Frank Russell's splendid little sideline

The pension consulting firm has turned its knack for picking money managers into a prosperous money management business of its own.

By Alyssa A. Lappen

Frank Russell Co. chairman George Russell has a visceral — you might even say biological — grasp of motivational psychology. In March 1980 he was mulling over how to cater to the small pension plans that ordinarily wouldn't qualify for the sophisticated services his Tacoma, Washington, pension consulting firm offers. Russell wanted his staff both to come up with a scheme for setting up equity and bond funds using managers that Russell was already recommending to large plans.

He tells the rest of the story: "I borrowed a conference room from Citibank, reached into my pocket, pulled out the key to the men's room and told everyone that they would get the key when they figured out how to do it. They got the key two and a half hours later. We were in business in October."

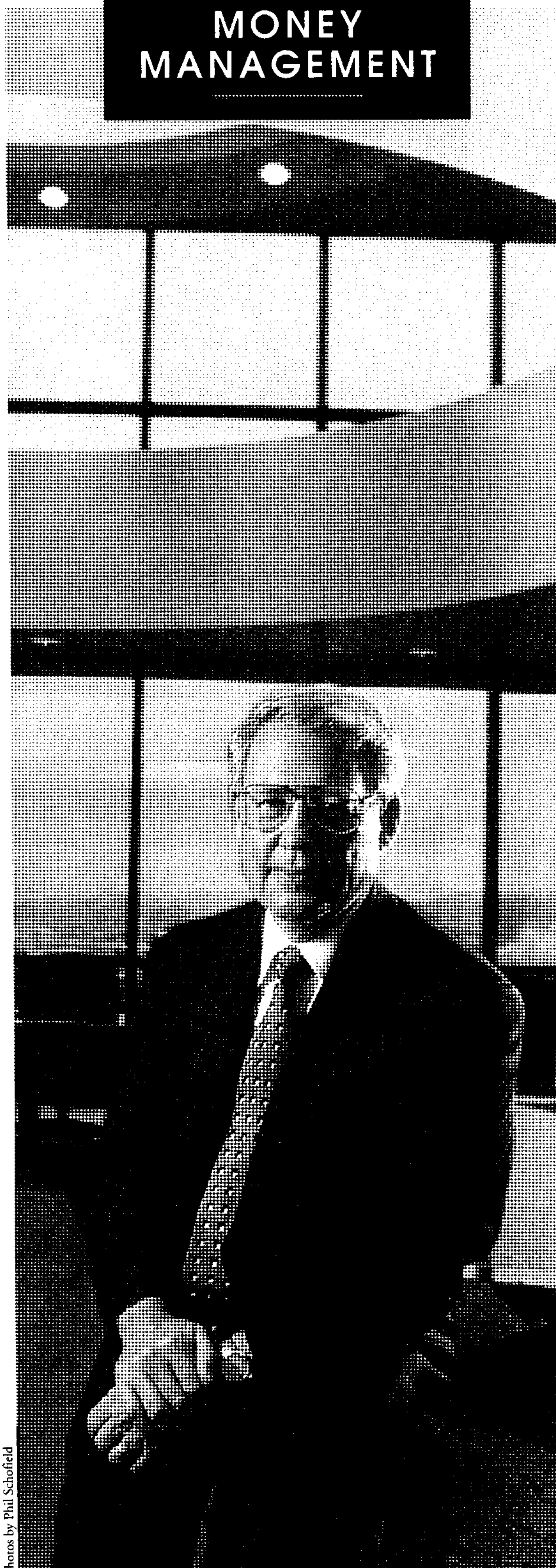
What that session came up with was a method of selling funds made up of batches of multiple managers to small and midsize pensions and other institutions for a comparatively modest tariff. Administration, custody, transfer fees and so on were are all tossed in with the money management itself.

The operative investment theory was that by enlisting multiple managers, each with a particular expertise, and stringing together complementary managers in individual Frank Russell commingled funds, the firm could ensure that, collectively and over time, the funds would reduce risk and beat their market benchmarks by meaningful, if not necessarily tremendous, margins (as has in fact happened). "We have a story to tell on nonheroic money management," proclaims Frank Russell chief executive officer Michael Phillips.

That tale is surprisingly little told. Frank Russell's enduring fame in finance circles derives from its mammoth pension consulting business. Some 171 major clients around the globe, from General Motors Corp. to Japan's Postal Life Insurance Corp., trust the firm to counsel them on a combined $650 billion in actively managed assets.

Russell's money management operation looks paltry by comparison: $22.5 billion. That this sum isn't a great deal larger frankly irks George Russell. "Given the quality of the products we offer, we should have $100 billion under management," he mutters.

Perhaps Russell should be (uncharacteristically) patient. After all, the 15-year-old money management operation already grosses an estimated $150 million a year, easily accounting for half of Frank Russell's revenues and profits.



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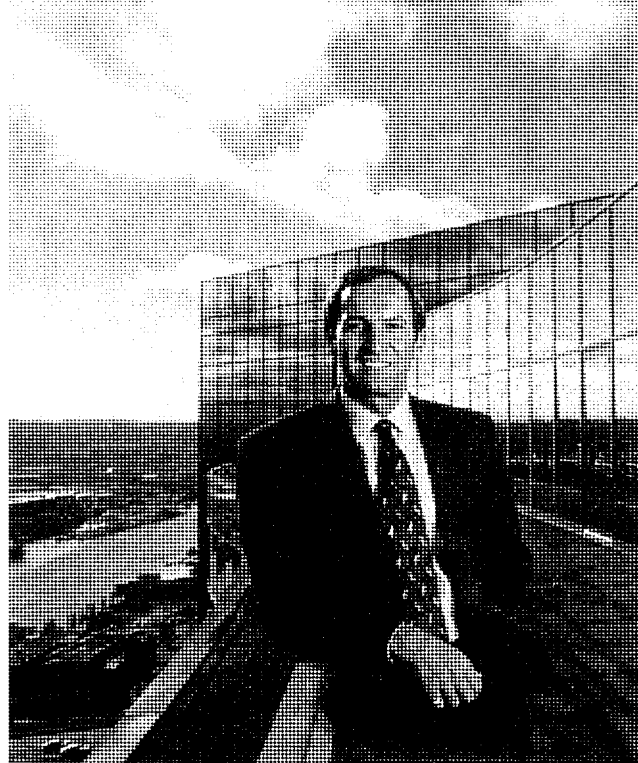
Chairman Russell: "Given the quality of the products we offer, we should have $100 billion under management"



CEO Phillips: "We have a story to tell on nonheroic money management"

Trust and Frimco CEO Anderson: Russell is hardly a brand name in the 401(k) business. "We are working on that," he says

Duncan McFarland, CEO of Boston's Wellington Management Co., a subadviser to the firm on $700 million of equity funds, suggests that "George Russell goes to bed with a huge smile on his face every night." Yet Russell CEO Phillips says flatly that if the firm "hasn't achieved assets of $75 billion by early in the next century, we will have failed."

This effort will plainly require more than withholding the rest room key. Frank Russell's manager-of-managers' formula has been widely emulated in one form or another. Evaluation Associates copied the idea with commingled funds and separate accounts in 1984, and such firms as SEI Asset Management, RCB International and Collins Associates have all followed. In the mutual fund universe alone, there are nearly 100 multi-manager offerings, representing nearly $28 billion of assets, according to Lipper Analytical Services; Russell's funds make up more than one quarter of that universe.

But in commingled and mutual funds, Russell remains the biggest and, by all accounts, the best performer in the burgeoning manager-of-managers' field. "Imitation is the sincerest form of flattery," observes Phillips wryly.

Frank who?

For Frank Russell to reach its lofty $75 billion goal, Phillips grants, the firm must scrap its sotto voce, practically secretive style of marketing money management services and throw its sales effort into high gear. "Our name is not a household name," concedes Lynn Anderson, CEO of both of the firm's U.S. money management arms, Frank Russell Trust Co. and Frank Russell Investment Management Co. (The trust handles commingled funds and separate accounts; the management company, mutual funds.) In the 401(k) market in particular, brand names weigh heavily with plan sponsors. "We are working on that," says Anderson, a lawyer and former trust and commercial banker who joined Russell in 1987. The firm recently hired El Segundo, California's Team One Advertising, the ad agency that does Lexus commercials, to develop a national campaign.

The slogan for the ad campaign might well be: Like Pizza Hut, Frank Russell delivers. Most of Frank Russell Trust's six commingled domestic equity funds have beaten their benchmarks by a healthy margin over the one-, three- and five-year periods ended September 29 (see table). The annualized returns of the trust's $3.2 billion Equity I Fund, its largest, have outpaced the Standard & Poor's 500 index in nearly every investment period since its 1980 launch, often by more than 200 basis points before fees. The fund's ten managers include such top names as Alliance Capital Management, Lincoln Capital Management Co. and Wellington. For three of the trust's four bond funds, the margins over the relevant indexes are also impressive. Only in small-cap and international equities has Russell fallen short; recent changes have improved those returns.

Frank Russell Co. got into money management by the side door. In 1980 the pension manager of a small international construction company, J.A. Jones Construction Co., rang up asking for advice. Jones was exactly the kind of unremunerative client Russell shunned. But that call and others like it got George Russell thinking. "He had a notion to provide the same kind of consulting services to smaller plans by bundling manager research, asset allocation and pension fund consulting

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negative *or* positive. It also red-flags firms with highly unstable management staffs or ownership and often tracks a firm for years before hiring it.

Next comes assembling individual managers into appropriate groups for each fund. "In a perfect world, we never want a fund with less than three managers," says fund development director Loran Kaufman, who, together with investment director Randall Lert, prepares the roster of managers for each trust company commingled fund and management company mutual fund. Most funds have many more managers.

In the early years manager turnover at the trust company and Frimco (as the management company is known) reportedly ran from 25 percent to as high as 75 percent. Often what impelled this revolving door was managers' styles not working as well together as expected.

Investment director Lert (left) and fund development director Kaufman: "In a perfect world," says Kaufman, "we never want a fund with less than three managers"

The fine tuning is never-ending. Lert and Kaufman have completely revamped the small-cap and international products, firing some managers, adding others to the small-cap offering and merging two international funds. But the firm tries assiduously to avoid manager blowups. Russell researched Fiduciary Trust Co. International, a recent hire for the Equity II small-cap offering, for four years before tapping it. The average Russell fund nowadays changes a sedate 10 percent of its managers per year, only about half because of poor performance. Equally often, firings relate to changes in personnel or ownership at firms.

Most of the 77 managers of the trust company's and Frimco's funds seem to appreciate Russell's expertise. Russell took money away from Lincoln Capital in early 1990 when its manager analysts presaged the end of a long run in the large-cap growth stocks that Lincoln managed for Russell. Yet Lincoln president J. Parker Hall III, whose firm runs roughly $520 million in equity for Russell funds, today rates Russell the best and most thoughtful manager-of-managers. He says of the 1990 episode: "They bought assets that had not done well and sold those that had. You need internal fortitude to do that. A lot of consultants just give money to the manager that is doing the best." Declares Paul von Kuster, a small-cap manager at Peregrine Capital Management, "Russell is the most sophisticated client we have."

Money managers don't seem to mind competing head-to-head with Russell any more than with any other money manager. Perhaps one reason is that in a number of cases, Russell is also one of their biggest clients. "The day and age when everything was compartmentalized was gone 20 years ago," says Wellington's McFarland. "We have lost business [to Russell], but we've also gained it." Mary Rudie Barneby, president of United Asset Management Corp.'s Regis Retirement Plan Services, once recommended that one of her hot prospects stick with Russell. "A number of UAM managers, including Sirach Capital Management and Cambiar Investors, handle some Russell funds," she says. "Russell offers great diversification through great managers. Their pricing is incredible. They are a gift to the market."

Russell's pricing can be low indeed. At the trust company in particular, pushy volume buyers may wangle deep discounts. Fees officially range from a high of 1.65 percent on emerging-markets equities down to 25 basis points on a Russell equity index fund. But some clients get away with much less. The Town of Greenwich, Connecticut, pays less than 60 basis points on $205 million invested 58 percent in equities and 42 percent in bonds and real estate. Countrymark Co-operative, a regional farm co-op in Indianapolis, pays about 50 basis points on $250 million invested through several 401(k) savings and pension plans, says benefits manager Joseph Worley. And those fees cover consulting, client conferences, investment management, trusteeship and custody. However, few of the trust company's clients are big enough to cut such sweet deals; only 24, less than 10 percent, have accounts of $100 million or more.

Russell pressures managers far more often than clients pressure Russell. The firm can drive a hard bargain with subadvisers because it places a huge volume with them — through both Frimco and the trust company. For big managers, combined accounts from Russell can easily run into the billions of dollars. Thus Frimco and the trust company reportedly pay as little as 20 basis points to some big active equity managers. Russell is loath to confirm it. "[Publishing subadvisory fees] would work against us in negotiating," explains Anderson. (Although the SEC ordered Frimco in April to break out subadvisory fees, it was allowed to do so on a collective rather than firm-to-firm basis.)

Applying the pressure is smart strategy. Russell's gross operating margins on money management are perhaps 25 basis points, or about $56 million. The firm nets about 15 percent of total investment management revenues, or $23 million. "Our margins are lower than those of a traditional money manager," allows CEO Phillips. "Every time we hire a manager, we have to pay a large component of what we get to them. So we don't have

the same incremental gains as others in this business. But while we have higher variable costs, we have lower fixed costs — so where margins for traditional managers go down in a bad market, ours don't fall as much." Margins matter. "We don't want to reach $100 billion in size with no margins," Phillips says.

Russell's fees, attractive though they may be, are hardly its deal clinchers. The firm's money management clients repeatedly refer to it in terms such as "top drawer" and "cutting edge." Clients prize Russell for diversification and for performance. The Town of Greenwich, which has its entire defined-benefit plan with Russell, has seen it grow by 13.6 percent a year since 1984. "They have given us one heck of an edge, and they have lowered volatility," says Jack Welch, who manages employee benefits for Greenwich. Says Lanny Michael, treasurer of Airborne Freight Corp.: "We have been with Russell since 1987 and have a little more than $100 million with them. We would not have stayed if they had not met our performance goals."

Other clients are captivated by different Russell attributes. Crawford & Co., the nation's largest insurance claims adjuster, was sold on the firm by its willingness to build two custom offerings from six of its commingled funds, providing employees in Crawford's $90 million defined-benefit plan with access to 33 top-notch equity and fixed-income managers. Says Douglas Mure, benefits administrator at the construction firm Perini Corp.: "Over time, performance is very stable. It's better than average in good times and bad. Three years ago we took a serious look at [companies like] Fidelity Investments, Putnam Investments and Scudder, Stevens & Clark, but their performance just wasn't as good."

Russell's mostly small and midsize pension clients are high on its service and education. "We liked their willingness to come to our remote locations for no extra charge and lecture our associates," says Gregory Stevenson, treasurer of Services Group of America, a food distribution and insurance company with a modest defined-contribution plan. Russell's "education program is the best thing we've done," says Countrymark's Worley. "Frank Russell went with us to 59 locations. It raised the level of interest in our 401(k), and we got 93 percent initial enrollment. We've gotten letters from employees thanking us." Early last year Worley switched his co-op's defined-benefit as well as defined-contribution business to Frank Russell after considering Merrill Lynch & Co. and SEI, among others.

Russell's operating principle is that intensive client service provides sales support. "Our objective is to get a partial assignment and then to get the whole plan," explains client-service head Kelly Haughton. "I can think of several relationships where we started with a special assignment and ended up being the manager for the whole fund."

Some large companies, among them Kaiser Aluminum & Chemical Corp. and the U.S. subsidiary of Canada's Moore Corp., have turned over virtually all of their pension and defined-contribution business to Russell. In 1992 a search for diversification and better service led Kaiser to switch a $125 million defined-contribution plan to Russell from Dodge & Cox, a San Francisco adviser that also manages equities for three Russell funds.

"Russell was successful right from the start," says Norman van Patten, the former Kaiser pension officer who was able to cut his hours to half-time as a result. "We began to look more carefully at performance and to wonder why we couldn't duplicate the program in defined benefits, too. There, we had $600 million and 11 managers. We realized that if we were to invest with Russell, with the same allocation, we'd do better. To replicate Russell's funds, Kaiser would have to hire 32 managers." Last year Kaiser moved most of its defined-benefit plan — everything except real estate and special investments — to Russell. Performance has improved, and Kaiser was able to cut costs across the board.

A Frank Russell sampler

Most of Frank Russell Trust Co.'s domestic equity funds have outperformed their benchmarks, as have the fixed-income funds. Here's a look at some commingled funds' performance (before fees).

Fund / Benchmark	Total return period ended 9/29/95: 12 mos.	3 yrs.	5 yrs.
Equity I Fund	29.96%	18.20%	20.44%
S&P 500 index	29.81	14.99	17.25
Equity II Fund	25.37	19.13	23.27
Russell 2000 index	23.37	19.03	21.66
Growth Fund	33.56	15.38	NA
Russell 1000 growth index	32.19	14.03	
Value Fund	24.73	17.92	NA
Russell 1000 value index	27.69	16.71	
Equity I Special Fund	26.09	18.58	19.32
Russell 3000 index	29.31	15.62	18.27
International Fund	4.84	13.82	9.83
Salomon Brothers BMI ex-U.S.	6.14	13.18	10.34
Fixed Income I Fund	14.17	7.47	10.47
Lehman Brothers aggregate bond index	14.06	6.68	9.63

Source: Frank Russell Co.

George Russell, Mike Phillips and Lynn Anderson all believe that many more companies like Kaiser are in the market for such outsourcing services. Competitors agree. "Growth prospects are very bright," says Carmen Romeo, the head of SEI's competing $4.5 billion multimanager mutual fund group. "This is not pegged to [the sluggish] retail segment. Most institutional and high-net-worth investors feel frustrated with the business today and want someone to take over and give them a solution." Michael Caccese, a former Russell general counsel who is now at the Association for Investment Management and Research, predicts that "Frank Russell will be $50 billion by the next decade, and a lot of that growth will be in the trust company from pension funds like United Air Lines, for which Frank Russell does private-label work."

The perception of many in the market that Russell's money management effort constitutes a conflict of interest with its pension consulting could be a snag to the stepped-up marketing push. "Russell's motivation [in going into money man-

agement] was the finite returns from consulting," says one investment banker. "There is absolutely a conflict of interest here."

Russell is acutely aware of the conflict contretemps (*Institutional Investor*, May 1994). Although the trust company and Frimco do use research provided by the firm's pension consultants, Russell has attempted to build a Chinese wall between its two key businesses, much in the way that J.P. Morgan and Morgan Stanley & Co. have separated money management from investment banking. Frank Russell's money management units are contained by separate companies. Russell also scrupulously avoids peddling money management to its consulting clients. General Motors' defined-benefit plan couldn't buy the trust company's products unless *it* requested them (although the nonclient GM defined-contribution plan could).

"The client base is completely different," swears CEO Phillips. "We have a very limited list of very large consulting clients, and we don't sell trust company or Frimco funds to them. Further, with the exception of cash, we do not manage money ourselves. The management community doesn't lose anything by our activity."

Alfred (Pete) Morley, a former Russell investment company president who is now a consultant, agrees with this assessment. "Once clients have understood that the conflict is not a reality," he says, "Frank Russell has never lost a customer." Just the same, Morley and others caution that Russell will have to work harder to combat the perception of conflict if it intends to nurture money management as a cash cow.

Russell has had little trouble selling its commingled fund concept outside the U.S., to small, midsize and large companies' pension funds alike. A separate Frank Russell unit, Frank Russell Investment Co. plc, has since early last year offered five funds (four equity, one fixed income) based in Dublin and the Cayman Islands. The clients all come from outside Russell's pension consulting client base. (The firm has 106 foreign pension clients — 44 in Europe, 11 in Japan, 20 in Australia and Asia and 31 in Canada). In that short time, 30 clients have invested $1.1 billion in Russell's commingled funds outside the U.S. Indeed, Russell is counting on foreign institutional investors' mounting interest in going global to meet a significant chunk — as much as 25 percent — of its millennial goal of $75 billion under management. For the time being, Russell has no designs on selling mutual funds abroad.

Whichever the market, the U.S. or abroad, Russell must jack up its low marketing profile. "We have not been successful enough in telling the world about our money management capability," grants Phillips. "There are some 13,000 [U.S.] pension plans, and 10 percent make some investment changes each year. So if we were saturating the market, we'd be making 1,000 final presentations a year." That's not easy to do with just six salespeople nationwide for the trust company and eight for Frimco. The trust company is in fact beefing up its scrawny sales force. "We have to work on marketing, advertising, image," proclaims trust sales manager Brian Barker. But how ambitiously the firm will move on the marketing front is deemed to be proprietary.

George Russell is correct: By rights, Frank Russell *should*

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have more money under management. Since the end of 1993, the trust has raised $2.7 billion in net new assets, giving it an annualized growth rate of 13.4 percent. That doesn't sound so bad in comparison with the sluggish, 9 percent growth rate of the defined-benefits market. This putatively moribund segment provides more than half of Russell's new business. But considering that nearly 40 percent of the trust's assets come from the burgeoning defined-contribution market, Russell ought to be growing faster.

Admittedly, competition for the defined-contribution trade is stiff. Moreover, this is one market in which performance has never been a decisive tipping factor in vendor selection, although as the market matures, it may become more of one. "Our most frequent competitors in this area," notes sales chief Barker, "are Fidelity Investments, T. Rowe Price Associates, Vanguard Group." None is exactly a marketing slouch. The trust company may offer clients with as little as $15 million in their coffers a series of funds featuring stellar managers and consistent performance of the sort only plans with $250 million or more could ordinarily hope to duplicate. By design, Russell can't ever shoot the lights out. Yet the trust company "is a great, sexy story," asserts AIMR's Caccese. "Frank Russell gets consistent second-quartile performance. And [yet] selling that story against Fidelity's or Vanguard's superfund-of-the-month is tough."

At Frimco the marketing challenge is more daunting — and big changes are imminent, says CEO Anderson. He won't, however, say precisely what they'll be. Presumably, the impending ad campaign is a preamble to a much-needed shift in distribution strategy to a more direct, retail approach. As it is, nearly 60 percent of Frimco's assets are sold through bank trust departments ($4.25 billion worth), and as more and more banks combine, this channel becomes less and less dependable for wholesale distribution. Frimco has relied predominantly on 25 midsize regional banks, the very ones most susceptible to takeover. The other 40 percent of Frimco's business has been generated by a small set of 35 financial adviser firms, to which Russell has been reluctant to add; it wants only the most sophisticated financial advisers. And so far the company has been oblivious to what would seem to be logical distribution alternatives, particularly developing the direct-sales segment, available through discount brokers like Charles Schwab & Co. "Do we think our position is vulnerable?" he says noncommittally. "Yes, but we don't want to create channel conflict."

This strategy may prove to be overly cautious. "Frimco is missing a whole market," says East Greenwich, Rhode Island, mutual fund consultant Geoff Bobroff. And it's one that the firm is particularly well positioned to exploit. "By the end of the decade, most mutual funds will be sold in some kind of multimanager mechanism," argues Bobroff, "either through fee-based advisers or, for techies, through on-line software." Proclaims CEO Phillips: "We're going to make [the $75 billion goal]. We have a proposition whose time has come."

That may well be, but even a better mousetrap has to be pitched to customers. ii

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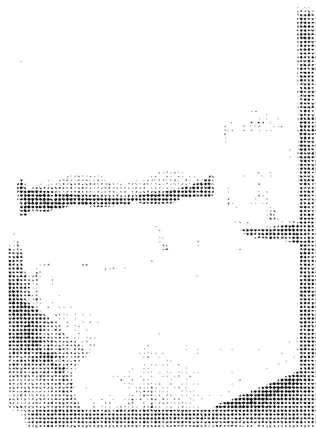

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