PART ONE

Fidelity: Past, Present, and Future

ONE

Fidelity

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Fidelity is the world's largest mutual fund company, bar none.

With more than $1.1 trillion in mutual fund assets and more than 19 million shareholders, Fidelity Investments has long ruled the mutual fund industry.

In fact, you could say that Fidelity was and still is in no small measure responsible for the growth of the mutual fund industry itself.

It is a Goliath, even in the land of Goliaths.

From its headquarters on Devonshire Street in Boston's financial district, 60-year-old Fidelity employs nearly 40,000 people; offers over 300 actively managed, index-focused, and ETF-based funds; and casts its investment shadow across the globe.

The sun never sets on Fidelity.

While Fidelity is known as a leading provider of financial services, its empire is vastly greater than its mutual fund company and offerings. Its services extend far beyond mutual funds to include discount brokerage services, retirement services, estate planning, securities execution and clearance, life insurance, real estate, publishing, venture capital, outsourcing, and even a national executive limousine service (aptly named *Boston Coach* which, by the way, I recommend highly).

Although it has occasionally stumbled, Fidelity has a long and illustrious history of success as a business—as a business that has been able to reinvent itself to not only compete with changing times and changing leadership in the financial services landscape, but to lead and dominate that landscape time and again.

That success can be traced to traits not typically associated with Boston's Puritan roots: guts and gusto. But ingenuity, hard work, and an eye for global trade has always been part of the Hub's heritage ("the Hub" being the nickname given to Boston precisely because of its intense historical focus on global commerce). In Fidelity's founder, one Boston trust lawyer named Edward C. Johnson II, the twain met.

Johnson hailed from a distinguished and wealthy Brahman family. Smart and ambitious, he earned a degree in business from Harvard College and went on to graduate from Harvard Law School.

But Johnson didn't rest on his social standing—or even on his intellect. Graced with an independent spirit and a voracious appetite for adventure, Johnson soon found himself seduced by Wall Street, a place he once described as one "in which it was every man for himself, no favors asked or given."

In 1943, at the age of 45, Johnson assumed the reigns of the 13-year-old Fidelity fund. Even by the standards of the financial markets six decades ago, the fund's $3 million in assets represented a modest sum. Three years later, Johnson established Fidelity Management and Research Company to act as an investment adviser to Fidelity Fund, which by then had grown to $13 million. That 400 percent gain in three years would be a harbinger of growth to come.

Johnson was an imperious leader, one who likened playing the market to being England's Sir Francis Drake in the midst of a sea battle. By setting high standards, and by rewarding individuals who met those standards, Johnson cultivated a highly competitive money management culture that continues to distinguish Fidelity from most of its peers today. Under Johnson, Fidelity became known as a place where employees were almost fanatical—if not downright, cutthroat—in their quest to meet exacting standards set by Johnson himself.

In fact, Johnson's steadfast pursuit of individual excellence led him to reject the popular notion that mutual funds were best managed by investment committee. To his way of thinking, funds were best run by individuals—individuals who were smart, decisive, and empowered to make investment decisions. The focus on the manager, not the fund, has been imprinted on each and every Fidelity manager, past and present.

In 1947, Johnson launched a second fund, the Fidelity Puritan Fund. The income-oriented balanced fund was positioned as a less-aggressive offering than the Fidelity Fund. The principle of diversification both in terms of investment choices and as the basis for investment decisions remains a core component of Fidelity's money management business and investment discipline to this day.

Although money flowed into Fidelity at a healthy clip—by 1956, the firm had $256 million in assets under management—Johnson was in no rush to grow his young money management firm. In fact, it wasn't until 1958, long after Americans had begun to develop an appetite for risk in the financial markets, that he launched two funds aimed at what we now consider to be aggressive growth investors.

One of the new funds, Fidelity Capital, was created at the behest of Fidelity stock analyst Gerald Tsai Jr., whose no-holds-barred style of investing would transform into a Wall Street star in the go-go days of the 1960s.

Two years later, the other new growth fund, Fidelity Trend, would become the first management assignment held by Johnson's son Edward C. "Ned" Johnson III, who joined Fidelity as a research analyst in 1957. The younger Mr. Johnson shared his father's passion for investing and quickly distinguished himself as a stock picker par excellence.

Eventually, Ned would replace his father at Fidelity's helm—a move that would mark a dramatic turning point in Fidelity's history.

The 1960s were heady years for Fidelity—and for all of Wall Street, for that matter. Tsai, a native of Shanghai, became the first "star" manager to rise from Fidelity's ranks. But Tsai's bold and adventurous investing style, which involved taking big positions in a stock and then bailing out just before its short-term run-up was about to end, soon became the poster child of Wall Street's appetite for risk in those days.

Fidelity, it seemed, had become Wall Street's "it" money management firm. Assets, for example, reached $4.3 billion in 1969, up dramatically from $500 million at the beginning of the decade.

But, neither the run of economic prosperity nor the breakneck growth that Fidelity experienced because of it would go unchallenged. Thanks to inflation and a deteriorating U.S. economy, the Dow Jones Industrial Average, which had reached a peak in 1968, began a tortuous series of drops that culminated with a 40 percent decline in one year—1973–1974—preceded by tough years. (Fortunately for Fidelity, Tsai had struck out on his own in 1965, before the market turned so decisively against his hyperaggressive investing style.) Still, as a result of the broader market's decline, mutual fund shareholders across America began to yank money from their investment accounts, killing off dozens of fund companies and brokerage houses in the process.

Fidelity, of course, survived. But it did more than merely survive; it learned a lesson about its own need to diversify its business, which it took to heart and put into practice. And, even though the best example of learning from such past experience to better maneuver through difficult times took 28 years to materialize, when the market crash of 2000–2002 took place, erasing nearly 47 percent of the value of the S&P 500, and competitors like Charles Schwab were forced to lay off more than half their workforce, Fidelity not only hired more workers, but gained share in the brokerage marketplace.

But let's get back to earlier times. Fidelity's assets under management dropped to $2.4 billion by the end of 1974; nearly a 50 percent drop.

A Family Affair

In the midst of that tumult, Edward C. Johnson II turned to one person for help: his son.

Even though he was only 42 years old when he was appointed president of Fidelity in 1972, Edward C. "Ned" Johnson III, had earned the respect and admiration of Fidelity's stock-picking team. In fact, the returns he posted while managing Fidelity's famed Magellan in the 1960s would prove even better than when the much larger fund was in the hands of über-investor Peter Lynch (see Figure 1.1).

Ned Johnson was more than a good stock picker, however. He was a visionary—a visionary with a knack for product development as well as an early appreciation for the essential business and philosophical role technology would play in Fidelity's continued success.

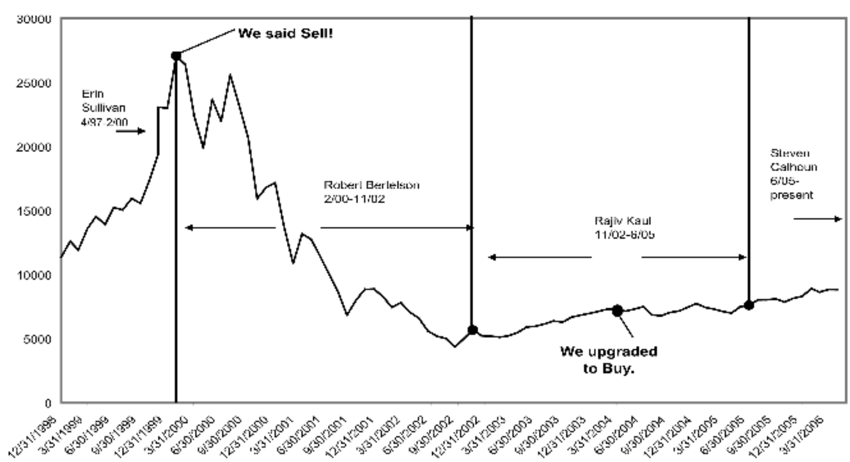

FIGURE 1.1 Manager changes at Fidelity Aggressive Growth
Source: www.fidelityinvestor.com

With the sky-high-oil-priced economy still in the tank, stocks, and mutual funds that invested in them, had become persona non grata in the portfolios of many American investors. Recognizing this, the younger Johnson set out to recast Fidelity as a company that would appeal to the more skittish investors of that era.

Innovation: Back to Basics

How did he go about doing that? By using the simplest, most efficient, and what proved to be most profitable instrument available (and one that most money managers treated with disdain): a money market fund that also doubled as a checking account. Faced with high inflation and interests rates, many yield-hungry yet conservative investors were flocking to money market funds. Fidelity did not open the first money market fund, but adding the check-writing feature was Johnson's idea.

Launched on May 31, 1974, Fidelity Daily Income Trust (FDIT) was not only successful in attracting some $500 million from low-yield (or zero-yield) savings or checking accounts during the first seven months of its existence, it also established the secretive Fidelity mascot. Even to this day, when you walk through the inner sanctums leading to Ned Johnson's office you'll find glass cases lined with all manners of frog sculptures, the ticker symbol for Fidelity's first money market fund, FDIT. Two years later, Fidelity unveiled another major investment innovation, tailor-made for the shell-shocked conservative investors of the 1970s: It was the nation's first open-end municipal bond fund.

In 1977, the same year Ned Johnson's succession was completed by his ascension to chairman and chief executive, Fidelity expanded its menu of bond offerings to include its first junk-bond vehicle, the Devon Bond Fund (now Capital & Income).

But Ned Johnson was focused on things other than money market and bond funds. Internally, he had also turned his attention to building Fidelity's technological prowess. Thanks to Johnson's commitment to computerization and the skill of operations manager Bob Gould, Fidelity would finish the decade by also distinguishing itself through the automation of its back-office operations as well as through the creation of a sophisticated telephone customer service system.

Initially, the calls pouring in to Fidelity's toll-free lines were all handled by live operators. By 1979, however, the Fidelity Automated Service Telephone (FAST)—forerunner of the account service systems now standard throughout the industry—was up and running.

The economy finally bottomed out with the 1980–1982 recession. In response to President Ronald Reagan's massive tax cuts and a lowering of interest rates, the Dow Jones Industrial Average in August 1982 broke free of the malaise that had plagued it since 1968 and took off on an upward trajectory.

By that time, Fidelity had amassed some $10 billion in assets. But two-thirds of those assets were held in money market accounts, which generated far less fee revenue than stock funds. On the bright side, the money pooled in those accounts was already sitting in Fidelity's coffers.

Now it was up to Fidelity to convince its money market investors to dip their toes back into the stock market—and to do it through Fidelity.

The 1982 to 1987 bull market was unlike any other. The trials and tribulations of the 1970s had raised the awareness of many ordinary investors to the concept of yield. As stocks began to improve and interest rates declined, money fund investors naturally looked to stock funds for higher returns. Fidelity, which had billions in money fund assets and an impressive stock team that included a promising young manager named Peter Lynch, was ideally suited to reap the benefits of the Reagan boom. But stellar fund performance alone doesn't build a business; human capital is equally essential. And it was here, long before the notion of complementary CEOs became the buzz of the business world, that Ned had another remarkable success: He hired a man who would be instrumental in shaping Fidelity's future. His name: Jim Curvey.

James C. "Jim" Curvey joined Fidelity in 1982 as vice president of human resources, and a short time later became senior vice president of administration. Together, Ned and Jim would build Fidelity into the powerhouse it is today; Ned focusing on innovative product and service ideas, and Jim translating those ideas into the key hires that could implement them.

In 1987, Curvey started Fidelity Capital—the company's new business development arm—and served as its president until 1997, when he was named president and chief operating officer of Fidelity. During his tenure at Capital, the organization grew from a fledgling group of venture businesses with $10 million in revenues to a company that both operated and invested in businesses and had revenues of $270 million.

Curvey was named president and chief operating officer in 1997, a position he held until July 2000, when he became head of Fidelity Strategic Investments, the umbrella organization for Fidelity's capital, venture investing and real estate operations. He narrowed his focus to Fidelity's telecommunications interests in January 2002. "When Ned asked me to oversee day-to-day operations of the whole company in 1997, we were going through a difficult period in which performance of our funds and other parts of Fidelity weren't up to our standards," Curvey said. "Working with a terrific team of Fidelity people, we got back on the right track, where we remain today."

During Curvey's tenure as president and COO, Fidelity had some of its best years ever. The company grew from 24,000 to 31,000 employees from 1997 to 2000, while its assets under management increased 82 percent to $973.4 billion (at July 1, 2000). Net sales, revenue and operating income also increased dramatically during 1997, 1998, and 1999, with operating income in 1999 totaling more than twice its what it was in 1997.

When, at the age of 67 Jim announced his retirement from Fidelity on November 13, 2003, he had this to say: "The past 20 years have filled me with the great satisfaction of helping Ned (Chairman Edward C. III) Johnson to build one of the finest financial services firms in the world. It's been an exciting time. From starting and growing Fidelity Capital, to serving as president of the company, to focusing on our telecommunications interests, I've been challenged, rewarded, and blessed. But it's time now for a new generation of Fidelity people to take on the challenges we face today."

Ned returned the compliment: "Everything I asked Jim Curvey to do over the past 20 years was done eagerly and well," said Johnson. "Jim brought intelligence, experience and dedication to each task he undertook, and he was always willing to tell it like it was. I will miss the guidance he provided to Fidelity and the counsel he provided to me. The work of Jim Curvey over the past 20 years is one of the major factors behind the success that Fidelity has enjoyed. He set an example for all of us and he will be missed."

Today, Curvey remains a member of the board of directors of FMR Corp., Fidelity's parent company, and of COLT, the pan-European telecommunications company in which Fidelity is a major investor. Curvey also is a director of Geerlings & Wade, Inc., and Reading is Fundamental, and a member of the Corporation of Northeastern University, the Boston College Carroll School of Management Board of Advisors, and the Villanova University Board of Trustees.

Without Jim Curvey, Fidelity could have easily been just another spoke in the Hub's money management wheel. And without star managers, Fidelity's asset gathering wheel could have stood still.

Long before Morningstar thought up its popular star rating system, Fidelity cottoned on to the star power of its managers. In fact, if you were to name one mutual fund manager, chances are it would be this Fidelity one: Peter Lynch.

To describe Peter Lynch's stock-picking skill as "legendary" is not an overstatement. During his 13-year tenure at Magellan's helm, Lynch led the fund to a 2,703 percent return, far exceeding the 574 percent gain by the S&P 500 during the same period.

Even in the early days of his reign, Lynch's performance did not go unnoticed by investors. As assets began pouring into the fund, Magellan—and Lynch—soon began to receive a level of attention from the media not seen at Fidelity since the days of Gerry Tsai.

Lynch also received an intense level of attention from within Fidelity—particularly from Fidelity's cadre of eager young security analysts who were hell-bent on duplicating his eclectic investing style. Lynch's habit of grilling analysts about every facet of a company's balance sheet, coupled with the analysts' desire to meet his standards exacting standards, turned Fidelity into a veritable boot camp for hotshot stock pickers.

Under Lynch, Magellan's assets ballooned from $22 million in 1977 to $13.1 billion—a sum larger than Fidelity's entire asset base a decade earlier—when he retired in 1990.

Needless to say, Johnson's mutual fund empire was back in full swing.

By 1986, the Fidelity organization offered 70 retail mutual fund offerings, which the company promoted with print advertising, direct mail solicitations, and television spots, as well as through a growing number of walk-in investor centers.

Then came October 19, 1987, the day the Dow Jones Industrial Average fell 508 points and the bull market came to a crashing end. Almost overnight, the greed and gluttony that had come to define Wall Street during the first half of the 1980s was swept away. In its wake remained a nation of shell-shocked investors and thousands of investment industry workers without jobs.

Ultimately, the crash of 1987 would prove more of a hiccup than a heart attack. Fidelity ended 1987 with $75 billion in assets, down moderately from its record high of $80 billion.

But two years later Fidelity's assets would pass the $100 billion mark.

Fidelity sailed into the 1990s with its characteristic surefootedness. The combination of low inflation and high employment—not to mention reduced government deficits and high productivity growth—had turned Fidelity into a moneymaking machine. In fact, Fidelity's assets under management would skyrocket to $955 billion at the end of 1999, from $109 billion at the beginning of 1990.

But the 1990s were also an era of uncertainty for Fidelity. Lynch, who had attained superstar status at the helm of the nation's largest and most successful stock fund, announced plans to retire in 1990s at age 46. Though Fidelity was well stocked with smart, aggressive stock pickers, Lynch's departure proved more than a glancing blow to Fidelity's celebrity status on Wall Street.

Fidelity also faced intense and often brutal competition in the 1990s. Much of that competition came from one firm: Vanguard Group Inc.

Vanguard had found a way to distinguish itself from Fidelity by becoming a leader in low-cost money market funds and index funds. The popularity of both products in the late 1980s and early 1990s called into question one of Fidelity's main reasons for being—that is, to provide small investors access to professional money management they would never be able to afford otherwise.

But Johnson was not about to let Vanguard blunt his edge with investors. Early in 1989, Fidelity launched the Spartan Money Market Fund. By shouldering the fund's expenses—and offering above-average yield—Fidelity was successful in attracting assets, not to mention more media attention. In the first six months, Spartan Money Market picked up about $2.5 billion in assets. A year later the fund would grow to a whopping $8.3 billion.

Buoyed by the success of the money market fund, Johnson, in the spring of 1990, unveiled the Spartan Market Index Fund. The fund, which was later renamed the Fidelity Market Index Fund, was designed to track the performance of the Standard & Poor's 500 Index. Once again, Johnson fought Vanguard by absorbing some of the fund's expense, and once again he was successful in bringing boatloads of new assets into the company.

But the 1990s also posed considerable challenges to Fidelity on the investment front. In 1994, its fund managers were hurt by investing too aggressively. Then, in 1995 and 1996, many managers took a hit for investing too conservatively.

Most notably, Jeff Vinik, then the manager of Magellan, injected a big dose of government bonds into the "stock" fund, causing it to stumble. Vinik "left" the fund, and Fidelity, in 1996.

Another big challenge facing Johnson in the 1990s had to do with turnover of portfolio managers. Since Fidelity's managers tend to be the cream of the crop, Johnson has long had to contend with them being heavily recruited by rivals. For a while, being part of the Fidelity machine provided enough cachet to keep talented managers.

But with the growing popularity of hedge funds in the mid- to late 1990s, Fidelity—as well as other fund companies—began to lose some of its stars. While Fidelity managers are well compensated, successful hedge fund managers earn two or three times what they would at the helm of a mutual fund.

So, in 1995, Johnson did the unthinkable: He gave Fidelity's top executives and fund managers a 51 percent stake in FMR Corporation, the firm's parent company. The move, which marked one of the largest transfers of voting control to employees in corporate history, reduced Johnson's stake in Fidelity to 12 percent (from almost 25 percent).

It also made Abigail Johnson, at that time manager of Fidelity OTC and the only one of Johnson's children active in the business, Fidelity's biggest shareholder, with a 24.5 percent stake.

Fidelity's performance improved over the next several years, thanks in large part to Johnson's efforts to impose more discipline on portfolio managers and to hold them more accountable for their performance results.

Then came the new millennium.

The bear market of 2000–2002 was difficult for the entire mutual fund industry. Fidelity was no exception. Besides having to cope with the collapse of the technology stocks and the fact that growth-oriented companies were being spurned by investors, Fidelity had to adapt to something else: Regulation Fair Disclosure (Reg FD).

Enacted in 2000, Reg FD bars public companies from selectively disclosing information to certain shareholders or investors. The rule change was intended to level the playing field between institutional and individual investors.

Once again, Fidelity's edge—which was based in part on the ability of its managers to use the Fidelity name to gain exclusive access to the CEOs of big companies—was under attack. On an asset-weighted basis, Fidelity's U.S. stock funds beat just 50 percent of their peers in 2004, down from 53 percent in 2003. In 2002, the funds beat 61 percent of their peers.

Something else would soon come under attack: Johnson's seat at the head of the board that oversees every one of Fidelity's mutual funds.

Since 1946, a member of the Johnson family has served as chairman of the board overseeing Fidelity's funds. But in 2004, the Securities and Exchange Commission issued a landmark ruling requiring that 75 percent of fund directors—including its chairman—be independent of the company managing the funds' assets.

For Johnson, who had clearly taken a lead in trying to block the proposal from being passed, it was a devastating blow to his ego.

In the months leading up to the ruling, Johnson spoke personally to William H. Donaldson, who was chairman of the SEC at the time. He also traveled to Washington—and made thousands of dollars in political contributions—to curry favor with key legislators.

The rule change, originally set to take effect in early 2006, has been put on hold pending the outcome of a legal challenge by the U.S. Chamber of Commerce.

Meanwhile, Magellan went from being famous to being infamous. Robert Stansky, who became manager of Magellan in June 1996, faced a barrage of criticism for his inability to significantly beat the Standard & Poor's 500 Index, against which Fidelity compares the fund. Fidelity itself was criticized for allowing Magellan to grow too big to deliver impressive returns.

After more than a decade of tepid performance, Johnson, in October 2005, finally replaced Robert Stansky as the fund's manager. It's easy to see why. Under Stansky, the fund returned an average of 6.9 percent a year, compared with 8.1 percent for the S&P 500.

The fund, which is now in the hands of Harry Lange, currently has $50.2 billion in assets, down from an all-time high of $106 billion in early 2000.

In the annals of Fidelity's history, 2005 will go down as the year of the "dwarf toss."

In July, Fidelity got word that the SEC may file civil charges stemming from allegations that Fidelity traders accepted excessive gifts and entertainment from brokers who did business with the company.

Among gifts allegedly accepted by one Fidelity trader was a bacchanalian bachelor party, complete with scantily clad women and a round or two of "dwarf tossing," which reportedly involves throwing a dwarf in a Velcro suit at a Velcro-covered wall.

Moreover, the Office of the U.S. Attorney launched an investigation into whether brokers from other firms plied Fidelity traders with drugs and prostitutes in order to win their business.

Fidelity immediately launched its own investigation into the matter. As a result, a total of 16 employees were disciplined (14 late last year and 2 more earlier this year) for violations of company policy regarding gifts and gratuities. Meanwhile, Scott DeSano, who had headed Fidelity's stock trading desk, was transferred to another business unit.

In September of that year, Fidelity revealed that the SEC is eyeing a second area of potential charges against it in connection with gifts and entertainment its traders accepted from other brokerage firms.

For Fidelity, the allegations were unprecedented and humiliating. This is, after all, a firm that sailed unscathed through the 2003–2004 improper trading scandal—a scandal that led to more than $2 billion in fines and mandatory fee cuts and involved dozens of fund companies. Should it be charged, Fidelity vows to "vigorously defend itself" against any allegations unsupported by facts and data.

For Johnson, however, the charges were no doubt personal. That's because the very suggestion that Fidelity's traders would take part in such base pursuits goes against the refined, dignified culture that he and his father dedicated their lives to cultivating at Fidelity.

Johnson, who at 75 years of age shows no sign of relinquishing the scepter at Fidelity, has recently taken steps to restore the firm's reputation. For example, he's hired more analysts to allow Fidelity's research team to focus more heavily on specific segments of the market. Along the same lines, he has also implemented a plan to develop so-called career analysts to allow analysts to deepen their knowledge in their area of expertise.

In May 2005, Fidelity disclosed sweeping changes in the ranks of its most senior managers. As part of those changes, Abigail P. Johnson, Johnson's daughter and long considered his successor, relinquished her role as president of Fidelity's investment unit to assume the same title at Fidelity Employer Services Company, the subsidiary responsible for providing retirement and other benefits programs to employers for their employees.

She was replaced at the helm of Fidelity Research & Management Company by Stephen Jonas, a 19-year veteran of the company and its chief financial officer.

As part of the shake-up Johnson assembled a brand-new management team to run the investment group. On that team is Boyce I. Greer, who is head of equity research/asset allocation, a newly created position at Fidelity. Mr. Greer's appointment marks the first time the executive who oversees research is reporting directly to the executive in charge of the entire investment unit—once again signaling Johnson's single-minded focus on restoring Fidelity's research edge.

Today, Fidelity continues to evolve and innovate. In 2003, Fidelity met a brand-new competitor head on when it launched its first and only exchange traded fund, the Fidelity Nasdaq Composite Index Tracking Stock, known as OneQ. Despite being late to the game in terms of its foray into the exchange traded fund (ETF) market, OneQ was the first ETF to track the Nasdaq Composite Index.

The recent management changes at Fidelity have also raised new questions about who is being groomed to replace Johnson.

In recent years, Abigail Johnson has been widely expected to succeed her father. But that long-assumed succession plan was called into question by some last year when Abigail stepped down as head of the company's investment operations. It was further questioned in October 2005 when Abigail reduced her personal ownership in Fidelity and again two months later when she stepped down from her role as a member of the Fidelity mutual fund board of trustees.

Regardless of who is at the helm, Fidelity is sure to be a dominant force—if not the dominant force—in the mutual fund industry for a long time.

"I am generally satisfied with our accomplishments over the years," wrote Johnson in the company's 2005 annual report, which is distributed to employees to provide an update on the company's far-flung businesses. "However, we must not allow our success in the past to lead to complacency in the future, because there is much that needs to be done."