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Morgan-Wachovia Combo May Yield Weak Fund Giant

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A possible merger of **Morgan Stanley** and **Wachovia** would create, among other things, an asset management giant, but one that would need extensive pruning if it were to compete with the fund industry's top firms, analysts say.

Morgan Stanley has been scrambling to raise capital to avoid becoming the next victim of an unrelenting credit crisis that decimated its stock last week. Even as shares rebounded Friday on the heels of an **SEC**-led moratorium on shorting, Wachovia remains a likely buyer and preliminary talks have been initiated.

Over the weekend, however, the Federal Reserve agreed to let Morgan Stanley and **Goldman Sachs** convert into traditional bank holding companies. That is likely to suspend the Wachovia merger talks for the time being.

The prized possession of Morgan Stanley is clearly its army of financial advisors — 8,500 strong, with annualized revenue per FA of \$741,000 — and their well-heeled clientele, but any merger between the two cash-constrained institutions would also create a powerful asset management combination.

Wachovia owns Boston-based mutual fund firm **Evergreen Investments**, which has \$246 billion in assets under management, while Morgan Stanley Investment Management, including **Van Kampen**, has \$570 billion. With more than \$800 billion in assets put together, a deal would catapult the combined entity's fund business to a new level among the nation's largest fund managers.

Morgan Stanley and Van Kampen retail mutual fund assets stand at \$227 billion, whereas Evergreen mutual funds account for \$120 billion of the firm's total assets.

A source familiar with the matter says Morgan Stanley isn't ruling anything out at this point, including remaining independent. In addition to having conversations with Wachovia, the firm has approached **China Investment Corporation**, which owns an estimated 10% stake in Morgan Stanley, about a possible deal.

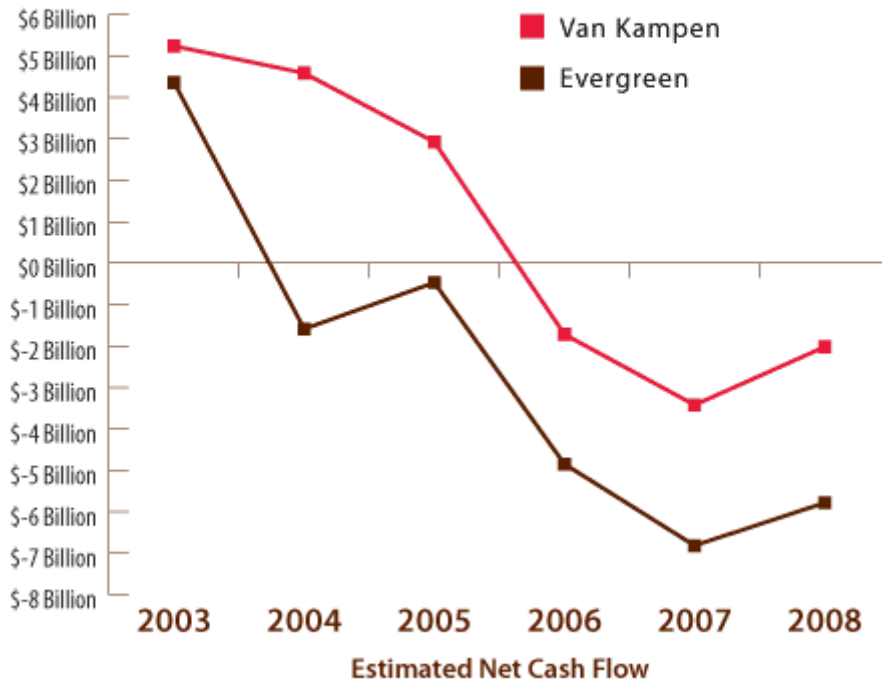
A Morgan Stanley spokeswoman declined to comment on the negotiations or the structuring of any potential deals, as did a Wachovia spokeswoman.

Since any deal would be more about shoring up the balance sheet than a strategic union, the marriage between the two fund families is less than ideal. Both retail mutual fund shops — Evergreen and Van Kampen — have struggled with subpar performance and sluggish sales. And analysts say blending the two fund complexes would require a lot of heavy lifting.

"There seems to be a lot of redundancy in their mutual fund lineups," says Scott Smith, senior analyst at **Cerulli Associates**. "They would have to merge or fold poor performers out of existence and create a better, smaller fund lineup. Although from a business standpoint, it works well in that it creates more ongoing revenue."

Seeing Red

Estimated net cash flows for Evergreen and Van Kampen have taken a nosedive over the past five years.



Source: Morningstar data through 8/31/2008.

Still, a sweeping rationalization of its funds would allow the combined entity to keep its best portfolio managers as well as sales talent. "By being able to choose their best performers on each side of the business, they'd be creating a deep and talented bench," Smith says.

With **Merrill Lynch, Citigroup** and a spate of other regional banks unloading their asset management businesses in the last few years to focus on core businesses and mitigate conflicts, dialing up the number of in-house funds isn't much of a competitive advantage.

"I don't think giant proprietary distribution is the play here," says Lisa Cohen, president of **Momentum Partners**. "It doesn't result in a net gain for investors." However, she sees plenty of upside if the integration were carefully managed. "There would have to be a very aggressive, creative and deliberate product rationalization in order for the combined fund lineup to achieve a leadership position." A leaner, more muscular fund lineup with lower fees and better funds would help shed the perception of these firms as purely distribution organizations.

However, the specter of duplicative offerings could prompt Morgan Stanley to sell off its asset management altogether if a Wachovia acquisition took place. That would alleviate the headache of trying to streamline two mediocre, similar fund lineups.

Only 35% of Van Kampen's funds are in the top half of their **Morningstar** fund categories over the three-year period ending Aug. 31, 2008. Evergreen isn't much better with 37% in the top half. **Janus**, which is about the same size in terms of long-term assets as the combined firms, boasts 76% of its funds in the top half of their respective categories. The two firms have combined for nearly \$25 billion in outflows since the end of 2005, according to Morningstar.

Still, Van Kampen has a handful of strong portfolio manager teams that Wachovia might find attractive. Jim Gilligan, Bob Baker, Dennis Lynch and Hassan Elmasry each have a solid track record in various disciplines. The question is, are they going to be able to keep those teams in place if the firm gets bought out by a bank conglomerate like Wachovia?

"At Van Kampen, there are some great portfolio manager teams on the equity side, but there are so many funds that have not done so well that they would get lost in the shuffle," says Karen Dolan, director of fund analysis at Morningstar. "It would be a pretty big mess to put together."

Historically, bank-run mutual fund complexes have not performed well due to the heavy emphasis on sales and distribution. "They have trouble attracting and retaining talent because of that," Dolan says. "It eats up resources that could otherwise be spent on investment management."

The tendency among these conglomerates is to push products through their captive sales forces. By pairing up these two companies, you're creating an even larger proprietary fund lineup, she adds. "That hasn't worked in the past and there's no indication that it's going to start working now."