My Most Commented on Reports

RUSSELL CAMPBELL

Introduction

If you are a leader of an investment management firm, this report encourages you to think differently. In order to win clients, you have to be at the top of your class. Thinking differently can put you there.

I write a subscription – based weekly report with "second opinions" for leaders of investment management firms. I have written well over 100 weeklies so far, with many more topics on the horizon.

Usually I hear supportive comments from my readers – but not always!

I've gathered together here a collection of the reports that have stirred up the most controversy, chuckles (sometimes at my expense!) or discussion. Some of the responses have occurred at industry conferences, some in private meetings and others have been angry letters from those who disagreed with my right to say what I believe!

At the risk of offending some people, while enlightening others – here are some of my weekly letters that have spurred the most comments.

I hope that you enjoy them, but I especially hope that they are helpful.

To subscribe to my weekly report, www.YourSecondOpinionLLC.com

Russell Campbell

CEO – Your Second Opinion, LLC

Topics

You Are Most Important 14-27 S

The recovery of the capital markets since the Great Recession should have lowered everyone's stress levels, but that doesn't seem to be true. While the level of stress isn't any lower, it is quite a bit different from a few years ago. Are you doing OK?

A few years ago, assets, revenues, profits and compensation were down a lot. Firms either chopped expenses or battened down the hatches, and survived the storm. So it seems logical to think that now that the storm has passed, the stressors have too. But many of the firms that I talk to seem to have either irrational fears, or grandiose dreams. Neither fears nor ambition are bad, but they seem to be contributing to sleepless nights.

First of all, a little paranoia and a little stress is a good thing for a leader, in our competitive business. We should be able to balance positive stress in our life, with the negative stress. Here are some suggestions of how to do that.

- Work life balance is often impossible to achieve, but ring-fencing times for work can be a more successful strategy.
- Emphasize what you like, and are good at in your role. Be willing to delegate to others who can contribute in their own complementary ways.
- Try to like other people first, before trying to influence them.
- Make your encounters with everyone more enjoyable for you by being helpful. *It's better to give a lot and get back even just a little, than to not give at all.*
- Pay attention to the needs that others have that they are shouting at you, but that you fail to hear or accept.
- Complete relaxation is overrated. It can go hand in band with excessive alcohol consumption, poor eating habits, fitful sleep and lack of exercise.

The experiences that you have, and your ability to roll with the punches is what creates resilience in your spirit. This resilience enables you to achieve what you want without debilitating stress.

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Professional Money Managers, or Money Makers 13.38 P

By any measure, Warren Buffett is one of the best investors of the last century. According to the 2012 Berkshire Hathaway annual report, the book value of this company's shares increased by nearly 20% per year, over the last 48 years. Warren Buffett shows us how to balance the profession of investing, with the management of a sustainable investment-related business.

But Warren is first and foremost, an investment professional. And all great investors have a story to tell about the one that got away. In 2010 on CNBC for example, Warren Buffett said that buying out Berkshire Hathaway, instead of investing directly in insurance businesses, was the biggest investment mistake he has ever made. He estimated that it had cost him compounded investment returns of about $200 billion over the past 45 years.

An investment business usually begins with idiosyncratic talent, but talent is not a fixed quantity. Talent may expand, shrink or change over time.

There is no doubt that Berkshire Hathaway would not have been as successful a company without Warren's ownership. But even the skills of an extraordinary investor like Warren have evolved.

His great results and evolution as an investor are a direct challenge to conventional industry thinking that an investment style is more likely to contribute to better investment performance if the style remains stable. He once focused on investing in smaller companies, had a rigorous pricing discipline and practiced a more traditional value-oriented approach. Warren's investment strategy has evolved over time due to changing market conditions, hard won experience, and because of the need to invest increasingly large pools of capital.

But investment wins and losses are not the whole story. Warren Buffett is not just a portfolio manager, and Berkshire Hathaway is not just an investment portfolio. It is a public company with broader issues that radiate from its origins as an investment vehicle.

His investment performance has led to his becoming one of the most influential people in the world in 2012, according to Time magazine. His reputation, in turn, has helped to build Berkshire Hathaway into one of the most admired companies according to Fortune magazine.

Strong investment performance has propelled Berkshire Hathaway, but considerable attention has been paid to creating a sustainable organization.

Warren Buffett offers lessons for all investment-related firms:

- Staffing – hire and most importantly, retain talent
- Investment process – continuously review and evolve in small steps
- Marketing – leverage your brand from your core investment strengths
- Planning - pay attention to what you spend money on
- Compliance means more than just meeting regulatory requirements
- Execution – focus first on building economic value

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First Comes Performance, Then Worry About Feelings 13.61S

There is a considerable amount of academic research that suggests that the culture of a firm contributes to business success. If everyone is aligned and engaged with the mission of the firm, it seems reasonable to expect that the firm improves its chances of winning.

But, this approach may not hold up as well, in investment management firms where extraordinary talent is required to compete, and investment performance matters more than everyone getting along. *A focus on talent and performance may trump emphasizing the organizational culture of an investment management firm.*

First, how can we measure the culture? Most studies of culture rely on self – reporting by investment management firms. A more robust way to measure the culture is to conduct an independent employee survey. Glassdoor.com is a web site that allows current and former employees to review their firms.

I was able to find employee reviews on Glassdoor.com for 123 mutual fund families. The 9 firms with the highest approval ratings (minimum 10 reviews each) were American Century, Baird, Boston Trust, Brandes, Goldman Sachs, Guggenheim, Lazard, Pioneer, and William Blair. Many of these firms are also cited elsewhere for having strong corporate cultures. So this list of firms is a good representation of firms with satisfied employees and healthy corporate cultures.

Second, how should we measure investment success? Most studies of culture look at self – reported historical performance results. It might be more valid to find an independent source of past results. We could also consider adding a method that attempts to predict future results. Morningstar offers both approaches. Morningstar measures historical risk – adjusted success and assigns 1 - 5 stars for each of the mutual funds analyzed. We might also gain some insight into each firm's prospects for future success by reviewing Morningstar's awards of bronze/silver/gold medals for each of the funds.

Does a strong corporate culture, suggested by the employee reviews gathered by Glassdoor, pay off in better performance results? Are these fund families overflowing with 5 – star, and gold medal funds, as calculated by Morningstar?

In fact, no. These 9 firms offer 43 funds which are tracked by Morningstar. None of these firms has a single 5 – star or gold medal fund. Just 12/43 funds were 4 – star. Otherwise, the distribution of historic investment performance results of these funds is unremarkable.

Stars	Number of Funds
5*	0
4*	12
3*	19
2*	10
1*	2

And just 5/43 funds received a silver medal from Morningstar.

Medal	Number of Funds
Gold	0
Silver	5
Bronze	21
Neutral	14
Negative	3

If good employee reviews on Glassdoor.com reflect a positive culture, this analysis suggests that *the positive culture of these 9 firms is not paying off, in terms of either historical performance (stars), or in the potential for good results (medals).*

Many firms believe that they need to build a strong culture, and performance will come. This may work in other industries, but this approach may not be very effective in a highly competitive, talent – driven industry like ours.

The risk is that leaders will spend too much time on trying to sustain a culture where everyone gets along.

Maybe performance comes first, and culture follows afterwards? Many firms have benefited from first, focusing on performance. It may not be necessary to have a culture that wins awards or even positive reviews.

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But What If My Feelings Were Really Hurt 13.63S

In last week's report, I noted that a positive culture doesn't necessarily lead to outstanding investment performance. Employee reviews posted on Glassdoor.com offered insight into the culture of 123 investment management firms and the firms with the highest reviews from employees were then examined. We looked at several measures of investment performance for each firm. The measures of investment performance were Morningstar's stars – for past performance, and medals – for future performance. Bottom line, none of the firms with the highest reviews from employees had any 5 star or gold rated mutual funds. Happy employees don't seem to be of much help in spurring top investment performance.

As you can imagine, I've had some reaction to this conclusion. One question was, "Is the opposite also true? Do firms with top investment performance have employees that are less happy?" The answer is mixed, but there is a hint that maybe the answer to the question is yes!

There are 19 firms that are rated poorly based on employee reviews. Yet three of these firms have both 5 star, and gold rated funds! Recall that none of the firms with the strongest cultures had any funds with 5 stars (historic results) or gold rated (expected results).

Maybe culture is the result of investment success, and not the cause of it?

This short study of course doesn't prove that a focus on investment performance trumps culture. But there are many firms that are spending a lot of time and money to build and sustain sound cultures. If these efforts take resources away from focusing the firm on delivering great performance, they may be misguided. A focus on culture also risks pushing difficult, yet talented people out of the firm. To summarize;

- The primary purpose of an investment management firm is to deliver outstanding investment performance
- Culture may be an outcome, and not a driver of investment performance
- Efforts made to change the culture of the firm may distract from the purpose of the firm to deliver outstanding investment performance
- If a significant shift in the culture of the firm is desired, it is likely that some of the people will either choose, or be asked, to leave the firm
- Some of the people that leave may be talented professionals
- Keeping the focus on the purpose of the firm may be lower risk than trying to directly influence cultural characteristics

In order to sustain outstanding performance, it may be better to allow employees who are not integral to the success of the firm, and who are unhappy with the culture, to leave, or to encourage them to do so. Consider keeping the focus of the firm entirely on the elements of the culture that support investment performance and firm success.

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Should Firms Treasure Talent?   13.20 S

In recent years, Jim Ware of Focus Consulting has written and spoken about what people who he calls "Red-Xs". As he describes them, *"These are people who are brilliant investment professionals, who clearly add value, but who live outside of some, or most of the core values of a firm. In simple terms, the Red X is disruptive and can be toxic to the firm's culture."*

I have a lot of respect for Jim's contributions to the industry. On the subject of Red Xs though, I have a different view. **If they act ethically and contribute to exceptional investment performance, they should receive special treatment.** Instead of dismissing them as Red X's, let's recognize their exceptional status and call them "**Gold A-Players**".

Jim suggests that there are 5 approaches used to deal with Red Xs/ Gold A-Players – fire them, firewall them, fix them, forget about them or just fret.

I think that there are other specific actions that may be helpful. But let's address these 5 approaches first.

- Firing a Gold A-Player guarantees that you will lose their contribution to your firm's investment performance.
- Firewalling them is rude and demeaning. Ignoring or not respecting their contributions to the efforts of the firm could hasten their voluntary departure. Once again, the firm risks losing talent.
- The idea that somehow you can fix their bad behaviors seems reasonable in theory, but it is unlikely to be a practical answer. It is hard to believe that a leader can make much of a difference in changing an individual unless the leader is a mental health professional, has a long-term horizon with a willing subject, and focuses on behaviors and not underlying attitudes and beliefs. Even if some behavioral change occurs, the people around this person may not recognize or believe that any change has occurred. This will make it difficult for any improvements in the behavior of the Gold A-Player to stick.
- Should you just ignore their bad behavior? Yes! If you "ignore" their bad behavior and their value to the firm is high, the culture will adjust to revolve around the talent - as it should. *If I hire a Picasso, I hope and expect that the outdoor sign painters that I have on staff will leave*. There are many firms with cultures that revolve around those who have the talent and power in the firm. I don't believe that there is anything wrong with that.
- Worrying about these Gold A-Players is also an appropriate response by leaders, in my view. There are many steps that you can take to ensure that the contribution of alpha by Gold A-Players is not lost.

Here are some practical suggestions of how leaders can work with Gold A-Players to heighten their contribution to the organization.

Offer Support

- Assign another person to act as a buffer or intermediary for your portfolio manager to interact with others – especially clients
- Assign a mentor who can guide the person
- Set reminders of important tasks which the person may overlook
- Provide supporting resources if needed – people, time, money
- Offer positive reinforcement, appreciate them

Give Them Space

- Give them ample warning and preparation time for formal interactions such as internal meetings, client meetings etc.
- Attendance at social events should be optional

Listen to their Needs

- Be responsive to their minor requests
- Be responsive to significant requests
- Listen and acknowledge their input when they offer contributions to the larger firm

Change Yourself

- Prepare for interactions
- Stay calm
- Don't be intimidated
- Talk to them behind closed doors
- Be specific
- Don't lie
- Discuss facts
- Don't try to sell them
- Expect a debate
- Recognize that you aren't going to change them

Change Others

- Encourage the practice of better social skills by everyone
- Encourage others to find better ways to work with the talent
- Teach conflict resolution techniques to everyone

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How to Ensure that Your Best Investment Team Disappears 12-67 S

To be clear, I really don't want your best investment team to be lifted out! But, there is an epidemic of lift-outs of investment teams in this industry. While the firms that are gaining teams may be pleased with their access to proven talent, firms losing talent are likely less pleased.

Usually I try to offer prescriptions and actions. Instead, I thought that I'd offer a recipe for ensuring that your best team leaves, in the hope that it will provide some cautionary notes for leaders.

Lift-outs are the end of a long process of missteps, and the warning signs are usually clear. Investment managers rarely in my experience, come to these decisions rashly.

So here are more than 25 ways to help encourage money management teams to leave your firm!

Rewards

- Base pay for your best team should be set below industry norms if necessary to maintain pay alignment with others in the firm.
- Incentive pay should be largely based on factors outside of the control of the team, e.g. overall firm performance.
- Incentive pay should bear little relationship to the performance of the team.
- Do not share rewards fairly between the firm and your best team, and increase this disparity as the team's success grows.
- Assume that team members are risk averse, live pay check to pay check and are unable to personally afford to leave the firm.
- Assume that immediate monetary rewards are all that matter to them.
- Assume that the carrots, e.g. deferred awards, and sticks, e.g. non competes and non solicits, are ironclad and impossible to walk away from.

Expenses

- General hiring freezes in the firm should also apply to a successful team.
- Ignore requests for additional marketing or support resources.
- Starve for resources any extraordinary marketing efforts that currently exist to support the team.
- General drives for efficiency should be equally applicable to successful teams.

Relations with Colleagues

- Don't discourage the rest of the firm from feeling jealous, and ignore any resulting conflict.
- Don't discourage an "us and them" mentality internally.

Relations with Leadership of Firm

- Create teams that are standalone so that they are easy to lift out.
- Don't pay attention to the team's own goals, which may range from an eagerness to gain assets, to focusing almost exclusively on investment performance.
- Insist that the team accept numerous small custom mandates.
- The team should not be given any special attention because it might go to their heads - so no special rewards or favors.
- Ignore the team leader's ideas for the larger firm.
- Don't protect the team from challenges to its mandate or resources.
- Ignore the team. Why would they need your attention?
- Assume that what the team thinks today, won't change tomorrow.
- Be confident knowing that, after all, anyone, and any team, can be replaced.

Clients

- Assume that they can't take clients with them.
- Clients are loyal to the firm, not teams or individuals after all.

Competitors

- Assume that independence is the team's only option, and that your firm's infrastructure is crucial to their current success.
- Assume that no one else - either other firms, or intermediaries - is talking to them.
- No other firm could value the team differently than you do, and no other firm can offer superior synergy or support.
- Take comfort in knowing that no other firm will care more to help the team to achieve its goals.

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No More Excuses – 10 Steps to Kick-Start Sales Efforts Now M 13.26

Other firms are winning mandates and growing their assets under management in your areas of investment expertise. Is your firm winning its share of mandates also? I don't care how many times you've tried to kick start sales before, it's a great time to try again. Here are ten steps to boost sales of your investment products in the short run.

1. Tell everyone in your firm that the current sales slump is unacceptable. Making people a little anxious inspires productivity and creativity according to research.

2. Set a sales goal that has a 50/50 chance of being achieved. This strikes the right balance between a goal being too easy and too ambitious.

3. Your employees will do what they want to do. What they want to do will depend on avoiding pain and gaining pleasure. Make it easier for them to get on-board with your goals by adjusting or replacing the sources of pain and pleasure.

4. The skeptics in your firm will doubt that your goals can be achieved. Offer evidence that it can be done to turn the mood from pessimism towards optimism.

5. What capabilities (investment, marketing) do you have, or can you easily acquire, that will resonate with prospective clients? Identify your next most likely client.

6. What did you used to do that was successful in driving sales in the past? Many firms have forgotten good lessons from the past. Consider reviving what you stopped doing, and try it again.

7. What are outsiders telling you, or yelling at you to do? Have you been ignoring or rationalizing away their requests? Pay attention and consider giving them what they want.

8. Allocate most of your firm's resources to the best opportunities.

9. What behaviors have to change (even if attitudes don't)? Wield the carrots and sticks to elicit the behaviors from your people to achieve your firm's ambitious goal. You don't need to change who they are - just what they do.

10. Celebrate small wins to build momentum.

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What Clients and Prospects Want to Hear 14.40M

Like many of you, I read a lot about branding – what it is, how it helps, what to do. But the concept of branding in our business still seems a little vague. Some firms seem to have a great brand. The big guys, and the firms that are focused have the most identifiable brands. But how does a firm get from here to there? Get bigger or smaller seems obvious. And spending money on enhancing the general perception of a firm's brand seems wasteful. Here is my practical approach to enhancing the brand of an investment management firm.

First, there are 5 different stages where clients and prospects interact with your brand. There are distinctive ways at each of the 5 stages to reinforce their experience with your brand. For each stage, we should be asking three questions;

- what is in the client, or prospect, thinking now?
- what would we like them to be thinking, instead of whatever it is they are thinking?
- how can we best change their thinking?

Now that we have the questions, what are the 5 stages?

1. *The prospective client has never heard of you*. The answer to the first question is easy. They don't think about your firm at all. So you have to get known. An expensive route to becoming known is advertising. Cheaper and more compelling alternatives are thought leadership and social media. Your messages have to stand out amidst a cacophony of competitors' messages.
2. *The prospective client has heard of you, and they may be wondering if your product or service is any good, and if the price is reasonable*. Investment performance is probably the most compelling reason for a client to contact you, so marketing efforts are pretty straight forward at this stage. Make sure that every channel is aware of your investment performance.
3. *You have captured the prospect's attention, and they want more information*. This is where evidence of your thought leadership and efforts to display it need to increase. Databases, training of intermediaries and many other avenues need to be pursued. Marketing expenses are generally the highest at this stage, and these efforts have to be powerful and often customized.
4. *The prospect or client develops a powerful emotional attachment to you*. Branding efforts make the impersonal, personal. You are his or her investment adviser.
5. *The client willingly refers you to others*. This competes the circle back to step 1. You provide clients with the branding messages, which together with the passion for you that they developed in stage 4, leads to more business.

This all seems pretty obvious doesn't it? And yet, I know of firms who spend oodles of money at the wrong stage. General thought leadership pieces aren't going to impress your most passionate clients. Or specific evidence of your thought leadership will be wasted if people have never heard of your firm.

At which stage is there the most leverage to build your business and your brand? Focus your resources on the messages that will be most effective in building your firm.

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Are You Brand X? 14.33M

What could having a recognized brand do for your firm? In most businesses, having a great product is not enough, people need to know about it. The investment business used to be a little different from other businesses. Keeping your brand private and exclusive increased client interest (and kept fees high).

But things have changed. Most firms now acknowledge the importance of building their brand. But I am not so sure that they recognize what it takes to make them unique in the eyes of their clients and prospects. The result is that few firms have unaided brand awareness.

I once advised an intermediary firm that used external money managers. From time to time, the firm needed to invest money quickly and safely for their clients. The money was always allocated to the leading brand names.

There are many marketing firms who specialize in advising firms on branding. But they frequently misunderstand the business, and don't recognize that this professional services business has a twist. The critical importance of talent is the twist. Without a deep understanding, general branding recommendations and efforts are often wasted money.

Here is what to do to build your firm's brand, and how clients will perceive your efforts.

- You: Create a hook – Client: "I need to call your firm first"
- You: Present the attributes that clients care about – Client: "You know what I need"
- You: Present the attributes that you can convince clients to care about – Client: "You are smart enough to anticipate my needs"
- You: Answer questions – Client: " I understand you"
- You: Simplify explanations – shorter is better – Client: "You are clear and transparent"
- You: Prove what you say – Client: "I believe you in my heart and mind"
- You: Acknowledge that it is their money – Client: "You always remember that you work for me"
- You: Assume client is smart – Client: "I am not stupid, I am busy with other things"
- You: Don't cherry pick only favorable examples – Client: "You don't try trick or insult me"
- You: Trustworthy – Client: "You always represent my interest"

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Go Big Internationally, or Stay Home 14.24M

International expansion is unsuitable for the vast majority of investment management firms. Like the Sirens whose lovely singing drew sailors to the rocks to shipwreck them, pursuing international expansion offers little.

The attraction is clear. Armed with the USA brand, venturing abroad offers a promise of new growth opportunities, new clients, and clear sailing.

But the opportunity is largely an illusion. One recent study indicated that the profit margins of firms serving domestic clients were higher than those who ventured internationally. And for publically owned investment managers, there is no significant correlation between the appreciation of share prices and exposure to international clients.

If profit margins are lower, and shareholder value accretion is uncertain, why bother? Or are there “strategic” reasons to venture abroad - that don’t include making a profit?!

There is no first – mover advantage in expanding internationally. Why not continue to sharpen your capabilities against the toughest competition in the world, right here at home?

International managers continue to expand into US. What’s wrong with a domestic firm staying focused on the U.S. market? Have you effectively addressed every possible market segment with every product that you can possibly imagine having available? The turnover of managers by clients in this market is probably the highest in the world, and this activity continuously offers plenty of opportunities to gather new business.

Are you intimidated by the reports from management consultants stating that there is no net revenue growth in this industry? The truth is that there is plenty of net revenue growth potential, as money that tried to avoid all risk over the last few years, is coming back to managed accounts from its current location in mattresses, and unmanaged asset classes like T-bonds and insured deposits.

What else are you giving up by focusing on the rest of the world? If you grow internationally, can you really afford to compete in other segments too – what are the tradeoffs and where is your firm better off dedicating resources?

Keep in mind that the fastest growing international markets are small, local managers are preferred and there are limited opportunities for foreign managers. There are no guarantees that economic growth will continue at the same pace. A new foreign government initiative may pop up and steer capital away from managed investment accounts, into say, infrastructure.

Don’t count on distribution thru 3rd parties to build your brand. Any brand building largely accrues to the benefit of the distributor, not your firm. And you may find that you need to customize your offering to meet local tastes, which will add to your costs and lower your profit.

Laws and regulation are also fast moving. Shifts in regulation may not be enough to change anyone’s mind about international expansion.

What might change minds though, could be the quality of talent available to your firm in local markets. You probably won’t be hiring “A” talent, and you’ll have to be wary of the potential for hiring rogues, at worst, or the potential for cultural mismatches, at a minimum.

Even if your firm is successful, are you sure that you will be able to realize the value that you create? While not true in all markets, you may have to consider the risks of nationalization, hyperinflation, currency devaluations or currency controls. Even without these risks, the chances are high that you are going to want to exit the country at some point. That moment is likely going to be when it's difficult to capture the value that your firm has created - so keep that in your thoughts as you plan your overseas adventures.

If you unfortunately feel compelled to exit a market for any reason, the damage to your local reputation will hang around your neck for decades – and your local competitors will be eager to remind your potential clients of your prior failings. I have some personal experience with failed past attempts which hindered later progress.

How serious is your international effort going to be anyway? Is it likely that international staff are going to be considered for senior headquarter roles anytime soon?

Keep costs low. Look at what other managers have done to grow opportunistically. Some have had success with first focusing on non - US clients who are resident in the U.S.. Or look for a sovereign fund or another large foreign investor to find you. I once managed assets for a family office that was based in Monrovia, Liberia.

Opening an office in Canada or the UK, perhaps a UCITS fund in Ireland, or landing a sub-advisory relationship or distribution deal may also be in the cards. A caution though. Managers who tiptoe into new markets risk an inability to support clients in the ways that they expect.

If you are seriously determined to grow internationally, make a meaningful acquisition, if you can afford the capital and can justify the return. Organic growth only will be too slow and costly. If you are going to spend the time needed to succeed anyway, it is better to make it worth your while by acquiring a local operation.

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A Strong Response to My View: "Go Big Internationally or Stay Home" 14.28 PM

A recent weekly report that I wrote suggested that investment management firms should either go big internationally, or stay home. I had an opportunity to present this argument to a diverse group of COOs of U.S. - based investment management firms at the US Institute, a private networking group that includes 84 firms. An instant survey of attendees was quite clear. *Most firms believe that international growth is not only important, but surprisingly, at least to me, also believe that the current profitability of their international operations is higher than their domestic business.*

First of all, I share their view that international expansion is at least somewhat important. If a low cost, low maintenance strategy is pursued it can make sense. Firms can be open to, but not aggressively soliciting, new international business.

At the other extreme, a major acquisition or lift out may be an effective way to grow international. *But I believe that the middle/muddle approach of trying to grow the business organically, may succeed in attracting revenues, while at the same time, undermining the earnings, and economic value of the firm.*

Secondly, most firms claimed that their firm's profitability from international operations is higher. This flies in the face of other surveys, and third party analyses that I have seen. Maybe I'm wrong, and these firms are correct that international profitability is currently higher than domestic sales. However, I am skeptical that many firms know what their profitability is on international sales. Just because sales growth is higher, and perhaps variable costs are lower, this doesn't mean that there are profits from international distribution. I would still encourage these firms to consider the potential risks of their international ventures.

I stand by my views that a passive opportunistic approach, or an aggressive acquisition – oriented approach are the best strategies.

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Increasing Firm Revenues Five Ways 12-87 P

In recent months, I've described the 5 main avenues that firms can pursue to sustain and increase revenues. If only 1 or 2 of these avenues for growth are pursued, the risk of failure increases and opportunities are missed.

In previous letters, I suggested a number of specific ways to pursue growth. To make the concepts even more concrete, I thought that I would highlight current examples of how other firms address each avenue of opportunity. To recap, here are the 5 main avenues to increase investment management firm revenues:

1. Extend the duration, and the current profitability of each client relationship;
2. Respond to popular trends;
3. Capture market share from current competitors and close product substitutes;
4. Extend product lines, and access more distribution channels;
5. Seed brand new opportunities.

1. Extend the duration, and the current profitability of each client relationship

Where additional product capabilities are available, cross-selling can be helpful in extending the duration of relationships. Northern Trust and State Street are examples of firms that actively cross-sell.

There are other ways to prolong client relationships. Blackrock has been aggressively restructuring investment teams and processes in recent years, with fixed income a noticeable beneficiary of improved performance and interest from prospects.

Fixed income processes seem to be easier to recast than equity for example. Blackrock has restructured some of their equity products, as have other firms, such as Janus. Investment process redesign may be more effective in fixed income in restoring both performance and gathering clients than in other asset classes in the short run.

Ameriprises had a key manager departure that led to client outflows, which should be a cautionary reminder for those firms that overlook portfolio manager satisfaction with the firm. Being overly dependent on a few large clients is another lesson.

While clients are with your firm however, it is important to earn a fair profit. State Street and Northern Trust are increasing the profitability of existing client relationships by re-pricing relationships (usually upwards), and ensuring that a target profit margin is achieved for each client.

But what about firms who feel they cannot increase fees?

Fee revenue can still be increased by bringing clients on legacy fee schedules up to the current fee schedule.

Also, most firms have clients who are loss-leaders. Blackrock recently lost a large piece of fixed income business, but it was so underpriced that the revenue loss was almost immaterial.

2. Respond to popular trends

Clearly there have been significant flows towards passive investments, alternatives, fixed income and international investing in recent years. Some firms abhor jumping on the bandwagon and they stick to their knitting, lacking interest in pursuing these opportunities, in spite of persistent client demand. While it is easy to imagine that the current wave of interest in some of these asset classes or styles will wilt, if a firm has or can readily acquire an in-demand investment capability, why not pursue the opportunity?

Passive index providers such as Northern Trust and State Street have discovered that clients increasingly want custom benchmarks, and they have been responsive to these requests. Not all new products have to be carefully planned or entirely new to the market. Sometimes just responding to client demand, when existing or easily acquired capabilities are available is just as good strategically.

And it is not only passive index providers that are finding this to be true. Alternatives providers such as Blackrock and KKR have expanded well beyond illiquid investments into liquid markets, and other currently popular alternative asset classes, and both firms are gaining assets.

With access to lift-outs of experienced teams, many firms of all sizes are offering a welcoming home to new, in-demand capabilities. This is true in both the alternative and traditional asset classes.

3. Capture market share from current competitors and close product substitutes

Smaller firms such as Wisdom Tree are benefiting from the battles between Blackrock and Vanguard, which is both expanding investor awareness of ETFs, as well as allowing Wisdom Tree to position their offerings against their larger competitors. These precise opportunities aren't available to every firm, but it points out the importance of monitoring the direct competitive environment. No firm has a monopoly, and opportunities arise regularly to make inroads.

But there is a new wrinkle in the fight for market share. Increasingly, clients are looking beyond asset classes and style boxes for other ways to address their goals. For example, alternative firms such as Blackstone and KKR are eroding the share of traditional managers by winning client assets.

But this is not a one-way street. I have seen traditional products such as small cap and "go-anywhere" liquid funds from firms like AQR and Blackrock used as replacements for private equity allocations in recent months. Clients are willing to look at these substitutes because of the difficulty in either getting into a preferred private equity fund, or because clients observe a build-up of un-invested cash within the private equity fund due to a shortage of investable opportunities.

4. Extend product lines, and access more distribution channels

Earlier I mentioned pursuing currently popular mandates, some of which admittedly turn out to be fads (Remember technology, media, telecom funds?). But all firms should be looking forward at least 5-10 years to build sustainable firms based on existing and projected capabilities including investment capabilities, and all of the other capabilities that a firm can build and sustain.

Alliance Bernstein is currently addressing the retail market for alternatives, and Franklin Templeton has recently acquired a hedge fund-of-funds firm. The plans for these efforts don't appear to be robust at this point, and the likely outcomes of these efforts are as of now unclear, but these firms recognize that alternative investment in one form or another is here to stay.

For those firms with access to capital, this seems to be a unique opportunity to make acquisitions and acquire capabilities.

Distribution is another big initiative of many firms. Current investment capabilities are being offered more broadly as institutional and retail investors share needs and wants, and new distribution channels open domestically. Wisdom Tree has been successful with the fast growing RIA channel, while Federated has recently focused on, and found success with, the broker-dealer channel.

Even within specific distribution channels and product categories, firms are seeking ways to further segment the market. Blackrock for example has carved out a series of ETFs to address the specific needs of buy-and-hold investors.

While domestic channels continue to present opportunities to firms, it seems as if every firm is pursuing international distribution. U.S. firms are already well-represented amongst the largest European fund managers, courtesy of their well-known brand names, and they benefit from competing in the tough U.S. environment, which has now enabled them to crush international competition in their own home markets.

Opportunities remain in mature markets in Europe, and in Japan and Australia, and we have seen firms such as Janus, Federated and others open offices to further penetrate these markets.

Larger firms, who have a presence worldwide already though, such as Franklin Templeton, see even greater growth potential in what are currently secondary markets. Clearly, economic growth, market development, and demographic changes favor growth opportunities in the emerging markets which in the next 30 years will be emerged, and become part of the developed world.

5. Seed brand new opportunities

Quietly, most large firms have seed capital allocated to incubate new funds which gives them a head start in launching new products. New products generally offer higher margins, and so this innovation strategy works to sustain profit margins over time.

But even smaller firms should consider seed capital and pursue innovation. Wisdom Tree has been able to source seed capital from third parties in the past, while Janus has sourced capital more recently to support existing, but smaller funds.

If third party capital is unavailable, partners of the firm should be willing to fund innovation that will create a sustainable business for the long run. While the short run cost may seem high, without this forward looking effort, the value of the business may suffer and affect the realizable value of the firm when the current owners want to retire. The private market value of many traditional investment management firms has declined in recent years, as potential purchasers are concerned about the future prospects of these firms.

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Me – Too! Hello, It's Liquid Alts Calling 14.35 P

A little over a year ago (in early 2013), I surveyed the landscape of liquid alts funds. At that time, I wondered whether these funds had been successful. There was a lot of hype surrounding them. My conclusion was that they really hadn't been very successful for most firms. Have things changed for the better at all over the last year or so? The answer is yes in many ways, but I still see some lingering concerns.

In summary, the number of liquid alts funds have exploded over the last year, as have AUM. There are more large funds as well, which suggests that at least some firms, are finally starting to get rewarded for their efforts.

The bad news is that fees are falling on average, competition is rising, and many funds continue to struggle to gain assets, at least partly because of their brief track records. Liquid alts funds are still in the early stages of development, and they continue to be a drag on the average profitability of the sponsoring firms.

Morningstar listed 947 alternative mutual funds as of 2/28/2013, and on 4/28/2014 there were 1270 – a startling increase of 34% in a little over a year.

Performance

How have these funds performed? Not only is performance important in driving asset flows from mutual fund investors, but poor performance in public vehicles, such as mutual funds, could erode confidence in less liquid alternative products offered by firms.

Of the 947 funds listed a year ago, 20 funds had earned 5 stars from Morningstar, and this includes multiple share classes of the same funds. Today, 31 of the 1270 funds have 5 stars.

It is true that not all of the funds have been around long enough to justify any stars. A year ago, only 389 funds had any rating at all. Now, 639 funds have no rating – indicating that many new funds have been recently launched or picked up for coverage, by Morningstar. For those distributors who focus on ratings, not having a top rating or no rating at all, is essentially the same thing. So without a top tier rating, distribution is likely to be an uphill challenge.

Future Expectations for Performance

While star ratings are important in driving asset flows, we could instead, look at performance expectations instead. Unfortunately, expectations are not high.

Morningstar has introduced a forward looking analyst rating which is focused on attributes such as investment process, performance, people, parent and price. Of the 947 funds a year ago, just one had received a "Gold Medal" (TFS Market Neutral, in case you were wondering). Morningstar has not completed the task of rating all of the funds, so there may be more included in the top category in the future.

But today – there is still just one fund with a "Gold Medal". There are just 25 with Silver, and 38 with Bronze.

As mentioned a year ago, the culture and governance elements of alternative firms are often significantly different from traditional asset managers, and this may make it difficult for rating services, and more importantly, intermediaries such as distributors, to endorse firms offering liquid alt products.

AUM

Have these funds gained much traction in the market so far? This is a bright spot!

Only 411/947 funds had over $100 million in assets under management a year ago. Today the number of funds has increased to 554/1270. A year ago, 75 funds, had assets of over $1 billion, while today there are 133. A year ago the average fund had assets of less than $100 million, while now the average AUM is $239 million.

But not everyone is a winner. A year ago there were 95 funds that had been in existence for at least 10 years, and 30 of them, or 31%, had assets of less than $100 million. Today Morningstar lists 324 funds that have been around for 10 years and 112 of them, or 35% have assets of less than $100 million. Is it worth the ongoing management time and resources – including seed capital – to sustain a mutual fund that has less than $100 million in assets for an extended period of time?

Revenues

What about fees? Do the revenues support maintaining a fund even if the assets fall short of expectations?

The median total expense ratio for these 947 funds was 1.70%. The average fee has now dropped to 1.44%, although assets are substantially higher.

Implications

Investors appear to be buying liquid alts funds without having any evidence of past results (stars), or even guidance as to future results (medals). But liquid alts funds are growing rapidly in both assets and numbers of funds. My recommendations to leaders are the following:

- Prune funds that have not been successful over a longer period of time. If your fund isn't bringing in assets now in the midst of a tremendous boom in these funds – it isn't likely be a long term winner either.
- Liquid alts will be commoditized – i.e. fees will continue to be ratcheted down. Build an investment organization that can operate efficiently at a lower level of fees than seen today.
- Build an investment organization to support your liquid (and non-liquid) alts capability that mirrors investor and intermediary expectations of a capable and credible investment firm – i.e. get a medal from Morningstar (or equivalent from others)!

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Big Plans, Limited Resources – How to Choose 13.1 P

Do you expect that the products and services that you will deliver in the future will be different from today? You may be considering how to allocate resources to prepare for the future. But balancing today's needs and tomorrow's opportunities challenges the allocation of resources.

We'll look at a resource allocation process for products here, as an example. A similar approach can be used to allocate resources to the best combination of distribution channels, client segments or even geographic areas. It is helpful to look at a firm's resource allocation from a variety of perspectives.

The allocation process has four key inputs. These include current product profitability, long term expected product profitability, the direct linkages between products, and finally, the potential contribution of new products in the future.

First, list your products from highest to lowest normalized current profitability. Then estimate what the long-term sustainable profitability will be for these same products. Current and long-term profitability expectations could be the end of this discussion. After all, shouldn't your resources be given to the best opportunities identified by this profitability analysis?

There are two other inputs that can add value to the discussion, however. The first is the connection between products. For example, let's say that you have both a global and domestic fixed income capability. If your domestic business is currently unprofitable, you might have be considering closing down the domestic capability. But, if closing the domestic unit's capabilities causes the global group to suffer, you might not want to close the domestic capability. Even if domestic fixed income is a money loser for your firm, you might choose to retain the domestic capability anyway, if global fixed income is, or will be, a significantly profitable product. I'll come back to what you can do about strategically important, but financially troubled segments like domestic fixed income in this example, in a few moments.

The fourth input is whether a product is a gateway to future success. On the surface, a particular product might not be profitable now, and its future potential may be highly uncertain. But perhaps having this product is a necessary interim step that needs to be taken in order to be more competitive in the future.

For an example of this concept from another industry, a manufacturer can only expand a plant after they've built a manufacturing plant in the first place!

Here is an example from our own industry. An investment firm sometimes needs to make investments without the surety of a payoff. An example might be adding short-selling skills to a long – only capability. The additional staff will raise costs, and hiring them may be hard to justify from a financial perspective. But if the firm doesn't take the step of acquiring these skills and long – short strategies continue to crowd out long-only in the future, the firm may become uncompetitive.

In summary, using these four inputs – short and long-term profitability, analyzing the connection between products, and weighing the contribution of products and capabilities to the future, leaders of investment firms can prioritize where they expend the firm's resources. How each of these four inputs are calculated and weighted, will vary between firms.

So what do you do with the products that end up at the bottom of the list? Sure you could close them down, merge, or sell them off, if they are standalone. But sometimes these products are strategically important in some way. My suggestion is to challenge the manager responsible to either enhance profitability, increase the connection to other successful products or prove that the capability will become essential in the future. This challenge often leads to break - throughs. The challenge of finding new ways to deliver products more profitably in the face of the imminent demise of a line of business often inspires fresh thinking, and this creates value for not only the product line, but for the firm as a whole.

Thinking about how you spend every unit of currency, and considering each expense as an investment, can make a material difference in the development of your firm's economic value over time.

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Growing to 5 Times Your Current Size 14.23P

Many leaders of investment management firms are currently looking for help in developing a strategy that will increase assets under management substantially. I have often heard that the goal is to increase assets 5X!

Why is 5X being mentioned so often? Either some guru has convinced everyone that this is the right target, or perhaps, leaders are trying to push everyone in their organizations to really think about the long term.

A bull market brings out optimism in investment managers. They are ignoring the gloomy industry prognosis described by most management consulting firms. Most management consultants argue that revenues are unlikely to grow, profitability will never return to prior levels and that there will be only a few winners. I remember these same kinds of dismal predictions for the industry back in the late 1980's. Then, the conversation focused on index funds, fee pressure and the end of pensions.

I think that there are good reasons to believe that organic net revenue growth will be better than most experts expect, profitability will continue to rise, existing firms will continue to garner the vast majority of assets available, and turnover of managers by clients will remain high which will hold the door open for firms with strong offerings.

But 5X is still an aggressive target. What most firms don't quite recognize, is that 5X means a qualitative leap, not just a quantitative leap. This means not just more assets, revenues, profit and people, but also products, distribution channels, client segments and often different kinds of people. Not every firm is willing to undertake the kinds of changes required to grow and succeed as a much larger firm.

To start with, the goals and values of the key people in an investment management firm have to be supportive of the process and consequences of growth. Secondly, what enabled your firm to succeed to date is not enough.

There is still some opportunity within your existing product, distribution channels and client segments, so you can continue to invest in these areas. But for any company that's been around for any reasonable period of time, it seems unlikely that there is explosive growth remaining - with perhaps one exception. I have seen firms that were able to benefit from an existing distribution relationship that suddenly benefited from considerable unexpected growth. But I've also seen firms of a significant size that fell into decline. Luck is always a factor.

I think that there are steps that firms can take so that good luck is a bonus, rather than the driving force of their business. Here are the first few steps to consider;

- Will your key talent support the changes needed to achieve an ambitious goal like growing 5X?
- Are you preparing to preserve your culture through structural reforms, as products, markets, distribution channels, client segments, offices and people multiply.
- What do firms 5X your current size really look like?
- What is the path to grow to 5X for your firm?

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Protecting Your Firm From Rogue Employees 13.11 L

Every part of the financial services industry has experienced attacks by rogue employees threatening to destroy their firms. While the motives of rogues in investment management vary, the threat to the integrity and survival of firms is real.

While there is no guarantee that we can prevent rogue behavior, there are steps that we can take to minimize the possibilities. But we must be on guard as rogues attempt to fool us in new ways, or force us to relearn lessons about what not to take for granted.

Rogue employees, are to varying degrees, more common than you might think. Issues may arise and be quietly disposed of before they come to the attention of outsiders.

- Prevention starts with due diligence into the backgrounds of your people. Thorough background checks, and checking social media activities are helpful.
- Establish an ongoing independent review of your investment process. Not all investment processes are robust or sustainable. For example, if you write put options on the S&P index, you can collect the premiums, and virtually guarantee strong performance and a high Sharpe ratio, at least for a while. Collecting premiums generates income until the day you are required to pay the holder of the put, which would presumably be during a severe bear market. The strong and consistent performance history would be out the window. The point here is that the leadership of the firm cannot accept any investment process at face value. You need an independent review that considers scenario analysis, reasonableness tests, and third-party confirmation of the quality of the investment process.
- Companies often have policies that recommend exit interviews, but few firms take these seriously. Exit interviews should be seen as a unique opportunity for the firm to gain a truthful picture of what is going on in the company. A human resource professional can often link exit interviews to other discussions, and perhaps help to surface problems.
- More generally, it is important to pay attention to the rumor mill in your firm, which may hint at issues which should be further investigated. Leaders need to listen to the devil's advocates, the skeptics, and the outspoken, for cautionary flags that need to be further addressed. Be sure to separate your reaction to the personalities of the people from the issues that they raise.
- Compliance and human resource staff should have a free pass to attend just about every meeting held in the firm. They can be helpful in spotting warning signals that deserve further investigation.
- There are numerous policies and procedures developed over the centuries, such as checks and balances, dual controls, mandatory vacation policies and so on that can help to deter rogues. Regulatory requirements in our industry also contribute to deterring bad behavior. But crafty rogues will always find a way around rules. And because policies and procedures are so commonplace, people sometimes let their guards down.

- Outsiders may also be helpful in identifying potential rogues. Some auditors and regulators who visit your firm can be insightful, but they often lack the depth of experience needed. There are third-party firms though, that can look for weaknesses in the organization and processes.
- It is not only the psychopaths and sociopaths that are of concern. The focus needs to be on avoiding risky behaviors by anyone in the firm.
- Pay close attention to customer complaints whether they be direct, indirect, written or even just street rumors. Often there will be clues in these comments that will suggest the need for further investigation.

Pay attention to your people, processes, reputation, internal dialogue, external views and commentary and enforce rigorous controls to avoid the rogue behaviors that have the potential to destroy the firm. Investment management firms create enormous economic value for their owners, and damage to a firm's reputation may be irreversible.

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Taking a Hit to Your Reputation – How Do You Come Back 11-38 E

Rebuilding a firm's reputation can suddenly become your first priority. For example, if your firm is acquired or merges with another firm, concerns may center on possible employee departures, and future investment performance. If you have a corporate owner that is struggling financially, this can also raise eyebrows. Regulatory issues or lawsuits may draw negative attention as well.

In recent years, one large asset manager took a giant hit to its reputation. The firm underwent a large cultural shift, including replacing leadership. The new leader was previously with a company that believed in collaboration, and he imposed this sensibility on a culture that had a very different heritage. More staff turnover was the result.

One way to rebuild your firm's reputation, is to tell clients and prospects about the suppliers and providers who are continuing to do business with your firm.

If related companies such as sister firms or a holding company show their financial commitment to your firm, this can also help by demonstrating your organization's strength.

Remaining clients can also be a great resource for restoring more positive word-of-mouth, and so your efforts to serve these customers must be stellar.

Institutional investment consultants, particularly the largest ones, will not be your friend. At the best of times, they are slow in adopting new firms due to the large number of available money managers compared to the resources available to consultants. There are more than 20,000 institutional quality investment firms from which to select, and even the largest consulting firms are familiar with less than one half of these firms. If your long-term returns are also weak it is unlikely that you'll be on any intermediaries' preferred list.

To rebuild your relationship with consultants, you have to act as if you are a start-up again. Target small to midsize consulting firms to restart the momentum. Be aware however, that consultant or client preferences in the market may have shifted, and the lack of interest in your capability may have nothing to do at all with the hit on your reputation.

It is also likely that you will need to replace at least some of your sales staff. Their personal credibility will have been damaged by the hit on the firm's reputation, and they will have a hard time re-gaining trust with clients and prospects.

You will find that there are ex-clients who have memories like elephants, and while they may be cordial, gatekeepers, directors and trustees may be reluctant to rehire your firm. While this is an unpleasant thought, not to worry, there are many potential clients out there.

If the interest from old prospects and intermediaries in even meeting representatives of your firm remains low, use the time to explore new distribution channels, new client segments, new geographies and new prospects.

Turning around a firm from a challenge to its reputation can be a thrilling time in a leader's career. Many leaders can ride the wave when conditions are good, but only a few in the industry have the courage and skill to help an organization back to its feet in more turbulent conditions.

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Coming Soon – New Ownership 14.8PS

Planning for an ownership transition ranks high on the list of projects to be deferred! There are many issues to consider that are often difficult to reconcile. It usually takes a long time to arrive at a decision.

Once planning begins, a number of business risks are elevated, including the possibility of staff turnover, distracted focus from running the business, and suffering from industry gossip. Here are the stages of succession planning, and when these risks become most acute. This note ends with some suggestions on how to mitigate these risks.

1. *Independent reflection by one or more partners on their own* – planning for a transition usually begins with a partner having vague feelings of the need to do something. It may be triggered by the need to retain staff, by a desire to take personal risk off the table, or even retirement plans. An active owner who is thinking about not being around the firm anymore creates considerable angst for everyone. For the owner, it may be about as pleasant as organizing their own funeral! Most efforts begin with an informal survey of industry peers and their experience with transitions. The focus tends to be the valuation of owners' equity, and the amount of equity to be transferred. At this early stage, there is a significant risk of a partner becoming entrenched in their views, e.g. around valuation, which may be difficult to alter as the process goes on.
2. *Discussions with others* – these discussions are usually first held between the partners, but then often expand to responding to questions from key staff, as partner discussions become known to others. There is a risk that responding to questions prematurely may trigger employee turnover, but at a minimum, this dialogue will certainly cause a loss of staff focus on the business, as well as begin to entrench expectations. External inquiries about succession plans from clients/intermediaries may also lead to the need for soothing responses, but these tentative responses may need to be reversed as the process continues. Further, leaks of a transition plan to third parties constitutes hot gossip in this industry, and there is a significant risk that the message will be interpreted differently than intended, and this increases the risk of losing current or future clients.
3. *A conceptual outline for the plan.*
4. *Numerous large and small adjustments to the plan are made as discussions with others continue* – there is a risk that this process may raise concerns amongst staff (and others), if there is any backtracking on preliminary commitments, or if there is uncertainty around the final outcome, or timing.
5. *Discussions with professional advisers* – e.g. attorney. The risk here is that the reality check with advisers leads to overturning prior tentative commitments, or the process becomes overly legalistic.
6. *Further corrections are made reflecting professional advice* – At this point, the decision often becomes final at this point, because of anxiety amongst staff over further changes, and/or partners becoming entrenched in their views, or even fed up with the time consumed by the process.

7. *Finalize discussions between partners, possible signaling of final changes to others.*
8. *Decision, paperwork.*
9. *Communication of decision to all, and implementation.*
10. *Subsequent small adjustments as needed* – the risk here is that there may be unexpected consequences, which may include non – partner turnover, partner turnover, or client/intermediary anxiety.

Conclusions:

- Keep an open mind.
- Keep deliberations private as long as possible.
- Anticipate and prepare for responses from all stakeholders.
- Make few commitments prior to discussions with professional advisers.
- Arrive at a decision expeditiously, but not prematurely.
- Communicate clearly (simply) and widely, once there is a decision.

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How Much Equity to Give Up, and at What Price? 13.78 S

I have been often asked by owners of investment management firms for advice on broadening the ownership of their firm internally. The questioner is usually focused on the percentage of the firm to be shared, and the price. My advice on these two issues is usually, "it depends", which I realize is not a satisfactory response. I thought that it might be helpful to discuss some of the key drivers which affect the decisions about the proportion of equity to be shared, and the price.

Many leaders consider these decisions with expert advisers in compensation, valuation or legal matters. I think that these outsiders are hired far too early in the process. I believe that it is more helpful to figure out what you are trying to achieve, before you bring in the expensive advisers. The valuation and amount to be distributed is relatively easy to determine with the assistance of technical experts later in the process, after other decisions are made first.

Let's begin with a typical example. Let's say the firm has one, or a small group of owners. Most of them will want to liquidate their ownership, sooner or later. And most owners want to get some value for their stock. But there may be many more aspects of this succession plan which not only add complexity to the decision, but may even conflict with each other.

1. Some of the owners may not be currently active in the business. Their preference may be to maintain control, and continue to benefit from profit distributions. If they are willing to share equity ownership with others, they may only consider doing so at full market value.
2. At the other extreme, some owners may be more concerned with who is inheriting the business, and they may only seek a nominal value for their shares – even well below the fair market value of the firm.
3. Some of the active owners of the firm may wish to continue working, and this may also affect their views of fair pricing for their ownership interest. They may be willing to accept less than fair market value for their equity interest, and at a much later date.
4. But owners are not the only one to consider. What do clients believe is in their best interest? Typically, their preference would be for the current active owners to stay on as long as possible. Clients also want a sound succession plan that includes a reasonable price for ownership interests in the firm in order to retain staff.
5. What form of equity is being considered? Does it matter to successors if it is full voting stock, or a stock equivalent? How attractive or unattractive will these decisions about the form and quantity be in the event of an acquisition?
6. How much equity is available to be shared – with each person, and in total? After distribution, who will have control of the business?
7. Who deserves to get shares - should it be based on loyalty/time in service? This makes some sense as loyal staff can help to ensure continuity for clients, and the operation of the business. But you also need to consider the contribution of talented individuals, or perhaps teams, to creating and sustaining economic value. Should the irreplaceability of an individual be a more significant factor

than loyalty in the amount of equity granted? This decision is not an easy one and many firms stumble with this.

8. How can employees finance any ownership offered? If the shares are free or offered at a nominal price the issue is minor. But if the shares are valued closer to full market value, financing is often needed, which may affect the personal financial situation of employees, and push them to consider other options – including leaving the firm.

9. What will be seen as fair to current owners, employees and clients or intermediaries?

10. Should there be any difference between how, and at what price, you buy - in, versus how you liquidate? If you create a structure, it is desirable to create a precedent to assure stability and continuity into the future.

11. What if the structure stops working? What if it fails to retain people, complicates future M&A, repels clients or prevents additions of talent because of the lack of equity available? What if the business appears to failing, or many owners choose to leave or retire at once - what remedy is available to correct an unanticipated mistake?

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Pricing and Amount of Ownership Transferred	Lower Percentage of Total Ownership Transferred	Higher Percentage of Total Ownership Transferred
Higher Transfer Price (Related to fair market value)	• Passive owners desiring continuing distributions • Still active owners optimistic about the future, no intentions to retire • Successors may have difficulty with financing	• Passive owners looking to cash-in • Active owners less optimistic about the future/looking to diversify personal wealth/desiring to retain key staff
Lower Transfer Price (Usually unrelated to fair market value)	• May be first step in a multi-step process • May be to spread ownership widely in the firm for marketing reasons • Client preference coupled with a sound succession plan	• Owners who are less concerned with cashing-in

Buy Capabilities Instead of Build 11-41 P

Asset management acquisitions can be exceptionally tricky to execute successfully. The seller has the upper hand. When a money manager sells all or part of their firm, they are implicitly confident that their timing is good – that is, they do not see a higher value for their firm on the horizon (and they know their business better than the acquirer). You might also keep in mind that acquirees are professional buyers and sellers of stock. While my cautions here are intended for acquirers, potential acquirees also need to consider whether a sale is in their best interest.

The amount of money on the table for a purchase of an asset management business is large, when you consider that there is so little hard asset value in a transaction. Most of the value is payment for the value of the owner's services. But no matter how much you pay the owners of an asset management firm for the acquisition, keep in mind that they may forget how much they have already received when it comes time for their next annual bonus.

You also have to consider those in the acquired firm who did not directly benefit financially from the acquisition, who will also be expecting good bonuses going forward. Acquirers need to include equal or higher bonuses in their post acquisition calculations.

More broadly, compensation will remain an important issue. Portfolio managers are aware of the compensation of their peers at other firms, and there is upward pressure on compensation for talented managers.

Related to compensation is the risk that senior people may offer verbal promises to stay for a lengthy period, but then choose to leave the firm earlier than expected. Earn-outs and contracts can help somewhat, and the acquirer needs to think about non-monetary motivators as well.

Part of the non-monetary motivators can be having a say in the firm. While the former owners and portfolio managers generally have limited interest in acquiring general management skills, they often want to offer their opinions on the direction of the business. Soliciting their opinions is helpful and necessary.

When things get really tricky is when there is an investment performance shortfall. Performance can decline unexpectedly, either because of market conditions or weakness in relative performance. If clients start to leave, conversations may quickly turn to ways to slash costs. This is tricky because the newly acquired talent may become concerned about their future with the organization, and they may begin planning their exits from the firm.

More broadly, here are some of the soft cultural questions that acquirers should ask themselves before considering a particular acquisition:

- ☐ How can we realistically continue to build value in the acquired firm? What is the back-up plan if the original premise for the acquisition falls short?
- ☐ Will we be able to afford sufficient incentive compensation for all remaining professional staff in the future?
- ☐ What is our plan to keep senior staff on board as long as possible post-acquisition?

- ☐ How will we maintain the goodwill purchased, and earn and maintain the respect of the acquired staff?
- ☐ What if things go wrong with the acquisition, eg. investment performance declines – how will we make needed changes without contributing to further erosion in the value of the acquired firm?

Acquiring a money manager is unlike acquiring companies in other industries, and any deal deserves careful consideration. The value is in the people, not the assets under management.

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Q&A on M&A 13.75 P

I recently spoke (2013) at a US Institute conference, and offered my perspective on M&A in the asset management business.

What is popular in M&A currently? In North America, about one half of recent acquisitions have been in the high net worth space. The balance of transaction activity has been mainly smaller fill-in acquisitions that add specific product offerings or particular client segments.

Asset managers are the leading acquirers, but the second largest buyer is private equity firms. Some of these acquisitions have been for their limited partnerships, and some have been strategic acquisitions by the general partner. Why are private equity firms so interested in buying investment management firms now? Private equity firms have always been intrigued by the high-margin, high-growth, low capital nature of the investment management business. The dependence on investment talent was always a major sticking point, however. Now that many investment management businesses have matured, and are less reliant on idiosyncratic talent, private equity interest in investing in the industry has picked up. Private equity buyers see the momentum returning in revenues and profits, as well as moderating risks from further radical changes in client and regulatory demands.

Do you think that M&A is more important now than in the past? Yes! Flows are increasingly attracted to the largest money management firms in almost every product category. While new hires and lift-outs are helpful in building scale, an acquisition may be needed to achieve the size needed to appeal to clients, and to attract flows of assets.

Historically many investment management acquisitions were not successful. Has this changed? Buyers have become smarter. If they buy talent – driven investment boutiques, acquirers are allowing significantly more autonomy - which wasn't always the case in the past.

What do sellers want? The first hurdle for the buyer is that sellers are aware of current transaction values, and are loathe to accept any valuation discounts. Once satisfied that the price is fair, the seller often considers the extent to which the proposed buyer will disrupt the relationships and business model of the seller, as well as the potential impact on relationships with clients and intermediaries. Next, sellers are often seeking access to new channels for distribution of their products. Finally, sellers expect capital to be available to finance succession planning, support seeding new products, and even to make further acquisitions, which can then be merged into the seller’s business.

What are the biggest risks for a buyer to be aware of? Major compliance issues can destroy value faster than anything else. With an increasingly demanding regulatory environment, the risk of a compliance or reputational issue affecting firms has increased. Second, since buyers only want to buy currently successful firms, some of their acquisitions will inevitably have investment performance issues, or perhaps experience shifts in client preferences away from their products. The third major risk of an acquisition is that the acquirer will try to fix a profit shortfall by quickly cutting expenses, or otherwise interfering with the firm's business model.

Why have there been so few blockbuster acquisitions in recent years? There are four main reasons for the absence of large acquisitions. After the Great Recession ended, clients sought more diversification for their investments. This triggered uncertainty for the industry in trying to figure out which firms would be the winners. Second, organic revenue growth, in the form of new asset flows to managed assets, slowed to a trickle. This heightened concerns for the industry's future and delayed any thought of acquisitions. Third, weak stock prices of publicly - traded potential acquirers, and a tight credit environment post – 2008, made it more difficult to finance a major acquisition. Lastly, regulators everywhere became more aggressive and made buyers cautious.

When will we see more large acquisitions, and what are the targets likely to be? 2014 is likely to see at least one, and probably more, large transactions. Client preferences are pretty clear, organic revenue growth is accelerating, the ability to finance acquisitions has substantially improved, and the outline – if not all the details – of the regulatory environment is less murky. The environment is now quite favorable for M&A – a marked improvement over the experience of the last 5 years. Buyers tend to favor momentum in their purchases, and seek strong investment performance, sales growth and popular asset classes. This leads me to believe that firms focused on alternative investment strategies will be the main targets for acquisition. Alts firms, especially those with a wide range of strategies covering private equity, hedge funds and real estate together with international distribution skills, will be the favorite targets for acquirers in 2014.

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Authors Bio

Russell Campbell is the CEO of Your Second Opinion, LLC, a management consulting firm offering advice that makes a difference to leaders of investment management firms. He writes a weekly subscription newsletter for leaders, and also works one-on-one with leaders and teams on critical issues.

Russell has led 5 investment groups in his career. Prior to establishing his own firm, Russell was the CEO of The Marco Consulting Group, one of the largest institutional investment consulting firms, with a significant CIO outsourcing business. Previously, he was the EVP of AMCORE Bank, and led the Wealth Management Group which was one of the 60 largest bank wealth managers in the U.S. Earlier, Russell was the President and CEO of ABN AMRO Asset Management Holdings, Inc., which managed $75 billion in assets, and was the U.S. investment management affiliate of ABN AMRO Bank. Russell was promoted to this position after having been the CEO of ABN AMRO Asset Management Canada, Inc. He was previously a Vice – President and Partner of Beutel Goodman, Inc., one of Canada's largest investment counseling firms. His first leadership position was as Vice – President, Bank of Nova Scotia, where he led the investment management of the Bank's own pension fund, and a family office portfolio.

Earlier in his career, he held positions as an institutional investment consultant, an institutional equity sales and a precious metals portfolio manager.

Russell has an MBA in Investment Finance and Marketing from York University, and he has a BA in Industrial Relations from McGill University. He also attended the Advanced Management Program at INSEAD in France.

He has earned the Chartered Financial Analyst designation, and has attended both the Financial Analyst's Seminar and the Investment Management Workshop. Russell has also acquired the Certified Financial Planner ™ certification. He previously held Series 7 and 24.

Russell has been a director of several for-profit and not for profit boards, and he is a member of numerous non-profit, civic and industry organizations.

He is quoted frequently in the media, and has been a speaker at many industry conferences.

Russell Campbell
CEO – Your Second Opinion, LLC

Campbell@YourSecondOpinionLLC.com
www.YourSecondOpinionLLC.com
702-816-8430
@your2ndopinion

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