Strategic Directions in Investment Banking

-- **A Retrospective Analysis**

by

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May you live in interesting times!

(Ancient Chinese curse)

Few businesses have ever benefited, as the U.S. securities industry did, from the almost continuous eighteen-year economic and financial tailwind that occurred from 1981-1999. At a time when world and United States GDP increased at a compound (nominal) rate of 7%, U.S. and world equity market capitalization and trading volume all increased at about twice that rate. The worldwide volume of new issues of equity securities increased at 19% and debt securities at 25%. The volume of worldwide mergers and acquisitions also increased by more than 25% per annum during the period. During this time also, commercial banks, under pressure from bad loans and mismanagement and subject to intense competition, gave up vast amounts of deposits and assets to the securities market in a massive display of disintermediation.

In such buoyant market conditions, it would seem to be difficult for any of the handful of American investment banks that specialized in capital market services to do poorly. In fact, however, the burden of managing such rapid growth effectively was a great one, and not all firms fared well. Indeed, for many once-great firms, the opposite was true. Drexel Burnham went bankrupt and Kidder Peabody was subject to a distress sale. So was First Boston, a casualty of bridge loans in the late 1980s that had to be reclaimed by its principal stockholder, Credit Suisse. Lehman Brothers and Smith Barney, then ailing, were sold, and reshuffled several times (in Lehman's case, back to the public in 1994). Salomon Brothers, wounded from its illegal actions in the Treasury

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bond auction market in 1990, never fully recovered and was sold to a division of The Travelers Group. A number of other US firms that were generally thought unable to keep up with competition, including Dillon Read, Chase Manhattan, JP Morgan and Paine Webber, found merger with a stronger partner (although at a decent price) their best strategic alternative. Table 1 is a partial list of notable investment banks that disappeared during these past two decades.

Change and Competition

With all the financial market expansion resulting from disintermediation, deregulation, globalization and new technology there was also an avalanche of competition. For those who could make the most of the new environment and compete effectively, opportunities for growth and enrichment appeared limitless. For all others in the financial services industry, however, the times presented as much turmoil, confusion and distress as during any similar period they had ever experienced. During this time it was almost impossible to direct and manage investment banking businesses as they had been managed during the preceding twenty years. So much was changing so fast, every firm in the industry had to reconsider its essential strategy for growth and survival.

The process for doing this under pressure was often inchoate and quickly cobbled together. But the firms knew that while they were in danger of being marginalized by competitors, there were also, for those who succeeded, opportunities for great rewards. By “success” most firms would say they meant preserving their essential culture, customer franchise and ways of doing business, but this would be impossible. Much of these traditional ways of doing business had to change in order for firms to be able to compete effectively. And competitive results were measured chiefly along two important axes: market share and profitability. They either had to reorganize themselves so as to be able to perform well under these difficult measures, or save what they could of their investment by selling the firm or taking their chances in a sub-specialized niche.

The 1980s were watershed years for investment banks. This was the decade of the S&L crisis (which created a sudden need for securitization of mortgage securities),

burgeoning US government deficits (which greatly expanded Treasury securities markets), and the largest mergers and acquisitions boom in the century. It was a decade in which financial markets were also being affected by widespread deregulation, new technologies, and rapid international expansion.

These developments pushed investment banks into a major transformation. The leading players became "integrated " investment banks that brought all of their capabilities together into a core that could service clients on an immediate basis. The concept of "block trading" with institutional customers was transferred to the underwriting business with the introduction of the "bought deal," and the "bridge loan" to facilitate client transactions. "Capital market groups" would scour the world for innovative or low cost financing opportunities to be presented immediately to a dozen or more existing clients or prospects. Execution could occur immediately, on the phone. Merger teams too would combine the skills of top securities analysts and arbitrageurs with deal experts to offer clients all they could ever want in the way of transactional expertise. Relationship managers scurried to be sure that no service a client might need was overlooked, and a team of experts offered. These managers, teams and groups so no need to confine their efforts to serving existing clients, they went after the clients of other firms as well, and the clients were ready to pick the best deal and the best price, rather than rely on traditional relationships.

By the end of the eighties, firms like Merrill Lynch, Goldman Sachs, Salomon and Drexel had increased their market shares (especially in the US) at the expense of the more conservative, less adaptive old guard.[2] They had been very focused on perfecting the quality of their services and the aggressive marketing that promoted them. All survived the stock market crash of 1987, but criminal misconduct in the junk bond business finished Drexel in 1990. It also collapsed the junk-bond market that Drexel dominated, thereby ending the takeover boom (which was in its last, overpriced stages then anyway) and the ability to refinance large bridge loan positions taken on by First

[2] In the sixties, the "special bracket" of underwriters consisted on Morgan Stanley, Kuhn Loeb, First Boston and Dillon Read. Morgan Stanley and First Boston had transformed themselves to accommodate for integration but Kuhn Loeb and Dillon Read did not. By the 1980s, however, several of the "major bracket" underwriters of the 1960s and 1970s had disappeared.

Boston and several other firms to accommodate LBO clients.[3] The market slump that followed in 1990 forced investment banks into sudden layoffs and retrenchments. This was the first year in which all New York Stock Exchange member firms would report a combined loss since the 1930s.

Financial markets recovered the following year, and a series of continuous "booms" began that lasted throughout the decade. There was an extended international boom – beginning with the refinancing of a very large quantity of third world debt through the issuance of "Brady Bonds," then wide-spread privatization of state-owned businesses all over Europe, Asia and Latin America. Next was a flurry of excited interest in emerging-market equities that carried investment bankers all over the world. Throughout all this there was a powerful merger and acquisition boom that appeared around 1990 in the newly deregulated and reorganized European Union, which became the "Eurozone" after adopting the single currency in 1999. In the US another merger boom had also begun, fueled by rising stock prices. So had a technology and Internet boom in the latter 1990s. The various booms drove revenues sharply upwards at most of the major firms, but many investment banks used the 1990s to diversify also into different businesses. Many thought that pure investment banking involved more market risk than their shareholders were comfortable with. To offset that risk, most created some kind of large, fee-based asset management organization which sought to manage pension fund assets, mutual funds, and private investments for the world's rich people (the latter a service they called "private banking" after the Swiss). Some firms decided to extend their reach for clients further into the retail sector. Some began to offer lending and other commercial banking services to corporate and wealthy individual clients. And many firms, after tasting the returns from leveraged buyouts in the 1980s, invested significant amounts of their own capital in high-risk, high-return "private equity" transactions (venture capital, real estate equities, leveraged buyouts and other speculative non-traded investments acquired as private placements).

[3] Investment banks would offer to make the bridge loan to finance a takeover through a tender offer of a controlling position in a company, which would then force a merge on the rest of the stockholders, and refinance the bridge loan by a sale of junk bonds after the merger could be completed. As there were several large fees involved, investment banks pursued takeover assignments by offering to do the bridge loans. When the junk bond market broke, the bridge loans could not be refinanced and sank in value.

The nineties, however, presented considerable difficulties for investment banks to overcome. The insider-trading and junk bond market scandals of the late 1980s had cast a pall on the integrity of the industry, heightening the attention of regulators and class action litigants in the US and around the world. Kidder Peabody misreported earnings due to its failure to understand the actions of its star government bond trader in 1993, and later reported large trading losses in CMOs, forcing its owner, General Electric Capital Corp. to discard the firm (by selling it to Paine Webber) as a lost cause. Goldman Sachs and Lehman Brothers were forced to settle with regulators and plaintiffs in the UK over their roles in the looting of the Robert Maxwell pension funds in 1994. Baring Brothers failed in Singapore in 1995, and several of its top managers were accused of covering up what they knew. Bankers Trust infuriated its regulators, stockholders and clients by its conduct in the derivatives market in 1995, after which management was changed, and the bank was reorganized, then sold. Merrill Lynch had to face angry litigants and the SEC regarding its advice to, and trades with, Orange County, California in 1996. CSFB was raided in 1999 by regulatory authorities for misreporting its actions there.

As compared to prior periods, the 1990s had become quite dangerous. Not only were regulators more focused and motivated, they were better informed, and better supported technically. Also, the penalties for criminal misconduct had been raised (loss of licenses and large fines and penalties are to be expected, jail time is possible), and the exposures to large adverse judgments from class-action litigation in a finding of civil misconduct are potentially enormous. Today, firms are highly exposed to potentially severe penalties from even technical, non-criminal violations. Such exposures have placed a heavy, expensive burden on the firms to insure flawless internal compliance and control of non-trading activities. The securities industry has become one of the most extensively scrutinized and regulated industries in the world.

During this period, the Glass-Steagall Act, which kept commercial banks separate from investment banking since 1933, was gradually eroded, and then finally repealed after years of effort to do so. At the end there was very little support for

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Credit Suisse was required to bail First Boston out of its position, and in November 1990 it recapitalized the firm to give the Swiss control of First Boston.

keeping banks out of the securities business because the banks were thought to need access to these businesses to remain competitive. However, only a few banks – around a dozen US banks -- expected to participate in a significant way, indeed, only two (out of more than 9,000 in 1990) elected to transform themselves into serious investment banks – JP Morgan and Bankers Trust -- but neither were to survive the decade as independent companies.

But misconduct and regulatory change were only part of the story of the decade of the 1990s. The trading markets offered their own considerable challenges. First, bond market volatility exploded suddenly in 1990, then did so again in 1994 (after a series of unexpected interest rate rises by the Federal Reserve), and financial markets roiled. The large investment banks as a group had a negative return on equity in 1994, an event that rattled many of their principle investors. Then in 1998, the Russian default and other events appeared that flattened markets and forced a famous hedge fund (Long Term Capital Management) into insolvency. Despite the apparent good times, every four years had brought a crisis in the fixed income and foreign exchange markets, and each crisis had hammered the returns and the stock prices of the major securities firms. Though investment banks have a good record of weathering market storms, and of seeing their shares prices rebound, these market crises, in aggregate, began to show up in declining profit margins of Wall Street investment banks during the 1990s. Table 2 compares the growth in aggregate investment banking revenues with the aggregate pre-tax profit margins of the "large investment banks" for the period 1980-1999. The average margin for these firms in the 1990s (7.4%) was less than half of what it had been in the 1980s.[4]

The pressure on margins was coming from increased competition that was shifting the value-added in investment banking from the *manufacturers* of financial products to the *users*. Integrated investment banks were increasingly being required to stand up for clients in profitless trades and commodity-like transactions in which fees or commissions were reduced by competition. The remedy for this reduction in margins, the banks thought, was to shift business around into areas with greater profit potential. Proprietary trading was one such area that appealed to some firms, but the increased

market risk and capital required for it was worrying (if Long Term Capital Management, thought to be the best in this sort of business, failed, why would a more constrained, less-talented investment bank do better?). Increased efforts in asset management, where market volatility was not a factor, seemed a reasonable offset to exposures in corporate finance and investing services, though most of the assets under management had to be acquired in the market at relatively high prices, on which the expected return was not high. A few firms also placed greater on developing international business. This would diversify a firm's geographic exposures and also enable it to enter into markets that were somewhat underserved by effective, US-style investment banking know-how, but overseas expansion was expensive and risky (witness Barings) and progress was inevitably slow.

Finally, firms could increase their investments in private equities and/or real estate transactions. Such investments of the firms' own capital had three benefits. They could sell participations in the investment funds to clients as hedge-fund shares (for which the firm would receive a management fee and a healthy 20% share of profits). The investments might result in significant returns, shoring up profits that were weakening in other areas. And they could become a captive source of lucrative IPO underwriting and merger, recapitalization and advisory fees. Despite these efforts, Table 2 indicates that the net effect on pre-tax profit margins of large investment banks (there were only six or seven counted in 1999) still declined considerably, both from the early 1980s and from the early 1990s. The decline in profitability motivated the firms to do all they could to lower costs and utilize new technologies to their greatest advantage. The best way to lower costs was to reduce the number of employees. In 1980 Wall Street large investment banks totaled 16,800; in 1990, despite an eleven-fold increase in total revenues, the headcount was only 2.8 times greater, at 47,300.[5]

[4] Securities Industry Association, 2000 *Fact Book.*
[5] Securities Industry Association, 2000 *Fact Book*.

Strategic Choices

During the period from 1980-2000 almost all of the firms went public or merged with firms that were, usually at a substantial premium to book value.[6] But, as public firms their roles were changed. They were not just in business for themselves. They had to think about their new public stockholders and outside directors, potential predators, and investment analysts who publish recommendations to investors. They had to worry also about the effects of a rising and falling stock price on their key managers and employees. They had to learn how to articulate a long-range strategy to the market, and explain short-term actions that appeared to deviate from it. But mainly they were charged with keeping up with the breathless pace of action of those years while protecting and enhancing shareholder value. This was a formidable task. Looking in retrospect, we can see four basic strategies that were pursued by investment banks in the 1980-2000 period to accomplish this goal:

Growth through Market Dominance

This approach was based on using a firm's dominant expertise in certain product areas to expand into adjacent product and client groups, and to propel the firm upwards on the acknowledged strength of its momentum. Merrill used this technique in the 1970s to leverage its ability to distribute stocks to propel it into the upper tiers of investment banking, a big step for a firm previously seen only as a wirehouse. Salomon tried this too -- emphasizing government bonds, bank securities, corporate debt and CMOs. Drexel adopted the strategy to support its dominance in junk bonds, and some others tried to do the same in their own areas of expertise -- Bankers Trust (derivatives), Baring Brothers (Japanese securities) and Kidder Peabody (fixed income). The strategy suffered, however, from a serious flaw: the trading environment conditioned by the firm had to become so aggressive that the firm itself might not be able to control or govern it. Hence, many of the spectacular failures in the industry in the 1990s were really the result of having adopted a business strategy that could be only described as dangerous.

Growth by Continuous Acquisition

This strategy involved continuous acquisition of competitors for the purpose of absorbing their *customers*, while simultaneously reducing operating costs, especially fixed costs and staff overhead. The master of this strategy was (and is) Sanford Weill (now of Citigroup). Weill combined a dozen or so small or distressed organizations to create a firm then called Shearson Loeb Rhodes that was capable of attracting, first American Express (to buy it in 1981)[7], and then the once powerful, elegant house of Lehman Brothers (to sell to it in 1984).[8] Lehman was experiencing hard times then and looking to be sold to an upscale investment bank. Weill left American Express in 1985, uncomfortable in a second-fiddle position, and the Shearson-Lehman-American Express (and E.F. Hutton, later acquired) investment banking combine began to fall apart. American Express decided to sell the brokerage part of it to a new company that Weill had created since his departure.[9] This company (a consolidation of Commercial Credit Corp. and Primerica, a financial holding company) owned Smith Barney Harris Upham, a second tier retail broker with an old investment banking name. After the Shearson Lehman Hutton brokerage business, Weill's company would subsequently acquire (in order) Travelers Insurance, Salomon Brothers, Citicorp, Schroders (a leading UK merchant bank), and Associates First Capital, a large finance company acquired in 2000, and European American Bank, a Long Island based retail bank announced in February 2001. Citigroup, as the new firm is called, is the world's largest financial services company by market capitalization, and America's first true "universal bank" that includes banking, insurance, asset management and investment banking under one central operating company. Part of the appeal of the strategy is to be in

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[6] Donaldson Lufkin & Jenrette was the first NYSE firm to go public (1969). It was followed by others quickly – Merrill Lynch went public in 1971. The last major firm in the US to go public was Goldman, Sachs & Co. which succumbed in 1999.

[7] In 1981 there were two other acquisitions designed to put together a financial supermarket (by combining brokerage and insurance), Sears Roebuck and Dean Witter and Prudential and Bache. In 1985, Donaldson Lufkin was acquired by Equitable Life Assurance, which was since acquired by AXA. All of these fell short of their goals, and all except Prudential Securities, have been broken up.

[8] Shearson Loeb Rhodes was sold to American Express in 1981 and became Shearson American Express, which acquired a failing Lehman Brothers in 1984, and became Shearson Lehman Brothers, which acquired the nearly bankrupt EF Hutton in 1997.

continuous motion, with acquisition following acquisition, after the market has been convinced that the firm knows how to take on the customers while spitting out the costs. No one has managed this strategy of continuous aggressive acquisition as successfully as Weill, but the strategy nonetheless has all the disadvantages of haphazard conglomeration and organizational confusion, and because of the size of this particular conglomerate, of becoming unusually unwieldy and unresponsive.

Two other investment banking organizations, however, have followed similar continuous-acquisition strategies. One is Swiss Bank Corp., which first acquired the O'Connor Group (derivatives), then a seriously wounded S.G. Warburg, The Brinson Group (investment managers), Dillon Read, its ultimate rival Union Bank of Switzerland (also seriously wounded when acquired), and most recently, Paine Webber. The surviving enterprise is now called UBS.

The last of the super-acquisitive organizations is the entity once known as Chemical Bank. It began with the acquisition of a seriously troubled Manufacturers Hanover, then of a much larger but harried Chase Manhattan, followed by a bevy of investment banking niche players Hambrecht & Quist, the Beacon Group, and Robert Fleming (UK), and most recently, the faded rose of Wall Street, J.P. Morgan. However, in neither this case (now called JP Morgan Chase), nor in Swiss cases, has the stock market believed that Sandy Weill's essential magic touch was present. Citigroup's stock price has significantly outperformed the others, and stayed even with an index of broker-dealer stocks since 1997. In all three cases, however, the wholesale banking portions of the groups have found their way into the top ten global wholesale rankings by market share (see Table 3) – J.P. Morgan Chase ranked first in 2000, Citigroup was fourth and UBS ninth.

A consequence of this strategy of growth by continuous acquisition is that the acquiring business is interested only in the customers being acquired and some of the top talent. Thus the acquired employees are dispensable, and they know it, and this creates organizational uncertainty and management problems of its own. Even Weill's most senior associates, even the most loyal, have often not lasted long in their jobs.

[9] The investment banking part, now renamed Lehman Brothers, was sold to the public in 1994 and remains an independent firm.

Also, the strategy depends on feeding the market with a continuous supply of new acquisitions, which means that bigger and bigger additions must be contemplated for the future. It also means that new and recent deals obscure the ability of analysts to determine how well prior acquisitions have fared. This was a condition experienced by the industrial conglomerates in the 1960s and 1970s, most of which fell apart after a good run in the market and have now been broken up.

Truly "Strategic" Mergers

There have been four significant instances of one-time "strategic" mergers that are so important to the firms' involved that they change them irrevocably. They have almost always been transactions that were thought to be so unusual as to surprise the market when they were announced.

The first of these was the partial ownership arrangement between First Boston and Credit Suisse's London investment bank, CSFB. However, the uneven First Boston relationship with its Swiss partners was forever troubled, if occasionally helpful to each side. But it was unwound in 1990 after some mishaps and financial difficulties at First Boston in the US by merging everything into the parent company to give it greater control. It is hard to see how Credit Suisse could have made much money from its long investment in First Boston. But today after further major acquisitions in Switzerland of a retail bank and an insurance company, and of Donaldson Lufkin & Jenrette, it has assembled a powerful European universal bank that ranks sixth in the 2000 global banking market share tables.

The second case was the three-way merger of a merchant bank, a stock broker and a "jobber" (market maker) in 1984 that created (the new) S.G. Warburg, then making an open attempt to become Britain's first "integrated investment bank, like the Americans."[10] Warburg became the market leader in post-Big Bang London, but it was suddenly forced into a distress sale to UBS after serious trading losses in 1994 where it is one of several investment banking business that have been commingled at UBS.

[10] The second was BZW, a group put together by Barclays in the early 1980s, and disbanded in 199-, due to lack continued losses.

The example frequently pointed to by analysts of a successful strategic merger is the combination of Morgan Stanley and Dean Witter in 1997. Morgan Stanley had been a wholesale finance specialist firm since it's beginning as a spin off from J. P. Morgan in 1933. It inherited all of the famous Morgan clients, and had been the bluest of blue chip firms since its fortuitous birth. In the 1980s, Morgan Stanley changed itself into a full service, international firm and began to add investment management businesses aggressively in the 1990s. It was disappointed in its market valuation, however, and decided that its future would best be made by merging with a retail brokerage, Dean Witter, that had once been owned by Sears Roebuck and still retained its valuable *Discover* credit card business. The merger which left Philip Purcell, an ex McKinsey management consultant and former Dean Witter CEO, in charge represented big changes for the old Morgan Stanley people, many of whom departed. This group included John Mack, the firm's President and number-two officer after the merger, who resigned in January 2001. But Purcell (and Mack, as his deputy) managed the combination well, they did not integrate the firms very much. They continued to emphasize the old Morgan Stanley investment banking business while rebuilding the securities sales and trading and asset management business around the Morgan name (Dean Witter was dropped from its name in 2001). Morgan Stanley was the world's second leading global banking firm in 2000, based on market share, and third ranked by market capitalization.

Citigroup is also an example of a strategic merger to create a newly powerful market presence. Although the continuous acquisition strategy of Weill arrived fortuitously at Citicorp, the resulting combination must represent a major strategic event in totally reshaping the firm. Its presence is now very strong in several service categories -- Citigroup is now among the world's largest banks, broker-dealers, insurance providers, and asset-managers – it is also strongly positioned in the US, Europe, Japan and in Emerging Markets. Whether management can master the intricacies of coordinating between product and geographical lines to produce a seemless delivery of effective financial services or not remains to be seem, but certainly, as a strategy, the combination of Travelers (et.al.) with Citicorp, was a significant event.

Steady Internal Growth

The final strategy followed by investment banks in this period of the last two decades of the last century was to pursue only internal growth. Such firms would continue to do what they had been doing in the past, sticking to and reinforcing what they were good at, without succumbing to any of the abstract strategic ideas that were periodically presented. Such a strategy enabled firms to avoid the managerial chaos and disruptions of large mergers (especially of the so-called "mergers-of-equals," which seem to create the most trouble) and to retain more of their experienced bankers with strong, seasoned client relationships.

Merrill Lynch has made a few acquisitions. But its acquisition of White Weld in 1978 (rescuing it from bankruptcy) was perhaps its most important as it gave credibility to the firm in corporate finance. Since then, Merrill has mainly acquired firms abroad to enhance its local presence in important markets in the UK (Mercury Asset Management, Smith Newcourt) and Japan (the retail brokerage business of Yamaichi Securities). For the most part, it has relied on internal growth to maintain its significant wholesale market share (ranking fifth in 2000), while still developing its retail service businesses in the US and abroad.

Goldman Sachs was left, just prior to its initial public offering in 1999, as the most unchanged firm among the major bracket players of Wall Street. Goldman Sachs was organized in 1869 as a commercial paper house. Over the next 130 years its main effort was to grow organically in the wholesale finance markets, and to increase its market share and profitability. It acquired J. Aron & Co., a small commodities firm in the early 1980s, but otherwise kept to itself. The IPO would end Goldman's unique partnership structure, it would require including several hundreds of its more senior employees into its coveted "ownership" status, and force it to govern itself in the future differently, but it didn't change the central strategy of the firm. In 2000 Goldman acquired Speer Leeds & Kellogg to help it reinforce its commitment to equity trading markets, but this acquisition did not reflect a major strategy shift. It ranked third in the global wholesale banking tables in 2000.

Other firms sticking to their own knitting during the 1980s and 1990s included Lehman Brothers (since its re-launch in 1994), Bear Stearns, Lazard Freres (since merged with its sister companies in London and Paris). Lehman ranked eleventh in wholesale banking services in 2000, Lazard (a merger house only), thirteenth and Bear Stearns was seventeenth. .Four other important firms followed this strategy also until they sold out to others (at very good prices): Dillon Read, Donaldson Lufkin, Paine Webber, and JP Morgan. Of all these firms, however, only Merrill, Goldman and JP Morgan (now contributing to the Chase totals) made it into the top ten global investment banks.[11]

Strategy Requires Execution

One can see from these various cases that it has been possible to develop successful investment banking businesses in extremely challenging times by different strategic routes. Merrill has prospered by aggressively expanding a single product line where it had exceptional skills into a broader range of product lines. Several firms, especially Citigroup and JP Morgan Chase have accomplished some of their strategic objectives by strategies of continuous acquisitions. Morgan Stanley has flourished in its larger strategic role, and so has Goldman Sachs in its traditional one. Other firms pursuing similar strategies, however, have not fared as well.

If there are different strategies, what may be most important in determining their outcome is the effectiveness of their execution. Execution places a great weight on a firm's ability to make intended things happen on time, while preventing other (bad) things from happening at all. In essence execution is about good management, which over times depends on recruitment, training and retention of high quality, career-oriented professionals. It requires a firm to enculturate new and acquired personnel with the firm's values and standards, and to impose effective control and compliance systems to be sure that they are enforced. It means being able to evaluate performances well, and to set compensation policies that work. These tasks are much more difficult to do in merger situations in which many professional employees are seen

[11] In 1999, before the merger of JP Morgan and Chase, and DLJ into Credit Suisse, Goldman Sachs was ranked first in global wholesale banking transactions, followed by Merrill, Morgan Stanley, Citigroup, Credit

to be overlapping or redundant and when senior officers are consumed with protecting or projecting their personal power. It is also difficult when high merger premiums are paid (and have to be reclaimed by extensive cost-cutting), and when the firms' stock prices become volatile, depressing the value of compensation packages.

Investment Banking Today

During the last two decades probably twenty or thirty firms struggled to execute strategies that would assure their market position and profitability. They have had time and market conditions in their favor, but only a handful have achieved their objectives. Only a handful can claim to have secured significant market shares in the wholesale financial services industry.

Table 3 shows the 2000 market shares of the top twenty-five market leaders in an aggregate of global wholesale banking transactions (corporate banking, distribution of securities, merger advisory and medium-term notes). These services were selected because they are among the most important offered to clients in terms of transactional value. Thus they become the determinants of the market power or reputation of individual firms. To determine the overall impact of a firm in the principle marketplace for its services, we have taken a measure of the total volume of transactions for which an individual firm can be seen to be the originator, or "bookrunner." Data are available on the basis of "full credit to bookrunner" for the service areas chosen (no such data are available for secondary market activity, such as trading. Wholesale markets are now so well integrated globally than an issue originating in one market usually may be sold in several others, and the skills, capabilities and infrastructure of individual investment banks can be utilized with equal effectiveness in many parts of the world. To perform effectively and competitively in wholesale banking, firms must be more integrated and more globally connected than ever, hence the global volumes of transactions in the areas selected have been used.

At the end of 2000 six American firms were among the top ten global wholesale financial services rankings. Three were banking-related entities, JP Morgan Chase, Citigroup and Bank of America. Three were non-banking-related, Morgan Stanley,

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Suisse, Chase, JP Morgan, Lehman, DLJ, and Bank of America.

Goldman Sachs, and Merrill Lynch. The other four firms in the top ten were European universal banks, each with several mergers under its belt.. The top ten firms accounted for 79% of all global wholesale banking transactions that were originated during the year; the top five firms, more than half. The average market share of the top five firms was 10.6%; of the next lower five, 5.2%, and of the twenty-fifth placed firm, 0.6%.

To be outside the top ten, is to be not taken very seriously as a global wholesale banking services provider. Thus a number of firms have struggled to secure positions in the top ten, quite often by acquisition. In 1991, for example, all of the top ten firms were among the top ten in 2000, or among those firms that were acquired by firms that were in the top ten in 2000. Seven of those firms had been involved in at least one major strategic merger. In 2000 the top five firms, had between them, experienced more than *eleven* strategic mergers to solidify their positions. Those lower down on the ranking ladder certainly have found it difficult to climb their way up in the rankings (e.g., Deutsche Bank, BNP Paribas, ING Barings) even through acquisitions. The acquisitions have also reduced the dominance of American firms among the group; in 1993-1995 nine of the top ten firms were American, in 2000 the number had dropped to six.

The other measure of strategic success that all the firms have pursued is the creation of financial value. Table 4 shows the market capitalization of the major firms mentioned in Table 3 at January 20, 2001. To be a contender for a top 25 positions, firms have to be large, global, integrated platforms and they have to be able to compete in a concentrated market environment. But as Table 4 indicates, they do not necessarily need to be firms with the greatest size. Indeed, the average market capitalization of the three largest investment banks (without significant banking businesses) among the top ten ranked by market share (including three or the top five) in January 2001 was $69 billion. The average market capitalization of the five largest banking related investment banks was $126 billion. Obviously not all of the market capitalization of the universal banks is attributed to investment banking operations and equally, investment banks do not require excessive amounts of market capitalization in order to succeed – Lehman Brothers, for example, had a market capitalization of only $-- billion yet occupied eleventh place in the tables (8^{th} in 1999).

Market Share and Market Value

The top firms in handling wholesale transactions tend to be the ones that enjoy the greatest profitability. They get the best assignments, and can seek the highest fees. However, if a firm's position in the rankings is achieved only by merger, then the assumption of profitability may not be valid. To sustain profitability, the firm has to demonstrate superior capabilities, which newly jumbled together firms may not be able to do. Being profitable (in a time of declining margins) is good, of course, but the firm's profits have to be capitalized by the stock market at a multiple that reflects, among other things, both future prospects and the essential volatility (riskiness) of the firm's profit stream.

So here the firm's mix of business (which establishes the overall volatility of the firm) seems to count, with apparently lower risk being associated with businesses that are better diversified. However, current market data does not appear to offer support for the idea that financial service firms with lower *betas* will enjoy higher capitalization rates (p/e ratios). Table 5 compares forward looking p/e ratios, most recent six-month betas, and last twelve month total returns for the leading wholesale banking firms. Three of the firms have large commercial retail banking businesses in their product mix, three others have almost none. One firm, Merrill Lynch is known as a firm with little banking but a high concentration in retail financial services. The market in January 2001 reflected higher betas for the smaller, more specialized firms that reported somewhat higher total returns, but all of the firms were valued at about the same price-earnings ratio. Thus the market was apparently "paying up" for the larger, more diversified firms (because it apparently was valuing less risk more than it might otherwise, with the same p/e ratio as a riskier stock).

But it may not be clear that in the long run, merging one's concentrated profit stream into another profit stream that diversifies it will be the answer to the strategic requirements of investment banks. It has been for Citigroup, and for Morgan Stanley, which the market considers to be well-managed, profit-driven firms. However, if in the future the market decides that today's multi-market diversified financial services firm is tomorrow's ungainly conglomerate, the market value may be discounted until the firm is worth more broken up into its respective business lines. But future investors will decide,

and their message will shape the strategic actions of the players. Some investors will prefer highly diversified, very large capitalization companies in financial services in which to be able to make large long-term investments. Others investors will chose to make diversification decisions themselves, and instead prefer those investments that are “pure plays” in a particular expertise or dominant market share with room for substantial upward price movement. In the end they will look for superior profit making capability and for strategic objectives that sensibly preserve this capability, rather than expose it to excessive dilution (i.e., mixing it with other, less profitable businesses) or excessive risk.

Some investors may also believe that firms with large market capitalizations are inevitably tempted to continue pursuing a bigger-is-better strategy, which they do by issuing shares in even larger acquisitions. Such firms may feel the pressure to follow the actions of other highly visible firms in their industry -- Morgan Stanley’s John Mack said the firm felt challenged by not being able to lend to its large clients as Citigroup and JP Morgan Chase could do. Some companies make intriguing promises to gain support for a time for efforts that are difficult or impossible to do -- Citigroup said it was going to increase its number of clients after the Travelers/Citicorp merger ten-fold to 1 billion, i.e. to one-sixth of all the people on Earth. Some very big firms also simply lose to bureaucracy the ability they might have once had to manage efficiently and to react quickly. Today’s corporate dinosaurs include many companies that were once, not so long ago, lean and fleet.

Back to the Future

For several years, management consultants and academics have published credible data indicating the low success rate for large mergers; currently this is being revealed in the financial services sector by merger-related difficulties at First Union, Bank of America, Bank One, and on the wholesale side at Credit Suisse and Deutsche Bank. Academics also have studied economies of scale and scope in mergers in the banking industry (especially as these relate to creating universal banks) and have found little of the former (after the one-time gains from initial cost cutting) and almost none of

the latter.[12] Citigroup may prove these studies wrong, as it claims to be cross-selling effectively, but cross-selling is not without its own often significant incremental costs, and revenues are often hard to attribute or are unverifiable. The extensive record on the limited amount of efficiency gains from bank mergers leaves to management the burden of proof that net new economic value is created in large, multi-product merger situations.

Future profits in large banking companies are now subject as never before to fee cutting and the commoditization of once specialized, lucrative product lines. To sustain margins, firms have to take advantage of their abilities to maneuver between product lines and world markets and to make the most of their comparative advantages, their know-how and market franchise value. But they must be nimble enough to avoid becoming committed to low-profit business lines. Morgan Stanley may worry about big banks lending to its clients, but it should be hesitant to go into that (or any) business with such low margins and significant capital requirements. It should also be reluctant, especially during market downturns, to get into low-margin lending, investing or trading situations if difficult-to-control market exposures would have to be taken on to do so.

Firms may also have to face the reality that if profits are being squeezed or otherwise made more risky, then they will have to find ways to reorganize their business so as to pay out to employees something less than the current 50% or so of net revenues. How can employees in a commodity like business with declining margins and high personnel turnover command such high pay scales, year after year? If the best people leave, because they want to retire at 45 or because some other firm has made a marginally higher offer, yet the firm still manages to get by, could it have been paying the employee too much in the first place? Perhaps being able to pay employees differently would work better, for both the firms and the employees.

It is easy to predict (as predictions have been made in the past) that the next twenty years will involve more of the same. That is, more consolidation and flight to bigness. But this is unlikely. Financial services markets are unlikely to continue to grow

[12] See Steven Davis, *Bank Mergers*, St Martins Press, 2001, which quotes reports from the Bank for International Settlements and the Federal Reserve Bank of NY on their studies. See also Mark Sirower, *The Synergy Trap*, New York, The Free Press, 1997, and Anthony Saunders and Ingo, *Universal Banking in the United States,* New York, Oxford University Press, 1994.

at twice the real rate of economic growth. Mergers involving American wholesale banking firms are unlikely to be at the same pace (the number of firms available for mergers has decreased substantially) and if stock prices of prospective acquiring firms continue to fall – back toward the mean -- there may be little appetite for more mergers for a while. The market price of Chase Manhattan's stock fell more than 40% in the first six weeks after the news was released on Sept. 11, 2000 that it was acquiring JP Morgan for stock valued at 25% more than its market price. Unless there comes to be strong, convincing evidence of net economic gains from consolidation, the pendulum may begin to swing the other way. Markets can punish as well as reward strategic actions.

The wholesale finance business may already have consolidated about as much as it is going to, and from now on, the trend may be to go backwards in search of real value. That might mean pulling the best talent out of the "big box" firms, replanting it into comfortable, flexible, performance-oriented, small partnerships that function as specialized players (for example as Goldman Sachs was in the 1960s), or as investors managing money for clients (hedge funds, arbitrageurs, LBO firms).[13] Both would begin to compete with the old firms, but initially the old firms probably would not see much threat and might even encourage the effort.

Some of the old firms, in the meantime, may find that they have accumulated too much on their plates to be as good (as expert, as responsive) in everything as they were when they were on their way up. Citigroup with 180,000 employees (before the Associates First Capital and European American Bank acquisitions), JP Morgan Chase with 75,000, Merrill Lynch with 67,000 and Morgan Stanley with 55,000 must have some quality control problems. They all do. And, because the firms today are almost as active as investors and investment managers as they are investment banking service providers, they cannot avoid running into their own clients in the marketplace. And when they do, how do they decide the outcomes with fees going down on one side, and prospective private equity or other investment returns looking more promising on the other. If this happens often enough, the clients will feel there is an extra price to be paid

for dealing with the firm, and perhaps move its business elsewhere. And where might this business migrate? Perhaps to the re-born investment banks of tomorrow that will resemble the small, fleet opportunistic shops that their predecessors were forty or fifty years ago.

[13] There has been a substantial migration already to very successful firms like KKR, Blackstone, Wasserstein Perrela, and other boutique investment banks. Private equity and hedge funds have also draw much of the talent needs from Wall Street's major investment banks.

Table 1

Disappearing Investment Banks

(1986-2000)

1986 Kuhn Loeb

1987 E.F. Hutton

1989 Morgan Grenfell

1990 Drexel Burham

1993 Shearson Lehman American Express

1994 Kidder Peabody
S.G. Warburg

1995 Baring Brothers
Kleinwort Benson

1997 Alex. Brown
Dillon Read
Chase Manhattan
Robertson Stephens
Montgomery Securities
Peregrine Securities

1998 BZW
Cowen & Co.
Yamaichi Securities
Paribas
Hambrecht & Quist

1999 Bankers Trust

2000 Schroeders
Robert Fleming
Paine Webber
JP Morgan
Donaldson Lufkin Jenrette
Wasserstein Perella

Table 2

Growth, Concentration & Profitability
US Investment Banking Industry

	Securities Industry Revenues		Large Investment Banks Pre-Tax ROE
	$ Billions	Top 10 firms(%)	
1980	16.0	52.9	55.7
1981	19.8	55.5	56.7
1982	23.2	57.4	54.8
1983	29.6	54.3	43.8
1984	32.2	58.8	31.1
1985	38.6	57.5	38.5
1986	50.1	57.3	34.2
1987	50.8	54.5	9.2
1988	51.8	54.1	18.2
1989	59.5	58.5	9.2
1990	54.0	56.9	5.4
1991	60.7	56.2	25.2
1992	62.8	56.2	23.7
1993	73.2	53.5	23.8
1994	71.4	50.8	-7.2
1995	96.3	51.2	11.5
1996	120.2	51.3	26.2
1997	145.0	50.4	23.4
1998	170.8	48.3	16.4
1999	183.4	50.7	28.0
2000	245.2	50.8	24.6

Table 3

Global Wholesale Banking Rankings 2000
Full Credit to Book Running Manager Only
($ million)

Firm Rank 2000 (1999 in paren)	Syndicated Bank Loans	Securities U/W & Private Placements	M&A Advisory	MTNs Arranged	Total	Percent of Top 25
1. JP Morgan Chase(7)	486,662.7	297,314.7	426,307.8	84,934.4	1,295,219.6	11.22%
2. Morgan Stanley (3)	14,237.9	343,748.1	907,442.4	17,860.0	1,283,288.4	11.12%
3. Goldman Sachs (1)	31,061.0	303,483.5	928,037.7	5,595.0	1,268,177.2	10.99%
4. Citigroup (4)	209,756.5	360,280.7	620,022.6	46,188.7	1,236,248.5	10.71%
5. Merrill Lynch (2)		493,181.9	565,296.0	104,686.5	1,163,164.4	10.08%
6. Credit Suisse Gp (5)	59,508.0	357,803.8	626,353.9	41,383.9	1,085,049.6	9.40%
7. ABN Amro (14)	43,768.2	88,420.0	46,800.2	331,681.6	510,670.0	4.43%
8. Banc of America (10)	295,484.4	120,463.0	47,996.6	20,042.4	483,986.4	4.19%
9. UBS/WDR (12)	20,803.2	160,971.2	299,799.3		481,573.7	4.17%
10. Dresdner KBW (16)	23,796.0	55,068.9	365,332.6	4,340.0	448,537.5	3.89%
11. Lehman Bros (8)		203,537.2	180,864.2	34,405.9	418,807.3	3.63%
12. Deutsche Bank (11)	61,038.3	209,395.9	98,365.9	40,617.1	409,417.2	3.55%
13. Lazards (15)			203,538.3		203,538.3	1.76%
14. Rothschild (17)			165,899.2		165,899.2	1.44%
15. Barclays (24)	64,062.5	50,954.8		47,407.4	162,424.7	1.41%
16. BNP Paribas (18)	23,176.1	40,848.1	25,702.6	72,619.4	162,346.2	1.41%
17. Bear Stearns (13)		77,920.1	39,165.3	34,371.0	151,456.4	1.31%
18. ING Barings (-)		16,548.8	119,862.1		136,410.9	1.18%
19. RBC Dominion Securities (-)	9,634.3		92,633.4		102,267.7	0.89%
20. Societe Generale (-)	33,029.5	16,985.0	33,620.0		83,634.5	0.72%
21. HSBC (22)	16,169.0	33,810.4	25,038.1		75,017.5	0.65%
22. Fleet Boston Corp (23)	37,325.6	13,392.3	20,013.6		70,731.5	0.61%
23. First Union Corp. (-)	23,402.9	38,147.0			61,549.9	0.53%
24. Commerzbank AG (-)	11,135.8	26,239.1		3,427.6	40,802.5	0.35%
25. CIBC (25)	11,364.0		27,495.2	1,250.0	40,109.2	0.35%
Top 10 Firms	1,352,766	2,850,180	5,122,995	838,296	9,255,915	80.20%
Top 25 Firms	1,614,341	3,496,686	6,031,872	963,589	11,540,328	100.00%
Industry Total	1,784,885	5,216,668	2,498,968	980,695	10,481,216	
Top 10 as % of Top 25	83.80%	81.51%	84.93%	87.00%	80.20%	

a. Full credit to bookrunner only, and to named advisors to merging companies

Table 4

Composition of Investment Banking Revenue of Leading Investment Banks, 2000
(% of net revenues)

	Corporate Finance			Trading				Asset Management				Total Inv. Banking Revenues
Firm	Underwriting	M&A	Total	Fixed Income	Equities	Principal Inv.	Total	Fees	Commissions	Other	Total	($ millions)
JPM Chase	13.8	7.4	**21.2**	22.0	8.6	3.4	**34.0**	44.8			**44.8**	20,597
Morgan Stanley	11.6	9.1	**20.7**	11.4	20.0	0.8	**20.8**	31.6	15.5		**47.1**	23,561
Goldman Sachs	16.8	15.6	**32.4**	18.1	21.0	0.8	**21.8**	5.7	13.9	8.1	**27.7**	16,590
Citigroup	16.9		**16.9**	14.9	7.2	18.7	**25.9**	18.7	21.4	2.1	**42.2**	24,161
Merrill Lynch	10.0	5.2	**15.2**	8.7	13.6	11.8	**25.4**	21.2	26.0	3.6	**50.8**	26,787
Bnac of America	20.7	5.1	**25.8**	28.3	20.6		**20.6**	18.2	7.2		**25.4**	5,853
Lehman Brothers	18.5	10	**28.8**	21.2	27.0		**27.0**		12.2	10.8	**23.0**	7,707
Bear Stearns	7.4	11	**18.7**	16.1	14.5	10.5	**25.0**		22.0	18.2	**40.2**	5,476
Average			22.5				25.1				37.7	

Table 5

Comparison of Certain Market Values (Mar 2001)

Mkt share rank	Firm	2000 Inv Banking Revenues(a) ($ billions)	Market Capit'ztn Jan 2001 ($billions)	P/E Ratio	ROE	*Beta*	Dividend Yield (%)	2000 Total Return (%)	Dec 2000 # Employees	Market Cap Per Capita '($000)	IB Revs as% Market Cap
1	JPMorgan Chase	15.75	106.5	15.0	19.8	1.54	1.4	-22.80	75,000	1,420	14.8%
2	Morgan Stanley	23.20	94.1	15.7	29.1	2.16	1.7	-35.40	65,879	1,428	24.7%
3	Goldman Sachs	16.59	53.1	15.0	18.2	2.45	0.6	-19.10	22,600	2,350	31.2%
4	Citigroup	35.40	282.2	17.2	24.0	1.48	1.1	0.20	230,000	1,227	12.5%
5	Merrill Lynch	26.79	60.2	13.5	21.1	1.51	1.2	5.80	67,000	899	44.5%
6	Credit Suisse	16.87	54.1	13.6	24.4	2.19	2.3	-7.70	80,500	672	31.2%
7	ABN Amro	11.50	35.7	14.3	23.0	1.14	4.4	-18.90	110,000	325	32.2%
8	Bank of America	4.50	89.5	12.1	15.8	1.24	4.1	4.40	155,000	577	5.0%
9	UBS	n.a.	76.1	12.2	22.6	na	1.8	na	70,000	1,087	n.a.
10	Dresdner KBW	n.a.	24.0	28.3	9.3	1.09	1.7	20.2	49,000	490	n.a.
	Avg.			15.7	20.7	1.64	2.0	-8.1		1,047	

Source: Dow Jones Co.

(a) Revenues (net of interest interest expense) include (i) fees from financing and advisory transactions, (ii) trading, principal investing and (iii) fees from asset management