City Business Series 2003

Fund Management

International Financial Services, London

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IFSL also produces a separate series of reports that highlight UK expertise and are used to support IFSL's international promotional activities. Titles in this series include Public Private Partnerships, Pension Reform, Dispute Resolution, Privatisation and International Private Wealth Management.

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City Business Series 2003

Fund Management

City Business Series

IFSL has published a number of reports in its City Business Series covering UK financial and business services, which also include reports on Maritime Services, Legal Services, Derivatives, Insurance, Banking, Securities Dealing, and Accounting and Management Consultancy. Prior to February 2000, these and other IFSL reports were published under the organisation's previous name BI (British Invisibles).

This report on Fund Management follows earlier editions of the report that were published in 1997 and 2000.

The financial sector is by far the largest single positive contributor to the balance of payments with net exports of £13bn in 2001. It is a large contributor to GDP as well as a substantial generator of employment. Yet, information on financial and related business service sector activities is often not easily accessible.

Each publication in the City Business Series brings together statistics on the size and structure of each sector or activity, as well as their contribution to national output, employment, and net exports. International comparisons and shares of world markets are included where possible. The Series therefore meets the widely recognised need to have data on individual financial and business sectors available on a systematic basis, and has the strong support of private sector firms and institutions and public sector bodies.

These reports enable IFSL to highlight areas where there are gaps in information and problems in making international comparisons. Each report will be updated, incorporating improved quality and coverage of statistics.

This report has been compiled by IFSL Economist Marko Maslakovic with advice from IFSL's Director of Economics, Duncan McKenzie.

All IFSL's reports can be downloaded from its website at **www.ifsl.org.uk**

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Standard notes and abbreviations

m = million
bn or billion = 1,000 million
tn or trillion = 1,000 billion
= estimate
--- = data not available

Data may not sum exactly to totals due to rounding.
Unless otherwise stated, figures are not adjusted for inflation.

EXECUTIVE SUMMARY

The UK is one of the three largest markets in the world for fund management along with the US and Japan. It has a strong international orientation and attracts significant overseas funds. More funds are managed in London than in any other city. Fund managers in the UK and globally have been substantially affected by declining investment returns and falling equity markets since 2000. This has reduced commission income and fee levels, and made it more difficult to attract new funds.

UK fund management According to IFSL estimates, the UK fund management industry was responsible for around £2,600bn of funds at the end of 2002. This was down over 13% from 1999 and follows a period of high growth in the 1990s during which funds more than doubled. UK clients' pension assets and insurance funds have fallen by 24% and 11% respectively during this period.

Around 60% of funds were managed on behalf of UK institutional clients, mainly insurance companies and pension funds. Nearly a third of assets were managed on behalf of overseas clients and the remainder was accounted for by UK private clients' funds. Most of these funds were managed by investment banks and fund managers, with each accounting for around a third of the total; insurance companies managed 29% and self-managed pension funds the remainder.

The UK fund management sector has a strong international orientation reflected in the:

- Institutional presence of a broad mix of UK and foreign firms;
- Investment of over a quarter of institutional clients' portfolios in overseas securities;
- Management on behalf of overseas clients of funds totalling nearly £800bn.

London is central to the UK's strong international position having been ranked as the top city in the world for the management of institutional equity funds. Scotland is also a major fund management centre with nearly £300bn under management at the end of 2002.

Contribution to the UK economy Fund management makes a significant contribution to the UK economy, equivalent to 0.6% of the gross domestic product (GDP) in 2001, an important component of the financial sector's 5.3% share. However, the fund managers' wider contribution to the economy relates to their links with banks, securities dealers and information providers.

According to the latest available data, UK employment in fund management totalled 35,000 in 2000 with a further 14,000 employed by retail stockbrokers in the management of private client funds. Employment may have fallen since 2000 due to the downturn in the industry.

Fund managers' margins have declined in recent years with the average profit margin falling to 23% in 2001, from over 30% in 1999. Revenues fell by 8% in 2001, largely due to lower stock market levels partly offset by an inflow of new business. Overall costs were up by 6% in 2001, significantly less than their 18% average growth in the three prior years. There were indications of rising profitability in 2002 according to a survey by IBM. Operating margins of firms covered in their survey sample rose from 19% to 22% between the end of 2001 and September 2002.

Net exports of UK fund managers' services reached £600m in 2001. In addition to this, fund management accounts for a substantial proportion of portfolio investment earnings from overseas.

International comparisons The past three years have seen a fall in global assets under management, following a period of high growth in the 1990s. According to IFSL estimates, global funds under management totalled $52 trillion at the end of 2001. Pension assets, mutual funds and insurance funds contributed equally to this with around $11.5 trillion each. The 2001 total is slightly lower than 1999. The value of insurance funds and mutual funds was largely unchanged during this period while pension assets fell by 11%. Mutual funds and pension assets fell further in 2002 to $11.2 trillion and $10.4 trillion respectively due to the continued weakness of global equity markets. Merrill Lynch/Cap Gemini Ernst & Young estimated the size of the private wealth industry at $26.2 trillion in 2001 of which one third was incorporated in other forms of conventional investment management.

The US is by far the biggest source of funds. It accounted for over half of conventional investment management assets in 2001 or nearly $18 trillion. It was followed by Japan with 10% of total funds. The UK was the third largest centre in the world and the largest in Europe with around 9% of the total. However these rankings based on sources of assets understate the UK's position due to the funds managed there on behalf of overseas clients. Other large centres in Europe include France and Germany, although funds managed in the UK are larger then those managed in France and Germany combined.

Key aspects of the UK's strong international position include:

- *Pension fund assets* The UK's pension assets accounted for around 10% of the world total in 2001. This was well ahead of other European

countries and only exceeded by the US and Japan which both have a much larger domestic population. The UK is in a group of countries with the highest ratio of pension assets to GDP;

- *Mutual funds* More than $360bn is managed by UK mutual funds. The US is the major source of assets invested in these funds, with more than 60% of the world total in 2001;

- *Insurance funds* The UK insurance industry is the third largest in the world after the US and Japan. UK insurance companies' investments are almost double those of any other European country;

- *Overseas clients* The £800bn managed on behalf of overseas clients in the UK cannot be directly compared with any other centre, but is unlikely to be exceeded by any other country other than the US;

- *Largest fund managers* According to the annual Watson Wyatt World 500, of the $35 trillion managed by the top 500 investment managers in 2001, UK owned fund managers accounted for around 8.5% of the total. US fund managers managed more than 40% of the total and Japanese 11%;

- *Private wealth* The UK is one of the major onshore centres for private wealth management. It also accounts for around 15% of the offshore market. This was only exceeded by Switzerland with 33%.

Current trends and market issues This report refers to a number of factors likely to affect the UK fund management industry in the future including:

Pension reform Developed countries are set to experience a dramatic demographic shift during the course of the next 40 years due to increasing life expectancy and a falling birth rate. This implies a declining proportion of people in the workforce. The reform of pension systems throughout Europe and elsewhere should provide more cross-border opportunities for UK fund managers, pension providers, legal firms and consultancies offering actuarial, tax and investment services. UK fund managers should also be able to contract further business from external appointments with the easing of investment restrictions and diversification of international portfolios.

Asset allocation In a climate of falling investment markets asset managers are having to review their strategic asset allocations and may increase their focus on risk and capital preservation rather than on return. In a more uncertain market environment there may be a shift from equities into bonds over the next decade. Fund managers may also consider diversifying more into other assets such as property, high yield and emerging debt or derivatives products such as options.

E-commerce The growth of the internet is likely to introduce significant changes to the fund management industry in areas such as customer relationship management and personalisation of products and services. So far these changes have mainly been confined to marketing and lowering distribution charges.

Restructuring Over the past few years, there has been substantial restructuring of UK fund managers. There is likely to be further consolidation globally.

Profitability Fund managers' margins have declined in recent years. In order to remain competitive, organisations have needed to manage a fall in revenues through better cost management, increased efficiency and by finding new ways to add value.

Outsourcing In an effort to contain costs, large fund managers are increasingly outsourcing support activities. This includes services such as custody, accounting, daily valuation and shareholder record-keeping. Outsourcing accounted for 13% of overall costs in 2001, up from less than 4% in 1998.

Liberalisation A number of liberalisation issues will affect the fund management industry in the future. The challenges for governments will include allowing business development whilst protecting consumer interests, consumer education and avoiding over-regulation.

Section 1. UK Fund Management

Fund managers invest funds on behalf of institutions that are intermediaries between savers and users of capital. Their primary task is to invest the flow of cash from pension contributions, insurance premiums and personal savings in a portfolio of financial assets that will best meet clients' needs. In doing so they have above all to seek an appropriate balance between risk and reward. They must weigh the requirements of savers for security and liquidity against the range of returns available from different types of investment instruments.

The first section of this report gives an overview of the fund management industry in the UK which provides services to both institutional and private clients from the UK and overseas. The second section details the contribution of fund management to the UK economy. International comparisons and private wealth management are featured in Sections 3 and 4.

1.1 UK fund management overview

The UK has one of the largest investment markets in the world but like other countries has been substantially affected by declining equity markets since 2000. This has reduced commission income and fee levels, and made it more difficult to attract new funds. Investment management has been further affected by declining returns on investments caused by the slowdown in the global economy in recent years.

According to IFSL estimates, the UK fund management industry was responsible for around £2,600bn of funds at the end of 2002 (Table 1). This was down over 13% from 1999 and follows a period of high growth in the 1990s during which funds more than doubled. These estimates may however underestimate total funds under management. For example other funds managed from the UK for which there is no industry estimate include fund managers that manage their own portfolio of financial assets and funds managed on behalf of foreign governments.

Table 1: Funds under management in the UK

£bn	UK clients Dec-02	Overseas clients Jun-02	Total
Institutional funds			
- pension funds	615	325	940
- insurance companies	918	60	978
- unit trusts	177	} 142	367
- investment trusts	48		
- other	-	200	200
less unit and investment trusts held by other funds	-144	-	-144
Institutional clients total	1,614	727	2,341
Private clients	212	66	278
All clients	**1,826**	**793**	**2,619**

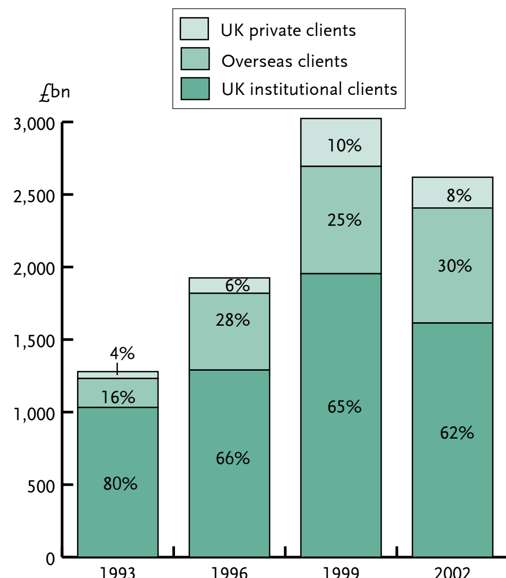
Source: IFSL estimates based on ONS, ComPeer, WM Company and IMA data

Around 60% of funds were managed on behalf of UK institutional clients such as pension funds of companies and local authorities, insurance companies and organisations operating unit trusts and investment trusts. Nearly a third of assets were managed on behalf of overseas clients and the remainder was accounted for by UK private clients' funds (Chart 1).

The UK remains one of the most important centres for fund management and by far the largest in Europe. Factors contributing to its strong international position include:

- Highly sophisticated and innovative management styles, techniques and strategies;
- Skilled labour force and high quality professional and support services;
- Wide ranging client base: private and institutional, UK and overseas;
- Highly liquid market with the opportunity to trade in large blocks of shares;
- History of openness with relatively easy access to markets;

Chart 1: Funds under management in the UK



Source: IFSL estimates based on ONS, ComPeer, WM Company and IMA data

- Liberalised operating environment combined with protection against abuses;

- Competitive infrastructure in telecommunications services and airline links.

Within the UK, the importance of London is essential to its strong international position. Scotland is also a major centre for fund management with £298bn under management at the end of 2002. According to Thomson Financial surveys of the largest centres for the management of institutional equities, London was ranked in first place between 1996 and 1999, ahead of New York and Tokyo (Table 8, Section 3.1). Edinburgh and Glasgow combined were ranked as the sixth centre in Europe and fifteenth in the world in 1999.

1.2 Types of funds

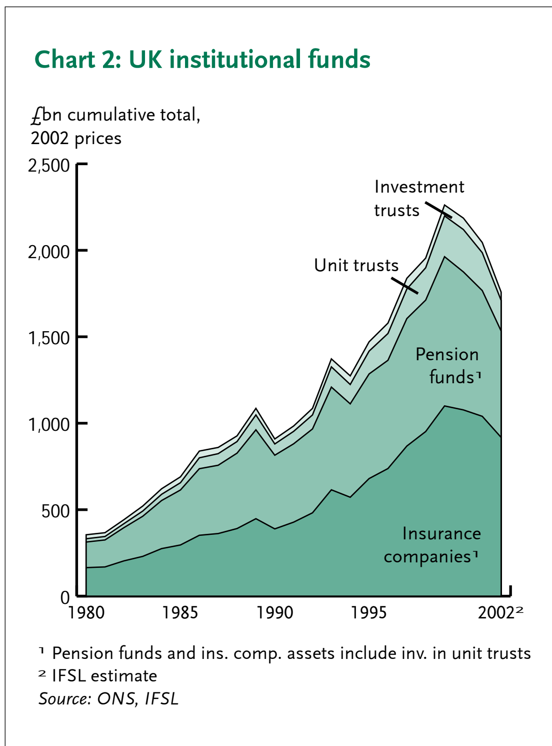
Institutional funds have become increasingly predominant in the UK over the past two decades and account for the bulk of funds under management. The UK's strong international position as a fund management location means that significant funds from overseas are managed there. UK private clients account for the remaining funds.

Institutional funds According to IFSL estimates, in 2002, fund managers held £2,341bn of institutional funds under management of which £727bn was held on behalf of overseas clients (Table 1). As shown in Charts 2 and 3, the £1,614bn of UK institutional funds managed at the end of 2002 was down 17% from the record 1999 level. The falling equity markets during this period have been the primary reason for the decline as a large proportion of funds was invested in equities. Over the long-term UK institutional funds increased, in real terms, nearly six times over the past two decades and have more than doubled during the past decade.

Insurance companies generate the majority of institutional funds in the UK. They accounted for £978bn of funds under management in 2002, more than double the amount in 1990 but down over 10% from 1999. The insurance sector has been one of the sectors that has been particularly affected by the three years of declines in equity prices. Some insurance companies have been forced to reevaluate their portfolio allocation and increase their holdings of other asset classes in order to increase their solvency ratios. According to the ONS, around a quarter of all UK share holdings in 2001 were in the hands of insurance companies as beneficial owners.

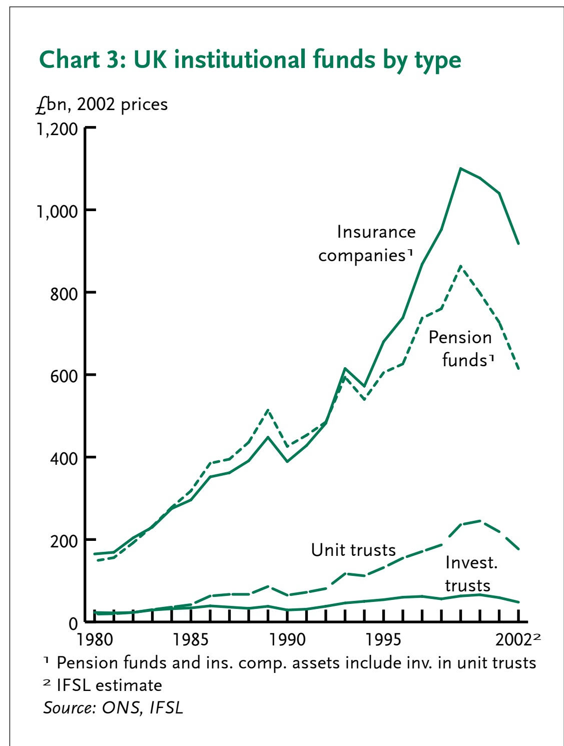
The fall in insurance funds between 1999 and 2002 followed a period of high growth during the 1990s. This was mostly due to growing long-term worldwide premiums. Life insurers' premiums increased by 170% between 1990 and 1999 while general business premiums grew by a third. Insurance funds have also increased during this period due to healthy returns.

Chart 2: UK institutional funds



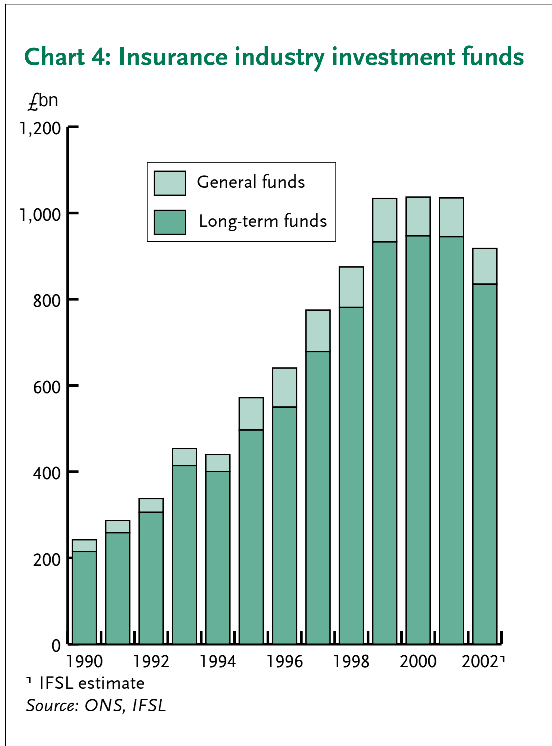
¹ Pension funds and ins. comp. assets include inv. in unit trusts
² IFSL estimate
Source: ONS, IFSL

Chart 3: UK institutional funds by type



¹ Pension funds and ins. comp. assets include inv. in unit trusts
² IFSL estimate
Source: ONS, IFSL

Chart 4: Insurance industry investment funds



¹ IFSL estimate

Source: ONS, IFSL

Table 2: Market value and average return of UK pension funds

	Market value Total £bn	Market value 2002 prices £bn	*Average return (%)*
1980	56	148	*26.4*
1985	168	318	*15.2*
1990	303	426	*-11.4*
1991	344	453	*17.7*
1992	382	485	*17.5*
1993	480	594	*25.5*
1994	444	540	*-3.0*
1995	508	605	*19.6*
1996	544	626	*10.4*
1997	657	737	*16.8*
1998	699	760	*14.9*
1999	813	863	*20.4*
2000	768	798	*-2.7*
2001	714	727	*-8.8*
2002[1]	615	615	*-13.9*
Average return (% p.a.)			
1980-2002			*12.4*
1990-2002			*7.1*

¹ IFSL estimate

Source: ONS, UBS Asset Management, WM Company

As shown in Chart 4, over 90% of insurance investment funds arose from long-term insurance policies. Premiums paid to insurance institutions for long-term business are invested in order to meet the liability at maturity. General insurance policies, which by definition have a shorter timescale with claims less easy to plan for, contributed the remainder.

Pension funds According to IFSL estimates based on ONS and WM Company data, UK clients' pension fund assets totalled £615bn at the end of 2002 (Table 2), down by a quarter from the record level in 1999. Before this, pension assets had risen each year from 1994, nearly doubling in value by 1999. Smaller schemes, those with assets of less than £1bn, had been the most affected by the recent downturn. On average, UK pension funds have invested more than 70% of their portfolios in UK and overseas equities since 1990. This share has declined somewhat in recent years as investments in other asset classes such as bonds have increased.

The UK pension fund industry has been affected in recent years by various other factors including: changes in regulation and accounting standards, personal pension mis-selling, movement away from defined benefit to defined contribution schemes and the introduction of Stakeholder Pensions. Current UK pension provision embraces both state and private sources of pension income. It includes a basic state scheme which is financed on a pay as you go basis through taxation and a State Second Pension which replaced the State Earnings-Related Pension Scheme (SERPS) in April 2002. This is funded by contributions. Private pension provision includes occupational and personal pension schemes which are both funded. Currently around 60% of retirement income in the UK is provided for by the state while 40% is funded by occupational and private pensions.

A major feature of the UK pension industry is the gradual movement away from defined benefit (DB) to defined contribution (DC) schemes. Greenwich Associates estimates that the proportion of UK plan sponsors offering DC schemes had risen from 26% in 1999 to 45% in 2001. It is anticipated that DC schemes will account for over a quarter of pension funds' assets by 2010, up from the 2001 level of 8%.

Stakeholder Pensions were introduced in April 2001 (Section 1.5). According to the Association of British Insurers, nearly 1.2m stakeholder pensions have been sold by September 2002. But take-up was down from 66,000 per month (between April and June 2002) to 46,000 (between July and September 2002). The UK government has imposed a 1% charge cap, that is charges for mainstream services must not exceed 1% of funds under management. Most personal pensions being sold today meet the Stakeholder charging criterion, and many existing personal pensions have had their existing charges reduced to remain competitive.

The system of private provision in the UK has

had to deal with the consequences of mis-selling of personal pensions, particularly in the 1990s. This resulted in many members losing out on benefits that they could have accrued had they remained in occupational pension arrangements. The outcome of the misseling review is that redress totalling about £11.5bn will be paid to 1.25m people.

The UK pension industry is also seeking a way forward on a number of other issues such as: simplifying pension law and structures; making the balance sheet treatment of pension funds more transparent; working toward the portability of pensions across the EU; and reviewing the rules of the annuity market to allow greater flexibility, particularly for more wealthy individuals, whilst not eroding the guarantee of retirement income.

The UK Government announced a number of reviews of pensions and savings in 2002. This includes reviews by Pickering and by Sandler (that are discussed in Section 1.5), and a review by the Inland Revenue. The pensions Green Paper was published in December 2002 building on the earlier Paper issued in 1998, and opens consultation about future policy and legislation.

Unit Trusts and Open Ended Investment Companies (OEICs) According to latest official data from the ONS, funds invested in unit and property trusts totalled £215bn in 2001, down 9% from the previous year. IFSL estimates based on Investment Management Association (IMA) data indicate that the stock of invested funds fell further in 2002 to around £177bn due to the continued weakness of equity markets. Unit trusts' share of total institutional funds under management increased from 5% in 1980 to 12% in 2001. In December 2002, there were over 130 unit and investment trust groups which had combined funds under management of around £195bn.

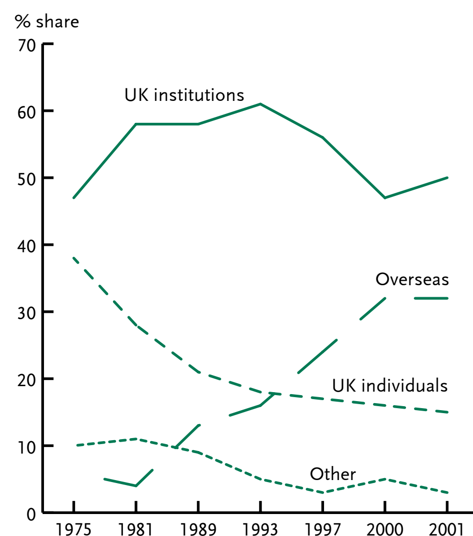
Investments in unit trusts were lifted in the decade up to 2000 from the growth of tax-free Personal Equity Plans (PEPs) and, since April 1999, from Individual Savings Accounts (ISAs). Sales of equity related ISAs dropped substantially in 2001 and 2002 due to falling equity markets. ISAs were introduced to allow investment in a range of products including unit and investment trusts, OEICs, bonds and shares, life assurance and cash. In April 2002, assets totalling £62bn were held in ISAs, £81bn in PEPs and £19bn in TESSAs. OEICs have greater flexibility and were introduced to provide a vehicle which was more familiar to non-UK investors. As of February 2002 approximately 36% of authorised investment funds assets were held by OEICs, significantly up on their 1998 share of 8%.

Investment trusts accounted for £58bn of funds at the end of 2001. According to IFSL estimates based on IMA data, this has declined further in 2002 to around £50bn. Investment trusts' share of total institutional funds under management more than halved during the past two decades from 6% to 3%. There may be consolidation in the next few years as there were nearly 400 investments trusts in the UK in April 2002.

Private clients Funds managed in the UK on behalf of private clients have been estimated at £278bn in 2002, bringing together the ComPeer survey of UK clients of £212bn and £66bn in the IMA survey of overseas private clients assets. Private clients remain a significant niche in the market with around 10% of total UK identified funds. Individual ownership of UK shares accounts for around 15% of total share ownership (Chart 5), or around £174bn in 2002, down from over 50% in 1963. Within Europe the value of private client funds handled in the UK is probably exceeded only by those in Switzerland.

Retail stockbrokers handled £188bn on behalf of 4.1m clients in 2002, with an average shareholding of £46,000 (Table 3). Although some private clients' funds are invested in mutual funds, it is likely that about three-quarters of this is invested directly in UK equities. Consequently fund managers, principally retail stockbrokers, have a significant stake in the £174bn of UK equities held by private individuals. The remainder is in the hands of predominantly small shareholders who buy and sell equities via their local bank branch, building society or through the internet as well as some private clients who manage their own

Chart 5: UK share ownership



Source: ONS

Table 3: Private clients of retail stockbrokers

end-2002

Size of portfolio £(000)	No. of client portfolios 000s	Funds £bn	Funds % of total	Ave. size of portf. £(000)
<50	3,555	20	11	6
50-150	311	31	16	99
150-250	108	22	12	204
250-500	80	30	16	369
500-1,000	33	24	13	746
1,000-3,000	14	25	13	1,843
3,000+	4	35	19	9,168
Total	**4,105**	**188**	**100**	**46**

[1] Overall UK private clients' funds totalled £212bn in 2002. This table does not include funds held in investors own names
Source: ComPeer

portfolios but who may take advice from a broker.

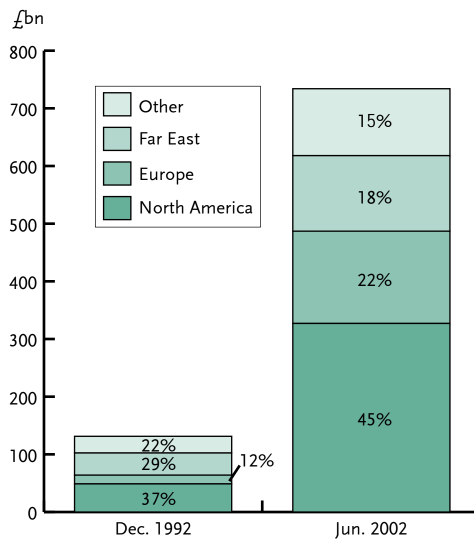
Following privatisations in the 1980s and the demutualisation of building societies in the 1990s, the number of individual shareholders in the UK increased from around 4m to over 12m. Despite this, the proportion of shares directly held by individuals halved from 30% to 15% between 1980 and 2001. This is partly because individuals tend to prefer holding equities in mutual funds.

As shown in Table 3, a great majority of the 4.1m clients of retail stockbrokers are relatively small investors, some 3.5m accounting for £20bn or 11% of the total, implying an average holding of just £6,000 in this group of smaller investors. At the other end of the scale, nearly half of the total funds were managed on behalf of a small group of 51,000 investors, each with funds exceeding £500,000 and averaging £1.6m per investor.

Overseas clients In recent years, the UK has consolidated its position as the most important centre for the management of funds on behalf of overseas clients. According to IFSL estimates based on IMA data, funds in the UK managed on behalf of overseas clients totalled £793bn in 2002, £727bn (92%) for institutional clients and the remaining £66bn for private clients. This is more than five times the 1992 figure due not only to growth in the client base, but also due to consolidation which has been reflected in some significant acquisitions.

As shown in Chart 6, 45% of overseas institutional investment is from North American countries, up from 37% in 1992. European countries nearly doubled their share during this period to just under a quarter. Far Eastern countries accounted for 18%, a fall from 29% in 1992.

Chart 6: Overseas institutional clients by geographical area



Source: IFSL estimates based on IMA data

1.3 Asset allocation

The pressure to increase returns from asset allocation has been significant in recent years due to falling investment markets and rising cost of liabilities, in particular of pension funds (Section 3.5). The past three years have generally seen negative returns following a period of high growth in the 1990s (Chart 7).

Institutional fund managers have an array of investment choices available to them at home and abroad including equities, bonds, property and cash. Active managers use primary research to make stock selections offering the best potential return. A passive manager is essentially one who designs a portfolio with the objective of tracking a particular index. Most pension schemes in the UK use either active management or a combination of active and passive. The size of the fund also influences the type of management applied - the larger the scheme the more likely it is to adopt a combination of active and passive rather than purely active.

Chart 8 shows the pattern of pension fund asset allocation during the past two decades. UK institutions have traditionally favoured investment in equities, although their attraction has lessened somewhat in recent years. Other key features of UK historical asset allocation include the rising proportion of assets invested in overseas securities, gradual widening of the number of investment instruments used and diversification of portfolios.

Turnover in assets held by UK pension funds varies between asset classes with trading greatest in government securities, equivalent to 119% of the average annual holdings in 2001. This was partly due to low transaction costs in the gilts market. Turnover was lower for UK equities at 39% of holdings although it has been on an upward trend during the past decade; overseas equity portfolios had a much higher turnover (80% of holdings).

Equities have been the favoured investment medium for UK institutional investors since the 1960s although their share of total portfolio allocation has fallen in recent years due to falls on global equity markets and greater investment in other asset types. This was particularly the case for pension funds and insurance companies. Domestic equities, which made up around a third of pension funds' portfolios in the 1960s and 1970s, increased their share to reach a high of 57% in 1993 but contracted to 39% of the total by 2002 (Chart 8). Investments in all types of overseas securities by UK pension fund managers now account for over a quarter of all assets, a higher proportion than in other major countries.

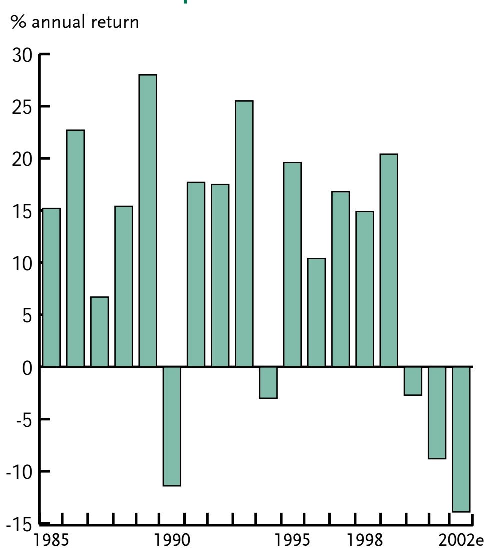
Cash and property investments have produced more stable returns than equities and bonds (Chart 9). Over the long-term, UK equities have generally produced higher returns than other forms of investment with an average annual return of over 14% between 1965 and 2001 although this was reduced by falling stock markets in the last two years of this period.

Venture capital and private equity are investments in companies that are not quoted on stock exchanges. These generally involve higher risk. The ten year average annual return on such investments in the UK was around 17%, significantly higher than the growth of the FTSE 100 or FTSE All-Share indices. The UK private equity industry is the largest and most developed in Europe and accounted for 38% of total annual European private equity investment in 2000. Since 1984 UK private equity has provided over £43bn to over 20,000 companies. UK pension funds generated around 10% of total investments in these funds in recent years.

Bonds The UK bond market has grown markedly during the past decade. The nominal value of bonds outstanding at the end of 2001 was £758bn, more than four times the 1990 total. A major feature of the UK market has been a movement away from gilts into non-government bonds in recent years. The outstanding value of non-government bonds overtook gilts for the first time in 1999 with 51% of the total, and increased further to 65% by 2001. This was partly due to a smaller supply of government bonds caused by the strengthening of public sector finances between 1995 and 2001, although the supply has risen since then as public finances have deteriorated. A a result, net issuance of gilts was positive in 2002/03 for the first time since 1996/1997 and is targeted at between £15bn and £18bn in the following years.

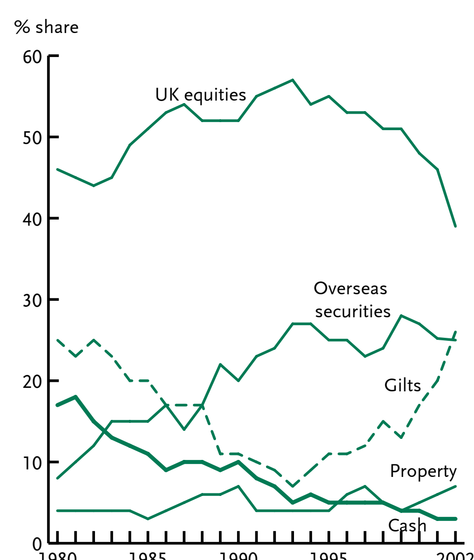
Government bonds have the highest credit ratings in

Chart 7: Average real annual returns of UK pension funds



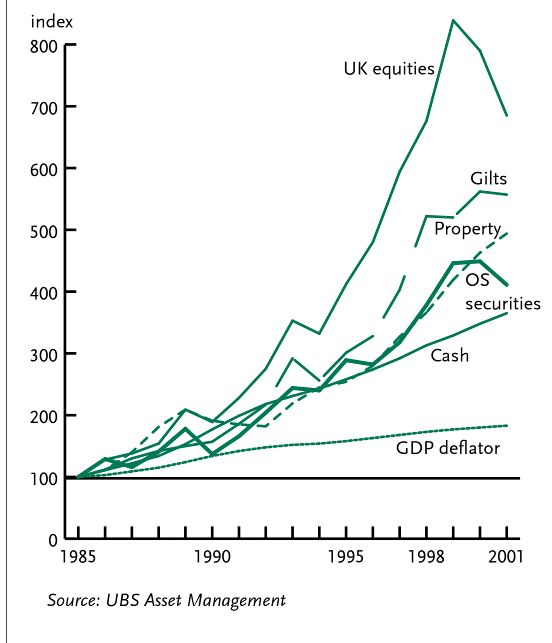
Source: UBS Asset Management, WM Company

Chart 8: UK pension funds asset allocation



Source: ONS, WM Company

Chart 9: Cumulative return on investment



most countries and account for the bulk of pension fund investments in bonds. The proportion of UK pension funds allocated to bonds increased from 11% in 1990 to 26% in 2002, although it had previously fallen from 25% in 1980. Of this, around a half was accounted for by traditional gilts, and the remainder by index-linked gilts and overseas bonds.

Property Sentiment towards property investment by institutional managers has been rather volatile in the past two decades, reflecting changes in investors' needs, changes in the property market itself and varying market conditions. Property investments have a number of valuable characteristics such as lack of correlation with other assets and high income yield. Since 1990 the proportion of UK pension fund investments allocated to property has been around 5%. Previously in the 1970s and 1980s it had been much higher at 10-20%.

There are several ways in which funds can invest in property including: direct property; property shares; property unit trusts; and managed funds. Returns on various types of investments can vary, with for example returns on direct property and pooled funds totalling around 7% in 2001 while the return on property shares showed a loss of 6% in the same year. UK property investments had above average long-term returns with nearly 12% a year over the past three decades. Property as an investment has performed particularly well since 1993.

Cash Allocation of pension assets to cash has been relatively stable in the past two decades fluctuating between 4% and 7%. Cash is capital secure in nominal terms but its real value can be eroded by inflation.

Use of derivatives as a means of facilitating the transfer of risk and implementing tactical asset allocation decisions, has become a common feature of many fund managers in the UK and US. Less popular elsewhere in Europe, interest is nevertheless increasing. Because of risks surrounding the use of derivatives, control in their use remains of paramount importance with each fund required to set out a clear policy on the use of derivatives.

IFSL's *City Business Series* report on *Derivatives* outlines in more detail the role and scope of the derivatives markets.

1.4 Leading UK fund managers

Consolidation in the UK in recent years has reflected global developments in the fund management industry. It was driven by the need to expand the pool of available resources, develop sophisticated distribution systems, provide a quality service, as well as to widen the search for new customers from different regions.

An indication of the respective shares of the various types of institutions involved in UK fund management can be obtained from the Institutional Investor's table of the largest 100 fund managers in Europe which includes 34 fund managers from the UK (Chart 10):

- *Investment banks* accounted for the majority of funds under management with 35% of the total in 2001. They represent integrated banking and securities groups that combine securities firms, i.e. brokers or market makers, and fund management firms within the same group;

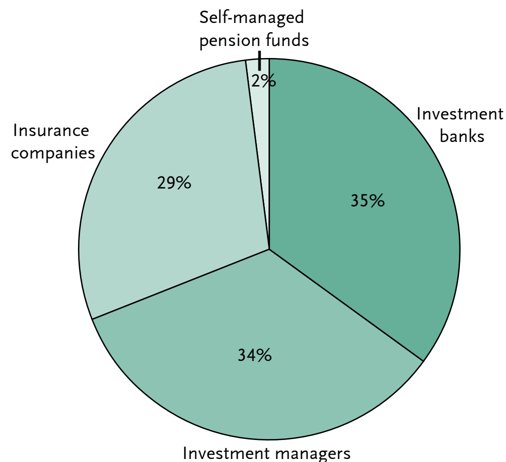
- *Independent investment managers* increased their share in recent years and managed around a third of funds in 2001. They include fund managers that are not linked to any UK-based banking, securities or insurance groups;

- *Insurance companies* managed more than a quarter of funds in the UK. They operate their fund management activities either from their investment department or from a separate subsidiary which might manage funds of external clients as well as those of its parent company;

- *Self-managed pension funds* represent separate legal entities set up to manage a company's pension fund assets. Their share has gradually

Chart 10: Fund management organisations

% share of UK funds, 2001



Source: *Institutional Investor*

Table 5: Largest UK pension funds

£bn assets under management, 2001

1	British Telecom	28.9
2	Coal pension Trustees Services	26.4
3	Electricity Pensions Services	21.4
4	Universities Superannuation Scheme	20.0
5	Consignia	16.0
6	Railways Pensions Management	15.1
7	BP	12.5
8	Lattice Group	12.2
9	Scottish Public Pensions Agency	12.0
10	Lloyds TSB Group	11.7
11	National Westminster Bank	11.0
12	Barclays Bank	10.7
13	Shell Pensions	10.7
14	British Airways	9.9
15	Corus UK	8.5

Source: Investment & Pensions Europe

fallen in recent years and totalled only 2% in 2001 as most companies' pension funds are managed externally.

The UK market is heavily concentrated with the top five fund managers accounting for around 60% of the pool of assets of the top thirty fund managers. Major deals in the UK in recent years include the mergers between Hill Samuel and Scottish Widows, Norwich Union and CGU to form Aviva, and AMVESCAP and LGT. Old Mutual's institutional broking and corporate finance division merged with Albert E. Sharp to form Old Mutual Securities. Some of these mergers were not solely between asset management firms but also involved banking and insurance companies.

The largest UK registered fund management organisation by far is Barclays Global Investors with £530bn of global funds under management at the end of 2001 (Table 4). Amvesco and the UK's largest insurance company Aviva Plc were the next largest fund management groups.

The pensions market is less concentrated with the top five accounting for just over a half of the assets of the top 15. The largest UK pension funds are BT, Coal Pension Trustees Services and Electricity Pensions

Table 4: Global assets of UK owned fund management organisations

	Assets under management, 2001	£bn
1	Barclays Global Investors	530
2	Amvescap	274
3	Aviva	209
4	HSBC Holdings	196
5	Prudential M&G	152
6	Legal & General Group	122
7	Schroders	110
8	Standard Life Assurance	82
9	Lloyds TSB Group	78
10	HBOS Group (Insight)	63
11	Royal & SunAlliance	62
12	Threadneedle Asset Mgmt	46
13	Hermes Pensions Mgmt	46
14	Aberdeen Asset Mgmt	37
15	Friends Ivory & Sime	34

Source: P&I/Watson Wyatt Global 500

Table 6: Largest mutual funds in the UK[1]

£bn assets under management, end-2002

1	Fidelity Investments	16.3
2	Scottish Widows Unit Trust Managers	10.0
3	Invesco Perpetual	9.9
4	Threadneedle Investments	9.7
5	Legal & General Unit Trust Managers Ltd	8.4
6	Schroder Investments Ltd	7.9
7	M&G Group	7.9
8	Gartmore Investment Management Plc	6.4
9	SLTM	5.5
10	Halifax Investment Fund Managers Ltd	5.3
11	Henderson Global Investors	4.9
12	HSBC Investment Funds (UK) Ltd	4.7
13	Jupiter Unit Trusts Ltd	4.4
14	Aberdeen Unit Trust Managers Ltd	4.3
15	Morley Investment Services Ltd	4.1

[1] including Unit Trusts, OEICs, PEPs and ISAs
Source: Investment Management Association

Services (Table 5). The UK's unit and investment trust industry is even less concentrated with the largest five firms accounting for less than half the assets of the top fifteen (Table 6).

1.5 Regulation and reform

Fund management in the UK, particularly at the retail end, has been regulated by the authorities as part of the legal framework to protect investors. With increasing liberalisation of financial markets, the regulatory framework has had to adapt to combine a legal framework that gives adequate protection against abuses with one that allows maximum freedom in making investment decisions.

On 1 December 2001 the Financial Services Authority (FSA) assumed its powers and responsibilities under the Financial Services and Markets Act 2000. The FSA is now the single statutory regulator responsible for the regulation of deposit taking, insurance and investment business. The FSA's main responsibilities include: authorisation; setting standards for firms; supervising firms and other institutions; enforcement; and reducing financial crime.

The liberalisation of fund management in the UK was facilitated by the abolition of exchange controls in 1979, which resulted in a substantial rise of investments in overseas equities. The Financial Services Act (1986) which accompanied the deregulation of the London securities market and the removal of restrictions on the ownership and functions of traders led to a substantial reduction in the cost of trading for institutional investors.

The FSA's Investment Firms Division regulates around 7,500 investment firms such as fund management operations, investment banks, large UK stockbrokers and major networks of independent financial advisers to the smallest corporate finance boutique operations and one-person financial advisers. It also regulates firms which carry on mainstream investment business, such as giving direct advice on investment products. This includes for example lawyers and accountants.

Where breaches of regulatory requirements are found, the FSA is empowered to take a range of actions to remedy and punish wrongdoing. These include powers to require that consumers be compensated for losses arising from breaches. They also include the power to impose fines and, in very serious cases, to terminate the authorisation of a firm.

Changes in the regulation of occupational pensions were implemented by the 1995 Pensions Act as a result of concern about the security of company pension funds. The Act established a Pensions Regulator and a compensation scheme for members of pension schemes that become insolvent through theft, fraud or misappropriation. The Minimum Funding Requirement (MFR) was also introduced to ensure minimum solvency ratios for employers' pension schemes. In 1999, the government instigated a review, and in March this year, it was announced that the MFR will be abolished and replaced with a "scheme-specific long-term funding plan" to be published.

The UK pension system has seen further changes with the introduction of a new pension regime known as "Stakeholder pensions" in April 2001. This represents a combination of institutional schemes and retail pension products. "Stakeholder pensions" are designed to benefit people who do not have access to a normal occupational scheme.

In June 2001 the Accounting Standards Board issued FRS17, Retirement Benefits, with transitional arrangements prior to full compliance in 2003. This replaced SSAP24, the previous UK accounting standard for pension costs. SSAP24 assumed that pensions were a long term commitment, and that

Funds under management in Scotland

Finance has been an important industry in Scotland for the past three centuries. Employment in Scottish finance and business services has expanded by over 30% since 1986 to a current total in excess of 280,000 people. The sector contributes around 20% of Scotland's GDP.

According to Scottish Financial Enterprise, the Scottish investment management industry grew by over 50% since 1998 to reach £298bn at the end of 2002. A third of the funds invested by Scottish managers are long term life assurance funds with a further third in pension assets. Mutual funds and private and charitable funds make up most of the remainder. Two-thirds of investments are in equities and a quarter in bonds. The UK is the biggest investment market, accounting for over 70% of all funds invested. Europe is next with around 10%, then North America with nearly 8%.

The fund managers are a mixture of quoted companies, partnerships and subsidiaries of some of the major Scottish financial institutions. Overseas players find Scotland a useful base from which to operate largely due to the independence, cost efficiency, prudential care for customers' interests and specialist expertise in niche markets which the Scottish fund management industry provides. The Scottish industry mainly serves institutional clients, but there is a growing interest in personal wealth management.

companies should recognise the costs of providing pension benefits on a systematic basis over the period during which the employer derives benefit from the employee's services. FRS17 starts from the assumption that the assets and liabilities of a pension plan should be recognised at market price on the company's balance sheet with no period of grace permitted for 'smoothing' returns over time. The incorporation of pension fund surpluses and shortfalls into company accounts in the period in which they arise is also an international requirement under IAS19 to be phased in by 2005.

The Myners Review of the fund management industry published in March 2001 directly addressed issues of widespread interest in pension management and beyond in investment management generally. It concluded that several factors were working against competition in governing the performance of retail investments and proposed greater transparency of charges and simplification of procedures. Since then, the recommendations have largely been implemented. For example an increasing number of companies now offer trustee training schemes and fund managers routinely break down their charges to show broker commissions and other fees. In 2003, the Government will review how much progress the industry has made in adopting the Myners principles.

This was followed in 2002 by the Pickering Review of private pension legislation and a review of the retail savings industry by Sandler. Alan Pickering's report proposed a radical simplification of pensions legislation and of the administrative burdens on schemes and employers. The recommendations were aimed at making private pensions more efficient whilst ensuring scheme members were properly protected and retained confidence in their company schemes.

The Sandler Review of Medium and Long-term Retail Investment was set up in response to a recommendation of the Myners Review. The review proposes the introduction of cheaper, simpler, more effective savings products with a less complicated tax structure that may be sold without financial advice. Three new savings plans will be offered: a pension, unit trust and with-profits life policy which will have strict rules over terms, charges and conditions. These savings plans will be exempt from the Financial Services Authority's rules governing financial advice. Consumers will, however, be required to read literature containing details about risks and basic advice before buying the plans. The review also proposes a series of reforms to the way life insurance products are managed and sold. The Government endorsed the report and has launched consultations on how to implement the recommendations alongside the FSA.

1.6 Future market issues for UK firms

The UK fund management industry has experienced significant changes in recent years. Firms based in the UK are well positioned to gain new business, particularly in the international markets as the pace of pension reform accelerates. In a climate of falling returns, firms in the UK and internationally will need to increase emphasis on cost management and product innovation in order to stay competitive. Some of the factors which will affect the future of UK fund management include:

- *Pension reform* Momentum away from defined benefit towards defined contribution schemes is set to continue. The reform of pension systems throughout Europe and elsewhere should provide more cross-border opportunities for UK fund managers, legal firms and consultancies offering actuarial, tax and investment services. UK fund managers should also be able to contract further business from external appointments with the easing of investment restrictions and diversification of international portfolios; (Sections 1.2, 1.5, 3.2 and 3.5);

- *Asset allocation* In a climate of falling investment markets asset managers are having to review their strategic asset allocation and may increase their focus on risk and capital preservation rather than on return. In a more uncertain economic environment, there may be a movement from equities into bonds over the next decade. Fund managers may also consider diversifying more into other assets such as property, high yield and emerging debt or derivatives products such as options (Sections 1.3 and 3.3);

- *Profitability* Fund managers' margins have declined significantly in recent years and this is expected to continue. In order to remain competitive, organisations will need to manage a fall in revenues through cost management, increased efficiency and by finding new ways to add value (Section 2.3);

- *Outsourcing* In order to contain costs, large fund managers are increasingly outsourcing support activities. This includes services such as custody, accounting, daily valuation and shareholder record-keeping. In 1998 outsourcing costs were less than 4% of overall costs. This has increased to over 13% of total costs in 2001 (Section 2.3);

- *Restructuring* Over the past few years, there has been substantial restructuring of UK fund managers. There is likely to be further consolidation globally (Sections 1.4 and 3.4);

- *Impact of the euro for UK firms* The single currency has and will have an affect on the fund management industry in several business areas including: market structure - more pan-European mergers, acquisitions, joint ventures and strategic alliances should offer the opportunity of expanded markets as well as increased competition; prices - there should be greater price transparency; and customers - opportunities to introduce new products and services and to offer some services cross-border will increase.

- *Investment consulting* Specialist investments are facilitating an increased demand for investment consulting services. Investment advice has gained in importance as a service for most UK pension consultancies in recent years.

SECTION 2. CONTRIBUTION TO THE UK ECONOMY

2.1 Revenue and value added

In this section, an attempt is made to estimate the contribution of fund management to the UK economy in terms of value added, employment, productivity and efficiency, and net exports. While there is no official estimate of the contribution of fund management to the total UK gross domestic product (GDP), an estimate can be derived from industry sources. The income measure of GDP is calculated from income of labour, land and capital, which in the case of commercial companies is largely derived from the pay bill and gross trading profits.

According to the PricewaterhouseCoopers Investment Management Survey, in 2001 total revenue from fees in the fund management industry totalled 0.24% of funds under management for institutional funds, that is £6.2bn. This puts the total revenue generated at around £7.6bn including revenue for private clients separately estimated by Compeer at £1.4bn in the same year.

Applying PricewaterhouseCooper's estimates of cost margins to total identified institutional assets, implies costs equivalent to 0.19% of funds under management or £4.9bn. Costs of funds under management of private clients amounted to £1.2bn in 2001. Approximately 55% of costs are attributable to employment for institutional clients and 60% for private clients, which would put income from employment at around £3.4bn.

Pre-tax profits for institutional funds amounted to 0.05% of funds under management in 2001, that is £1.3bn in addition to £200m for private clients – equivalent to £1.5bn for the whole industry. On this basis, a rough estimate of value added in 2001 is £4.9bn. This is equivalent to some 0.6% of the GDP and therefore an important component of the financial sector's total contribution to GDP of 5.3%.

The fund managers' wider contribution to the economy lies in the promotion of a broad and efficient capital market that mobilises and allocates the nation's savings as well as those investments which originate overseas. There are many links between fund management and other financial services, particularly with banks, securities dealers and information providers:

Banks are a major beneficiary of fund management operations, providing custody, payment and foreign exchange services. Although some fund managers supply custody as an integral part of their service, the proportion of funds using independent custodians has risen steadily and is more common amongst the larger funds. Custodians may also provide fund administration services such as accounting, performance analysis and portfolio valuations;

Securities dealers The scale of fund managers operations means that they contribute substantially to the activity and liquidity of the markets;

Information providers/analysts The industry depends on the availability of in-depth research on companies and economic developments. It therefore supports a considerable number of information providers, including analysts and financial press.

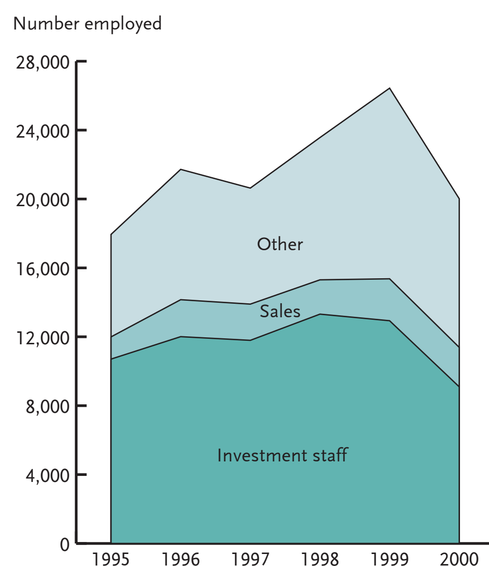
2.2 Employment

The most recent measure of employment in fund management appeared in the 2000 survey undertaken by IMA. This included 69 firms which managed the bulk of institutional funds under management.

The survey estimated total employment of the fund management industry at 22,236 in June 2000 (Chart 11), of which 81% were in London and the remainder mainly in Scotland. There were 3,700 staff directly involved in managing investments, 5,600 in administration and 2,300 in selling. In addition to this, there was also, according to the IMA, a less well defined miscellaneous category of 8,600 other staff. Employment fell in 2000 and has probably fallen further in subsequent years. Previously, staff numbers had risen in the late 1990s.

Total employment in the fund management business

Chart 11: Employment



Source: Investment Management Association

including the large number of smaller firms totalled around 35,000 in 2000. These figures do not include retail stockbrokers, who are thought to employ around 14,000 people.

2.3 Productivity and efficiency

The main drivers of fund managers' profits are stock market values, fee levels and the flow of new business. Fund managers' margins (profit /revenue) have declined significantly in recent years. In the mid and late 1990s, despite the growth in costs and a gradual decrease in fee levels, margins remained high due to rising stock market levels and a sustained inflow of new business. Although cost control has improved since 1999, margins have declined, due to falling stock markets resulting in a decline in revenue. According to PricewaterhouseCoopers, in 2001, margins averaged 23%, down from over 30% in 1999 (Chart 12 and 13). Revenues fell by 8% in 2001 in an environment of declining returns and constant fee levels. Costs increased only slightly during the year.

There were indications of rising profitability in 2002 despite the unfavourable market conditions according to a survey by IBM. Operating margins of firms covered in their survey sample, which were different from the ones covered in the PricewaterhouseCooper's survey, rose from 19% in 2001 to 22% in Q3-2002. The recovery was more evident in larger fund management organisations.

Fund managers' margins have also been constrained in recent years by rising costs. There has, however, been a marked improvement in cost control. Overall costs were up by 6% in 2001, significantly less than the 18% average growth of the three prior years. There has been a particular focus on controlling staff and marketing costs. As noted in Section 1, fund managers have also opted for outsourcing support activities as a way of reducing costs. In 2001, outsourcing accounted for over 13% of overall costs, up significantly on its 1998 share of 4%.

While costs are generally under the direct control of management, revenues are more subject to market demand. In addition to better cost management and increased efficiency, organisations have also managed the fall in revenues by finding new ways to add value. Some managers have been able to soften the impact of the downturn by picking up higher-margin specialist mandates. In 2002, specialist pension fund mandates accounted for 47% of total mandates, compared with 44% in 2000 and 37% in 1998.

2.4 Net exports

Net exports generated by fund managers' services totalled £600m in 2001, having risen steadily from £202m in 1990 when the data were first collated (Chart 14). This may understate overseas services income, because the survey does not capture some insurance companies and investment banks where fund management is integrated with other operations.

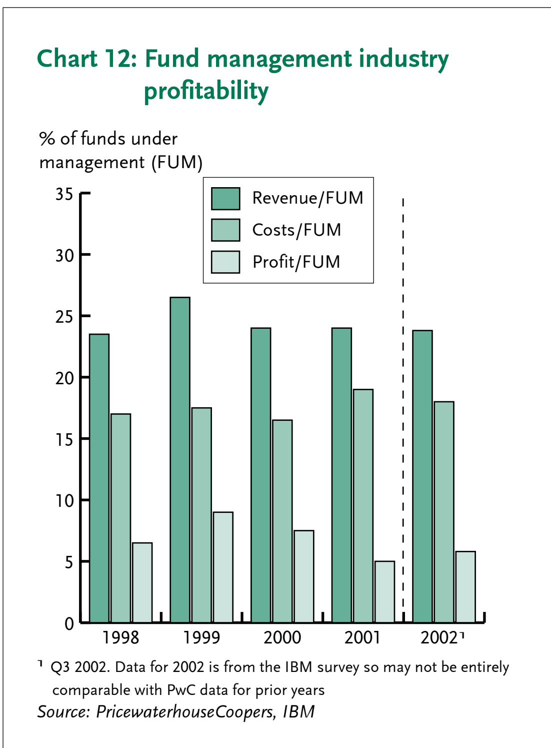


Chart 12: Fund management industry profitability

¹ Q3 2002. Data for 2002 is from the IBM survey so may not be entirely comparable with PwC data for prior years

Source: PricewaterhouseCoopers, IBM

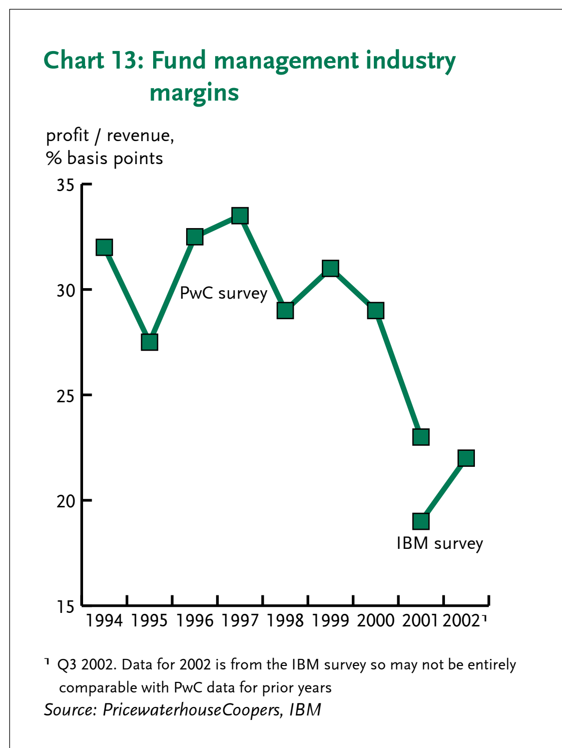


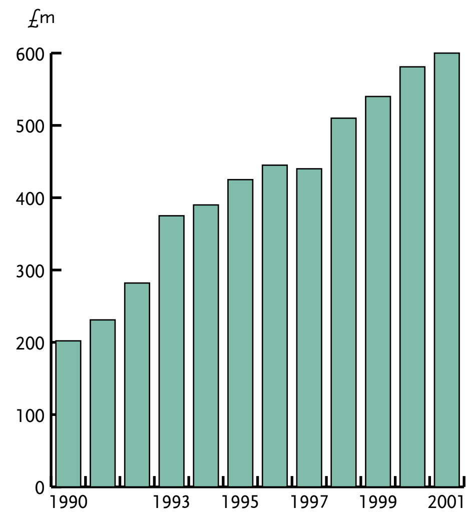
Chart 13: Fund management industry margins

¹ Q3 2002. Data for 2002 is from the IBM survey so may not be entirely comparable with PwC data for prior years

Source: PricewaterhouseCoopers, IBM

Net exports from portfolio investment by financial institutions, which will have owed much to the activities of UK fund managers, amounted to £12.1bn in 2001. Foreign ownership of many of these managers, of course, means that there is also a net outflow of profits and dividends to foreign parents and shareholders.

Chart 14: Net exports of fund managers



Source: ONS

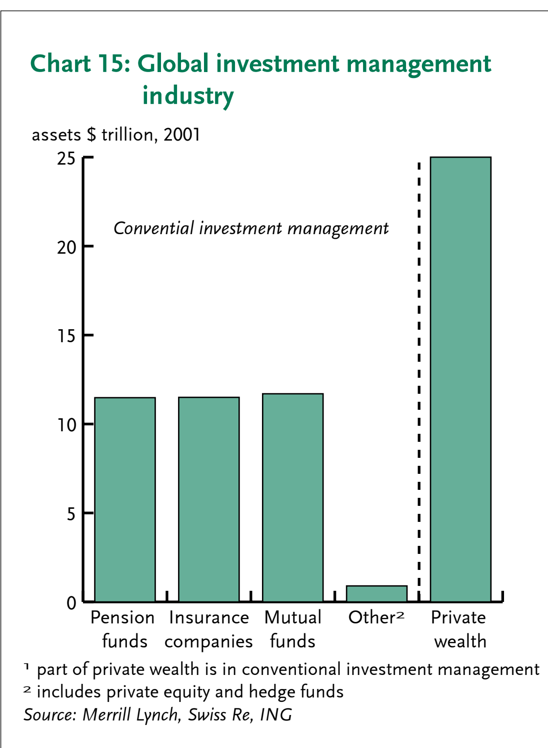
SECTION 3. INTERNATIONAL DEVELOPMENTS AND COMPARISONS

3.1 Global overview

The past three years have seen a fall in global assets under management, following a period of high growth in the 1990s. According to IFSL estimates, global funds under management totalled $52 trillion at the end of 2001. Pension assets, mutual funds and insurance funds contributed equally to this with around $11.5 trillion each. The 2001 total is slightly lower than 1999. The value of insurance funds and mutual funds was largely unchanged during this period while pension assets fell by 11%. Mutual funds and pension assets fell further in 2002 to $11.2 trillion and $10.4 trillion respectively due to the continued weakness of global equity markets. Merrill Lynch/Cap Gemini Ernst & Young estimated the size of the private wealth industry at $26.2 trillion in 2001 of which one third was incorporated in other forms of conventional investment management (Chart 15).

The US is by far the biggest source of funds. It accounted for over half of conventional investment management assets in 2001 or nearly $18 trillion. It was followed by Japan with 10%. The UK is also a major player although the rankings based on sources of assets understate its position due to the substantial proportion of funds managed there on behalf of overseas clients. Nevertheless, the UK is the third largest centre with 9% of total funds according to this measure. Other large centres in Europe include France and Germany, although funds managed in the UK are larger then those managed in France and Germany combined (Table 7).

Chart 15: Global investment management industry



¹ part of private wealth is in conventional investment management
² includes private equity and hedge funds
Source: Merrill Lynch, Swiss Re, ING

Table 7: Distribution of funds under management

assets $bn, 2001

	Pension	Insurance	Mutual	Total
US	7,010	3,947	6,970	17,927
Japan	1,235	1,635	466	3,336
UK	1,200	1,428	363	2,991
France	65[1]	783	705	1,553
Germany	125	838	211	1,174
Netherlands	384	231	83	698
Italy	65[1]	248	356	669
Switzerland	316	205	75	596
Other	1,084	2,185	2,503	5,772
Total	**11,484**	**11,500**	**11,732**	**34,716**

¹ IFSL estimate
Source: Merrill Lynch, ING, OECD, Swiss Re, IFSL

London is a major centre for fund management. Although the US and Japan have larger overall markets, latest available international comparisons show that in 1999 London was ranked as the leading global centre for the management of institutional equities (Table 8). New York is the largest centre in the US, with a further six cities from the US appearing in the top 10.

In Europe, the largest centre outside of London was Paris, followed by Zurich, Amsterdam, Frankfurt and Edinburgh/Glasgow. Milan and Geneva were the only other European cities appearing in the top 20. Tokyo, which had fallen from 1st to 3rd between 1995 and 1999, was the only centre outside Europe and North America that appeared in the top 20 (Table 8). In addition to London and Edinburgh/Glasgow, other UK cities that feature in the list include Manchester which was ranked as the 12th largest centre in Europe, Birmingham (ranked 17th in Europe) and Bristol/Southwest (22nd).

3.2 Types of funds

Insurance funds At the end of 2001, insurers held $11.5 trillion of funds of which 82% was from life insurance and the remainder mostly from health and property and casualty insurance. Over the past decade, insurance assets grew faster in Europe than in the US and faster for life companies than for non-life ones. UK insurance companies' investments are almost double those of any other European country (Chart 16).

In order to reduce costs in the current economic climate, many insurance companies are outsourcing the management of their assets to third party fund managers. In the US, according to Swiss Re, there are some $300bn of insurance assets outsourced to fund managers as compared to the $140bn in Europe. The third party asset management market in the US is very

Table 8: The top international target cities

$bn, assets under management ranked by institutional equity holdings, 1999

1	London	*UK*	2,461
2	Metropolitan New York	*US*	2,363
3	Tokyo	*Japan*	2,058
4	Boston	*US*	1,871
5	San Francisco	*US*	726
6	Los Angeles	*US*	569
7	Paris	*France*	458
8	Philadelphia	*US*	419
9	Zurich[1]	*Switzerland*	414
10	Denver	*US*	340
11	Amsterdam	*Netherlands*	327
12	Chicago	*US*	316
13	Frankfurt	*Germany*	310
14	Toronto	*Canada*	289
15	Edinburgh/Glasgow	*UK*	253
16	Houston	*US*	242
17	Hartford[2]	*US*	199
18	Milan	*Italy*	196
19	Minneapolis	*US*	186
20	Geneva	*Switzerland*	185
	Other UK cities		
36	Manchester	*UK*	81
56	Birmingham	*UK*	32
72	Bristol[3]	*UK*	15

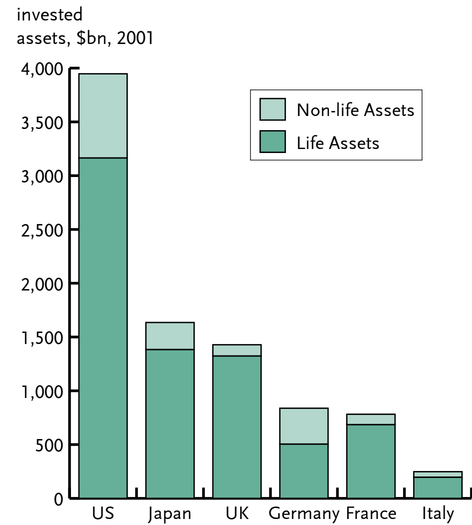
[1] includes Basel, Winterhur
[2] includes Greater Connecticut
[3] includes Southwest
Source: Thomson Financial, Target Cities Report 2000

competitive and banks, insurers and asset managers are all competing for business. In Europe, third-party management has a lower penetration than in the US principally because European insurance fund managers have to maintain a local presence. The outsourcing of insurance companies' fund management operations is forecast by Swiss Re to grow by 10% a year in the US and Europe over the next decade.

According to the Swiss Re study, several factors are stimulating insurers' demand for third-party fund management including:

- Difficult investment environment characterised by declining equity markets, low interest rates and record levels of corporate bond defaults;
- Performance pressures on chief investment officers;
- Increased scrutiny from rating agencies;
- Growing need for fund managers to follow an increasing number of sectors and countries;
- The demand for specialist expertise in matching insurers' assets against their liabilities;
- Changing accounting rules and regulations.

Chart 16: Insurance companies' invested assets under management



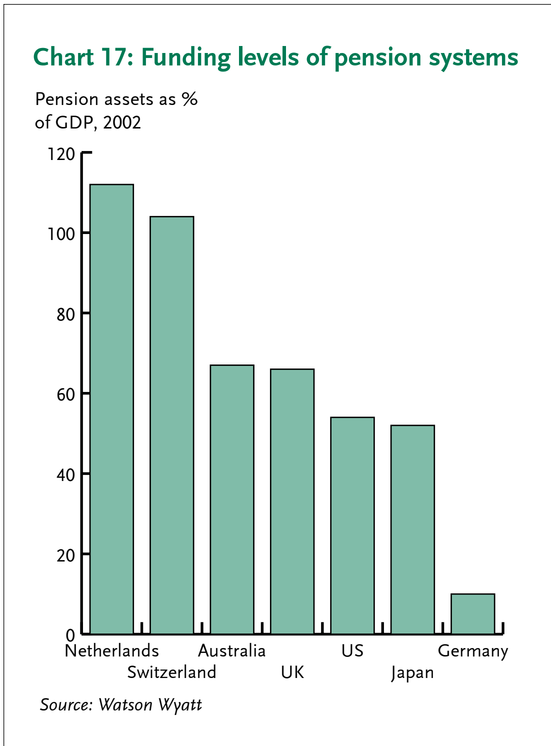
Source: SwissRe

Pension funds According to the latest available full breakdown published by Intersec Research, global pension assets totalled $11.5 trillion in 2001, although market estimates indicate a further drop of about 10% to $10.4 trillion by the end of

Table 9: Global pension fund assets

$bn	1990	1999	2001	*% share 2001*
US	2,624	7,765	7,010	*61.0*
Canada	198	345	297	*2.6*
UK	616	1,365	1,200	*10.4*
Netherlands	237	427	384	*3.3*
Switzerland	179	351	316	*2.8*
Germany	106	139	125	*1.1*
Other Europe	226	465	400	*3.5*
Japan	574	1,544	1,235	*10.8*
Australia	53	139	147	*1.3*
Other Pacific basin	84	200	160	*1.4*
Latin America	25	134	120	*1.0*
Africa & M East	-	104	90	*0.8*
Total	**4,922**	**12,978**	**11,484**	***100***

Source: InterSec Research

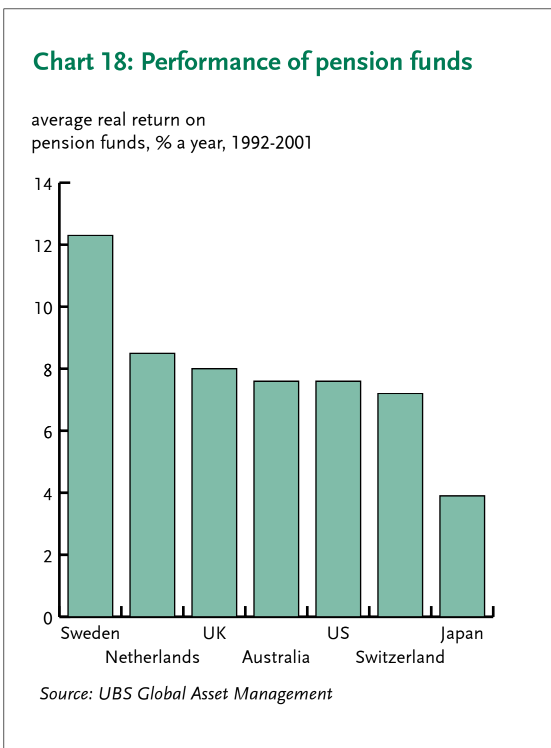


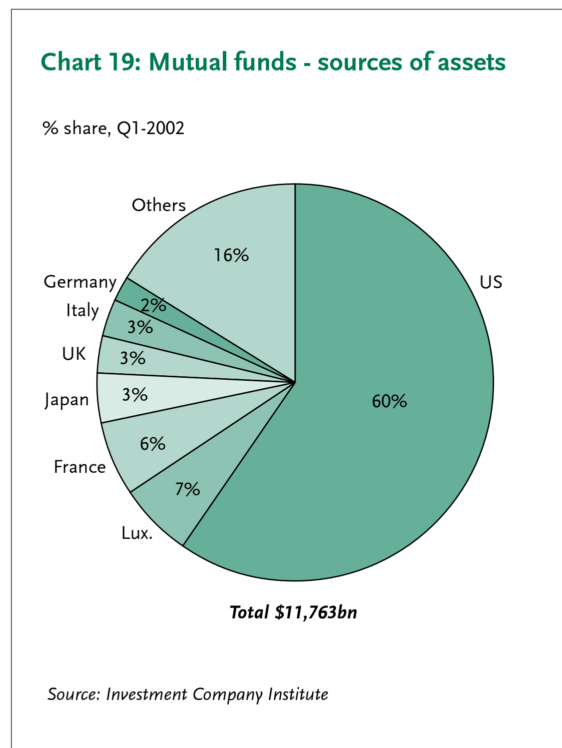
2002. This followed smaller falls in the previous two years, and contrasted with average growth of 12% a year in the seven years leading up to the peak in 1999.

The US remains the largest single market with $7.0 trillion in pension assets or 61% of the world total in 2001. Japan was the second largest centre with $1,235bn or 11% of the total followed by the UK in third place with $1,200bn or 10% of the total. The large volume of pension assets in the US and Japan is mainly a reflection of their larger domestic markets with populations of 270m and 126m, compared with the UK's 59m.

The UK has one of the largest and most sophisticated pension industries in the world. The volume of pension assets managed there by over 3,500 individual pension funds was much higher than in other major European countries – Germany, France and Italy – a result of the high proportion of funded pension schemes in the UK. The long-term demographic profile is also more favourable in the UK than in many other European countries (Section 3.5). As shown in Chart 17, the Netherlands has the most well funded pension system followed by Switzerland. The UK, system, with assets amounting to 66% of GDP, is better funded than most other major economies. The primary determinant of funding is the proportion of pension arrangements that are funded by employers and employees relative to pay-as-you-go approaches which are financed by general taxation.

While many funds produced negative returns between 2000 and 2002, over the last 40 years UK pension funds have generated real returns of 5% a year. Returns in the 1990s were particularly favourable. Between 1992 and 2001 UK pension funds recorded a





real return of 8.0% a year. This was less that Sweden, similar to the Netherlands, the US and Australia but much higher than Japan or Switzerland (Chart 18).

Mutual funds Assets of mutual funds more than doubled between 1995 and 2000 but then fell by 9% to $11.2 trillion by the end of 2002. This was primarily a reflection of the global weakness in equity prices.

Investment in US mutual funds accounted for nearly 60% of the world total. In Europe there are three times as many funds than the US which means that on average US funds are six times the size of European funds. Other countries with significant mutual fund assets include France, Luxembourg, Germany, Italy, Japan and the UK (Chart 19). Despite steady growth in recent years, the UK's Q1-2002 total of $346bn represented only 3% of the world total.

3.3 Asset allocation

Asset allocation around the world varies considerably as shown in Table 10. However, there is some evidence of convergence of broad asset class allocation between the different markets. In the UK, the proportion invested in equities has generally been much higher than in other centres, with commensurately less investment in gilts and property.

Domestic and foreign equities accounted for 71% of UK pension funds' portfolios and 57% of insurance companies' assets, although this has fallen since 2000 as noted in Section 1.3, due to the decline in global equity markets. Elsewhere, pension funds in the US and Japan both invest around a half their assets in equities. However, the proportion of equity investment is lower elsewhere in Europe, mainly due to investment restrictions which may set a ceiling on certain types of investment, e.g. equities and foreign bonds, or a minimum holding of other assets. Funds on the European continent and in Canada have traditionally invested heavily in fixed income assets, particularly bonds, but have pushed up equity allocation somewhat in recent years.

Table 10: International pension and insurance fund asset allocation

% share, 2000

	Equity	Bonds	Real Estate	Cash	Other
Pension funds					
UK	71	20	4	5	0
US	62	30	3	5	0
Japan	57	39	1	3	0
Australia	58	22	5	12	3
The Netherlands	48	44	5	3	0
Insurance funds					
US	30	53	1	3	13
UK	57	27	6	0	10
Germany	28	8	3	2	59
France	31	62	6	1	0
The Netherlands	31	29	7	2	31

Source: UBS Asset Management, SwissRe

Table 11: Source of international portfolio holdings

% share, 2001	Equity	Debt securities Long Term	Debt securities Short Term	Total
US	*33*	*54*	*14*	3,069
UK	*56*	*31*	*12*	1,254
Germany	*24*	*69*	*7*	1,151
France	*50*	*43*	*7*	775
Netherlands	*41*	*53*	*5*	691
Italy	*20*	*75*	*5*	586
Japan	*63*	*30*	*7*	528
Others	*45*	*50*	*5*	4,491
Total	***41***	***51***	***8***	**12,546**

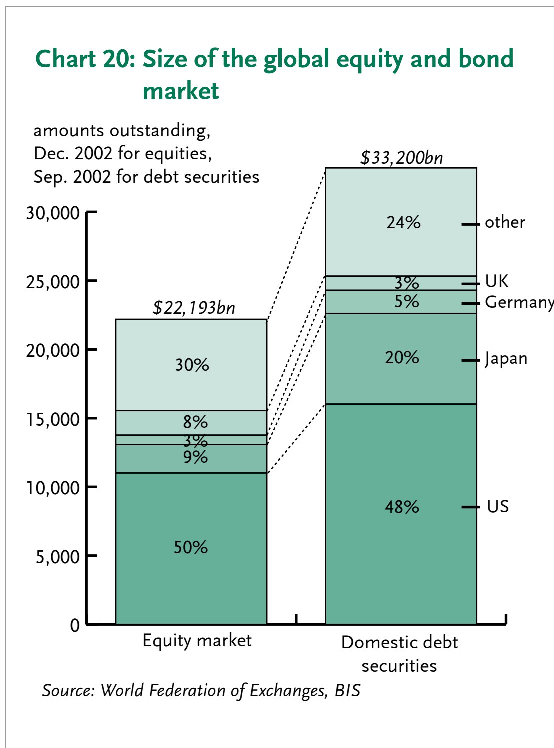
Source: International Monetary Fund

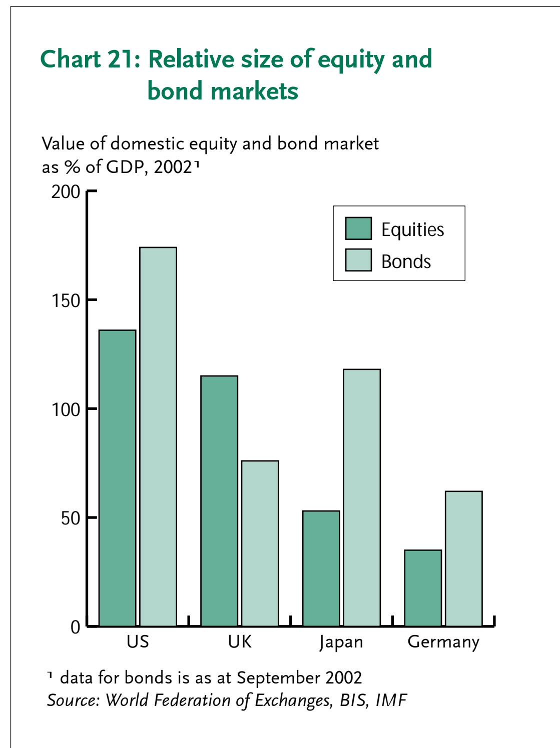
According to the International Monetary Fund, the majority of international portfolio holdings are in debt securities (51%), with equities accounting for 41% and the money market for the remainder. The US is the major source of such investments with a quarter of the total followed by the UK and Germany, with 10% and 9% respectively (Table 11).

Equities The US accounted for more than half of the world's equity markets, which had an estimated market capitalisation of $22.2 trillion at the end of 2002, significantly down on the $35 trillion in 1999. Although the Japanese stock market was the largest in the world in 1989, the fall in prices there meant that in 2002 its share was only 9%. The UK equity market was the largest in Europe with market capitalisation of $1,786bn, followed by the Euronext and Deutsche Börse (Chart 20).

Based on the value of listed companies on the domestic equity market, the UK had the second highest market capitalisation when measured as a percentage of GDP with 115% in 2002. This was several times that of the large European countries and second only to the US, taking New York and Nasdaq together at 136% (Chart 21).

European comparisons of the structure of share ownership need to be taken in the context of the larger UK equity market, but a number of features stand out: the proportion of shares held by the UK financial sector, at over 60%, is higher than in most other countries; individual ownership of shares - 15%





of the UK total is generally lower than in other European countries, although the greater size of UK market capitalisation implies greater penetration of individual share ownership.

Bonds The total value of the world's domestic debt securities exceeded $33 trillion in September 2002 (Chart 20). The US bond market accounted for nearly half of this, followed by Japan with 20%. The UK had a 3% share, less than Germany, France and Italy, each with between 4% and 5%. In addition to domestic issues, there was also a total of $8.8 trillion in international debt securities. The UK is the major market for international bonds with 60% of the primary and 70% of the secondary market.

The share of government bonds has declined in the last decade, mirrored mainly by a rise in international bonds. The latest available breakdown shows that the share of government bonds in the world bond market fell to a ten year low in 2001 of 53%. The remainder was accounted for by corporate bonds with 29% of the total and international bonds with 18%.

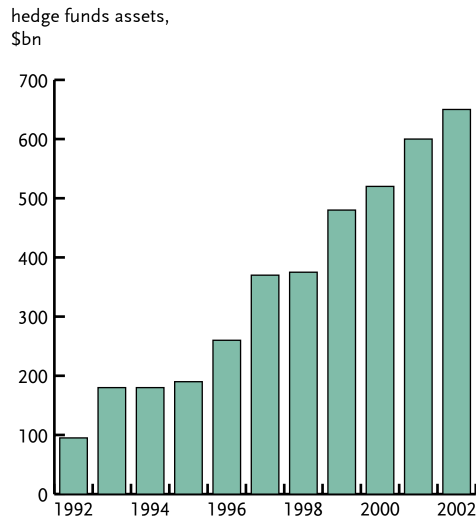
Other investments Institutional investors invest in a variety of alternative instruments:

- *Property* investments have been volatile in the past two decades reflecting wider changes outside the property market itself. Many factors can affect the size and value of a domestic property market, such as supply and demand and taxation issues. There are a number of ways in which fund managers can invest in property such as direct property, property unit trusts, managed funds and property shares;

- *Private equity* represents investments in companies which are not quoted on the exchanges. These investments offer better potential returns but with a higher degree of risk. After a period of high growth, since 2000, the returns on private equity have fallen significantly causing a sharp decline in new investment;

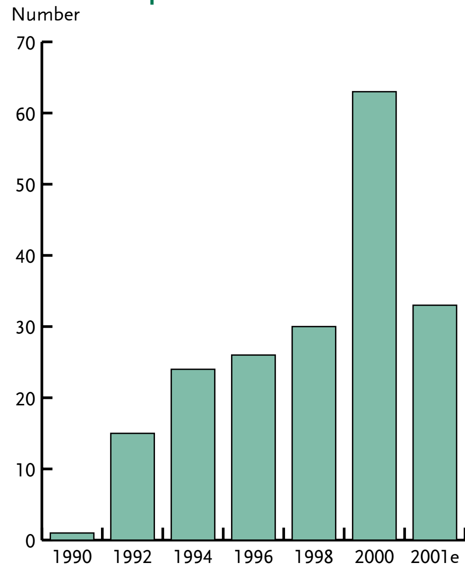
- *Hedge funds* are pooled investment vehicles that are privately organized, administered by professional investment managers, and not widely available to the public. Offshore hedge funds usually are mutual fund companies that are domiciled in tax havens such as Bermuda. Between 1992 and 2002, global hedge fund assets have increased at an annual growth rate of 21% to reach $650bn (Chart 22). Hedge funds primarily originate in the US. In 2001, out of a global number of around 7,000 hedge funds nearly two-thirds were from the US. The assets of the European hedge fund market have more than quadrupled to over $70bn since 1999. Hedge funds invest primarily in publicly traded securities and financial derivatives. They therefore have the flexibility to pursue strategies that produce returns with low correlation to the overall stock market, which is particularly useful

Chart 22: Global hedge funds



Source: Swiss Re, J.P. Morgan

Chart 23: Asset management mergers and acquisitions worldwide



Source: FTfm

in periods when stock prices are declining;

- *Precious metals* Gold and other precious metals investments have various advantages such as: high liquidity, diversification benefits and relatively low risk;

- *Commodities* represent investments in commodity funds or investments through the futures market;

- *Art and collectibles* offer possibilities for diversification although a small number of institutional funds have such investments due to low liquidity, high transactions costs and risk.

3.4 Leading global fund managers

According to the P&I/Watson Wyatt World 500, global assets under management of the top 500 fund managers decreased by 0.2% during 2001 to $35.2 trillion. This followed a 5% increase in 2000 and a period of high growth in the 1990s when assets grew on average by 14% annually.

Between 1996 and 2000, the impact of M&As between fund managers was to increase concentration of assets under management amongst a smaller number of firms. However in 2001 there was less M&A activity to sustain asset growth (Chart 23), mirroring the fall in M&A activity in the financial sector as a whole.

The top 20 fund managers accounted for 38% of the assets of the top 500 in 2001, while the smallest 250 fund managers on the other hand held only 5% of the assets. The consolidation of the fund management industry in recent years has been primarily in the direction of large organisations taking over smaller ones, rather than horizontal integration of the industry.

Table 12: Largest global investment managers

$bn, 2001

1 UBS	*Switzerland*	1,476
2 Allianz Group	*Germany*	1,038
3 Fidelity Investments	*US*	1,008
4 Credit Sisse Group	*Switzerland*	851
5 AXA Group	*France*	806
6 State Street Global	*US*	785
7 Barclays Global Investors	*UK*	769
8 Kampo	*Japan*	709
9 Vanguard Group	*US*	606
10 JP Morgan Fleming	*US*	605
11 Mellon Financial	*US*	592
12 Capital Group	*US*	574
13 Deutsche Asset Mgmt	*Germany*	549
14 Merrill Lynch	*US*	529
15 Citigroup	*US*	502
16 ING Group	*Netherlands*	455
17 Zurich Financial Services	*Switzerland*	416
18 Morgan Stanley Inv Mgmt	*US*	416
19 AMVESCAP	*US/UK*	398
20 Prudential Financial	*US*	388

Source: P&I/Watson Wyatt Global 500

Table 13: Largest global self-managed pension funds

$bn, end-2001

1 California Public Employees	US	144
2 ABP	Netherlands	131
3 New York State Common	US	106
4 Local Government Officials	Japan	99[1]
5 California State Teachers	US	96
6 Federal Retirement Thrift	US	93
7 Postal Savings Fund	Taiwan	91[1]
8 Florida State Board	US	89
9 General Motors	US	83
10 Texas Teachers	US	75
11 New York State Teachers	US	75
12 National Public Service	Japan	69[1]
13 General Electric	US	69
14 New Jersey Division	US	67
15 Verizon	US	66
16 Boeing	US	58
17 IBM	US	57
18 National Pension	Korea	57
19 Wisconsin Investment Board	US	55
20 New York City Retirement	US	55

[1] as at 31 March 2001
Source: Watson Wyatt, P&I data

Deals in 2002 included the merger between Man Group and the Swiss fund manager RMF and between Friends Ivory & Sime and Royal & Sun Alliance's fund management arm.

US-owned fund managers account for the bulk of the Top 500 funds and have increased their share from 40.9% to 42.4% during 2001. Japanese managers' share nearly halved between 1996 and 2001 to 11.4%. Due to the higher exposure to equities, UK firms' share fell from 9.2% to 8.5% during 2001. UK fund managers that appeared amongst the top 50 include: Barclays Global Investors (in 7th place), AMVESCAP (19th), Aviva (27th), HSBC Holdings (30th), Prudential M&G (44th).

Although the UK and Japanese fund managers' share in Table 12 correlates with their country's share of overall funds in Table 7, the US fund managers' share is lower due to significant funds held by self-managed pension funds. As shown in Table 13, US companies represent the largest self-managed pension funds with 15 of the top 20 places.

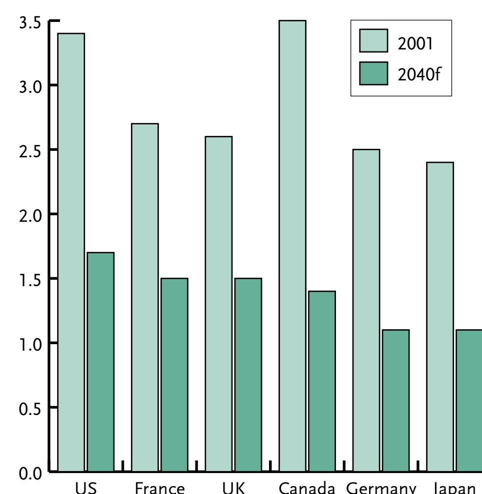
3.5 Current trends and market issues

The future funding of pensions Developed countries are set to experience a dramatic demographic shift during the course of the next 40 years due to increasing life expectancy and a falling birth rate. It is estimated, for example, that the dependency ratio of people aged 65+ to those aged 20-64 will decrease from the current level of around 2.6 in the UK to 1.5 in 2040 (Chart 24). The decline will be larger in other European countries, Japan and Canada. This implies a smaller proportion of people in the workforce.
Many countries are therefore reviewing their pension funding systems. Reforms of pension systems are partly being driven by governments which are seeking to shift the burden of pension provision away from the state and on to employers or individuals. In Europe reform is already under way. The reform is being approached in many ways including: reducing the pensions paid by raising the retirement age, restricting eligibility for early retirement and privatising part of the state pension. The UK is in the strongest position of the EU states mainly due to the extensive pre-funding of pensions and the state pension being lower than in other countries, 29% of average pay compared with a range of 40-80% elsewhere in Europe.

The EU is looking at pensions as part of its review of the financial services industry. The Commission aims to implement its Financial Services Action Plan fully by 2005. The establishment of a specific EU framework for institutions for occupational retirement provision is central to the plan. Occupational pensions cover a quarter of the EU population which holds around €2,300bn in pension assets. The proposal aims to establish a high level of protection for the pension beneficiaries whilst providing sufficient freedom to develop an efficient investment policy. It also seeks to establish the right for institutions to manage pension schemes on a cross-border basis.

Chart 24: Ageing population

Ratio of population aged 20-59 versus population over 60 years old



Source: OECD, Eduard Bos and others, Johns Hopkins University Press

Even though fund managers have continued to increase their business in the pension market, in many European countries there are still restrictions in place in, for example Germany, Switzerland and the Netherlands, which restrict the outsourcing of pension assets to third party fund managers. Mercer estimates that about half the pension fund market is closed to third-party managers in these countries, compared with less than 10% in the UK.

Defined contribution arrangements or money purchase plans, which are the basis for both private pensions and increasingly many company plans are likely to gain in importance. Defined contribution schemes give members their own individually identifiable retirement funds where the final retirement pot is dependent on the contributions made and the underlying investment performance. They also offer greater flexibility for job mobility.

Despite the UK's favourable position, Commerzbank Securities estimates that there will be a further inflow of €62bn between 2002 and 2008 into UK pension funds. Amongst European countries, only flows into German pension funds are forecast to be higher at €201bn.

In summary, increased longevity, falling inflation and reduced expectation of future investment returns will all have a profound effect on the pension industry in the future. More freedom of access and investment would give UK fund managers the opportunity to manage the non-domestic portfolios of pension funds in other countries. Such international expertise is not necessarily shared by many of the large institutions elsewhere in Europe which are orientated mainly to domestic markets and government bonds.

More details about pension reform in the UK and internationally can be found in IFSL's report - *Pension Reform: UK Expertise for International Markets*.

Liberalisation In November 2001, Ministers, meeting at the 4th World Trade Organisation Ministerial Conference in Doha, agreed on the launch of a new broad round of multilateral trade negotiations in the WTO. The new round of negotiations, which is scheduled to finish in January 2005, is the first chance in many years to address the numerous types of obstacles that affect international trade in services, including barriers that exist in the financial services sector.

A sectoral agreement in financial services was concluded in the WTO in 1997 but the liberalisation commitments made by WTO Members at that time were based largely on the status quo. Moreover, to date only just over a half of WTO Members with financial services commitments have made them in the area of fund management. The 1997 agreement therefore did little to ease the restrictions that exist in the financial services sector. However, it did establish a good foundation upon which WTO Members - developed and developing countries alike - can make further liberalisation commitments to provide real market access and to put foreign financial services firms on an equal footing with their domestic counterparts. This will benefit their economies and enhance global growth.

During the current negotiations, important work will continue on other elements of the services agenda. In particular, in order to ensure that market-opening commitments achieve their promised objectives, there is a pressing need to supplement them with new undertakings on improved transparency and, in addition, domestic regulatory reform as necessary and appropriate for each specific sector.

A number of liberalisation issues will affect the fund management industry in the future such as: harmonisation of EU-wide consumer protection rules; harmonisation of tax and regulatory systems; introduction of pension schemes that enable cross-border worker mobility; and the new UCITS directive which should expand the range of retail funds available on a cross-border basis. The challenges for governments will include allowing business development whilst protecting consumer interests, consumer education and avoiding over-regulation.

E-commerce According to the PricewaterhouseCoopers 2002 Investment Management Survey, there are five major areas of potential for electronic commerce in fund management. These include:

- *Data capture* which will enhance customer relationship management;
- *Mass personalisation* of products and services;
- *Speed to market* allowing rapid development and rollout of new products;
- *The internet* which will be a powerful catalyst for convergence and alliances;
- *Delivering self service capability to customers* which will allow customers to carry out their own transactions or seek assistance.

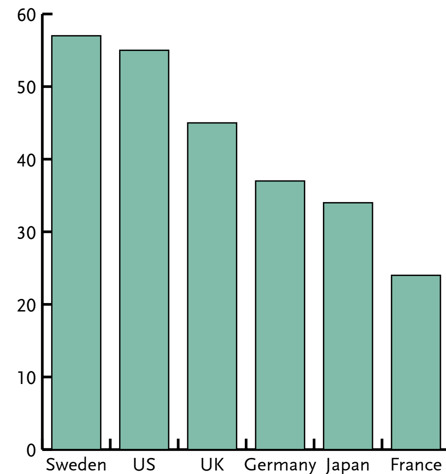
The survey also identifies major barriers to further development of e-business in fund management. These are similar to those faced by other financial services sectors and include: lack of IT skills, IT infrastructure costs, measuring potential benefits, awaiting industry wide initiatives, security and performance issues.

Internet usage has grown at a remarkable pace in recent years. The US has the largest number of users with 55% of its population having internet access in 2001 compared to 35% in 1998. The Nordic countries have a high percentage of users as well. The UK is in a group of countries along with Switzerland and the Netherlands where around 45% of the population has internet access (Chart 25).

The internet and e-commerce are introducing significant changes to the fund management industry. So far these changes have mainly been confined to marketing and lowering distribution charges. Within the securities markets, the use of the internet is mainly associated with low cost execution for share dealing.

In the months ahead internet capabilities will continue to evolve and provide new business opportunities. Growth of new businesses will be facilitated by lower business costs, lower barriers to entry while increased competition will put pressure on prices. Consumers will have the option of choosing the lowest prices and search for services most suitable for their needs.

Chart 25: Internet access



Source: Deutsche Bank, BITKOM: Basis EITO

Section 4. Private Wealth Management

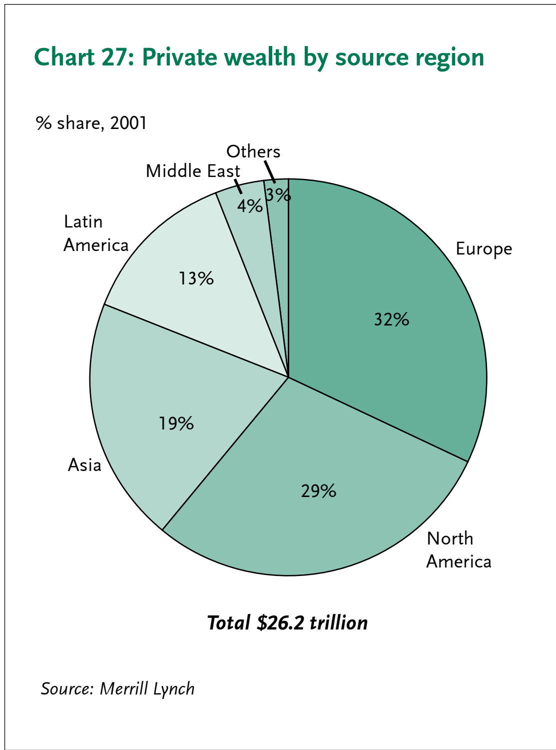
4.1 Global overview

According to the Merrill Lynch/Cap Gemini Ernst & Young World Wealth report, there were 7.1 million people with financial assets in excess of $1m in 2001; their combined financial assets totalled $26.2 trillion (Chart 26). This means that the private wealth industry is larger than the global insurance industry, pension industry or mutual funds industry. However, these categories overlap since the private wealth industry is also an investor in conventional asset management.

Europe and North America accounted for more than half of global private wealth in 2001, with Europe having the largest share with a third of the assets (Chart 27). The major factors behind the rapid rise in private wealth in the 1990s were economic growth and buoyant stock markets. In 2001 however, private wealth in North America and Europe grew only by 1.7% and 0.1% respectively primarily due to substantial portfolio allocation in equities. Asian private wealth grew by 7% because of the impressive performance of several local stock markets (South Korea, Thailand, Taiwan). Latin American private wealth grew by 8% helped by the substantial allocation of investments in dollar-denominated bonds and other fixed income products.

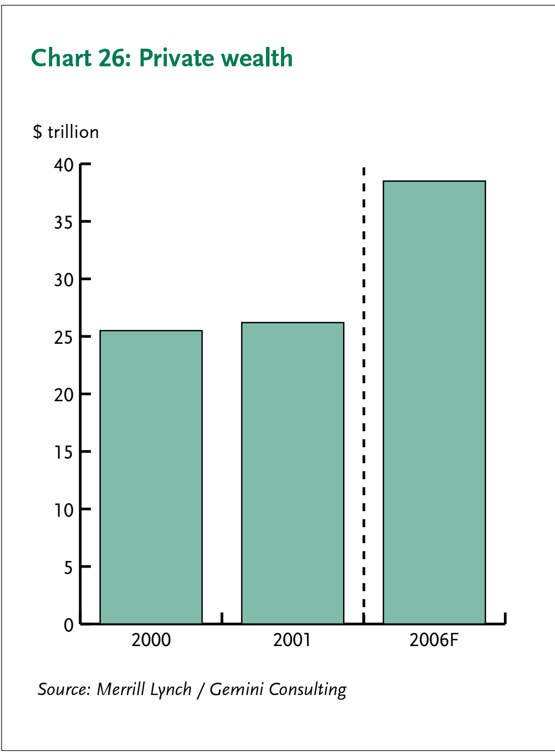
US and European capital markets attract the bulk of private wealth investments regardless of where the assets are officially domiciled. Equities and fixed income securities have typically accounted for around a third of portfolios of high net worth individuals in recent years. Approximately a quarter of portfolios are held in cash deposits.

Chart 27: Private wealth by source region



Source: Merrill Lynch

Chart 26: Private wealth



Source: Merrill Lynch / Gemini Consulting

The UK is one of the major onshore centres for the management of private wealth. It also holds an estimated 15% of the offshore market. This was only exceeded by Switzerland with 33%. The US and the Caribbean are the next largest destinations for offshore wealth with 12% each.

4.2 Source and destination of wealth

There are two basic profiles of high net worth individuals: “new money” or earned wealth and “old money” or inherited wealth. The list of the 400 wealthiest individuals in the US, compiled by Forbes, highlights the increasing influence of technology as a source of wealth (Table 14). Individuals in technology and telecoms sectors accounted for 22% of wealth in 2001, five times the 4% in 1984. Financial services and media and publishing were, along with software, the largest sources of wealth, each having doubled in importance during this period to 16% and 14% respectively. The activities that have less representation are oil, real estate and inherited wealth, the latter down from 32% to 12%.

Table 14: Wealth source of 400 wealthiest US individuals

% share, by value

	1984	2001	Change in share (%)
New money			
Software	0	15	+15
Telecoms	1	3	+2
Computers	3	3	0
Internet	0	1	+1
Finance	8	16	+8
Publishing & media	7	14	+7
Retailing	5	6	+1
Real estate	10	3	-7
Oil	8	3	-5
Other	26	24	-2
Old money			
Inherited	32	12	-20
Total wealth ($bn)	**124**	**950**	

Source: Forbes

4.3 The UK market

The UK had, after Germany, the second highest number of high net worth individuals in Europe, followed by France and Italy (Table 15). The number of high net worth individuals in the UK nearly doubled between 1997 and 2001 to reach 1.1m. At the same time, their assets also nearly doubled from €398bn to €752bn (Chart 28).

Four-fifths of UK high net worth individuals held

Table 15: High net worth individuals in Europe

	Number, thousands			Assets, bn		
	1997	1999	2001	1997	1999	2001
Germany	663	967	1,243	438	686	841
UK	582	835	1,073	398	614	752
France	483	724	1,002	323	520	686
Italy	386	592	870	250	411	575
Spain	191	277	426	128	199	293
Nordic region	111	180	240	80	122	256
Total	**2,417**	**2,720**	**4,858**	**1,607**	**2,720**	**4,858**

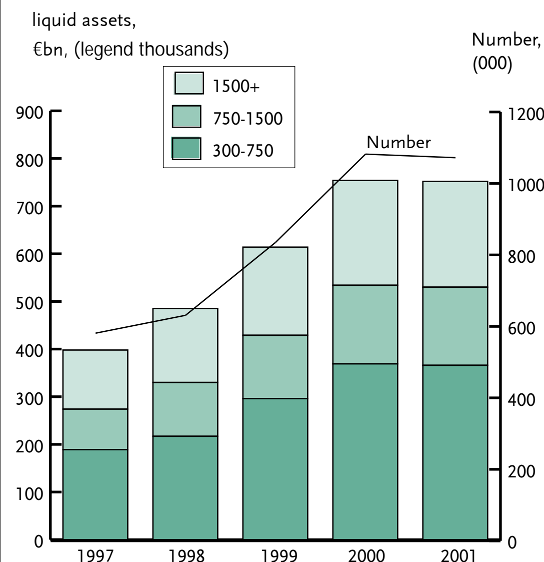
Source: Datamonitor

between €300,000 and €750,000 in liquid assets. This however accounted for less than half of the overall wealth. At the other end, individuals with over €1.5m in liquid assets accounted for 6% of the number of high net worth individuals but nearly a third of the overall assets.

As shown in Chart 29, over a third of UK private wealth assets are held in private banks. Asset managers and retail banks accounted for a quarter each and investment banks for most of the remainder

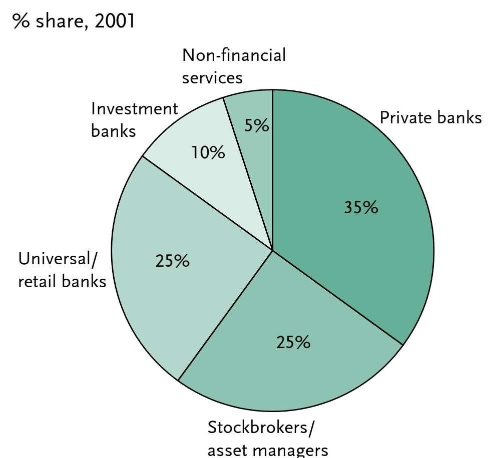
More information on private wealth management can be found in IFSL's report *International Private Wealth Management: UK Expertise for International Markets.*

Chart 28: UK high net worth individuals



Source: Datamonitor

Chart 29: UK's wealth management market by competitor type



¹ Intermediaries (Independent Financial Advisors) are not included
Source: Datamonitor

Appendix 1. Functions and History of Fund Management

Functions of fund management Fund management covers a broad range of activities. In Chart 30, these are broadly divided between front office and back office functions. Front office functions include those directly related to the management of funds such as: decisions on asset allocation and risk management, investment analysis, dealing and cash management.

Back office functions are mainly support activities including: transaction processing, systems support, accounting and administration. Such services can be delivered either by investment departments of parent firms or by independent managers who offer their services for a fee.

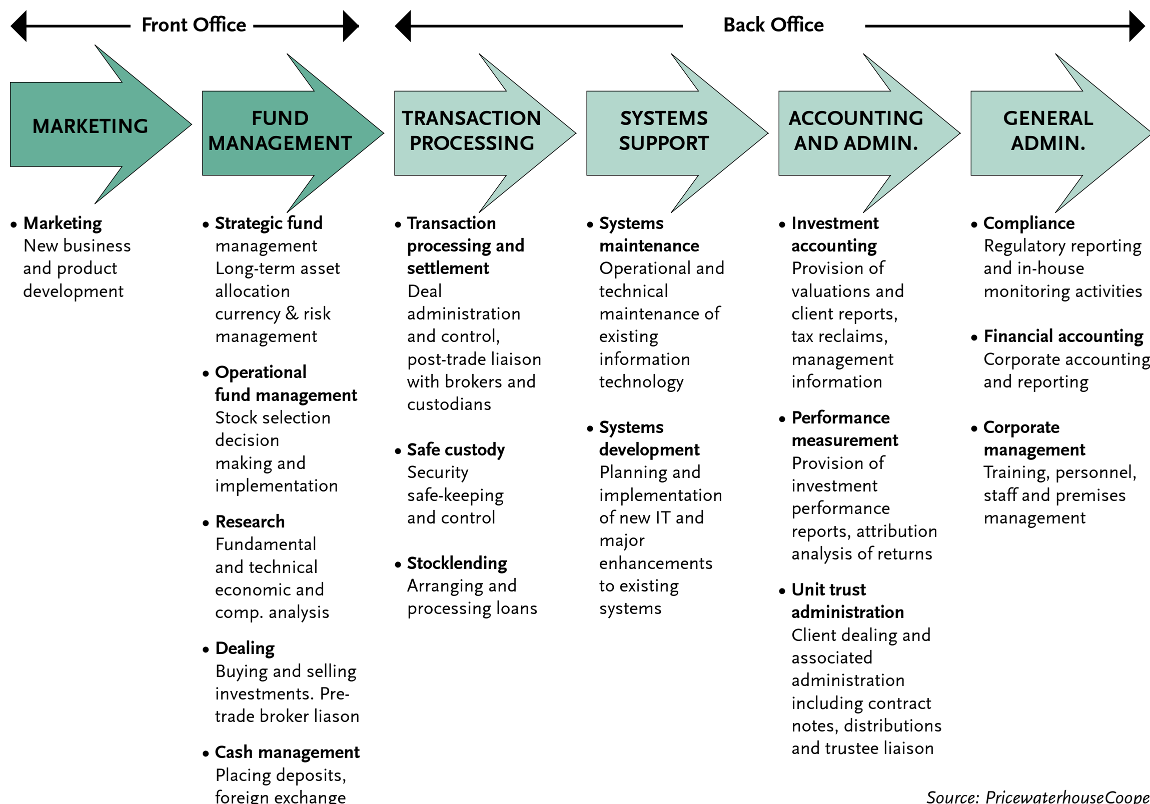
History of fund management The rise of professional fund managers in Britain began during the 19th century as the savings habit spread among the new industrial middle classes and the first private sector pension funds and investment trusts were developed.

The first quarter of the twentieth century saw a substantial increase in corporate pension provision. Private trusts were first used as a legal vehicle for pensions at the turn of the century; the use of pension trusts was boosted by exemption from income tax granted in 1921. Pooled, or "group", pension schemes in Britain were first offered by an insurance company in 1927. Such schemes proved attractive to employers as they offered lower administration costs, and a wider pooling of risk, than schemes run by the employers' themselves.

The fund management industry had broadened its scope during the 1930s with the introduction of the first unit trust. In the 1960s other financial institutions, such as merchant banks, entered the fund management business. The increasing competition for funds also spawned a wider variety of products and investment vehicles.

Specialist property trusts were launched in 1966, followed by investment products in such areas as small companies, new technology, venture capital and overseas investment. The expansion of equity investment since then was underpinned by a newly developed approach to investment by institutions which emphasised optimal diversification strategies as a mechanism for reducing risk. Structural changes in UK fund management during the 20th century have mainly been characterised by continuing consolidation.

Chart 30: Functions of fund managers



Source: PricewaterhouseCoopers

Appendix 2. Glossary of Terms

Active management A style of investment management where the fund manager aims to outperform a benchmark by superior asset allocation, market timing or stock selection.

Annuity Form of financial contract, usually offered by insurance companies, to provide a given income at a regular interval from retirement till death; usually backed by long-term bonds; can be flat rate or indexed.

Asset allocation The distribution of funds (or the process of distributing funds) in a portfolio across various asset classes, currencies and geographical areas.

Balanced portfolio manager A manager who both sets the asset allocation, subject to guidelines set by the investors, and chooses the individual securities for clients' portfolios.

Contracted out Feature of private pension plan in the UK and Japan permitted to replace state system of earnings-related social security.

Contribution holiday Period during which an employer ceases to contribute to an overfunded defined-benefit pension scheme, so as to eliminate the surplus.

Defined-benefit pension scheme Pension scheme where the benefits are defined in advance by the sponsor, independently of the contribution rate and asset returns, as where a pension is related to final salary.

Defined-contribution pension scheme Pension scheme where only contributions are fixed, and benefits therefore depend on the return on the assets of the fund.

Derivatives Instruments based on the movement of an underlying asset. Futures and options are just two of the basic types. Derivatives are either exchange traded or over the counter contracts.

Diversification The spreading of investment funds among different types of assets, markets and geographical areas in order to reduce risk.

Equity The capital of a company belonging to the ordinary shareholders who have voting rights allowing them to influence the management of the company.

Expected return Gain from holding a financial claim net of expected loss from default risk, etc.

External management Fund management conducted by a company other than the sponsor.

FRS 17 A new accounting standard which requires companies to incorporate their pension funds into their balance sheets and specifically that all pension fund liabilities should be valued using an AA corporate bond yield.

Funded pension scheme Scheme where pension commitments are covered by real or financial assets.

Hedge fund An investment fund that takes a very high degree of risk, often by gearing the fund, in the hope of achieving a very high return.

Hedging The process of fixing the currency exposure of a trust portfolio, and hence reducing the effect of exchange rate fluctuations on the portfolio's value. Hedging is used to reduce the risk of loss thorough adverse movements in interest rates, equity markets, share prices or currency rates.

Indexation (Inflation) rule that benefits be increased in line with an index of prices or wages; (portfolio) holding of all the securities in a market in line with their relative capitalisation, or a subset whose combined risks and expected returns approximate those of a market index, (e.g. the FTSE 100 index); (global) holding of assets in all securities markets proportionate to their global capitalisation weights.

Indexed bond Bond whose return is tied to an index, such as the index of consumer prices.

Investment company A variable capital company which serves as a collective investment vehicle. The investment company, not the investors, owns the assets. Investors buy shares of the company that are backed by the company's net assets.

Investment trust This is a closed-ended investment vehicle which issues shares to investors and invests the proceeds in a portfolio of shares. Like a unit trust or variable capital (open ended) investment company, this sort of vehicle allows investors to build a diversified portfolio with reduced transaction costs, but unlike these other vehicles its share price can diverge from its net asset value.

Liability A financial obligation or cash outlay that must be made at a specific time to satisfy the contractual terms of such an obligation. In the case of a pension fund, liabilities are linked to the age structure of scheme members.

Liquidity The amount within a portfolio which is held in cash rather than being invested.

Maturity (1) time between issuance and repayment

of principal on a debt instrument; (2) a mature pension fund has a long-term equilibrium ratio of workers to pensioners, and a constant average age of members.

Money-purchase plan Form of defined-contribution plan where the employer makes regular payments equal to a proportion of employee's compensation. Often used more loosely as a synonym for defined contribution plans.

Mutual fund US terminology for open-ended collective investment vehicles; usually unit trusts.

Nominal rate of return A rate of return expressed only in monetary terms, i.e. not adjusted for inflation.

Option The contractual right, but not the obligation, to buy or sell a specified amount of a given financial instrument at a fixed price before or at a designated future date. A call option confers to the holder the right to buy the financial instrument. A put option involves the right to sell the financial instrument.

Open-ended investment company (OEIC) Introduced in the UK in 1997 as a more "Europe-friendly" vehicle than a unit trust for use within EU countries. OEICs are structured with different share classes to suit retail and wholesale investors.

Passive management A style of investment management that seeks to attain performance equal to market or index returns.

Pay-as-you-go An unfunded pension scheme; contributions of employers and current employees are relied on to pay pensions.

Pension plan Contract setting out the rights and obligations of members and sponsor in an occupational pension scheme.

PEP UK personal equity plan, which enables individuals to accumulate limited quantities of equities, trust units etc. each year in an account where capital gains and dividends are tax free.

Personal pension Individual defined-contribution pension contract, usually arranged with a life insurance company.

Pooled fund A fund in which several investors hold units. The assets are not held directly by each client, but as part of a "pool". Unit trusts are a type of pooled fund.

Preference shares A class of share capital which receives a fixed rate of return, and comes ahead of ordinary shares in order of priority in a winding up.

Present value calculation Summation of future cash flows by use of an appropriate discount factor.

Private equity Funds put up by investors to finance new and growing businesses. Also known as venture capital.

Property unit trusts (PUTs) Pooled investment vehicles that enable investors to hold a stake in a diversified portfolio of properties.

Real return Return on an asset less inflation.

Segregated fund Where the assets of a particular fund are managed independently of those of other funds under the fund manager's control.

UCITS (Undertaking for Collective Investment in Transferable Securities) Open-ended investment vehicles which invest in equities and bonds and are capable of being marketed across border under the 1985 EU UCITS Directive. This authorisation is commonly described as "Single European passport".

Unit trusts Established under a trust deed, these vehicles allow investors to pool their holdings, achieving diversification with lower transaction costs than they could investing individually. The units reflect the proportional ownership of the investor in the collective assets.

Venture capital Often identified as a distinct asset class, venture capital serves mainly as a source of funds for start up companies and leveraged buy-outs. It typically carries higher risk (and hence higher expected return) than equity, as well as being less liquid.

Appendix 3. Other Sources of Information

The following sources, many of which have been used in the compilation of this report, give further details on issues and statistics relevant to the fund management industry.

ComPeer Limited
Private Client Stockbroking & Fund Management Survey
Retail Broking Survey
www.compeer.co.uk

Department for Work and Pensions
UK - National Strategy Report on the Future of Pension Systems
www.dwp.gov.uk

Euromoney
Intersec 250
www.euromoney.com

ING
Major Themes in the Global Fund Management Industry
www.ing.com

Institutional Investor/Watson Wyatt
Worlds top 500 fund managers
Euro100
www.institutionalinvestor.com

Investment Management Association
Funds Under Management, December 2002
Fund Management Survey
www.investmentuk.org

FSA
Introduction to the FSA
www.fsa.org.uk

Merrill Lynch/Cap Gemini Ernst & Young
World Wealth Report
Size and Structure of the Global Bond Market
www.ml.com

Office for National Statistics
Insurance Companies', Pension Funds' and Trusts' Investment, Q4
www.nationalstatistics.gov.uk

Thomson Financial Investor Relations
International Target Cities Report
www.thomsonfinancial.com

UBS Asset Management
Pension Fund Indicators
International Pension Fund Indicators
www.ubs.com

PricewaterhouseCoopers/IBM
Investment Management Survey
www.pwc-global.com
www.ibm.com

Watson Wyatt
Global Investment Review
www.watsonwyatt.com

Appendix 4. Data Coverage and Quality

The starting point of the analysis in this report is the data collected by the Office of National Statistics (ONS) on the pool of assets held by institutional funds based in the UK. This is published quarterly in both a "First Release" and subsequently in the Business Monitor MQ5. Information on institutional investment also appears in ONS Financial Statistics.

The broader picture for funds under management in the UK is filled out with various industry surveys including those undertaken by the Investment Managers Association (IMA), InterSec Research Corp., PricewaterhouseCoopers, ComPeer and CCF Charterhouse, although inevitably their coverage while extensive, is not complete. The reports by the IMA and PricewaterhouseCoopers, for example, mainly cover the largest fund managers. IFSL has used the output from the ONS, ComPeer, WM Company and IMA to estimate UK funds under management in 2002.

The industry surveys by PricewaterhouseCoopers and IMA, in particular, permit some estimates to be made of fund management's contribution to GDP, employment and productivity, supplementing the ONS data on net exports. The data collected by the ONS and from industry surveys together provide sufficient coverage to give a good indication of the scale of funds under management in the UK and their contribution to the economy.

International data collected by InterSec Research Corp., UBS Asset Management OECD and Merrill Lynch give some indication of the UK's position internationally, particularly from the perspective of pension funds.

The management of pension fund assets, generally, is the subject of a much greater volume of research than insurance companies' assets. This means that, for example, international comparisons of asset allocation, investment restrictions, rates of returns and forecasts of market growth are generally focused on pension funds alone. Furthermore, in the context of the UK, data on the use of various management styles and derivatives also generally relate to analysis of pension funds.