

Fidelity grapples with gigantism

The fund company's remarkable growth is generating strains that are showing up in performance, marketing and morale.

By Alyssa A. Lappen

Last year Edward C. Johnson III, chairman of FMR Corp., the parent of Fidelity Investments, got wind of a disturbing development. Charles Schwab, whose Charles Schwab & Co. is the largest discount broker selling no-load mutual funds sans transaction fees, was pushing his OneSource mutual fund program's original fund-company members — Neuberger & Berman, Dreyfus Corp. and Invesco, among them — to deal exclusively with Schwab, according to several sources. Drop out or stay out of Fidelity's competing no-fee FundsNetwork, Schwab purportedly told them, and he'd waive any increase in their cost of membership in OneSource for 1995.

During a face-to-face chat in Ned Johnson's office, Chuck Schwab invited Fidelity to join the OneSource program, too, according to Fidelity officials. Johnson demurred, firmly. Indeed, Schwab was reportedly led to believe that Fidelity would yank the 100 or so of its funds in the Schwab Mutual Funds Marketplace program if Schwab proceeded with its scheme. As Fidelity accounts for perhaps 7 percent of the mutual fund assets held by his clients, Schwab couldn't very well forgo either the transaction fees the funds generate or the Fidelity name as a marketing lure.

Thus his little exercise in arm-twisting succumbed to a rougher, more muscular version of the same technique, as practiced by Johnson's Fidelity. (Fidelity officially denies this account, which is confirmed by several sources.) Whatever took place, Schwab & Co. dropped its exclusive deals with its original OneSource members. "Under Ned Johnson's Boston Brahmin veneer," says a competing

money manager half admiringly, "there's a real wolf."

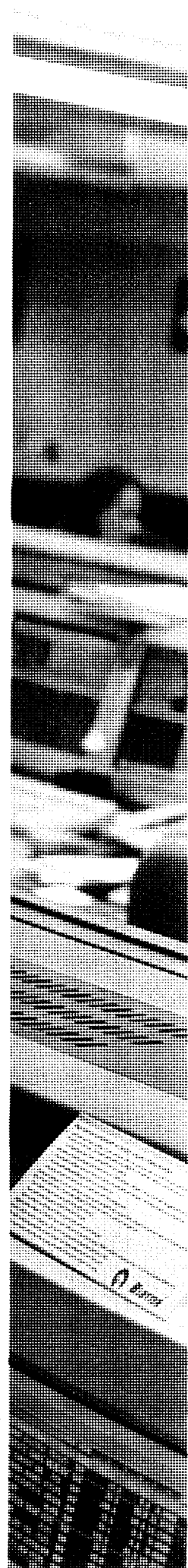
Johnson likes to have his way. And for the past 20 years, the Fidelity chairman's way has demonstrably been the right way. With nearly \$390 billion under management worldwide (including \$19.6 billion at London-based Fidelity International), Fidelity is a global financial services empire some significant zeros removed from the modest (\$3.9 billion in assets) mutual fund company Johnson took over from his father in 1972. Today the U.S. firm, which employs 13,600 people, is easily worth in excess of \$6 billion (based on the market prices of money management firms sold recently). No one is a bigger manager of money worldwide.

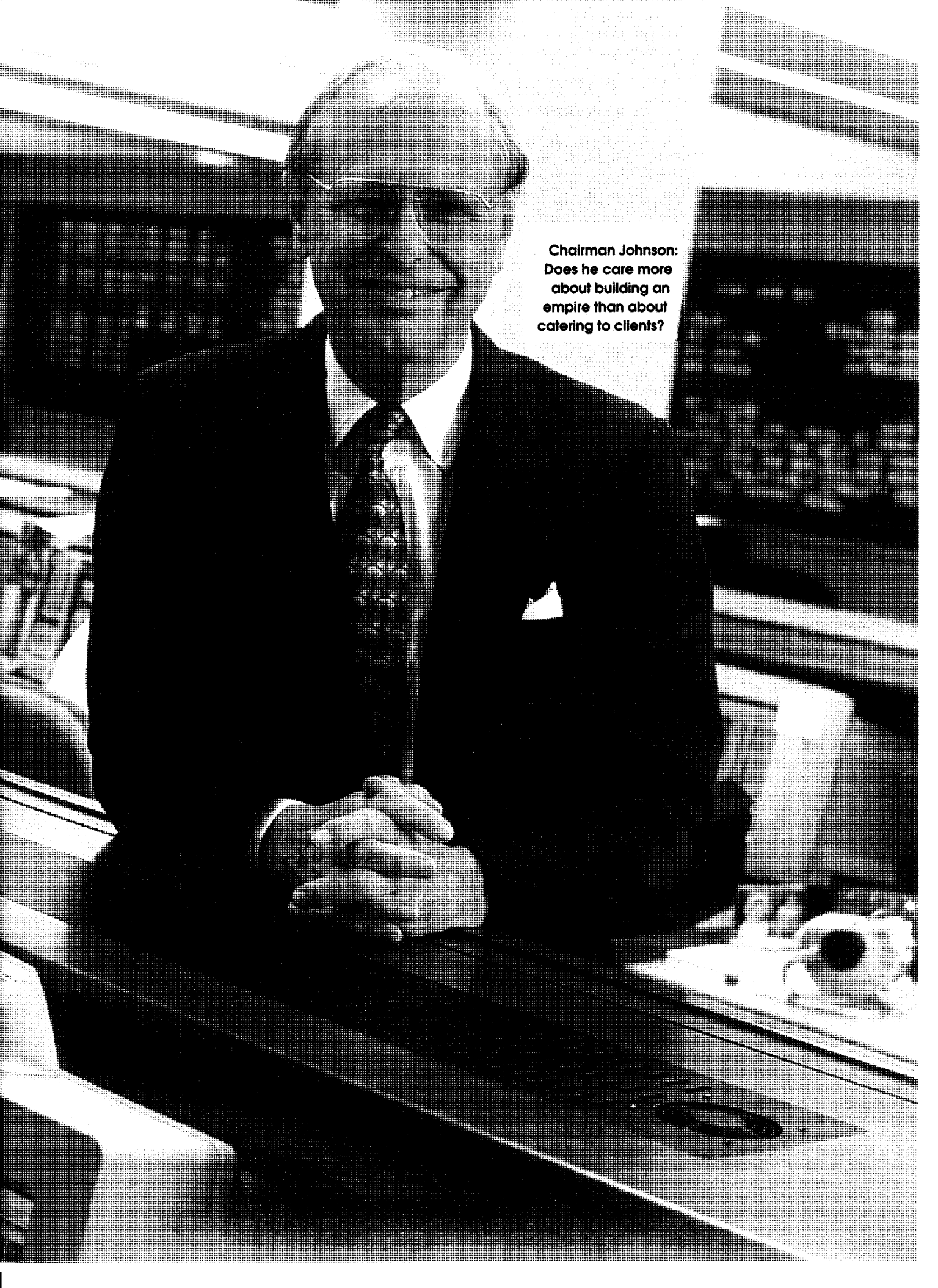
What's more, Fidelity has grown a startling 56 percent in just the past four years; in 1994 it generated more than \$3.5 billion in revenues, earning \$315 million in net operating profits. Barely ten years ago Fidelity's total managed assets were \$39 billion and its revenues \$470 million. In the first six months of this year, the firm's U.S. assets alone swelled by a further 18 percent. "We want to own [the financial consumer's] brain," declares Fidelity veteran Roger Servison, who was recently named head of corporate affairs. "We want them to think of us as their primary financial provider."

Because so many customers now do think of Fidelity that way, the firm's very size, with its seemingly endless mitosis, raises questions about whether it risks becoming afflicted with a crippling gigantism. In marketing, in investing, in managing, is Fidelity becoming just too big for its own — and its clients' — good?

Johnson won't admit to any such thing. "Oh,

Steve Johnson





Chairman Johnson:
Does he care more
about building an
empire than about
catering to clients?

[growth] isn't an end," he insisted during a long interview in his office at Fidelity's 82 Devonshire Street headquarters in Boston. "It's every day — the challenge of running and improving the businesses, being rewarded and also providing something of value to others. It's like collecting or like playing a professional sport. It's a desire to win, yes, but it's also the desire to produce something that has value to many people."

Johnson will grant, however, that Fidelity must be on constant guard against the inevitable corollary of such dazzling growth: corporate arrogance. "Success breeds success, and too much success begins to breed arrogance," he allows. "You take

one of the best-managed companies in the world: IBM. They had too much success for too many years. What disciplined IBM was a cyclical decline in the computer business, and what disciplines Fidelity and its competitors is a good healthy bear market, which we haven't had for a long time."

Ensuring that Fidelity does not succumb to the IBM syndrome may be the overriding challenge for the 65-year-old Johnson today. It may well require that he, or his successor, make some changes in the way this manifestly successful company has always done business. (In August Johnson revealed that he had recently put through one noteworthy change: He gave 51 percent of the company's voting stock to 50 longtime employees in exchange for their nonvoting shares, in part to promote loyalty and in part for estate planning.)

Whether it's merely mega-growth pangs or symptoms of something more serious, Fidelity has too often looked just plain foolish lately. Last year's blowup in the Latin American debt market was a special embarrassment for the firm, since it had been such a vocal supporter of emerging markets, in spite of Johnson's personal misgivings about them. A department shake-up banished two high-profile Fidelity fixed-income managers to other firms. A glitch in a daily pricing report last year and a mistaken report on the dividend of Fidelity's flagship Magellan Fund produced snickers, but they also raised alarms that something more fundamental was amiss at the firm.

Poor public relations handling of these episodes magnified their impact. Toward the end of last year, Fidelity was telling any customer who asked that Magellan would be paying out \$2.4 billion in dividends for 1994. But then, with no more formal explanation than a cursory press release, the company announced that there would be no dividends after all. Markets around the world reacted. The consternation of Fidelity customers, to say nothing of that of the markets, eventually forced the firm to admit that it had made an all too human mathematical error.

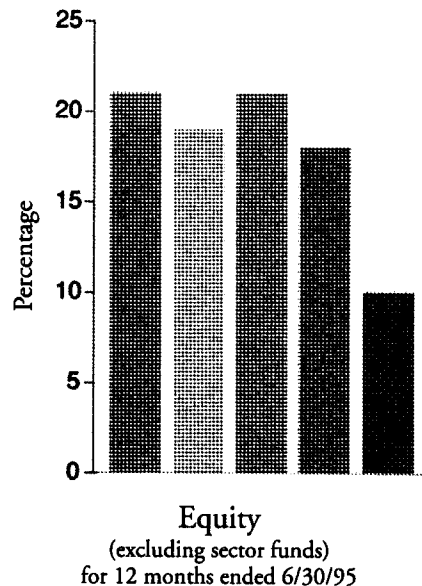
That wasn't Fidelity's old smooth style. Under former PR head Richard (Rab) Bertelsen, who may have been as much of

Performance realities

Fidelity has long boasted of the performance of its funds. The charts at right show the percentage of funds of the top five mutual fund families that fall in the top quintile. The result: very little difference between Fidelity and its top rivals in terms of the percentage of high-performing funds.

- Fidelity Investments
- Franklin Templeton Group
- Vanguard Group
- Capital Group
- Merrill Lynch & Co.

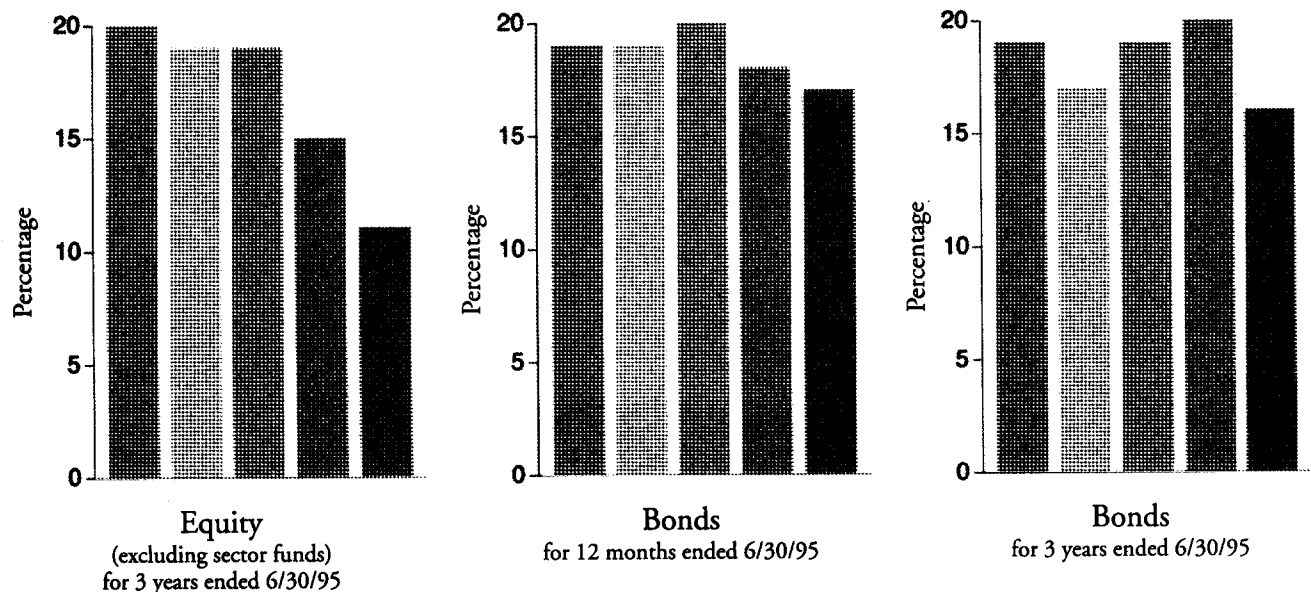
Source: *Institutional Investor*, based on data provided by Lipper Analytical Services.



a genius in his way as legendary Magellan Fund manager Peter Lynch was in his, Fidelity routinely enjoyed glowing notices in the financial and popular press. Bertelsen, who died in 1993, used to gloat that his department, with its meager \$2 million budget, generated as much favorable attention for Fidelity as the marketing department did with its \$100 million or more in annual ad spending.

But now the PR engine that Bertelsen built is being slowed in what seems to be a reversion to Fidelity's mean. "There is a pervasive attitude among key players that there is nothing to gain by cooperating with the press," says a former Fidelity man. (The firm's clout is such that fewer than 20 of the more than 80 Fidelity employees, former employees, consultants, competitors and customers who spoke to *Institutional Investor* would do so on the record.) The gala biennial press luncheons that showcased Fidelity's fixed-income operation in 1992 and 1994 will not be repeated any time soon. PR chief Jane Jamieson has welcomed a number of individual reporters on visits to the firm lately, but for the past two years, the financial press has been increasingly angered by the uncooperative vibes Fidelity is emitting. "Everybody hates them," confides the editor of a major mutual fund column. "They are rude, unhelpful, arrogant, take their time [with requests] and basically want to get rid of you." Counters newly appointed corporate affairs chief Servison: "We've had excellent press since Bertelsen left, too. We have very strong people in PR. Jane Jamieson has 17 years of experience."

By any measure Fidelity remains a formidable enterprise. But beneath this still-humming marketing machine are some clanking parts and the odd loose bolt. Overheating may well threaten. The direct-market retail business, which had been run by Servison, is struggling. His shift to corporate affairs is seen within the mutual fund industry as something of a demotion. Subtract the cash flow into money funds, individual retirement accounts, defined-contribution plans and broker-sold funds, say outsiders close to the company, and Fidelity's



fund business suffered net redemptions last year. (That is about on a par with the rest of the industry, which grew little more than 4 percent in 1994.) Growth in the retail fixed-income brokerage business has slowed down as well. Fund performance, particularly in fixed income, is less than sparkling. Fidelity's technology is straining to keep up with a surging, and demanding, customer base. Its foreign thrust has been less than overwhelming. Even the fabled competitive Fidelity culture appears to be feeling new stresses.

For years Fidelity's central strategy has been to gain what Servison calls "share of wallet": Fidelity wants its customers to give it an overriding proportion of their financial business, from money management to brokerage to credit. The firm has been much more aggressive than its competitors in building multiple distribution channels. Whereas most fund families sell either directly to consumers or through broker-dealers or banks, Fidelity — and Ned Johnson in particular — early on saw the value of doing both at once. "When we started the discount brokerage business in 1979, we were at the forefront," notes Servison. "Dreyfus and Federated [Investors] were slower and less committed to marketing to all segments." Ultimately, Fidelity went after market share in its usual voracious fashion in defined contributions, insurance and variable annuities and with banks, financial planners and brokerage firms, as well as through its own brokerage arm. The objective: to feed assets into Fidelity funds in every way imaginable.

This multichannel arrangement created some fierce rivalries among the firm's business groups. But most Fidelity insiders regarded the competition as basically healthy. Explains Gordon Watson, head of Fidelity Investments Brokerage Group and a member of Johnson's seven-person operating committee: "We have a flat organization made up of dozens of companies with their own management structures, business approaches and semiautonomous ways. There's some competition between them, but we don't allow it to get to the level where it works to our disadvantage."

The multiport approach does have its strategic advantages,

the intramural scrapping notwithstanding. Cash began gushing through the 401(k) pipeline into long-term equity and bond funds in the early '90s, just as the flow of money through the direct-retail-fund spigot was ebbing from a 25 percent compound annual growth rate over the past 15 years, to 8.8 percent last year. The once-fledgling brokerage group now boasts annual revenues of roughly \$360 million and, in trading 6 billion shares last year, controlled 4 percent of total market volume, more than the American Stock Exchange. Overall, the company's retail group still accounts for roughly \$150 billion of Fidelity's mutual fund assets and more than half of its revenues and profits. But Fidelity's institutional business — sales through 401(k)s, 403(b)s, banks and other brokerage firms as well as separate accounts — has now surpassed retail in volume. Defined-contribution plans alone account for more than one quarter of Fidelity's total U.S.-based managed assets.

Yet several former Fidelity hands contend that as the firm has delved into more and more businesses, the competitive ethos has become too intense, making employment at Fidelity something of a revolving door. Executives come in, stay four or five years and push on, they note. "The level of politics has moved sky-high within the firm," says one former marketing man. Asserts another: "Fidelity is so internally focused and the politics and turf battles so intense that people are constitutionally unable to work together. It is a zero-sum game. For someone to do well, another person must be obliterated. And this comes straight from Ned. It's blood sport. People are so worried about filling up the distribution channels that they gum them up. They are tripping all over each other."

Confides a third ex-Fidelity marketer, "I left because the organization is by its very nature in constant competition with itself." Says former Fidelity executive vice president Kurt Cerulli, who quit after Rodger Lawson left as head of retailing in 1991 and is now a Boston mutual fund consultant: "It is a very competitive environment [for business managers]. There are a lot of casualties." (Cerulli admits that he left under pressure, although his national list

of more than 60 consulting clients includes Fidelity.)

The cross-divisional competition can be messy. Last fall Fidelity's retail brokerage arm ran an ad listing six reasons to dump a full-service brokerage house. The thrust and tone of the ad enraged full-service brokers — who sell the highly lucrative Fidelity Advisor Funds — and didn't endear the brokerage arm to Fidelity Investments Institutional Services Co., which sells the Advisor Funds through banks, insurance companies and broker-dealers. Fidelity softened the ads.

A number of 401(k) plans pitched indirectly by Fidelity Investments Institutional Services and directly by Fidelity Institutional Retirement Services Co. have reportedly thrown up their hands at all the attention. A few defined-contribution clients have grown so disenchanted with Fidelity's quest for size that they have dropped the company altogether, although Fidelity has more than made up for the losses with big new clients, like General Motors Corp. and Ford Motor Co. (Fidelity also runs the 401(k) for Capital Cities/ABC, the parent of *Institutional Investor*.) "This is a business you have to build on yesterday's business," says FIRS head Robert Reynolds. "We have to grow client by client."

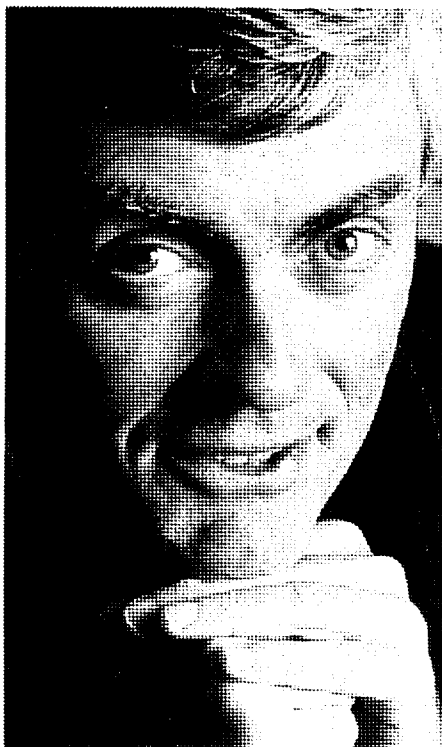
To Johnson the competitive climate and the resulting turnover is simply a cost of doing business Fidelity-fashion. "When you have highly motivated people," he argues, "I'm afraid that is the nature of the beast. There is always going to be somebody looking at the guy next to him and saying, 'Well, look, hey, you are losing money. I'm making money. I'm afraid you're no damned good, because you aren't making any money today.' You name the company that brings a lot of talent in the door [and] that can keep every bit of it. We'd like to keep it all, but, for many, many reasons, some of which have to do with the talent and some of which have to do with the company, people leave."

Mortar rounds

Talent, of course, is crucial to a key Fidelity customer value: investment performance. The firm's equity funds — most memorably Magellan — have long been perceived to be outstanding performers. But as the assets of the chief Fidelity funds swell (Magellan is now up to a hefty \$51 billion), their portfolio managers may well feel compelled, in the ultracompetitive Fidelity climate, to take added risks to sustain their impressive, growth-fund-style returns. "The more money you manage and the more fields you are in," notes the marketing head of a major competitor, "the greater the chances that you will be on the playground when a big mortar hits."

Fidelity funds have in fact sustained some shrapnel wounds. "They have given up ground [on performance]," reported Michael Lipper of fund follower Lipper Analytical Services earlier this year. At the end of April, Lipper Analytical's 12-month

FIRS head Reynolds:
His unit sales to 401(k) clients have overtaken those of the retail fund group




Fidelity International chief Bateman:
The overseas operation seems at last to have overcome hard times

Portfolio manager Johnson: Fidelity may not need a family member to lead it, but the CEO's daughter is an obvious candidate

data showed that Fidelity had placed a much smaller proportion of its diversified equity funds in the first performance quintile than had three of its four top fund-family competitors — Capital Group, Vanguard Group and Franklin Templeton Group. Only Merrill Lynch & Co. did worse.

By the end of June, though, as the bull market continued to bellow, Fidelity's 12-month returns had staged a comeback: Its proportion of first-quintile diversified equity funds was roughly equal to that of its competitors. (For a more complete look at Fidelity's performance, see charts.) The company's recovery, however, may be more of a testament to the cyclical character of its equity funds — and their big bet on technology stocks — than to any sustained management prowess. "They are willing to take tremendous positions," says Lipper. "In bad markets they look really bad, but we've not had any bad markets in recent memory."

In fixed income — never a Fidelity forte — Lipper Analytical statistics show that the company was no better, or worse, than the other top four fund complexes during the 12 months



ended June 30. Of course, 1994 wasn't a banner year for any of the big five. But Fidelity's own 1994 annual report concedes that its fixed-income group was in the bottom quartile among all of its peers.

Fidelity investors redeemed or lost nearly \$8 billion in bonds in 1994, reducing the assets in the firm's fixed-income funds by almost 25 percent, to \$27 billion, according to Lipper Analytical. The company's major competitors suffered setbacks in bonds as well, though none as dramatic as Fidelity's. Vanguard saw total redemptions and losses amounting to 13.4 percent of its assets, and Franklin Templeton, 13.6 percent. Since January Fidelity's bond assets had grown back to \$30 billion by June. But those are still only three fourths the size of Vanguard's and roughly half those of Franklin's. By contrast, Fidelity's equity funds total \$200 billion, more than twice as much as those of its nearest rival, Vanguard.

Fidelity's marketing approach doesn't in fact require that it outperform its rivals in

its own perils, however. Under Johnson, portfolio managers are given enormous latitude to succeed spectacularly — or fail abysmally (once, at least). Fidelity's equity prospectuses spell out its portfolio managers' liberal license, including the right to "temporarily" leverage up to 33 percent of their portfolios and invest up to 10 percent of their assets (and for some funds, more) in any one security. "They give you all the freedom to do what you want, and they give you the resources, the tools and the confidence that you need to find [stocks like] the Flight Safeties of the world," says Jeffrey Ubben, whose star Fidelity Value Fund grew from \$500 million in late 1992 to \$4.3 billion before he decamped in March for Richard C. Blum & Associates. Ubben left in large measure because, he says, the Value Fund had become too unwieldy.

Johnson's operating assumption is that the formula of freedom, research and resources can cure almost any performance ill. Question portfolio size at Fidelity, and business manager after business manager will cite the number of the firm's U.S. equity analysts and associates (66), the number of companies they follow (more than 4,000) and the number of research staffers outside the U.S. (73). "We're private, and we don't have to worry even in a slow year about recruiting," says William Hayes, who oversees the investment management company's equity side, including its 38 equity portfolio managers. "Ned Johnson has always given us the resources we need."

Nevertheless, portfolio size *is* an issue at Fidelity, and it becomes more of one the larger the company gets. Fidelity's average equity portfolio is now nearing \$1.7 billion (\$1.3 billion, if you exclude Magellan), which compares with an industry average of \$266 million, according to Lipper. "It's a bull market firm," contends one former Fidelity insider. "Its funds have a high beta. They are fully invested, and when the market turns down, they look terrible. Even when the funds were much smaller, the portfolio managers didn't want any more [assets]. And on a risk-adjusted basis, as the firm gets very big, the funds are getting more risky." Asserts a West Coast pension fund consultant: "The fewer stocks in a portfolio, the more stock selection drives performance. The more names, the more performance is driven by [industry] sectors. And funds [like Magellan] that were built as stock selection vehicles become far less so as time goes on. Magellan in the early 1980s had eye-popping numbers that just cannot be repeated, even with big sector bets."

Yet Fidelity doesn't appear altogether willing to cede the point. The firm owns more than 8 percent of the stock in more than 250 companies, according to CDA Spectrum Research Services, which tracks stock ownership in public companies. In more than 550 companies, Spectrum reports, Fidelity owns more than 3 percent. Says an ex-Fidelity equity manager: "[Magellan portfolio manager] Jeff Vinik has 45 percent of his \$51 billion portfolio in technology stocks. Is that responsible? Does the public know? Do the widows and orphans who bought Fidelity Asset Manager know that [portfolio manager] Bob Beckwitt runs a hedge-fund-in-drag?"

Comments PR chief Jamieson, "People here know that Jeff Vinik does bottom-up research, stock by stock, and that he thinks that many of the companies with the best prospects are technology companies." She adds that although Asset Manager's Beckwitt did buy a modest number of structured notes



every fund category, sources say. "Their strategy is to [always] have a leader," explains Lipper, whose company tracks most of the 223 Fidelity funds. "So by definition Fidelity will also always end up with some laggards. They are not trying to produce funds with level placement. The idea is, the more funds you have, the more winners you can sell in the years when there are winners." The \$2.3 billion Fidelity Overseas Fund, for example, has been consistently in the fifth quintile of Lipper Analytical's universe of foreign equity funds for the trailing one-, three- and five-year periods, while the \$2.6 billion Fidelity Low-Price Stock Fund has gone from first quintile to fourth in its group in the same period. Magellan, by contrast, has consistently been in the first or second quintile, and the Growth and Income Fund has regularly landed in the middle of the pack.

Producing winners rather than steady performers presents

linked to commodity prices, those moves — well known to president J. Gary Burkhead — were meant to offset inflationary pressure and worked fairly well.

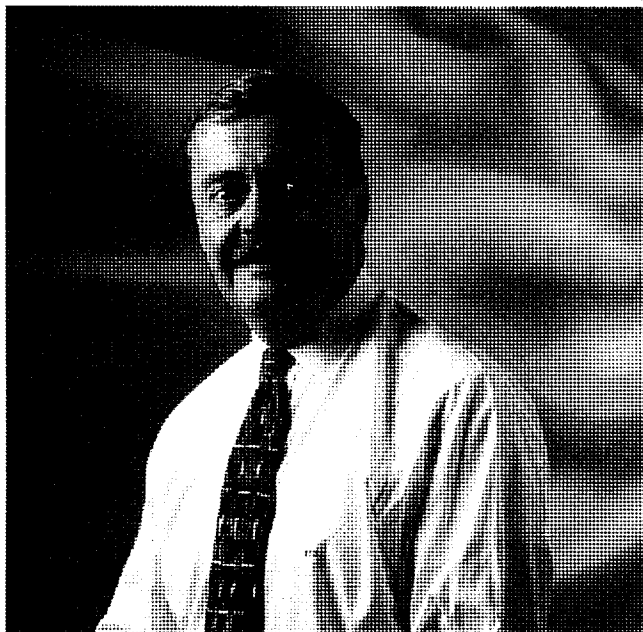
Portfolio size is not the bugaboo that many suppose, argues Morris Smith, who succeeded Lynch as manager of Magellan in 1990 but left the firm two years later to study the Talmud in Israel. "The stock market has appreciated fourfold since the early 1980s," Smith points out. "So liquidity is not an issue. I remember owning 13 million shares of Fannie Mae and 10 million shares of Philip Morris Cos. If the picks are good, the fund will do well. We've proved that Magellan can outperform."

Fidelity is nonetheless so huge that some retail and institutional investors steer clear of stocks it owns in any quantity, particularly in the volatile technology sector. "You don't want those," says a competing technology fund manager. Notes one Merrill Lynch broker: "In the past three years, market volatility has been below 10 percent, compared with an average market volatility over the past 20 years of 15 to 20 percent. As we get closer to a market top, volatility will revert closer to the mean. And you had better not be in the way when Fidelity falls."

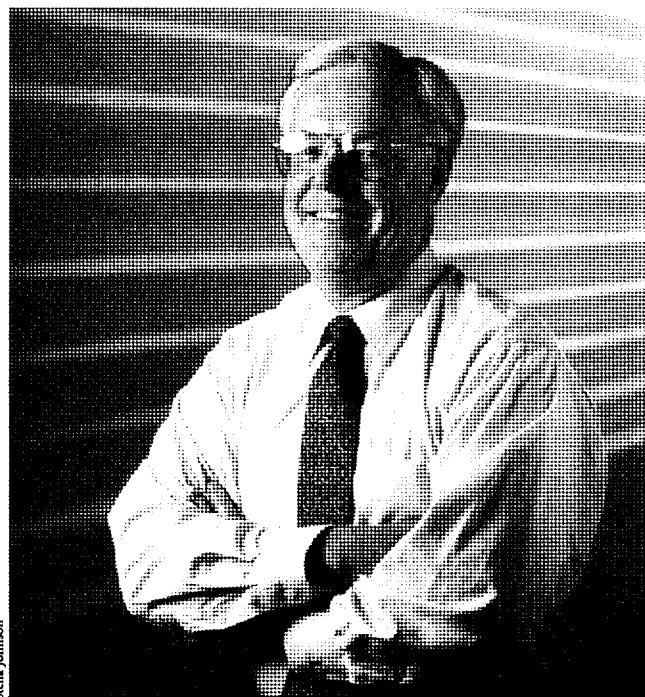
Fidelity portfolio managers are not in fact rewarded for taking short-term risks. Instead, their bonuses are pegged to their own funds' and also their fund groups' rolling three-year performance against comparable funds in the Lipper fund universe. Base salaries are modest by industry standards. But most managers are also paid to do their bit to increase Fidelity's size by bringing in fresh assets: They receive phantom stock whose value is tied to the increase in Fidelity's book value. Roughly half of the managers also get real Fidelity stock (employees control 50 percent of the equity value of the company), although they must sell the stock back to the firm if they retire or quit. Shares are lavished on stars like Magellan's Vinik, who reportedly owns at least 30,000, which last year were worth about \$100 apiece. The best Fidelity managers can easily make more than \$1 million a year.

Ned Johnson won't hear of putting a governor on Fidelity's growth. "The question [of size] is never going to be answered completely satisfactorily," he says. "If you don't grow, then maybe people think, well, you are not a factor in the business. And there really is no future in the company if it isn't growing. There are not going to be any new funds to be managed by some of the new and talented fund managers that are coming along." Paul Hondros, president of

Head of corporate affairs Servison: Fidelity's goal is always to gain "share of wallet"



Stella Johnson



Stella Johnson

Brokerage chief Watson: Competition among Fidelity's dozens of semiautonomous divisions is not a "disadvantage"

the institutional unit, which sells Fidelity services to banks, insurance companies and broker-dealers, echoes the company line. "If we deliver better solutions," he maintains, "we'll [simply] grow faster than the competition."

Even Peter Lynch was refused when he asked to close Magellan, according to one ex-Fidelity manager. "It would be ridiculous [for a portfolio manager] to put up much of a fight," says this source, "because [company executives] wouldn't listen." In the rare instances when funds have been closed, they were always reopened. The normal course for Fidelity when a manager complains of too-fast growth in his fund is to stop advertising it for a time. "The definition of success at Fidelity is to grow your fund," says another former Fidelity manager, "and if you ask them to cap it, you are limiting your career. It's insidious. You wake up one morning when your fund is \$3 billion or \$4 billion, and you realize that it is out of control."

Control was plainly a problem last year for Fidelity's fixed-income department. At a press luncheon in March 1994, the company trotted out then-bond chief Thomas Steffanci and star analysts and managers, including portfolio managers Robert Citrone and Ann Punzak, who boasted of

using Latin American paper even in ostensibly conservative investment-grade and short-term income funds. The result was disaster. Heavy investments in Latin bonds hammered the young Fidelity New Markets Income Fund. It lost 6.5 percent in the 12 months ended April 30 of this year; assets plunged from a peak of \$358 million in early 1994 to less than \$135 million in March. A bevy of other Fidelity funds, including Fidelity Asset Manager and Short-Term Bond Fund, were hurt as well.

Now Steffanci and Citrone have moved on, the latter to Tiger Management. They were more nudged than forced out, say sources. (Neither could be reached for comment; both presumably signed standard Fidelity agreements binding them to keep silent about all aspects of the business for at least a year or forfeit their deferred compensation.) The company's three emerging-markets-debt funds have been shifted out of the mainstream bond funds group and into the high-yield-bond group.

The Latin American adventure at-tests, in its way, to Fidelity's somewhat belated commitment to bonds. A few years ago president Burkhead told shareholders that Fidelity was indeed determined to become a powerhouse in fixed income. This was not an altogether natural impulse for Ned Johnson's firm. Says one former Fidelity bond manager: "Fixed income is a necessary evil to Fidelity. It is hard to direct-market bond funds. They carry lower fees and profits than equity funds, and they have never been viewed by Ned Johnson as an exciting asset class. But fixed income is necessary to build up the 401(k) business." Adds fixed-income chief Fred Henning, who developed Fidelity's money market assets and was spirited from Dallas to Boston last May to sort out the fixed-income situation: "If we don't have that [fixed-income] niche, we have a hole. The commitment [to bonds] comes directly from the chairman."

Henning, who wants more predictable results in fixed income, will be relying on bond managers like Dwight Churchill. The taxable-bond-group head is determined to reduce bond fund volatility, largely by limiting bets on duration and risky credits and by continuing to restrict managers' freedom to stray too far from their benchmarks (part of an initiative begun last year). Churchill will be relying on Fidelity's usual R&D might: "We have 45 research professionals [in bonds], a level you'd be hard-pressed to find in another group."

Research surely tells. The catch is that Fidelity may be better at picking computer stocks — its technology "sector" fund was up nearly 48 percent by mid-August — than at building computer systems. Fidelity suffers from a technology shortfall, despite spending as much as \$700 million on the development, maintenance and operation of computer equipment in 1994 (and \$500 million the year before). Its systems, an agglomeration of IBM and numerous other brand-name mainframes, have had trouble keeping pace with the company's swift asset growth. "We have some [computers] that we might be able to sell to local museums," Johnson remarks dryly.

Says a former insider: "They *are* struggling. They're still

running on some systems built in the mid-'80s." He notes that a new \$280 million back-office net-asset-value and processing system planned for this June has been delayed until late 1996. Adds a computer industry observer, "Their technology initiatives are forward-looking, but when it comes to implementation, they are bureaucratic and slow relative to the rest of the securities industry, more like an insurance company."

Fidelity got around only this year to providing retail customers with enhanced consolidated statements, which Merrill Lynch and Charles Schwab have offered for years. "They went through three teams to get the job done, too," notes one technology maven who is close to the company. In some cases, the company continues to send statements even when accounts have been closed, report retail clients. The release of day-old fund prices in June 1994 can largely be blamed on computer glitches.

Fidelity computer chief Albert Aiello has reportedly attempted to stretch existing systems simply by cloning them, building parallel systems to accommodate new business. (Fidelity declined to make Aiello available for an interview.) Now the company is in the midst of building a whole new system that will process information on both mutual funds and brokerage accounts, replacing two separate systems. "Every so often," says Johnson, "you have to gulp and say, 'Okay, it's gotten so complex, so difficult to modify, that we are better off building a new system.' And we are gulping." The new system, he hints, will be built around local area networks and will handle many more transactions and data. It will also, he says, be phased in over time.

Foreign relations

Global in its ambitions, Fidelity has managed to export its marketing strengths, but these were accompanied by some of its organizational weaknesses. Fidelity International, spun off from the domestic company for tax reasons in 1979, has been struggling for years to build assets. The company is at last making headway in its overseas unit trust push. Total assets reached \$18 billion at the end of last year, thanks largely to the unit trusts. Sales are booming in Hong Kong and Luxembourg (but not in Tokyo, where Fidelity doesn't have a domestic license, although it was one of the first foreign firms to set up an office and can sell offshore funds).

The London-based institutional business has suffered a reversal. In the early 1990s it lost a lot of U.K. pension fund accounts and has yet to rebuild completely. Assets stood at £946 million (\$1.5 billion) in June, down by one third from £1.4 billion in 1989. After a number of sluggish years during which the London institutional operation had several chiefs, Fidelity enjoyed a surge of pension business when it hired marketing man Neil Curtis in 1983 and managing director Phillip Nash in 1987. The energetic Nash came to be known among British pension officials as Mr. Fidelity. He and Curtis built the franchise in double-digit increments over five years. "Then the business went off the boil," says a former

**"Even Peter Lynch
was refused when
he asked to close
Magellan."**

Fidelity man in London. "Performance was not as good as was promised, and they lost high-profile clients like the British Shipbuilders' Fund and the Bass Pension Fund." Poor relationship management appeared to aggravate the lackluster performance.

Richard Horlick, who runs the British pension fund business today, agrees that it went through a very rough patch in the first half of 1991, when performance was indeed poor, and the firm lost several mandates. But performance has improved since the company quadrupled its U.K. equity research staff, to 40, he says. The company can compete well, he adds, particularly in its U.S. equity offerings.

"The international business is a poor second cousin to the domestic business," contends a former U.S. Fidelity fund manager. "It's the classic story of American arrogance, going abroad and stubbing its toes. Ned doesn't like bonds, he doesn't like foreign stocks, and he does not like institutions." At Fidelity International president Barry Bateman counters that he expects growth to be solid in the U.K. and on the Continent in both the institutional and unit trust businesses. "We think that the mutual fund industry in the U.K. and Europe is 15 years behind the U.S.," says Bateman. "There is good evidence that they will now experience the kind of growth rates seen in the U.S. market in the late 1980s and early 1990s."

Fidelity has tremendous resources to draw on to resolve its sundry problems. The company's reserves start with Ned Johnson's own sheer tenacity. He has a stubborn New England way of simply willing success. He also has distinctly non-New England-style deep pockets. As Johnson and his family effectively own Fidelity, he has been able to plow profits back into the business at will.

The company's operating revenues exploded 1,200 percent, from \$62 million to \$804 million, between 1980 and 1986, yet its net operating margins ranged from less than 4 percent in 1982 to a high of 10.8 percent in 1986, according to a case study by Boston University professor Kenneth Hatten. Other mutual fund companies more inclined to take profits while the taking was good were then reporting operating margins as high as 60 percent and net margins of up to 30 percent. In 1992, Hatten told a Harvard Business School class, Fidelity's net profits were only \$94 million — giving it a net margin that year of a mere 5.1 percent.

"A certain number of competitors may say we invest foolishly," says Johnson. "But as long as the good investments outweigh the bad ones, it will pay off. Part of mankind likes to see how they can improve whatever they are working with, and money is one of the ingredients of success." That has certainly proved to be the case for Fidelity. Says corporate affairs head Servison: "Where business really turned [for Fidelity] was in the bull market of 1982. When it arrived we had already been investing in telephones for eight years. We had a state-of-the-art computer processing center and were already very familiar with direct mail."

Reinvesting in the business takes numerous forms. By 1987 the company's main telephone center in Boston was backed up by sites in Dallas, Salt Lake City and Cincinnati. In 1985, 1986, 1989 and 1992, the company was recruiting, hiring and training 150 people per week. Now there's a new print and mail center in Covington, Kentucky, and a 401(k) and 403(b) phone and service center will open soon in Marlborough, Massachusetts.

Even at Fidelity, however, money can't resolve all management challenges. "I don't want to be an old goat, waving my cane at everyone's head," Johnson confides. "It is possible for one to stay on the stage too long." The big transfer of stock to employees this summer was in keeping with this sentiment. Who might succeed the sexagenarian? "Whoever loves the business and has a talent for it runs it," he says non-committally. One obvious candidate: Johnson's 33-year-old daughter, Abigail, a portfolio manager at the company, who holds one quarter of Fidelity's voting

shares and joined the board of directors this year.

Fidelity doesn't need a family member at its head, Johnson insists, although he wouldn't mind if the CEO owned plenty of stock. Other possibilities include Burkhead, Fidelity Capital president James Curvey, board member Caleb Loring Jr. and retail group head Mark Peterson. In the unlikely event that Johnson retires within the next couple of years, the door could also be opened for management by the seven-person operating committee.

Business has one undying rule: The customer is always right. In financial services the retail customers that Ned Johnson prefers to institutions (which deserted Fidelity after some hot hands left the company in the 1970s) are wising up. These days, as Johnson freely admits, fees matter. Perhaps soon they may come to matter as much as or more than saturation marketing, computer-linked phone banks and even performance (unless it's exceptional). And Fidelity is not this market's low-cost provider: Its fees on diversified equity funds average 1.09 percent (including a high 96 basis points at Magellan), compared with averages of 77 basis points at Capital Group and 39 at Vanguard.

Some former Fidelity insiders question whether Ned Johnson cares as deeply about catering to customers as he does about building an empire. "Ned hasn't got a clue about his customers," says one. "He likes technology and customer service because he likes widgets and gadgets. But he doesn't understand what it's like to be frustrated by an erroneous credit report or a cut in a short-term bond fund dividend. To management there is only one constituency, and that's market share. Ned doesn't realize that behind the market share, there are real people."

Perhaps the market itself will temper Fidelity's headlong growth. Mutual funds, after all, are expected to grow in single rather than double digits over the next several years. Is Fidelity arrogant? If so, the markets know how to provide the necessary discipline, as Ned Johnson himself appreciates. Fidelity might well be the better for it. ■

"Ned Johnson has a stubborn New England way of simply willing success."