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College Try A Wall Streeter Aims to Revive Handler of University Pensions

Sleepy TIAA-CREF Takes On A More Mercantile Focus Under Ex-Merrill Banker

Fidelity and Vanguard Move In

By TOM LAURICELLA

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For nearly eight decades, TIAA-CREF was the big man on campus. It had a virtual monopoly on managing retirement plans for millions of college educators. Now it's being schooled by Wall Street in how to compete in the field it invented.

TIAA-CREF's share of its main market -- managing retirement funds for employees of universities -- has tumbled to 70% from essentially 100% in about a decade. The problem: While rivals innovated and clients demanded new services, TIAA-CREF's ways of doing business seemed frozen in time.



Herbert Allison

For the past three years, the task of reviving its fortunes has fallen to an unlikely leader for a firm founded as a nonprofit and steeped in the academic world. Former investment banker Herbert Allison, once a contender for the top post at Merrill Lynch & Co., arrived in late 2002 to transform the stodgy organization and go head-to-head with financial powerhouses such as Fidelity Investments, **Charles Schwab & Co.** and AIG Valic, the retirement-plan arm of insurer **American International Group Inc.**

His plans at TIAA-CREF are ambitious. Mr. Allison, 62 years old, is launching an online brokerage arm. He is replacing a computer system so antiquated it's hard to find programmers to update it. (Mr. Allison jokes that it was "programmed in Aramaic.") To focus on the core business, he has dropped his predecessor's plan to market more to non-academics. In the biggest departure, he is hiring 500 financial advisers to persuade retiring university employees to keep their money at TIAA-

CREF rather than roll it into a competitor's shop.

But missteps and controversies have hobbled the overhaul. In 2004, two members of the board of trustees caused a scandal when they went into a side business with TIAA-CREF's independent auditors. Criticized for a conflict of interest, they left the board. Then, a bid to upgrade the computer system in a hurry backfired on thousands of clients, some of whom didn't receive pension or other retirement-account payments for a time. Meanwhile, a program of steeply raising mutual-fund fees angered some clients and prompted fund-tracker **Morningstar Inc.** to accuse TIAA-CREF of "blatant disregard" for shareholders. ([See related article](#)¹).

Reactions like that could imperil one of TIAA-CREF's great strengths: the nonprofit's longtime reputation as being on the side of the little guy. "It doesn't seem right that they would turn this company into a Merrill Lynch. They're not as interested in the individual clients as they are in making profits," says Dick Benson, a retired math professor in Bellevue, Wash. Mr. Allison says the challenge is to execute a transformation "without the company losing its soul."

TIAA-CREF's main business is to contract with universities to handle the retirement money of their employees. Most of that money resides in two giant TIAA-CREF accounts, one invested in stocks and the other in bonds and real estate. Since the late 1990s, TIAA-CREF also has given these employees the option of several mutual funds that it runs. Today TIAA-CREF manages a massive \$370 billion for 3.2 million active and retired university employees, as well as some employees at research and health-care institutions.

This is a tempting target for Wall Street firms that have built up big businesses managing retirement money for corporate employees and that offer lots of investment options. The 1990s explosion in popularity of do-it-yourself retirement plans such as the 401(k) has edged into the insular world of academia. There, transplants from the corporate world have been demanding more investment options. The result is an intensifying competition to manage a huge pool of retirement money -- some of it up for grabs as baby boomers retire -- that TIAA-CREF once had to itself.

Andrew Carnegie, the steel magnate and philanthropist, in 1918 founded what would become TIAA-CREF, partly to help ease aging professors into retirement and open spots for younger people. The TIAA part of its name stands for Teachers Insurance and Annuity Association, and is the part that invests in bonds and real

estate. CREF, or College Retirement Equities Fund, invests in stocks. TIAA-CREF as a whole is a nonprofit, though a couple of its diverse units are for-profit.

The company was a pioneer, making it possible for professors to switch jobs and take their pensions with them. They could do that in part because whatever college they moved to, TIAA-CREF would be in charge of retirement money there, as well. After World War II, when inflation became a concern, the organization combined stock investing with an insurance guarantee that holders would get their investment back if they died before retirement. It thus created the first variable annuity.

TIAA-CREF's nonprofit heritage and low management fees persuaded many it was on the side of the angels. Bolstering this image, it has offered people the chance to have their retirement money in "socially responsible" investments, such as firms with environmentally friendly policies. It also has sometimes used its large stockholdings to pressure companies on issues such as high executive pay.

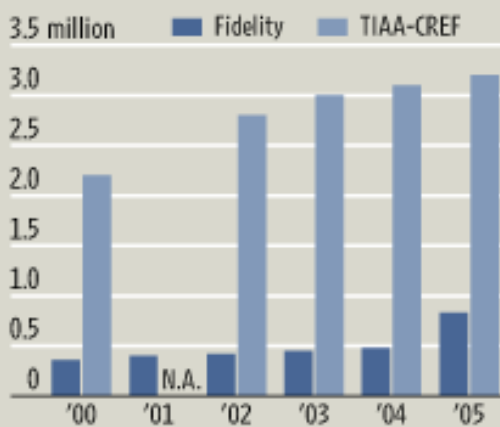
Falling Behind

But by the 1980s, TIAA-CREF was falling behind the times. For instance, it didn't offer a basic money-market account until late in the decade, after they had become common. In the 1990s, Fidelity, Vanguard Group and other large mutual-fund firms started making inroads on its campus business. Colleges were feeling pressure from employees to offer more choices for retirement money than just TIAA-CREF's limited lineup.

Then in 2002, one of its oldest clients, Stanford University, brought in Fidelity for a computer upgrade. Stanford wanted a better system to track money withheld from paychecks and to generate account statements. In a sign of TIAA-CREF's lack of awareness of its changing industry, it declined to help. Fidelity provided the computer system free. In the process, it made it more convenient for Stanford employees to invest with Fidelity.

Hard Lesson

Competitors such as Fidelity have been eating away at TIAA-CREF's core market of managing money for universities' employees. Number of clients:



Note: Fidelity data for higher education clients, TIAA for all clients.

Sources: the companies

This was a big break for Fidelity. It took the system it built for Stanford and used it to pitch money-management services to other universities. Since the end of 2002, Fidelity has nearly doubled its higher-education clients to 843,000 individuals through contracts with the likes of the University of Virginia, Vanderbilt and the University of California.

Because the universe of college employees is growing, TIAA-CREF has been able to increase its numerical client total even as its market share -- that is, its share of total retirement money held by campus employees -- declined. Its individual clients number 45% more than in 2000, but in the past several years growth has slowed.

One thing that hasn't been an issue for most is investment performance. TIAA-CREF's fixed annuities provide higher returns than are available just about anywhere else. And the giant \$116 billion CREF stock fund has returned 5.9% annually over the five years ended March 31, just short of its benchmark, which gained 6.4% a year.

With other firms making inroads, TIAA-CREF trustees were nervous about the future in 2002 as they sought a successor for Chief Executive Officer John Biggs, a former administrator at Washington University in St. Louis. Some were ready to break tradition and hire from outside academia.

Mr. Allison by this time was gone from Wall Street. He had joined Merrill in 1971, and in 1973 opened an office in Iran. In four years there he helped create the Tehran stock exchange and met his wife, whose father, he says, insisted he learn Farsi before they could marry. Mr. Allison eventually rose to be Merrill's president and chief operating officer, but left in 1999 after it grew clear he wouldn't get the CEO job.

He then headed a joint venture of Oxford, Stanford and Yale universities to offer courses online. TIAA-CREF's board contacted him in early 2002 and he joined as CEO that fall. Including a \$1 million salary, he earned \$4.7 million in 2004.

Wall Street quickly took notice of his arrival. In his first week on the job, he says, four investment banks phoned to talk about taking TIAA-CREF public. Mr. Allison says that's not in the cards.

He quickly made a bid to salvage the Stanford relationship -- and got a taste of the challenges. When he visited the campus early on, he says, its officials complained loudly that TIAA-CREF wasn't following through on a promise to provide client information to Fidelity, so Fidelity could create unified account statements. "They blistered my ears for about 40 minutes," he recalls.

He moved quickly to cut costs. He let go 500 employees, about 8% of the staff, in what the company says were its first ever large-scale layoffs. The move -- with scenes of security guards escorting former staffers off the premises -- sent a shock through the paternalistic company.

He also reversed one of his predecessor's strategies: marketing life insurance and mutual funds outside the core market of educators. The efforts weren't catching on, largely because of inexperience but also because of a lack of name recognition outside academia. And fixing the core business was more urgent.

The heart of Mr. Allison's strategy is offering financial advice doled out by "wealth management consultants." They will offer detailed investment advice to current clients -- especially those nearing retirement, who have the right to accept a lump sum and take it elsewhere. The specifics of those recommendations will come from an independent company to avoid potential conflicts of interest, such as touting higher-fee investments that benefit TIAA-CREF. The company also is opening dozens of branch offices near college campuses, another big change.

The adviser strategy has some risks. For one, it assumes clients will want financial advice from TIAA-CREF, a firm with no track record in giving it. TIAA-CREF is betting clients will turn to it in part because of decades of goodwill it has earned at universities.

Yet that goodwill has been stressed by other aspects of Mr. Allison's strategy. He is determined that the firm won't stick with money-losing projects.

In 2003, he sold off one such business: insurance for long-term care, as in nursing homes. This sort of insurance has been a tricky area for consumers, who worry that an insurer might nickel-and-dime them later when they're old and vulnerable. In this respect, TIAA-CREF's good-guy reputation as a nonprofit was a selling point.

But the sale of its existing long-term-care policies to a for-profit insurer has upset some clients. "They betrayed me," says Jeremy Stone, former head of the Federation of American Scientists and a TIAA-CREF client since 1964. With a long-term-care policy, "you have to trust the organization to follow through," he says.

Last summer, Mr. Allison's approach set off another backlash. TIAA-CREF's eight-year-old mutual-fund group, which had a consumer-friendly policy of low management fees, also was losing money. Executives decided they had to either raise fees or shut the group down.

Mr. Allison figured the fees were so low they could be raised significantly and still be below most funds. But he proposed to as much as quadruple some of them. When shareholders in the funds got a chance to vote on the increases, they rejected them on nine of the 30 funds then offered. Those funds had \$4.6 billion in them -- about 40% of the fund group's assets.

Now he was boxed in. He didn't want to close the funds and return that money to investors. But he also didn't want to continue a business that was losing money. Mr. Allison decided to hold a second shareholder vote on the boosts.

Top executives at TIAA-CREF warned him he was putting his own reputation at stake and it would take a hit if he lost again. He says he saw it a different way: Retreating on the fee strategy would make the company look weak. So he made an aggressive lobbying push to get several big clients to reconsider. The fee increases passed in January.

Sharp Criticism

Still, the move triggered some sharp criticism. "TIAA-CREF's version of democracy gives investors raw deal," said a headline in a Morningstar report. "This isn't the TIAA-CREF longtime observers of the firm know and respect."

Technology continues to bedevil TIAA-CREF. Last year it started phasing in new software. Some executives urged a slow timetable. Mr. Allison went for an aggressive one, saying the old system's limits were costing it business.

One upgrade took place just before Thanksgiving, and the timing was terrible. The new software had bugs that surfaced just as the traditional end-of-year surge in account activity commenced. Thousands of people suffered delays in receiving or moving money, and to some who used TIAA-CREF's Web site, it looked as if money had vanished from their accounts. Although the 13,000 clients who had problems were a tiny share of TIAA-CREF's total, some had to wait till January to get fully restored service.

There's more work to do. TIAA-CREF clients don't yet have the ability to reset passwords on their online accounts if they forget them. They have to phone in. Expenses charged on TIAA-CREF's main retirement offerings rose last year, partly to cover the technology bill.

Mr. Allison says the firm was right to stick to a fast-paced computer upgrade. He says it has moved 1.9 million accounts to a new record-keeping system. In the long term, "it's in the participants' and institutions' interests," he says.

TIAA is also now readying itself to take a stab at the difficult task of getting other brokerage firms and advisers to carry its investment products. The firm says this won't be an effort to market outside its core audience, but rather, a way to hold onto clients' assets even if they go to other companies for advice.

The Stanford problems continue to haunt him. More than three years after his initial hostile reception there, TIAA-CREF still isn't able to do what Stanford has been asking: put its account information on Fidelity's computer system. So Stanford's benefits office must still run two separate systems, one for retirement money invested at TIAA-CREF and one for accounts held with Fidelity.

Mr. Allison says the problem lies in the structure of some of TIAA-CREF's retirement investments, which were set up before anyone thought of using a computer to track them. He says the firm is starting to offer new annuities, for instance, redesigned to work with others' record-keeping systems. The bad news: Returns on the newer ones aren't quite as high as on the older ones.

Write to Tom Lauricella at tom.lauricella@wsj.com²

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