

Federal Reserve Bank of Boston

To: Basel II ANPR Public File**Date:** June 15, 2004**From:** Patrick deFontrouville and
Victoria Garrity**Subject:** Meeting with The Vanguard Group

Attendees: Representatives from The Vanguard Group (Vanguard): Jim Harrington and Mike Miller. Federal Reserve Bank of Boston representatives: Patrick deFontrouville, Linda Barriga, Maureen Tighe, and Victoria Garrity.

Purpose: To obtain information on competition in the asset management business in connection with a study to assess the competitive impact of the Basel II Operational Risk capital charge.

Perspective: Vanguard, with assets under management of approximately \$800 billion, provides investment management to both institutional and retail investors. Vanguard is unique in that it is structured as a mutual company, which means that those who own Vanguard funds are the shareholders of the company.

Key Points Discussed:*(1) Vanguard Background*

Vanguard services both institutional and retail clients, although publicly the company is known as a retail mutual fund company. The portion of business derived from each sector is approximately 50/50. Vanguard offers a range of mutual funds for retail clients and uses these same funds for investments by institutional clients.

A significant portion of Vanguard's retail business is IRAs. On the institutional side, Vanguard services pensions as well as foundations and endowments. In the institutional market segment, a distinction was made between full service money management (which includes recordkeeping) and pure institutional money management in which the manager does not keep the records. Providing the full service option requires more systems and staff, but tends to improve customer retention as the recordkeeping piece provides some "stickiness" to the underlying assets. A distinction was also made between servicing companies and servicing the employees that are participants in company retirement plans.

Other products include ETFs (VIPERS), commingled trust funds, 529 plans, and stable value funds. The majority of Vanguard's business is in the U.S., although within the past ten years Vanguard has expanded internationally.

Vanguard offers all types of asset class investments. While the company specializes in index strategies, it offers a full range of strategies, some of which may be implemented through subadvisors. However, Vanguard itself does not engage in subadvisory activities.

(2) Competition

The asset management industry can be broken down into the following two segments, depending on the type of mutual fund activity: manufacturing and distribution. Vanguard, Putnam, and The Capital Group are examples of fund manufacturers. Wachovia, Merrill

Lynch, and Edward Jones are examples of companies engaged in fund distribution. Some companies, such as Vanguard and Fidelity, are both fund manufacturers and distributors.

On the retail side there are lots of companies and the market is “tremendously competitive.” Even the smallest of players can be a competitor if they have strong performing funds. Companies can grow quickly by having a “hot fund” on the retail side. On the institutional side, clients will typically not go to small players, particularly if they are looking for a full service asset manager.

(3) *Capital at Nonbank Asset Managers*

Capital, or investment, is determined by the competitive market place. For example, in order to remain competitive, an asset manager must invest in such technology as a public website that offers information and allows clients to perform certain investment activities.