The title of this article is inspired by a recent book by the well-known liberal economist Robert Heilbroner (1995). In this book, Heilbroner takes on the humble task of summarizing 150,000 years of history, plus some vision of tomorrow, in only 133 pages. The much more modest objective of this article is to survey 30 years of investment management history and provide some vision of the future in a mere four pages.

The distant past refers to the 1960s up to the mid-1970s, yesterday refers to the mid-1970s through the 1980s, today is the 1990s, and tomorrow is a vision for 2000 and beyond.

The Distant Past
In the dark ages of the distant past, the investment world of the individual was ruled by an ancient monster, the dinosaur, also known as the stockbroker. Your savings were best invested in the hot stock of the week. Pension sponsors left their treasurers to oversee their funds. Typically, the treasurer kept a close eye on the pension fund—pension statements were kept in a desk drawer. If advice was given, it was to invest pension monies with one of those stodgy but trustworthy and safe insurance and trust companies. These companies offered a narrow product line focused on a conservative, balanced approach composed of government bonds and domestic blue chip stocks. Asset mix and diversification guidelines were left to these advisors. Pioneering sponsors split their funds. The role of the consultant on the investment side was trivial. Benchmarks were used to test athletic skills and not to evaluate manager performance. Managers had to provide stability but did not have S&P 500 performance objectives.

Bob Kirby, former chairman of Capital Guardian Trust Company, best summarized the early history of the distant past era when he said, “Money management didn’t really exist until the 1960s. The big banks had all the money, and their charge was to be careful and produce income” (quoted in English 1994).

In the distant past, the seeds were being planted for the paradigm shifts that occurred during the evolution of yesterday. Three major catalysts were ERISA, modern portfolio theory, and technology.

The Employee Retirement Income Security Act (ERISA) of 1974 formalized pension fund fiduciary responsibilities. ERISA elaborated on the Prudent Man rule and the need for investment diversification.

Modern portfolio theory also budded in the distant past (see Sharpe 1979). How should portfolios be constructed? How should investors take return and risk into account? How can the asset allocation decision be balanced to match a client’s risk-tolerance level? What is the relationship between risk and return in an efficient market? The Nobel prize-winning work of Harry Markowitz, Bill Sharpe, and James Tobin laid this foundation during the distant past. Modern portfolio theory was officially christened with the advent of the first index fund in 1971.1

Technology’s future was ready to take a sharp turn as Intel redesigned the “brains” of the computer into something called, “a computer on a chip” (see Sherkin 1996). These new devices, aptly renamed “microprocessors,” gave birth to the computer age.

These three catalysts initiated the rise of the data society of the distant past. In the mid-1960s, a Chicago-based brokerage firm called A.G. Becker first started to produce performance numbers, which suddenly placed pension fund performance in the spotlight. Becker, the predecessor of the performance measurement firm SEI, set off the performance derby madness of the next era, yesterday.

Yesterday
From the mid-1970s through the 1980s, our friend the stockbroker was magically transformed into a financial consultant. Although the advice dispersed did not change much, the name change offered another decade of life to the jobbers of individual stocks.

Yesterday also saw the demise of insurance and trust companies as big players in the investment
industry, along with the rise of the independent counselor. The rationale was strictly economic. Investment managers at the insurance and trust companies realized that their earnings potential was seriously capped by the salary of the president of the company. Those entrepreneurial investment managers decided to leave the relative security of home to set up their own independent firms and risk becoming millionaires and having fun. Marketing and sales were introduced into the professional investment arena, and the investment industry entered the growth phase of its life cycle.

Unfortunately, pension sponsors were overrun by all sorts of government rules and regulations. Weak capital markets caused by two major oil shocks added more salt to the injury. Notwithstanding these events, the rapid growth of pension assets and the constant barrage of performance numbers pushed pension sponsors to spend more time on the funds. Unbiased advice was needed, and investment consulting was invented.

Members of the pension investment industry were responding to their burgeoning self-importance. Specialist manager structures arose and consultant-driven manager searches became a yearly focus. In the 1980s, AT&T had 111 external managers (see English 1994). Patience was no longer a virtue. Managers were bought and sold like stocks. When their results were less than satisfactory, passive management was given active consideration.

The technological revolution continued as 21-year-old Steve Jobs and 26-year-old Steve Wozniack designed the Apple I—a circuit board that could plug into a television display. The Apple Computer Company was incorporated, and the personal computer race began. Contributing to this revolution were another two “kids,” Paul Allen and William Gates III, who formed the first computer software company, Microsoft, in July 1975 to develop software for desktop computers (see Gates 1995).

These high-tech progressions gave academics and practitioners the opportunity to formulate ever-more complex mathematical models and “positively” test them. The computer revolution was a significant factor in the rise of quantitative investment approaches such as that used by the renowned consulting firm, BARRA. Sophisticated modeling and testing blasted off in the 1980s and spread from equity and fixed-income markets to derivatives and over the counter markets (see Merton 1995).

**Today**

Today, in the information age of the 1990s, we are witnessing the coming of age of financial planners, also known as financial consultants (at one time known as brokers), who provide “unbiased” load mutual fund recommendations and “wrap” programs for conspicuous consumption.

We have come full-circle. Independent counselors no longer dominate institutional investing, and large financial institutions flex their muscles in the search for positioning. The institutional investment industry has reached past the fast-growth stage of the industry life cycle and is slowly approaching maturity as industry consolidation grows and compounds. This development is made obvious by the entrance of these players into the retail industry and by the proliferation of investment products (see Shultz 1996). Servicing also is finally becoming a differentiating factor.

Nonetheless, it is hard to believe that modern portfolio theory is still not widely accepted in North America. Many investors still consider derivatives to be a “four-letter” word. Finance theory, however, is absolutely clear that derivatives markets help make markets complete (see Flood 1991, and Sharpe 1991). Asset allocation and portfolio construction remain more an art, driven by behavioral biases, than a science. For example, the home country equity bias (i.e., the extent to which equity portfolios are concentrated in the investor's domestic market) has been academically documented and is practically persistent.²

In today’s information age, consultants cannot survive by simply providing data, because data have become a commodity. Consultants have come to the fork in the yellow-brick road—enter the investment management arena or supply unique value-added information insights.

Pension sponsors, too, are at the cusp of the curve. After the restructuring and reengineering of their core businesses in the 1990s, plan sponsors have shifted their attention to their pension funds. Although some leading-edge clients are asking how they can run their funds as profit center businesses, total quality management is still only a buzzword in our industry. A recent survey of pension sponsors found that only 10 percent of respondents had implemented a total quality management program (Institutional Investor 1995). Sponsors are starting to ask whether they are receiving value commensurate with the fees they pay. This and other questions concerning the economics of the $5 trillion pension asset business are being raised with more frequency, questioning the legitimacy and image of the pension industry (see Ambachtsheer 1994). One often-quoted study concluded that the structure of this industry is not unlike that of hair salons or trendy restaurants (Lakonishok, Shleifer, and Vishny 1992, p. 364). As the authors of this study describe, “Money managers who can provide a good story about their strategy have a comparative advantage. In fact, the
product sold by professional money managers is not just good performance but schmoozing, frequent discussions of investment strategies and other forms of hand holding” (p. 375).

Management guru Peter Drucker (1996) sounded the alarm more than 20 years ago about the impact of “pension fund ownership on the governance of the American corporation and on the structure of the American economy all together.” Only recently, however, have pension funds shown any interest in correlating equity ownership with corporate results (see Gilpin 1995). Unfortunately, some plan sponsors have also taken the easy route and have thrown in the towel, converting or introducing self-directed retirement programs.

**Tomorrow**

Tomorrow, or beyond the 1990s, the investment industry will continue its dynamic evolution into the knowledge age. The retail industry has a long way to go to maturation, but it will eventually occur as the high returns of this field attract better people. As competition grows, fees will fall and providers will attempt to differentiate themselves through multiple product offerings and service distinction. Loads will slowly evaporate, and distributors will demand fee-based revenue instead. The average investor will have his or her own personal investment manager, also known as a financial planner, a financial consultant, or a broker.

Distribution avenues will be one of the keys to success for mutual fund companies. Distribution will be everywhere and nowhere. Among the more than 6,000 U.S. funds, those caught in the middle without critical mass, adequate distribution, or niche positioning will be swallowed up (see Bederman 1994). We are not too far off from “surfing the net” for funds.

The continued growth of self-directed retirement programs will, in fact, benefit all retail investors as investment education programs improve. Individuals will also pump up their investment IQs, leading to a focus on settings, long-term allocation, and greater use of indexing as opposed to selecting the fund flavor of the month.

The institutional investment industry will be subdivided into two sectors: small boutiques and large institutions, or investment factories. The excellent investment factories of the future will have a very clear identification of their raison d’être. These superior firms will have distinguishing organizations, products, performance, and services. They will have the depth of systems and professionals in place to produce each of their product lines. This structure means that product, style, and results will be successfully replicated. In the knowledge society of the future, excellent firms will continuously improve and set higher quality standards for their organizations and products.

Modern portfolio theory will finally be accepted. Investors will disown their home equity biases, derivatives will be highly accepted and widely used investment vehicles, and portfolio construction will become more of a science and less of an art.

Sponsors will help lead the industry on a number of platforms, beginning with managing their funds’ long-term economic risks. This development will have a direct impact on fixed-income policy development. Sponsors will shift toward using longer duration fixed-income benchmarks; after all, the liability duration of the typical pension fund is significantly longer than the average fixed-income benchmark.

Investors will more seriously consider alternative investments as domestic markets continuously increase in asset pricing efficiency. Alternative investments such as venture capital, distressed securities, and leveraged capital buyouts will receive more consideration as hungry investors search for excess risk-adjusted returns.

One trend the U.S. market has not experienced is the development and growth of inflation-linked bond markets. In Canada, the United Kingdom, and Australia, this market has developed largely through the support of pension funds that view these instruments as natural hedges for inflation-linked liabilities. Such a market would, no doubt, also succeed in the United States if the government issued such bonds.

Just as the mantra of the 1980s was “asset mix,” and in the 1990s, “style management,” the slogan of the future will be “value for service” (i.e., a strong relationship between what you pay for and what you receive). Pension sponsors will provide the industry’s initiative toward basic economic principles. As one prominent consultant concluded, “Adam Smith’s invisible hand is not dead. It has just been waiting for someone to shake it” (Ambachtsheer 1993).

Fee schedules will be performance-base driven. Reengineering and total quality management will become accepted and widely used pension practices. Institutional activism, representing the best interests of equity owners, will provide more grease for the wheels of capitalism. In conjunction with emphasis on long-term objectives and asset mix policies, “the paradox” of long-term purposes being managed via short-term objectives will be resolved.5

For the average manager, profit margins will shrink. Relationships will be closer and more consultative in nature as sponsors, managers, and consultants form a “trinity” in which to further develop their holistic relationship. This expectation is somewhat ironic, given the current fractured...
state of specialty management in the industry. Accountability pressures will also force soft dollars eventually to harden. The increased sophistication of pension sponsors in the knowledge economy of the future will force consultants to lead the industry in providing independent counsel that has been both rigorously tested and is practically implementable. World-class consultants will supply domestic and global products and services.

These changes during the next decade will continue to illustrate Peter Drucker's claim that pension funds are "the only true capitalists" in market economies (Drucker 1995, p. 174).

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Notes

2. The home equity bias is examined in more detail in French and Poterba (1991), Tesar and Werner (1994), and Cooper and Kaplanis (1994).
3. Davis and Bothier (1994) discuss the economic transition from data to information to knowledge-based economy.
4. Goldman, Sachs & Company and Frank Russell Capital Inc., in the 1995 Survey of Alternative Investments, revealed that only $69 billion, or about 5.5 percent of the total assets of 254 of the largest pension fund endowments and foundations, is invested in alternative investments.
5. Ellis (1993, Chapter 4) discusses this "paradox" in more detail.
6. We see the genesis of this "holistic" relationship developing under the guise of what Greenwich Associates calls the "new paradigm" (see Ellis 1991).

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References


