

SPECIAL REPORT
MONEY MANAGEMENT



Fidelity gets Serious

By Virginia Munger Kahn

THE RETAIL GIANT HAS NEVER BEEN A MAJOR PLAYER IN INSTITUTIONAL ASSET MANAGEMENT. ITS PYRAMIS UNIT IS SUPPOSED TO CHANGE THAT.

PHOTOGRAPHS BY JASON GROW

Kevin Uebelein, Pyramis's just-named CEO, is one of several new executives. Some clients say they'll give the new team time, but they have found the departure of veterans unsettling



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THREE YEARS AGO THE TOP BRASS AT FIDELITY INVESTMENTS decided it was high time they got to work on their institutional asset management arm. Stock markets were booming, and rival institutional money managers were growing at double-digit annual rates, but the 800-pound gorilla of the U.S. retail fund business remained a marginal player in the pension business. Fidelity had managed such funds since 1964, and in 1981 it had created a dedicated institutional sales and marketing unit. But, by its own admission, the company had never given the business the attention it needed. Portfolio managers ran institutional funds side by side with retail funds. The freewheeling stock-picking style favored by Peter Lynch, the renowned former portfolio manager of Fidelity Magellan Fund, wowed small investors but unnerved corporate pension fund CIOs, who crave predictability. Fidelity also lacked the alternative-investment products that were becoming the rage. And the company suffered from a reputation for high manager turnover and indifference to its biggest customers.

By the end of 2004, Fidelity had \$102.3 billion in institutional assets separate from its huge retail 401 (k) business. That was relatively paltry compared with the assets of competitors like BlackRock, which had \$341.6 billion under management at the time, or Pacific Investment Management Co., which had \$445.7 billion. "It's fair to say that the institutional business was not growing as fast as we wanted," says Robert Reynolds, the former Fidelity vice chairman and chief operating officer who is set this July to become president and CEO of rival Putnam Investments.

In May 2005, Reynolds and Fidelity CEO Edward (Ned) Johnson III responded with a sweeping reorganization. They carved out a new company exclusively dedicated to institutional business. It would manage equity and real estate investments itself, but its fixed-income assets would continue to be managed by Fidelity. They gave the stand-alone entity, dubbed Pyramis Global Advisors, a new home — in Rhode Island — sufficiently far from Fidelity's 82 Devonshire Street address in Boston to bolster its independence. Pyramis hired an impressive lineup of executives, portfolio managers, analysts and traders, aiming to develop alternative strategies and products and provide institutional investors with more-stable investment management.

"It's an impressive buildout in terms of the speed and quality of the people they're bringing on board," says Dan Lefkowitz, who followed Fidelity for Morningstar until mid-February, when he became the research and data firm's head of European mutual fund research. But changes at the top at Pyramis have been unsettling. In the most recent

move, last month Pyramis named Kevin Uebelein, the former chief investment officer for Prudential Financial's international business, as its new president and CEO. Rodger Lawson, president since last July of Fidelity Investments, had previously been Uebelein's boss as vice chairman of Prudential Financial. Uebelein will report to Michael Wilens, another new hire, who is Fidelity Investments' head of asset management. Uebelein says his long-term goal is to make Pyramis an international competitor.

"The opportunity in institutional asset management is really global," he notes. "Both Ned and Rodger want Pyramis to be a global company."

Uebelein inherits an operation whose efforts have met with mixed success. Assets grew at a compound annual rate of 21.3 percent between June 30, 2005, and December 31, 2007, to \$164 billion, according to Rogerscasey, a Darien, Connecticut-based institutional investment consulting firm. That compares favorably with the growth rates of its bigger competitors, most of which saw assets compound annually by 15 to 20 percent. Pyramis's assets, however, subsequently declined to \$157 billion under management at the end of the first quarter. Like other firms, it must contend with market turmoil that has broadsided its most successful strategies, including its Large Cap Core 130/30 strategy, which lost 15.5 percent in the first quarter, and its U.S. Equity Market Neutral strategy, which lost 7.88 percent. (Pyramis's institutional fixed-income strategies, managed by Fidelity, were also hit during the first quarter.) Meanwhile, Pyramis has yet to grab much of a slice of the lucrative and growing alternative-investment market. Last year, according to *Institutional Investor's* ranking of the 300 largest U.S. asset managers, alternatives like hedge funds, private equity and real estate made up the fastest-growing asset class, increasing \$600 billion, to \$1.9 trillion (see page 70). Just \$4 billion, or 2.5 percent, of Pyramis's assets is in alternative strategies.

Still, there appears to be no lack of confidence among the company's leaders. "Over the next five years, we expect to see assets rise to two or three times their current level," says Fidelity president Lawson. "We expect to see Pyramis grow faster than the rest of the company."

"I don't think the market has an appreciation yet for what they're doing," says Kevin Quirk, a partner at management consulting firm Casey Quirk in Darien, which has worked with Fidelity. "The market has a historic view of Fidelity: that it is a mutual fund company first and a company that works for institutions second. It is incumbent on Pyramis's management to be very aggressive in communicating what they can do for clients now."

Fidelity's hopes are on display at a 500-acre campus in Smithfield, Rhode Island, about an hour's drive south of Boston, where a new \$200 million, 577,000-square-foot building that will house the Pyramis headquarters is nearing completion. The glass, brick and limestone edifice will feature a trading platform at the hub of an open space the size of a football field — the brainchild of CIO Young Chin. "When you look at that space, you'll see energy, passion and teamwork," says Chin. "You'll see how Fidelity has devoted all the necessary resources to building a world-class institutional asset management firm in a manner that only Fidelity can do."

Pyramis now employs 142 investment professionals and is opening offices — its first overseas — in London and Hong Kong to house additional research analysts. (The firm plans eventually to have eight in London and ten in Hong Kong.) Among the key hires were Chin, a former president and CEO of Gartmore Global Investments; Mark Friebel, Barclays Global Investors' former head of asset allo-



Mark Friebel (left), formerly Barclays Global Investors' head of asset allocation and life-cycle funds, now runs Pyramis's life-cycle unit. Young Chin has been Pyramis's chief investment officer since 2006. He designed the open floor plan for the company's new headquarters, currently under construction in Smithfield, Rhode Island

cation and life-cycle funds, who now handles Pyramis's life-cycle products; and 12 new investment managers.

Uebelein replaces recently retired CEO Peter Smail, who had been tapped to run the firm in 2005 by Fidelity chief Johnson. Smail announced his plans this January. Then in February, Drew Lawton, a Smail protégé and president of Pyramis Global Advisors Trust, the sales and marketing arm of the firm, announced his resignation effective at the end of that month. In April, Pyramis hired Patrick Mc Nelis, the former head of institutional advisory services for Principal Global Investors, to take Lawton's place as executive vice president for global sales and distribution. The announcements were part of a slew of resignations and retirements of Fidelity executives in the past year. Many were associated with COO Reynolds, who retired in April 2007. Smail had worked for Reynolds for almost 18 years and joined Pyramis after heading Fidelity's 401 (k) and corporate outsourcing businesses. Of his decision to retire, Smail says: "I felt the timing would be good for me. I'm trying to get a better balance between work and my family."

Some clients are wary of the changes. "Bob Reynolds and Peter Smail are people we have come to identify with Fidelity," says Michael Travaglini, executive director of Massachusetts' Pension Reserves Investment Management Board, a longtime Fidelity client. "We never like it when senior executives whom we like leave an organization. But we will give the company time."

"WE DID THIS TO DEDICATE RESOURCES TO THE MARKET so we could do a better job for our institutional clients," says Smail of Pyramis's launch. "The heart of the decision was about market focus and specialization."

When Smail walked into the fledgling institutional firm's temporary headquarters at 53 State Street in Boston in July 2005, his first task was picking a name. After a few weeks — and with the help of Fidelity's corporate communications staff — he settled on

"Pyramis," an allusion to Fidelity's pyramid logo.

Just as important was choosing a CIO. Smail recruited Chin in March 2006 in a move that was considered a major blow to Gartmore. In his five years at Gartmore, Chin had built a fundamental and quantitative investment management process and a long-short capability for the firm. "The quantitative book at the company, which had been nonexistent in 2002, is now a \$3 billion business for Gartmore," says Paul Hondros, the former Gartmore Group CEO (and former Fidelity marketing executive) who had hired Chin. "There are not many people Fidelity could have recruited with his skills on the quantitative and client-service side of the business and his experience in building products that Fidelity is interested in developing."

Before Pyramis's creation, with Fidelity managing both the institutional assets and its \$1 trillion in retail assets, the needs of the latter overshadowed those of the former. Regulatory restraints on portfolio disclosure, shorting and other techniques not allowed under the Investment Company Act of 1940, which governs mutual funds, were an impediment to managing the portfolios in a more institutional manner, says former COO Reynolds. Meanwhile, derivatives, frowned upon by retail mutual fund investors, were playing an increasingly important role in institutional portfolios. With Pyramis, money managers who had been serving two masters at Fidelity could focus on institutional clients, and the new firm could develop alternative strategies. Also, some separation from Fidelity would help Pyramis create a culture of investment management stability.

Since his arrival at Pyramis, CIO Chin has worked to develop products aimed at the 401 (k) market. He has also focused on creating a suite of alternative products, such as market-neutral strategies, and on building the firm's long-only domestic and international equity offerings.

Chin created an investment strategy and asset allocation group under Mark Friebel, who had developed BGI's first life-cycle funds.

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“Our group was formed with a very broad mandate: to develop asset allocation as a cornerstone for the success of Pyramis,” says Friebel. “In looking at the market, we asked ourselves, ‘Where can we play to our strengths immediately?’” In the first quarter of 2007, Pyramis introduced three life-cycle commingled pools, the firm’s first. What makes the life-cycle offerings unique, Friebel says, is the combination of strategies underlying the pools. Unlike such competitors as BGI, which relies on quantitative and other techniques, or T. Rowe Price, which is an active manager, Pyramis offers a combination of quantitative, active and hybrid techniques. This diversified approach should provide more alpha and stability, Friebel asserts.

With margin pressure on traditional long-only equity products increasing and assets rising at half the rate of those in private equity and hedge funds, according to management consulting firm McKinsey & Co., alternative investments are critical to Pyramis’s future. Chin has focused on building long-short capabilities at the firm. Pyramis has hired 33 fundamental and quantitative analysts — in addition to the 350 Fidelity analysts worldwide it has access to — skilled in researching potential shorts as well as long investments.

Chin says Pyramis has no plans to launch hedge funds, preferring to concentrate on alternatives such as 130/30 strategies. “We don’t offer hedge funds,” he says. “What we offer are the processes, strategies and technology that hedge funds use. Our products are lower-volatility products. We are focused on absolute returns. Hedge funds are high-risk, leveraged products. Our products are designed to provide good absolute returns from diversified sources of performance.”

Chin has also built up the firm’s trading operations, hiring traders experienced in short-selling as well as in handling derivatives and systematic trading strategies. Pyramis’s desk, launched in July 2007, now employs seven traders and should expand to as many as a dozen under the direction of Michael McCauley, a Fidelity veteran who left the company in 2002 to become president of electronic brokerage firm Pulse Trading before returning as head of trading at Pyramis in 2005.

Much as he did at Gartmore, Chin is working with portfolio managers and analysts to expand their shorting skills. An encouraging example is the Large Cap Core 130/30 strategy, based on Pyramis’s successful Large Cap Core long-only strategy. The 130/30 strategy is designed to maintain style and sector weights similar to its Standard & Poor’s 500 index benchmark, while beating the benchmark by 400 basis points a year through stock selection. The strategy, with \$127 million in assets, performed superbly in 2007, returning 30.05 percent, 24.56 percentage points above the S&P 500, and ranking in the top 4 percent of the eVestment Alliance Extended U.S. 130/30 universe. Pyramis executives note that their offering is one of only a few fundamentals-based 130/30 strategies in the market, an advantage over rival quantitatively based strategies, which were battered last August.

Pyramis’s strategy got its comeuppance in the first quarter of 2008, however, when equity markets sold off broadly on fears of a U.S. recession, rising commodity prices and the continuing subprime crisis. Nonetheless, in the first four months of the year Pyramis attracted \$100 million from three new clients, including the \$5.3 billion

defined benefit plan sponsored by Richmond, Virginia, energy company Dominion Resources. Dominion assistant treasurer Donald Borneman was impressed by the combined analytical heft of Pyramis and Fidelity. “It’s hard to imagine someone can get an edge on these guys,” he says.

Chin is looking to leverage the long-short market-neutral record of Timothy Heffernan, who ran the U.S. equity market-neutral strategy for Fidelity for 17 years and now manages it for Pyramis. In his strategy, designed to provide returns 400 to 500 basis points above that of the three-month U.S. Treasury bill, long and short positions are managed to be neutral in regard to dollar, beta, market cap, style and sector exposure. “We are as pure market-neutral as anyone,” says Heffernan. “The strategy boils down to our ability to discriminate between the best and worst stocks in an industry sector.”

Heffernan and his team have racked up strong returns: Last year the strategy beat its benchmark by 20.36 percentage points. In the first quarter of this year, Pyramis closed the strategy to new investment when an existing client upped its financial commitment and assets surged above \$1 billion. The firm is rolling out a global version of Heffernan’s strategy in what is expected to be a series of new market-neutral offerings.

Chin has also worked to strengthen domestic equity offerings. Of the \$100 billion in equities managed by Pyramis, just \$24 billion is in U.S. stocks. Among the firm’s problematic offerings has been its large-cap growth strategy, with \$746 million in assets under management, which should be a market leader, given Fidelity’s historical focus on growth stocks. In 2007 it trailed its Russell 1000 index growth benchmark by 667 basis points, landing in the 99th percentile of its eVestment Alliance universe. Pyramis’s large-cap value offering, with more than \$2.2 billion in assets, ended up in the bottom quartile for returns for the one- and three-year periods ended December 31, 2007.

“In the past five years, I can’t think of one instance in which we have recommended one of their domestic equity offerings,” says Soon Yong Park, head of traditional manager research for RGC Research. “Their offerings just have not been as compelling in relation to their peers’.”

Says another consultant, who declined to speak for attribution: “The problem has been a revolving door of managers on the mutual fund side, which has reflected poorly on Pyramis. The investment strategies are a moving target. There’s just not a lot of consistency there.”

“Consultants perhaps have not heard the full story,” counters Chin. “Pyramis is intended to give focus, stability and consistency to our investment operations. We are looking to address those issues and to hold ourselves to an institutional standard.”

Indeed, Pyramis has taken on 12 new portfolio managers, eight of whom work on domestic equities. It has added capacity in the midcap growth sphere with hires like Daniel Crowe, who ran Dreyfus Founders Mid-Cap Growth Fund, the top-ranked U.S. fund for total return for the one-year period ended December 2006. And the firm has made changes in the management of its struggling large-cap growth strategy. Going forward, Pyramis can count on some important advantages. On the asset front, the firm’s \$76 bil-

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— Robert Reynolds
Former Fidelity COO





Pyramis portfolio manager Cesar Hernandez developed and oversees the firm's Select series of international equities funds, which have \$22 billion in total assets

lion in international equity strategies is a strong suit. "If you're going to have a trump card, this is the one to have," says Benjamin Phillips, head of strategic analysis at New York-based investment bank Putnam Lovell. "Long-only global equities are the most sought-after asset class by institutional investors around the world."

Some \$22 billion of these assets are in the firm's successful Select international strategies. These strategies pick stocks rated as attractive by Pyramis and Fidelity analysts worldwide; quantitative models are then used to match the regional weights of the portfolios to their benchmarks. Pyramis portfolio manager Cesar Hernandez developed the framework for the strategy in 1989 at Fidelity and continues to oversee the core group of offerings, including Select International, Select Global, Select Europe and Select Pacific. In 2001 he turned over management of Select Small Cap to Robert Feldman, who has compiled an outstanding record: Last year the strategy beat its benchmark by 11.43 percentage points.

Fidelity's fixed-income offerings have long been one of the company's strengths, representing one third of assets. When Johnson and Reynolds created Pyramis, they left management of the institutional fixed-income group with the corporate parent because of economies of scale. Fidelity's fixed-income operations remain organized around specific strategies in which teams manage both retail and institutional assets. The core investment-grade fixed-income strategy is sold as the Broad Market Duration commingled pool on the institutional side and as the Fidelity Investment Grade Bond mutual fund to retail clients.

But the firm's fixed-income offerings have been hit hard by problems that originated in the subprime mortgage market. The Broad Market Duration and Core Plus strategies, which account

for \$35 billion of the \$50 billion in institutional fixed-income assets under management, underperformed the Lehman Brothers U.S. aggregate index by 167 and 253 basis points, respectively, in 2007. But sales remain steady: Fidelity attracted \$5 billion in fixed-income assets last year, about equal to the amount in 2006, and it has added \$2 billion in assets so far in 2008.

INSTITUTIONAL INVESTORS ARE TAKING notice of Pyramis's efforts. Through the first four months of this year, the firm won commitments of \$5 billion in new mandates and is in discussions on an additional \$10 billion. Among the firm's big wins is a new \$600 million active international equity mandate from the Massachusetts PRIM Board, which manages \$50 billion in retirement assets for state employees and teachers. The mandate had formerly been managed by local rivals State Street Global Advisors and Boston Co.

The firm has made notable progress in the defined-contribution-plan market, where it is selling its new life-cycle commingled pools to large-plan sponsors. Among the \$6 billion Pyramis has gathered in its life-cycle offerings are assets from the \$20 billion 401(k) plan of General Motors Corp., a longtime Fidelity client. In March 2007, GM switched out of Fidelity's life-cycle mutual funds and into Pyramis's commingled pools. Does that constitute cannibal-

izing Fidelity's mutual fund sales? Not according to former CEO Smail. "If the customer wants institutional products, it will get them from somebody else if we don't offer them," he says.

But Pyramis needs to do more to meet institutional investors' demand for long-duration strategies. And although the firm is making progress in creating alternative strategies, the \$4 billion business remains small compared with JPMorgan Asset Management's \$84.7 billion in alternatives or Goldman Sachs Asset Management's \$95.6 billion. Some investment consultants remain skeptical as to whether Pyramis can train its long-only equity managers to short stocks with the same skill as managers with longer track records. "They need to prove to the marketplace that they are not a work in progress," says Rogerscasey's Park.

The firm also faces internal challenges. The move to Smithfield, a long drive from the suburbs of Boston, where many Pyramis employees live, and the open floor plan designed by Chin are not universally applauded. "The move will narrow the field of people interested in working for Pyramis," says one executive recruiter. But former CEO Smail disputes the notion that the Rhode Island location is an issue: "We've had absolutely no problem recruiting people."

Smail is confident that the firm he named is well positioned for growth. "We start from a tremendous position of strength. We have the largest 401(k) business, one of the largest DB businesses, and we have an enormous client base," he says.

He's not alone in his confidence. "They have a lot of advantages: client relationships, research horsepower, and they're very good at execution," says Gregory Allen, president of investment consulting firm Callan Associates. "I would be flabbergasted if they weren't successful." ●●