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Rethinking Financial Services Diversification for a New Century

by Philip Dutter

For several decades, diversification was the prevailing strategic theme among major corporations in the financial services field. The notion of becoming a financial supermarket seemed to have considerable appeal for corporate executives and the investing public.

To recall the dominance of the diversification theme from the late 1960s to the early 1980s, let's review the major financial services acquisitions during that period. In the relatively benign competitive climate of the 1960s, diversification became popular among insurance companies. Life insurers, such as Connecticut General and Lincoln National, acquired property-casualty insurers. At the same time, most of the large property-casualty insurers, such as Hartford, Continental, INA, Chubb and St. Paul, acquired or formed life insurance subsidiaries, at least partly in hopes of gaining greater earnings stability. Also in the 1960s a considerable number of insurers, particularly life insurers, entered the mutual fund business.

The 1960s also saw several acquisitions of insurance giants by even larger giants from outside the industry:

- Hartford acquired by ITT
- Fireman's Fund acquired by American Express
- Paul Revere acquired by AVCO

During the 1970s life insurance giants, Prudential, Metropolitan, and Equitable, entered the property-casualty business to provide their agents with auto and homeowners insurance product lines.

The pace of diversification slowed somewhat in the late 1970s, but picked up again in the early 1980s with a rash of acquisitions of securities firms:

- Bache by Prudential
- Shearson by American Express
- Donaldson, Lufkin and Jenrette by Equitable
- Dean Witter by Sears Roebuck

In 1983, Xerox acquired the property-casualty insurer, Crum and Forster, and later several life insurance and annuity companies.

Drivers of Diversification

The thinking behind these strategic moves was usually some combination of the following motives:

- A belief that entering the new field would enable the company to grow faster at an acceptable rate of return. In many cases, this belief was based partly on an expectation of significant marketing synergy between the acquirer's existing business and the business being acquired.
- A belief that greater diversification would spread risk by dampening the effects of competitive pricing cycles in certain lines of business and thus provide more stable earnings growth.
- For stock companies, the hope that investors would see a venture into a new field as a sign of confidence and aggressiveness and would react favorably to the logic and financial terms of the acquisition, thus boosting the company's market value.

> The lure of marketing synergy among various lines of business or types of financial services has long been part of the rationale for diversification.

Problems Encountered

While some of the diversification moves worked out reasonably well, others did not. The disappointments could generally be traced to one or more of the following factors:

➤ **Top management's inability to exercise effective control.**

There is a natural tendency for executives to be uncertain of their judgments in evaluating operations in a business in which they have no experience. They are sometimes hesitant to address troubling concerns or inclined to rely too heavily on the judgment of others who "know the business" but may not share the same values.

➤ **Lack of market position and competitive strength in the new business.**

Any company seeking to enter a new but relatively mature business faces a formidable challenge. Opportunities to acquire a well-managed company with a strong competitive position are rare. Too often companies available at an acceptable price either lack competitive strength or have internal problems not apparent on the surface. The alternative of entering a new business de novo requires unusual commitment over an extended time period. Many such ventures "die on the vine" from undernourishment in terms of both skilled people and financial support.

➤ **Expected marketing synergy has proved elusive.**

The lure of marketing synergy among various lines of business or types of financial services has long been part of the rationale for diversification and has long been a source of frustration for management. Cross-selling always seems easier in theory than it proves to be in practice. Equally discouraging for those companies seeking to provide life insurance agents with automobile, homeowners, and disability insurance products, success in achieving marketing synergy has frequently led to substantial losses from bad claims experience.

➤ **Financial markets have lost their enthusiasm for conglomerates.**

Back in the '60s, '70s and early '80s, it seemed that Wall Street loved diversification. Of course, conglomerates provided handsome fees to investment banking firms. They also were widely applauded in the financial press. In more recent years, however, investors seem to have become increasingly skeptical of the outlook for conglomerates. Partly for this reason the potential "break-up" value of many diversified companies substantially exceeds the current market value of the company as a whole.

A Shift in Strategic Themes

As the allure of diversification and conglomeration faded in the late 1980s, a new strategic theme began to emerge in the 1990s.

Many multi-industry conglomerates reduced their involvement in financial services.

- Sears spun off Dean Witter and then Allstate
- American Express sold Fireman's Fund and Shearson Lehman
- ITT spun off ITT Hartford
- Xerox sold Crum & Forster and its other insurance holdings
- Textron, which had acquired Paul Revere with AVCO, sold Paul Revere

Insurers have withdrawn from lines of business they found difficult.

- Equitable, Aetna, and Lincoln National withdrew from the property-casualty business
- St. Paul and Chubb withdrew from the life insurance business
- Equitable, Metropolitan, Travelers, Provident, Lincoln National, Hartford and others withdrew from the group medical businesses
- Equitable, New York Life, Lincoln National, General American and others withdrew from the individual disability income business

Some insurers have increased their concentration on "core" businesses through acquisition.

- CNA increased its property casualty concentration by buying Continental
- Travelers increased its concentration on property-casualty by buying Aetna's property-casualty operations
- Aetna increased its concentration on the group medical business by acquiring U.S. Healthcare
- Provident Life and Accident increased its concentration on individual disability income by acquiring Paul Revere
- Several companies increased their concentration on the individual life business
    - Mass Mutual by acquiring Connecticut Mutual
    - Phoenix Mutual by merging with Home Life
    - Metropolitan by acquiring New England Mutual
    - American General by acquiring Franklin and U.S. Life
    - Jefferson-Pilot by acquiring Alexander Hamilton and Chubb Life
    - Aegon by buying Providian's agency operations
    - Lincoln National by buying Cigna's individual life operations

In some cases the combination of withdrawal and acquisition moves can appropriately be characterized as "repositioning". For example, for Travelers, Metropolitan, and Provident Life and Accident, withdrawal from the group medical business helped provide funds for management to increase concentration on lines of business considered more attractive in light of the company's strengths and competitive position. Similarly, Aetna's sale of its property casualty business helped provide funds for its purchase of the HMO company, U.S. Healthcare, and Lincoln National's sale of its group insurance and property-casualty businesses provided funds to purchase Cigna's individual life operations.

The effect of most of these moves, whether they involved simply withdrawal or repositioning by eliminating one business and building up another, has been to concentrate top management attention and corporate resources on a smaller number of businesses. In some cases, previous diversification moves were reversed. In all, the strategic theme has been greater concentration, not greater diversification.

The shift in corporate strategies away from diversification has not been simply a matter of one fad replacing another.

The notion of diversification is not dead. Before Travelers' recent repositioning moves, its CEO, Sanford Weill, created the most newly minted financial services conglomerate by starting with commercial credit, adding securities brokerage (Smith Barney and subsequently Shearson), and finally all lines of insurance (first Primerica and then Travelers). General Electric, through GE Capital, has continued to acquire specialist insurance companies. Dean Witter and Morgan Stanley are merging to put their related but different businesses under one tent.

Recently, a spate of acquisitions of securities firms by major banks has raised questions regarding a possible resurgence of the financial services diversification theme. Encouraged by loosened regulations and a buoyant stock market, Bankers Trust and Nationsbank, among others, have acquired mid-sized security firms. Commenting on the Nationsbank purchase of Montgomery Securities, Peter Truell of the *New York Times* wrote, "Nationsbank and Montgomery executives talked of one-stop shopping as a benefit of their transaction. In doing so, they resurrected a term that was bandied about in the heady 1980s when Shearson-Lehman American Express proposed to offer companies and individuals everything from credit cards to stock issues.

What lies ahead?

I believe the diversification resurgence will prove to be brief and narrowly focused rather than a pervasive long-term trend across a broad range of financial service sectors. The predominant theme is likely to be greater concentration and sharper focus rather than diversification.

The shift in corporate strategies away from diversification has not been simply a matter of one fad replacing another. In my view it is driven mainly by the increasingly intensive competitive pressure in every segment of the financial services arena. The requirements for profitable growth - market position, distribution strength, operating efficiency, and product development, marketing and technical capability - have been raised sharply. Results for marginal players in each market segment are deteriorating, and the chances of successfully rebuilding a weak operation seem to be growing slimmer every year.

Added to this basic driving force is the fact that diversification and prospective synergy are now viewed with a jaundiced eye in the financial markets. The phrase, “focusing on core businesses”, is now as popular in the financial press as the terms “diversification” and “synergy” were in the past.

It seems unlikely that competitive pressures in the financial services arena will abate. Therefore, it seems unlikely that we will soon see a return to the former fascination with diversification. For most companies the risks are too great, the chances of success too small.

This does not mean that management can afford to stand pat. To pursue a strategy of focusing on core businesses, they face the challenge of:

- Selecting, after thorough, objective analysis, core businesses on which to concentrate, considering the outlook for each business and the company’s competitive positions, its strengths and weaknesses in each.
- Determining how best to build each of those core businesses, including considering whether acquisition or joint venturing with another organization would strengthen the company’s competitive position.
- If acquisition or joint venture is part of the strategy, finding a suitable partner and then developing and executing a plan for merging operations or implementing the joint venture so as to produce a stronger more competitive operation within a reasonable time.
- For some companies, a strategy of focusing on core businesses will also involve the difficult, sometimes painful, decision to withdraw from businesses where the general outlook and chances of developing a strong competitive position are too slim to warrant further investment of resources and management time.

For most companies concentration on a few, carefully chosen core businesses would seem to offer the best chance of long-term success in an increasingly competitive world.

While diversification strategies will still have some appeal, that appeal is likely to be far less widespread than it was in the past. For most companies, though, concentration on a few, carefully chosen core businesses would seem to offer the best chance of long-term success in an increasingly competitive world. ■

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