry has turned a corner throughout Western Europe.

The focus, however, remains the U.K. Major custodians are trying to come to grips with an unfamiliar problem: too much business. ■

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Germany's bank

By Wendy Cooper

To mark its 125th anniversary in 1995, Deutsche Bank, the biggest of the three German *Grossbanken*, commissioned five leading academics (three Germans and two Americans) to write its history. This formidable, door-stopping tome is the result of their labors.

It is a work of considerable and (for an official business history) remarkably objective scholarship. One big reason is the authors' unprecedented access to archival material, much of which was housed in Potsdam, in the former German Democratic Republic, and largely unavailable to Western researchers before the collapse of communism in 1989, when the project got under way. Though plainly not intended for the general reader, the book is rich in anecdote and statistical detail and will prove a compelling read for anyone interested in the events and personalities that have shaped one of the world's most powerful institutions.

Deutsche was established in 1870 as an unabashedly nationalist enterprise by Prussian private bankers eager to wrest German export finance from the British and French houses that then dominated the trade. "The very name, Deutsche Bank, implied a program," observes Lothar Gall, a professor of modern history at the University of Frankfurt am Main, who takes the bank from its founding to World War I. "The founders wished . . . to seek freedom from foreign supremacy."

In pursuit of that quest, they created an institution that was both a dominant player in domestic industry and a force to be reckoned with abroad. Indeed, in 1914 the *Frankfurter Zeitung* described Deutsche as the "greatest bank in the world."

Small wonder. In addition to its key role in financing and owning stakes in some of Germany's most important enterprises, Deutsche was a financial power in the Ottoman Empire and the Middle East, the Balkans, the U.S. and Latin America, and it had growing interests in the Pacific, Asia and Africa. As the Great War began, observes Gerald Feldman, a University of California at Berkeley history professor, "[Deutsche] was the most universal of universal banks . . . a tangible expression of Imperial Germany's rise to world power status."

For many readers the section entitled "The Deutsche Bank and the Dictatorship" will prove the most provocative. Princeton University history professor Harold James handles this difficult subject with admirable evenhandedness. Deutsche, he says, like other German banks, played a key role in the Aryanization of Jewish property during the Third Reich, and several of its officials personally supported National Socialism.

Yet James admits that the bank also found itself on the horns of an impossible dilemma. The Nazis needed the banks, but their propaganda held bankers to be "parasites." This accounts, James says, for the banking industry's passivity — not a single German banker was a member of the Resistance — in the face of the worst excesses of the regime. Hermann Abs, who became head of Deutsche's foreign department in 1937, incurred the wrath of the regime — he was attacked for being a Catholic — by openly criticizing its autarchic trading policy. But despite contacts with the Resistance, he self-consciously decided not to be a hero. "Banks," James comments, "do not make their own history."

Nonetheless, Abs came to embody the might of Deutsche to the outside world. In May 1943 Per Jacobsson, an economic adviser to the Bank for International Settlements, invited Abs, Emil Puhl of the Reichsbank and Carl Goetz of Dresdner Bank to Zurich's Hôtel Baur en Ville to discuss the postwar currency plans drawn up by the U.K.'s John Maynard Keynes and the U.S.'s Harry Dexter White — the same plans that would evolve into the Bretton Woods system of fixed exchange rates.

After the war Deutsche raced ahead of its two big rivals, Dresdner and Commerzbank, because it had moved more of its assets to the west in the days before Berlin fell to the Red Army. And in 1957, when the Allies permitted the reformation of a single Deutsche Bank — the *Grossbanken* had been dismembered in 1945 into separate banks, corresponding to the three zones of Allied occupation — Abs, as speaker of the managing board, set about capitalizing on this advantage.

The rest, for readers of this magazine, anyway, is largely history. Deutsche has developed into one of the largest and most influential financial institutions in postwar Europe; and it, too, is "going global." That process, involving a sometimes painful adaptation to Anglo-Saxon management style and techniques (*Institutional Investor*, December 1995), is posing challenges that the bank's founding fathers would barely recognize. ■

Wendy Cooper is an Institutional Investor *Staff Editor based in London.*