AGF Management Limited

Introduction

As Blake looked out the window of the giant 747 he could see clearly the Sea of Okhotsk and the eastern coast of the Russian Federation. Soon the plane would cross the International Date Line and he would have a whole extra day in the week to work. But is that what he wanted?

As he thought back on his visit to Japan he did so with satisfaction. He had just completed a deal with Maruhachi Securities, a Japanese brokerage company, whereby AGF acquired a 5% position in the company. Only last year AGF had become the first Canadian mutual fund company to open a representative office in Japan and in the summer just past they had launched five offshore funds available only to Japanese investors.

As the rest of the Western world was retreating from Japan AGF was advancing. And not just in Japan but also in China and Singapore. All of this was in line with his goal of creating a global company with a Canadian home.

Given the long flight ahead of him he couldn't help thinking further back to the tumultuous mid 90s when AGF had acquired 20/20, another mutual fund company. That acquisition had almost caused him to resign his position as Vice President of Marketing and go elsewhere. But he saw the opportunity, the challenge and stayed with it. In 1997 he had become President and Chief Operating Officer of AGF and in 2000 he had been appointed CEO as well as President.

The late 90s, right up to and including 2000 had been great years. AGF, which in 1995 had revenue of less than $90 million and mutual fund assets under management [AUM] of less than $4.5 billion, ended 2000 with revenues nearly six times greater – over half a billion dollars and AUM more than six times larger –close to $30 billion.

Beyond those raw numbers AGF had entered the new millennium as a much more significant player, not just in Canada, but also increasingly on the global scene. Who would have believed it in the mid 1990s? No, in spite of the short-term pain of the 20/20 deal it had provided the springboard for the success of the past five years.

But 2001 was a different year, a much different year. Nothing like this had been seen for a decade. All year the markets had been hurting and there had been significant redemptions of mutual funds in the industry. The competitive scene was fierce with major mutual fund companies merging as well as competition from the big banks and from large US players. New products were appearing which had lower margins and then September 11 had occurred hurting markets further. While there were signs of recovery, the economy was now officially in recession. On top of all that there were increasing signs of public concern in regard to management expense ratios [MER].

As the flight moved towards the International Date Line, Blake's thoughts moved back and forth between the tumult caused by the acquisition of 20/20 and his near decision to quit, to the extraordinary success of the late 1990s and to the storm clouds of 2001.

The Acquisition of 20/20– a watershed event

After the Second World War a new financial product entered the consumer field in Canada – the mutual fund. Already available in the United States mutual funds became a popular personal savings alternative to whole life insurance in Canada.

AGF was a pioneer in this new field. Established in 1957, its' original purpose - to provide opportunity to the average Canadian to invest in the American economy - had been unique at the time. The original fund offering had been called American Growth Fund, hence the name AGF.

By 2001 the Company had grown to the point where they offered more than 70 funds covering a wide variety of investment opportunities and was regarded as one of the major players in the Canadian industry [see Exhibit 1]. While most of the large funds [$1 billion +] were North American – the original American Growth and the Canadian trio of Dividend, Tactical Asset Allocation and Stock – their largest single fund was the giant International Value fund with assets of nearly $7 billion.

And there were other International/Global funds with assets in excess of $1billion as well: Continental Funds – Europe, Asian & Latin America, plus Country Funds – Japan [established as early as 1969], China, India and Germany. Indeed, if you looked at their AUM they were evenly split between Canada and Global with 42% each and the balance in the United States.

That was not the case back in the mid 90s when the decision was made to do the merger with 20/20, a company two-thirds the size of AGF at that time. The first half of the 90s had been good for AGF and its shareholders. Top line had more than doubled to $87.6 million. Bottom line had done even better, increasing by more than 3.5 times to nearly $17 million. Earnings per share were right in line with that growth. And AUM had climbed to $4.5 billion in 1995 from $1.7 billion in 1991.

These were remarkable achievements but Warren Goldring, the founder and controlling shareholder, knew they were not enough to survive into the next century. Warren had been leading AGF since its beginning and he knew that AGF had to be bigger. The industry was over populated and was consolidating. The bigger players [like the Investors

Group, based in Winnipeg but owned by Montreal based Power Corp] were much larger than AGF. American firms like Fidelity were entering the market, as were Canadian banks and life insurance companies.

Warren also knew that in order to become more sophisticated in terms of technology, crucial to keeping up to date, it would be necessary to obtain a bigger base.

20/20 was a smaller mutual fund than AGF but not that much smaller, about two/thirds the size [$4.2 billion vs. $2.8 billion]. Based in Oakville, it was led by a former Olympic medallist who had surrounded himself with a tightly knit team. However 20/20, a public company, was 35% owned by Connor, Clark & Lunn, a pension management firm, 15% owned by the management team and the remainder was in the hands of the investors.

The pension fund, based in Vancouver, wanted out of 20/20 because the business was taking too much of its time and capital. The 20/20 management team led by Wood wanted greater control of management. And AGF wanted to grow. Here was a real confluence of interests and so in December 1995, the $100 million+ deal was done and John Wood, who had been President of 20/20 became the new President of AGF, now a mutual fund with $7 billion of assets under administration.

20/20 brought some real strength to AGF. The good news was a greater scale of assets under management, a broader product mix, additional distribution channels including financial planners to complement AGF's strong investment dealer base, and access to quality investment advisors such as San Diego-based Brandes Investment Partners and Chicago-based Driehaus.

The deal permitted AGF to deploy their surplus cash [they had over $60 million in 1995] and to step up their cash flow. As the CFO has noted "cash is real". The economics of the transaction were outstanding, notwithstanding the operational integration issues. The acquisition price was 4 to 5 times cash flow from operations versus the 9 times figures that Investors paid for Mackenzie and AIM paid for Trimark in 2000. And AGF doubled in size [see Exhibit 2].

Yet, like most mergers this one did not go easily. The fundamental issue was a difference in business philosophy. 20/20 was a marketing organization that used outside investment managers for their funds. AGF believed in having a blend of in house and external managers. This was not simply a philosophical issue in Warren's mind, it was an economic issue as well.

The differences were resolved when suddenly a change occurred in April, 1996, the three senior 20/20 people departed. Blake Goldring, who had wondered about his future only months earlier was promoted, along with Clive Coombs, a long time AGF employee, to Senior Vice Presidents: Blake for marketing and sales, Clive for fund management.

Five years of success: 1996 – 2001

As he looked back on the five years after the 20/20 acquisition in 1996, Blake reviewed results that had been so good they were staggering [see Exhibit 3]. Top line had grown nearly three fold, from under $200 million to in excess of half a billion dollars. So had mutual fund assets under administration [AUM] growing three fold from $10 billion to close to $30 billion. Bottom line had done even better, due to synergies and expense management and was up nearly four fold, from over $20 million to nearly $90 million. Shareholders had done well too. Earnings per share were up from $0.37 to $1.12 and share price had jumped to $24.50 at calendar year end 2000 from the $5.00 range at the end of 1996.

Those were the numbers. But really, there were four or five reasons that the Company had achieved such results. In any mutual fund company you had to be strong in terms of marketing and sales [creating the demand]; in terms of fund management [having a group of funds with superior returns – a 'supply' - that could be sold]; and a strong administrative and client service functions.

At AGF they had all of that in spades. In terms of marketing and sales they had high brand awareness through their innovative "What are you doing after work?" program, which had been honoured by the industry with the "Best Print Advertising" and "Best Overall Campaign" awards.

In addition, a key focus over the past five years had been on a revamped emphasis on sales. They had wide sales and distribution channels, some of it dating back to the merger with 20/20, some of it more recently acquired with the acquisition of another player, Global Strategy, earlier that year[1]. Now they were well placed with multiple distribution channels – brokers and planners, as well as selected and specialized products through banks, discount brokerages and insurance companies. They even had links with Investors Group that used its tied agency channel to sell products 'manufactured' by AGF, amongst others.

In terms of fund management, 77% of their mutual fund assets were in the 1st or 2nd quartile of performance on a three-year time horizon. If you looked out further they did even better with 85% in the top two quartiles over a five-year horizon and 92% over a ten-year time horizon. Yes, it could be safely said that they had excellent fund management.

In terms of administrative excellence he was equally confident. After all one of the things AGF brought to the Global Strategy acquisition was an ability to gain cost synergies and to improve Global's redemption position. He was committed to back office and administrative support for financial advisors and investors. And the proof lay in the high ranking they received in all the independent surveys of industry call centers, client service and response time.

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[1] Global Strategy had Assets Under Management of $5.6 billion. In addition they brought an exclusive advisory relationship with Rothschild Asset Management.

Overarching all of this were their international initiatives. Rather than resting passively in Canada, Warren had decided more than a decade ago to go international and established a European presence in Dublin. In the mid 90s the firm had decided to replicate their European model by establishing an Asian presence in Singapore. Then they had invested in London by buying a significant ownership stake in NCL, a UK based private client asset management and institutional fund management company. Finally in 2000 they had opened an office in Tokyo as well as a representative office in Beijing for the marketing, promotion and potential distribution of its mutual funds.

Clouds on the horizon – 2001

By 2001, this rosy picture had clouded over. There was aggressive merger activity within the industry - most notably the acquisition of Mackenzie by Investors creating a Canadian giant with a combined AUM of close to $70 billion, more than twice that of AGF. There was also the acquisition of Trimark by the British firm, Amvescap.

American players, AIM and Fidelity and Franklin Templeton, now accounted for over a fifth of all Assets Under Management in Canada and represented formidable competition given the economies of scale, which went with their huge size in the giant US market. They also had the ability to pounce on other Canadian players, given the weakness of the Canadian dollar.

Bear market conditions of 2001, exacerbated by September 11, plus the arrival of a plethora of new products all spelled challenge.

The impact of all this on the Canadian mutual fund industry was:

- year to date declines in fund flows other than money market sales;
- a 70+% industry decline in year to date equity sales;
- sub zero market returns, which added to the chill and put a freeze on margin expansion;
- unpredictability of earnings.

Yes, there were bright spots. In spite of competitive pressures from the giant gorilla, Fidelity, and the big five Canadian banks [not to mention a few smaller independents such as AIC Limited and CI Mutual Funds] AGF was doing well. In the first three quarters of the year their net sales were over $2 billion. This not only led the industry but was 22% of total net industry sales. Truly, a remarkable performance in a down market!! A key reason for this performance was that low redemptions of AGF funds helped offset their decrease in gross sales resulting in higher net sales [gross sales – redemptions = net sales].

More worrisome for the medium to longer term was fund performance. While five year returns were outstanding and three year returns were very good, one year returns for all funds was –13%, which may have been average, but not what the distribution channel wanted for their customers.

Surely these were short-term issues caused by the economic slow down and exacerbated by the tragedy of September 11. What were the longer-term issues?

In terms of marketing there was the absolute necessity of continuing to build brand equity in order to continue to have AGF products distributed by third party channels. In terms of sales, distribution would be center stage. The huge proliferation of retail funds – as the Chairman pointed out there were now more funds than there were stocks – would cause the focus to continue to shift from manufacturing to distribution. While firms that generated consistently superior performance could rest assured that customers would seek out their products, most fund companies, including his own, depended increasingly on third party distributors to sell their funds to end customers.

On the fund management side the issue was clearer and that was to sustain superior performance. Strong performance was absolutely essential to long-term success.

On the administrative side there were two issues; meeting rising customer expectations, and controlling risk. Customers today expected regular, personalized information not simply semi annual customer statements which arrived weeks after the half-year period. In addition internal operational risks had to be managed with an enterprise-wide risk management process.

Straddling both sales and marketing and administration was the whole issue of the Internet. The net provided the opportunity to improve customer service and to drive sales. But Blake was not clear in his own mind, just how to do it.

Finally there was the broader longer-term issue of globalization. Did AGF have the right strategy of building an international presence based in Canada? Or was this the time to sell out to one of the giant international players?

What Now?

Finally, Blake dozed off to sleep, only to be wakened as the plane began its descent into the Vancouver airport. He thought back to the traumatic events of 1996, to the thrill of succeeding his father as first as President & then as CEO and to the wonderful legacy his father had left. There were so many high points in the past five years it was impossible to count them.

And then his mood changed as he thought about the challenges of 2001 and beyond.

Maybe it was time to bring in that bright young management consultant Blake had interviewed several times and knew well. She seemed smart enough. She had an MBA from the Rotman School of the University of Toronto. Five years ago she had worked at

AGF and had departed on good terms with a sound reputation for good analytical work and a strong work ethic.

But what problem would he ask her to solve? Perhaps he should leave it wide open and let her give him an independent outsiders point of view.

The assignment would be simple. Reporting directly to him as CEO, she would be given all the facts as outlined and asked to assess the situation, then do a diagnosis and give him an objective evaluation of the situation. He would expect a set of recommendations on how to move forward, including next steps.

Exhibit 1 – The Canadian Mutual Fund Industry

Twenty-five companies control 94.5% of the nearly $400 billion in Net Assets as of October 2001.

Within those 25 companies there are a variety of groupings.

The largest company, with nearly $40 billion of AUM, is Investors Group, a Winnipeg-based, Power Corp controlled company. Investors is the only Mutual Fund Company that sells funds through agents directly tied to the Company. Their sales model is based on the old industrial model of life insurance agents that worked exclusively for one company, e.g. London Life, who would sell their products door to door.

Recently Investors purchased Mackenzie, a large independent Toronto based Mutual Fund Company, with AUM of over $30 billion that sells through the more conventional channels of investment dealers and financial planners. While they are continuing to operate separately the two companies together control 17.5% of the AUM in Canada.

Other than Mackenzie there are 14 independent mutual fund companies in Canada. Three of the largest of these are American – Fidelity, Franklin Templeton and AIM. The largest of the Canadian independents are AGF, CI and AIC.

The big five Canadian banks are all in the business as are National Bank and Hong Kong Shanghai. The Royal is the largest, followed by TD. Much of the bank business is in money market funds as distinct from equities. A number of life insurance companies have tried selling mutual funds but the only one which has had any success is Waterloo based Clarica.

In addition there are what is known as direct "no load" funds that sell directly to consumers. The largest is Vancouver-based Phillips, Hager & North. Altamira is also in this business.

Table 1 lists the ten largest mutual funds in Canada in terms of net assets and regardless of ownership or method of distribution.

Table 1: The Largest Mutual Fund Companies in Canada
October, 2001 – Net Assets [000,000]

Company	Net Assets	Market Share [%] Assets
Investors Group	39,257	9.9
Royal Mutual Funds	34,288	8.6
AIM Funds Management	31,484	7.9
Mackenzie Financial	31,106	7.8
TD Asset Management	30,273	7.6
Fidelity Investments	30,152	7.6
AGF Funds	26,351	6.6
CIBC Securities	24,720	6.2
CI Mutual Funds	20,031	5.0
Franklin Templeton	18,361	4.6

Exhibit 2 – Consolidated Statements of Income – 1995 & 1996

YEARS ENDED NOV. 30	**1995**	**1996**
REVENUE		
Mutual fund operations	$79,366,369	$170,070,112
Trust Company	8,261,990	8,922,615
TOTAL	87,628,359	178,992,727
EXPENSES		
Mutual fund operations	57,027,308	133,227,181
Trust Company	7,132,576	8,521,649
TOTAL	64,159,884	141,748,830
INCOME BEFORE TAX	64,159,884	141,748,830
INCOME TAXES	6,572,370	14,840,811
NET INCOME FOR YEAR	$16,896,105	$22,403,086

Exhibit 3 – Five Year Highlights

Item	**1996**	**1997**	**1998**	**1999**	**2000**
Total Rev. or Top Line [$000]	178,993	236,759	288,822	356,703	508,681
Net Income or Bottom Line [$000]	22,403	40,489	48,777	61,710	87,888
Share Price Per Share $	5.21	9.15	11.60	11.65	24.50
AUM [$000,000]	10,075	12,429	15,015	18,965	28,903