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The functional and spatial structure of the investment management industry

Gordon L. Clark

School of Geography, University of Oxford, Oxford OX1 3TB, UK

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Abstract

Most pension funds use an extensive array of service providers to administer and manage their financial assets. In this paper, I sketch a 'map' of the functional structure of service provision and the apparent spatial configuration of those elements. Theoretically, the paper could be thought inspired by Richardson, Coase and Williamson, but goes on to consider three substantive issues particular to pension fund management: uncertainty, trustees' fiduciary duty, and managing within cost constraints. While it is apparent that service providers are allocated assets to manage on the basis of their relative costs and performance, it is also argued that the pattern of service provision in the industry reflects an on-going and unresolved tension between the economics of distrust (implying short-term contracts) and the virtues of commitment (implying long-term relationships). As part of this argument, I consider the role and responsibilities of consultants and advisers to pension fund trustees. Having established four basic models which describe the principal ways of managing the investment process, the paper then deals with the spatial and network related implications of these models. The paper draws upon recent research on pension fund investment in the US, Canada, the UK, and Australia reported in previous papers. © 2000 Elsevier Science Ltd. All rights reserved.

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1. Introduction

It is widely recognised that pension funds are major players in global financial markets. It is also recognised that Anglo-American pension funds, in particular, are essential to the rapidly growing international investment management industry which involves firms such as J.P. Morgan, State Street Bank of Boston and Schroders as well as less well-known national and regional service firms. Useful discussions of the development of the international and national money management industries, including reference to both the retail (mutual funds and the like) and wholesale (pension funds) sectors of the industry, can be found in Lakonishok et al. (1992) and Pryke (1994). At the same time, the determinants of the structure and pattern of relationships between pension funds and their service providers are less well understood. At issue here is the scope and logic of funds' delegation of managerial responsibility to external service providers as well as the resulting geographical configuration of the industry.

E-mail address: gordon.clark@geog.ox.ac.uk (G.L. Clark).

The Anglo-American pension fund industry is remarkably concentrated on both sides of the industry. In the US and Canada, the UK and Australia, a relatively small proportion of big pension funds dominate the flow of funds; in the US, the largest 200 funds dominate the structure of the industry notwithstanding the fact that there are many, many thousands of very small funds with fewer than 10 participants. On the other side of the equation, a relatively small number of large international and domestic investment managers dominate the provision of services in each country notwithstanding the fact that there are many small specialised and not so specialised investment firms that co-exist with the global and national firms in these markets.[1] In effect, large

[1] In their survey of the international funds management industry Pensions and Investments (7 July 1997, pp. 18–19), the industry newspaper, reported that the top 300 money managers in the world held $21.2 trillion in assets and although these managers are spread around the world, more than two-thirds of all assets are managed by firms from just three countries: the US, Japan and the UK (in that order). Recent mergers have concentrated further the control of pension fund assets notwithstanding doubts raised by plan beneficiaries, consultants and managers about the efficiency of such concentration for investment performance.

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pension plans and their service providers sustain the national and international financial service industries of London, New York, Toronto, and Melbourne and Sydney even if contracted services are provided to pension funds and their beneficiaries at their 'home' addresses (see Clark et al., 1996 on the origins and structure of the Australian pension fund industry).

Explanations of the apparent structure of the industry typically invoke two variables: scale economies and agglomeration economies (two variables which are at the core of Krugman (1991) economic geography). So, for example, the former provide a rationale whereby pension fund assets are allocated to competing investment managers while the latter provide a rationale for the clustering of investment managers close together in specific financial trading centres around the world (see Houthakker and Williamson, 1996). In combination, these two variables may be thought to 'explain' the functional and spatial concentration of the investment management industry. But appearances are deceiving – all that is 'explained' is the *state* of the industry not the structure of transactions and the *flow* of assets that, together, drive competition in the industry. These two variables are also silent about a variety of crucial issues including the decision to delegate (or out-source) asset management; the decision about how many external managers to employ (*intensive* as opposed to *extensive* delegation); and the decision to switch assets between managers. Understanding the logic and determinants of these decisions in relation to the functional structure of the industry is essential if we are to appreciate the significance of pension funds in the dynamic world of regional and urban economic development.

The paper begins with the functional structure of the Anglo-American investment management industry. Based upon industry sources and interviews in the US, and Canada, the UK and Australia over the past five years, the flow of services are generally sketched and crucial relationships within and between funds identified. My research strategy is explained in Clark (1998a). Its empirical logic was first set out in Clark et al. (1996). This is the basis for a summary set of problems or patterns to be explained in subsequent sections of the paper. For the purposes of analysis, four models or types of pension funds are used to work through the logic for and against delegation, and for and against alternate forms of delegation. The analysis reveals important limits to claims made for the explanatory powers of scale economies and agglomeration economies as important components funds' of delegation and switching decisions. Implications are then drawn for the spatial and functional structure of the industry.

My analysis yields three important conclusions. First, any generalised claims made about the spatial configuration of Anglo-American pension fund systems must be sensitive to the particular model of delegation that underpins the functional arrangement of a pension fund. To imagine that the institutional structure of investment management and services is the same for all funds runs the risk of ignoring substantial differences between models of management. Second, the reliance of many funds upon consultants as the nexus between internal decision making and external service provision presumes the existence of highly developed markets for financial services. Inevitably, these markets are in the most important regional, national and international financial centres. Third, the reliance of some funds upon internal managers presumes the existence of stable employment relations, and a form of insulation from the apparent benefits (to employees) of being close to the major markets for investment managers. Sustaining such employment relations is a difficult task, especially in situations where expertise is vital to sustain fund performance. Ultimately, I am sceptical of arguments that suggest funds can remain decentralised (local) in relation to the (centralised) markets for financial services and labour.

As indicated, the paper begins with the functional structure of the industry and then discusses its spatial structure. It might be argued that the priority assigned to functional logic is at the expense of its spatial structure and that a better analytical strategy would be to begin with the 'home' locations of the funds themselves and then articulate the functional structure of the industry at large. This is the type of analytical strategy preferred by Graves (1998), Green (1995) and Martin and Minns (1995). If the industry was 'local' 50 years ago, reflecting a settled corporate and public geography of pension plan provision, in all Anglo-American countries national regulatory regimes now dominate the financial landscape just as national and international financial firms dominate industry. The industry has changed remarkably over the last 20 years, becoming dominated by sets of transactions between institutions and markets rather than remaining sets of independent self-sufficient organisations. In this sense, the functional structure of transactions (services in general) tends to dominate the geography of finance. At the same time, it should be acknowledged that there is no settled functional arrangement or model of transactions. Not surprisingly it is difficult to read-off from the functional logic a settled spatial configuration of pension fund capitalism. This point is noted again in the conclusion.

2. Structure of the industry

The pension fund industry is now the largest single source of savings in Anglo-American economies. In an era in which first-order financial intermediaries (banks) are of declining relative significance for managing personal assets and mobilising capital, pension funds and

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