“On the Approved List”
Workbook

“The most convenient and valuable resource for new and aspiring leaders of sustainably successful investment management firms”

Russell Campbell

Your Second Opinion, LLC

Acknowledgements

Thank you first to my wife, Suzy for her support of me in launching my new career, and the time required to bring this workbook to fruition.

I would also like to thank all of the leaders that I have had in my career. I have learnt something of importance from each of you. Wilfred Defreitas, John Hartmann, Peter Cavelti, Brian Long, Ann Marshall, Bill Whitbeck, David Williams, Owen McCreery, Frank Kusse, Tom Cross Brown, Huibert Boumeester, Don Wilson, Bill McManaman, Jack Marco.

I would also like to thank those who gave me very helpful feedback with this workbook – Alain Dromer, Tom Braake, Skip Newman, and others who will go unnamed.

I hope that you enjoy and profit from the experience of using this workbook and I look forward to your questions and comments for my next edition.

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Introduction

The title of this workbook, "*On the Approved List*", refers to the end result of the process that clients and intermediaries use to select a money management firm for an investment mandate. They typically screen candidates in order to consider a much shorter list of possible candidates. This shorter list is often called an "approved list". Getting on, and staying on, approved lists, indicates that your firm has convincingly demonstrated its ability to pass numerous quantitative and qualitative hurdles. While many of these hurdles relate to investment, there is also an assessment being made of the caliber of your organization.

In order to remain on approved lists, you need to demonstrate that your firm is a sustainable and successful business.

This workbook, as well as the accompanying readings in the appendix, is intended to assist new leaders, and aspiring leaders, in contributing to a sustainable and successful investment management firm.

My first leadership role in this industry was overseeing the investment group of a large pension fund. My career includes leading investment management start-ups as well as very large firms, a wealth management firm and a CIO Outsourcing and investment consulting firm. I have also held leadership positions in both investment and marketing.

The reason that I chose to offer this as a workbook is that existing firms already have business strategies, whether they are explicit or implicit, deep cultures and well-entrenched infrastructure. This workbook is intended to complement and support any existing investment organization by considering the issues and opportunities of each firm's unique existing circumstances and your leadership.

I am hopeful that you will take away at least three overarching lessons from this workbook:

1. **Leading an investment management firm requires an integrated view.**

2. **Each firm faces specific challenges which require custom applications of leadership skills.**

3. **Leadership is both necessary and respectable, and not at odds with the profession of investing and serving clients.**

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Purpose of this Workbook

- To address the most important issues faced by a leader of an investment management firm
- To leverage the human resources of a firm
- To bring focus to the effort to exceed client expectations
- To prepare to convince intermediaries of the benefits of the firm
- To address the expectations of regulators, the public and other 3rd parties
- To optimally use the resources that are available/can readily acquire
- To sustain and build the economic value of the firm

What do you hope to gain from this workbook?

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After completing this workbook, you are encouraged to review your initial expectations.

The SIMPLE Approach

The acronym "SIMPLE" represents the 6 Cornerstones of every investment management firm - **S**taffing, **I**nvestment, **M**arketing, **P**lanning, **L**egal and **E**xecution.

For example, the SIMPLE model can be used to describe how firms begin and grow. The first step for any firm is acquiring outstanding professional and support staff. Next, since investment performance is crucial to the firm's success, firms' focus instead on the investment process, which is within their control. Once the process and product are established, any new firm turns their focus towards gaining clients and providing service. Later, as the firm matures, planning for future growth rises in importance. Legal and compliance issues also grow in complexity. Lastly, as firms mature, leaders become increasingly concerned with efficient execution.

These 6 cornerstones are valid not only for new firms, but also for any investment management firm. This workbook will provide numerous prompts on topics related to these 6 cornerstones, and your responses will contribute to a 360 degree understanding of the specific and critical needs of your own investment management firm.

After completing the section for each of the 6 cornerstones, you are encouraged to make note of any insights that you have gained from answering the questions and reflecting upon your own experience.

You are further encouraged to create action steps for yourself and your firm. You will then be asked to indicate a score representing how significant a contribution your completion of the action step will make to the value of your firm. These action steps, and the scores that you assign to them, will create a leadership agenda that will guide you, and your firm's sustainable success.

"**On the Approved List**" boldly implies that by completing this workbook, you will enhance your ability to be selected to manage client mandates. That is the ultimate objective of this workbook.

Let's begin with your leadership. Since leaders have significant influence on firms, it is important that we begin with having you consider your own leadership skills.

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Your Leadership

- What positive comments have others said about your leadership style during your career?

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- How would you describe yourself as a leader?

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- What positive traits from your answers to the two previous questions are most helpful in your current situation?

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- Is your leadership style complemented by the skills of your current team?

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- Which box do you and your team fit into? What actions must you take as a result?

I need to adjust my leadership style (indicate how), but my team's style is effective.	My leadership and my team are effective currently, and complementary, and will continue to contribute to the firm's sustainable success.
Both my leadership style and my team's need to adjust (indicate how).	I have the right leadership style for this situation but my team's style is not appropriate.

- Do you care about the acquisition and exercise of leadership skills <u>more</u> than any technical skill that you may have acquired through experience or training?

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- Which of the following has influenced you in developing as a leader?

  - Mentor
  - Boss
  - Board
  - Trial and error
  - Peers – internal
  - Peers – industry
  - Staff
  - Self-reflection
  - Education
  - Training
  - Coaching

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- Which of the above influences could help you now to be more successful?

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Insights from the review of your leadership style. What is most important to you and your firm now?

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As a result of your review, what action steps will you commit to taking as a leader? List each step that you plan to take below. Score each one on a scale of 1-5, with 5 being the highest potential contributor to a sustainably successful firm. There is no limit to the number of action steps that you list, or how you score each.

- **Example: Score (3)**
  Meet regularly with peers at other firms

- **Score (   )**

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- **Score (   )**

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- **Score (   )**

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- **Score (   )**

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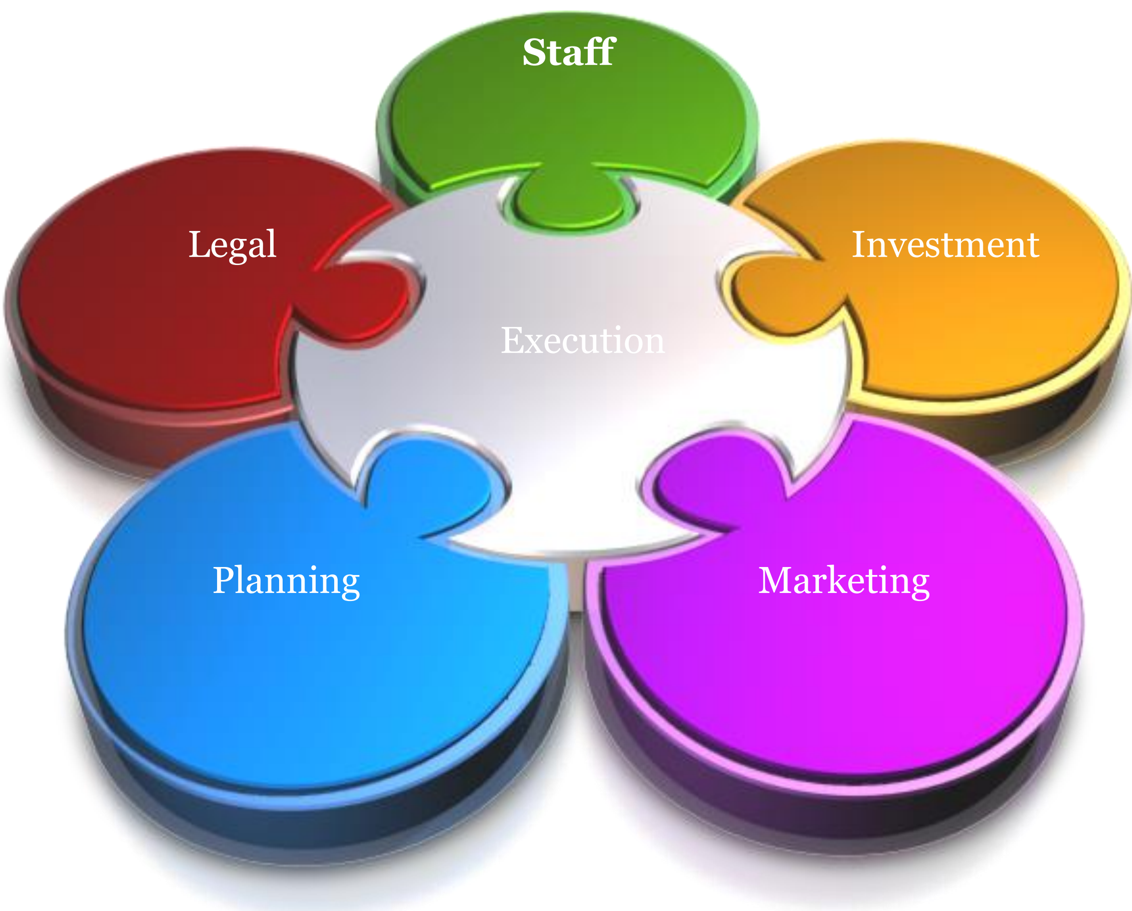
"Six Cornerstones of the Investment Management Firm"



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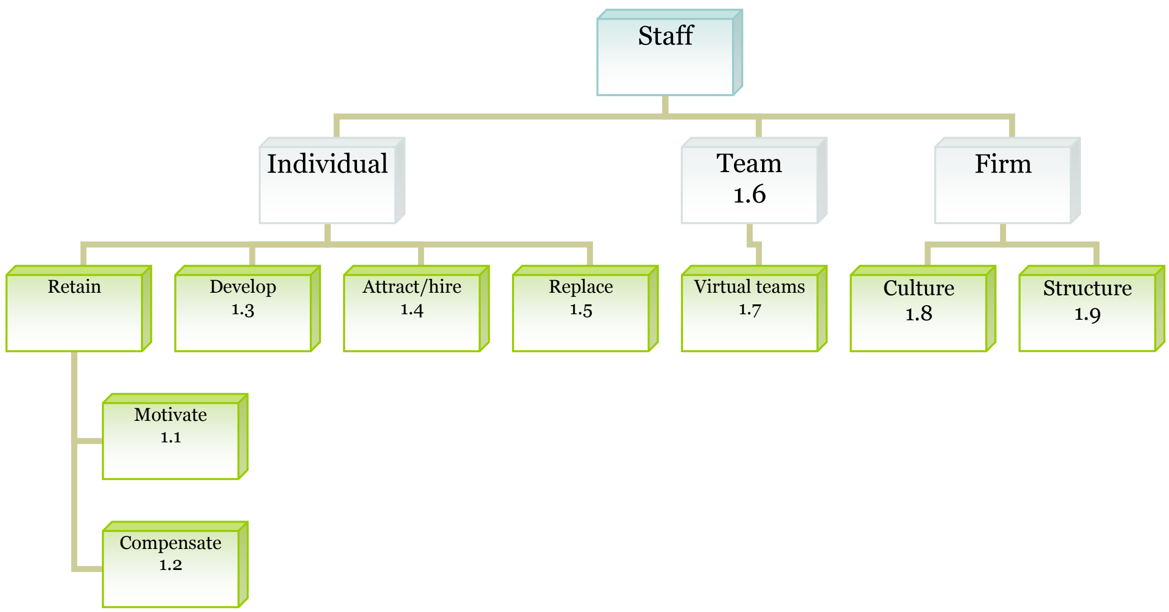
1.0 Staff

Introduction: Every existing firm needs to retain and motivate existing staff , offer competitive compensation, develop staff, attract and hire more staff as the firm grows, and plan to replace key staff who leave. Structuring successful teams and the firm also requires considerable attention.



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1.1 retain/motivate

Retaining staff always ranks high on the agenda of leaders as this is a very competitive industry. Once on board, motivating staff requires continuous effort.

1.2 retain/compensate

While other factors more strongly influence retention, compensation discussions are never far from the surface.

1.3 develop

Developing your staff's technical, sales and leadership skills is a way to enhance the talent in your firm and also motivate them.

1.4 attract/hire

As firms grow and change, recruitment becomes a higher priority.

1.5 replace

Whether due to retirement, quitting or firing, there will be changes in staff over time. Preparing for these changes is needed to sustain a successful firm.

1.6 teams

For those firms that rely on investment teams, results depend on cooperation.

1.7 virtual teams

Many firms are developing a significant international presence, which challenges team cooperation.

1.8 firm culture

The values and desires of staff in your firm determine success or failure.

1.9 firm structure

Organizing staff in a firm helps to provide a platform for further growth.

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1.1 retain/motivate

- Why do employees stay with your organization – what makes your firm a great place to work for them?

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- If your staff is unhappy, the chances are that your clients will also be unhappy. Is your staff happy?

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- What kinds of non-monetary rewards does your leadership team use to motivate staff?

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- What changes in the work environment have your staff requested, that can and should be changed?

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- What behaviors are you encouraging or accepting of, in your firm? What rewards and punishments are affecting staff performance?

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- Do you talk openly, explicitly and frequently about what it takes to be successful in your organization?

- Do you talk to high potential staff about future opportunities in your firm?

- What is the turnover rate of staff in the firm?

- Could you restructure the requirements, expectations and rewards of positions in order to reduce unwanted staff turnover?

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1.2 retain/compensate

- Does your firm make enough profit, and consistently so, to be able to pay people what they are worth in comparison to other firms?

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- How often do you keep people informed about your firm's profitability, and the likely impact on incentive pay, in order to manage short-term expectations for compensation?

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- What are the specific measures used in your incentive program for key employees in your firm? (rank order the following)

	Rank(1-5)	Percentage contribution to incentive pay
Linked to firm results		
Linked to team performance		
Linked to individual success		
Seniority		
Subjective		

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- What percentage of incentive compensation is short-term versus long-term, and cash versus non-cash (eg. equity)?

% short-term % cash	% long-term % cash	Total = 100%
% short-term % non-cash	% long-term % non-cash	Total = 100%
Total = 100%	Total = 100%	

- How closely does non-cash long-term compensation mirror equity ownership?

- What happens if your key staff members fail to meet minimum targets for their incentive compensation?
    - They are given a token bonus
    - No bonus
    - Termination

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- How could you adjust the program to encourage, as well as reward, desired behavior in order to minimize failures to meet minimum incentive targets?

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- What elements of the compensation program contribute the most to sustaining and growing the long-term value of the firm?

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- Could you change the compensation program to better sustain and create value for your firm?

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1.3 develop

- Which of the following are used to develop the technical, sales and leadership skills of key staff? Choose all that apply.
    - Mentoring
    - Internal training
    - External training
    - Conferences
    - Peer – peer review
    - Setting standards
    - Experiential learning
    - Formal performance reviews
    - Coaching
- How effective have these been for developing staff? Are there any of these that your firm could consider using?

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1.4 attract/hire

- What are the most important competencies of the key staff members who make a substantial contribution to your firm?

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Here are some examples of lists of competencies that have been used by other firms to identify top performing portfolio managers and salespeople.

You should add and delete competencies on these lists in order to customize the lists for your own organization.

Investment

- ☐ Driving curiosity
- ☐ Detail and big picture oriented
- ☐ Firmly decisive and flexibly creative
- ☐ Thinks out to the future
- ☐ Detached objectivity
- ☐ Independent-minded
- ☐ Calculated risk taker
- ☐ Skilled at interpersonal questioning
- ☐ Competitive but collaborative
- ☐ Passion & drive
- ☐ ...other competencies

Marketing

- ☐ Technical/ Professional Knowledge
- ☐ Independence/ Ownership
- ☐ Passion for the Mission
- ☐ Professional Drive
- ☐ Results Oriented
- ☐ Customer – Oriented
- ☐ Integrity
- ☐ Negotiation
- ☐ ...other competencies

Support

- ☐ Technical Knowledge
- ☐ Professional Knowledge
- ☐ ...other competencies

- Does your firm use behavioral interviewing techniques to identify the competencies that you are seeking? Is there a list of specific questions that can help to identify competencies during candidate interviews?

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- Where can your firm best source new hires with the necessary competencies?

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- Consider any unsuccessful new hires that have been made in the past. How has the hiring process been improved as a result of these experiences?

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1.5 replace

- Do you have a detailed succession plan, at least in mind, if not in writing, for every key member of your firm?

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1.6 teams

- Is the firm mainly focused on creating great teams, or supporting talented individuals?

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- Does the firm encourage interaction between people or are some people and teams isolated? What impact does this have on achieving the firm's objectives?

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1.7 virtual teams

- Does your firm have staff in different geographic locations? Does this present challenges? If so, which are the most important challenges?

- How does your firm ensure that individuals and teams outside of the home office do not feel isolated?

- How does your firm sustain trust between distant team members?

- How does your firm create social connections between distant team members?

- How does your firm ensure that there is a unified focus on the same goals, objectives and tasks?

- How does your firm share best practices with physically distant team members?

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- How does your firm monitor, recognize and reward individuals outside of the home office?

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1.8 firm culture

What are the most important values of the staff of your firm? Narrow the list first to 10, and then to just three.

- ☐ Accomplishments
- ☐ Action
- ☐ Authority
- ☐ Belonging
- ☐ Competition
- ☐ Creativity
- ☐ Current
- ☐ Experiences
- ☐ Friendship
- ☐ Fulfillment
- ☐ Global
- ☐ Goals
- ☐ Identity
- ☐ Intellectual Stimulation
- ☐ Leadership
- ☐ Lifelong Learning
- ☐ Making a difference
- ☐ Mentoring
- ☐ Passion
- ☐ People
- ☐ Power
- ☐ Prestige
- ☐ Problem Solving
- ☐ Recognition
- ☐ Self-Esteem
- ☐ Skills and Talent
- ☐ Social
- ☐ Structure
- ☐ Value
- ☐ Visibility

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- What are the expectations of the staff about the future strategy of the firm?

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- What does your staff believe is important? What do they want the firm to do?

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- Should you alter your firm's strategy to fit your staff, or are you prepared to replace staff?

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- What is your staff willing to forego, give-up or trade-off in order to achieve their desired goals?

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- What does your leadership group say and do to encourage cooperation in your firm?

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- What forms of communication are used to communicate with staff and with what frequency?

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- What aspects of the culture of your firm contribute to creating value for the firm?

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- What aspects of your firm's culture detract from creating value?

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- Do all of your staff contribute to your firm's success? Do your key staff complement one another?

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- Do you believe that it is possible to change a culture? Does the existing culture support the firm's goals?

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1.9 firm structure

- Is your firm structured by functions (eg. Sales, Portfolio management), geographic regions (eg. USA, Europe), or a combination (eg. Matrix)?

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- Are there clear lines of authority and responsibility to a key person for all critical activities? Would everyone in your firm agree with your perspective on this?

Unclear authority (shared) Clear responsibility	Clear authority Clear responsibility
Unclear authority (shared) Unclear responsibility (shared)	Clear authority Unclear responsibility (shared)

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- Think of some examples of major decisions. Is it always the same person making the decision? Could the decision have been made nearly as well by someone else in the organization?

  - Example#1____

  - Example#2____

  - Example#3____

Your insights from Cornerstone #1 - Staff

As a result of your review, what action steps will you commit to take as a leader. List each step that you plan to take below. Score each one on a scale of 1-5, with 5 being the highest potential contributor to a sustainably successful firm. Remember, there is no limit to the number of action steps that you list, or how you score each.

- **Score ( )**
- **Score ( )**
- **Score ( )**
- **Score ( )**
- **Score ( )**

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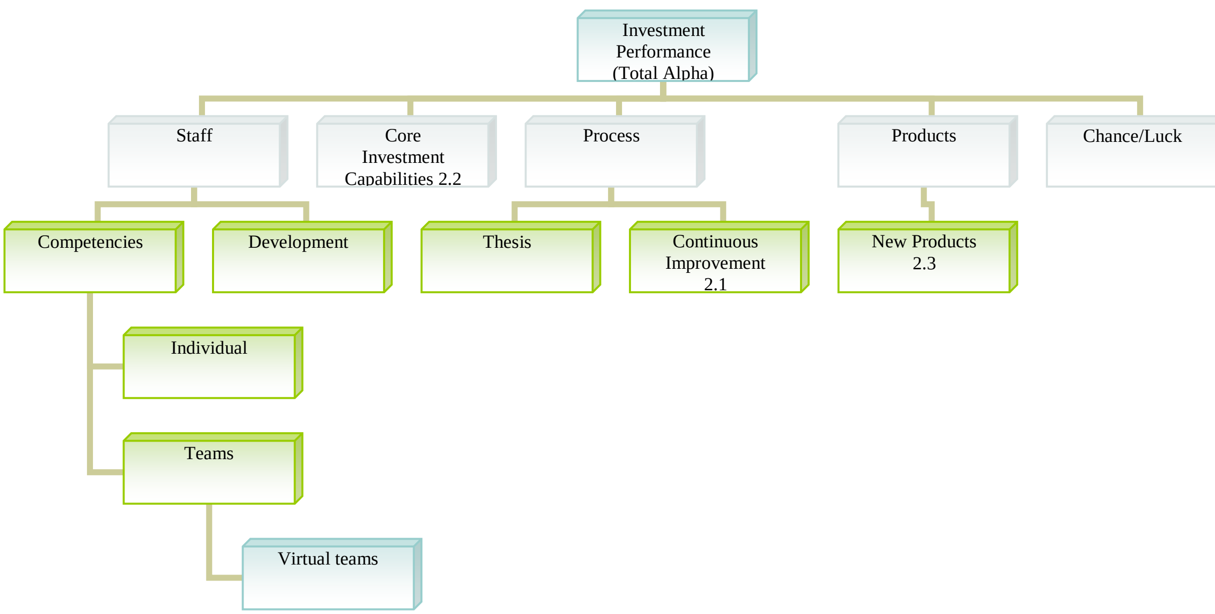
Cornerstone

Two

2.0 Investment Process

In many firms, senior leadership includes the top investment professionals who are deeply involved in managing the products and investment processes. Ideally, they'd like to directly control investment performance, but since it isn't possible to guarantee performance, the focus in this workbook is on identifying and improving capabilities and processes.



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2.1 continuous process improvement

Lean thinking and related ideas were first developed in the manufacturing world. Increasingly however, leaders are applying similar principles in service industries like investment management. While investing is arguably more art than science, leaders can help their firms sustain a competitive edge by thinking more deliberately about ways to cut wasteful efforts away from the investment process. The purpose is to free up time to spend on investment opportunities, and to add value by focusing on your firm's unique advantages.

2.2 capabilities

Identifying your firm's competitive capabilities, and "loving" the quality of your products is a step towards improving your existing products and developing new ones.

2.3 new product development

New product development is essential to the survival and growth of firms in the long-run and selecting new products should be heavily influenced by your firm's existing and easily acquired capabilities.

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2.1 continuous investment process review

There are three elements of the investment process that should be regularly reviewed. These elements are staff issues, investment process issues and support issues.

Staff issues:

- How does your hiring process contribute to complementing your existing portfolio management talent?

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- Does your firm mentor, train or set standards to ensure that new hires are making a productive contribution as soon as possible?

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- How are contributions to improvements in the investment process rewarded?

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- Is there an individualized employee retention strategy?

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- Is there a succession plan for individuals and teams?

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Investment process issues:

- How long does it take, on average, from the germination of an investment idea through to trade execution?

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- Are there parts of the investment process that are unnecessarily bureaucratic?

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- Are unstructured conversations and social time with the sponsors, managers and promoters of investment opportunities kept to a minimum?

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- How can emails and meetings be better organized to contribute and not distract?

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- Are the portfolio managers skilled in time management?

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- How do the investment teams guard against behavioral biases?

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- How consistent is the investment style of individuals within each team?

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- Is there an efficient process to quickly alter a portfolio's characteristics, if needed?

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- How effective is the firm's approach to risk management? How is effectiveness measured?

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- How is the level of risk in portfolios monitored?

- Has the firm ever permitted unusual deviations in risk, other than for investment opportunity, or at a client's request?

- Do you try to ensure that security selections that are made outside of the confines of the usual investment selection process are making a sufficient contribution to the portfolio, given the extra risk involved?

- How does the firm respond to investment under-performance issues?

- How does the firm identify and eliminate the causes of weakening individual performance?

- Is there a formal feedback loop from both successes and failures in order to further refine the investment process over time?

- Are the implications for others such as clients, prospects, intermediaries and staff considered when making any proposed changes to the investment process?

Support:

- Does your firm continuously try to improve the middle and back office in order to eliminate repeated errors that occupy the time of portfolio managers?

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- Does your firm aggressively use technology to reduce wasteful manual workarounds that slow the investment process?

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- Does your firm actively seek technology to improve the investment process?

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- Does your firm actively manage client demands for contact with investment professionals?

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2.2 capabilities

- What does your staff believe are the sources of your firm's sustainable competitive advantage in investing? How do these sources compare to the firm's competitors?

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- What are your firm's core investment capabilities that are superior in comparison to other firms, both within and across asset classes? Choose all that apply.

  - ☐ Original research
  - ☐ Information and data gathering
  - ☐ Model-building
  - ☐ Analysis
  - ☐ Decision-making
  - ☐ Portfolio construction
  - ☐ Risk management
  - ☐ Hedging
  - ☐ Use of leverage
  - ☐ Valuing illiquidity
  - ☐ Currency
  - ☐ Shorting
  - ☐ Trading
  - ☐ …

- Do you "love" the quality of your firm's investment products? If not, what could be done to enhance their quality?

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2.3 new product development

- What is your firm's philosophy of new product development – do you anticipate market trends, try to catch current market trends/or respond to client suggestions, or do you rely on your investment staff to suggest ways to benefit from existing investment capability?

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- How might your firm's core investment capabilities, that are superior to other managers, be stripped down, modified, combined or added to in order to create new products?

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Capability	New Product Idea #1	New Product Idea #2	New Product Idea #3	New Product Idea #4
Original research				
Information, data gathering				
Model - building				
Analysis				
Decision - making				
Portfolio construction				
Risk management				
Hedging				
Use of leverage				
Valuing illiquidity				
Currency				
Shorting				
Trading				
...other capabilities				

- What additional capabilities (or products/services/solutions) could be added by hiring, lifting out a team or by acquiring another firm?

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- Examine your portfolio of investment products by investment class (from low return to high return), value-added (from passive to active), and approach to investing (from quantitative to fundamental)? What other untapped product categories are available to utilize your firm's skills?

Product	**Return Potential**	**Value-added**	**Approach**
Eg. Domestic large cap	High	Active	Fundamental

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Your insights from Cornerstone #2 – Investment Process, Product

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- **Score (   )**
- **Score (   )**
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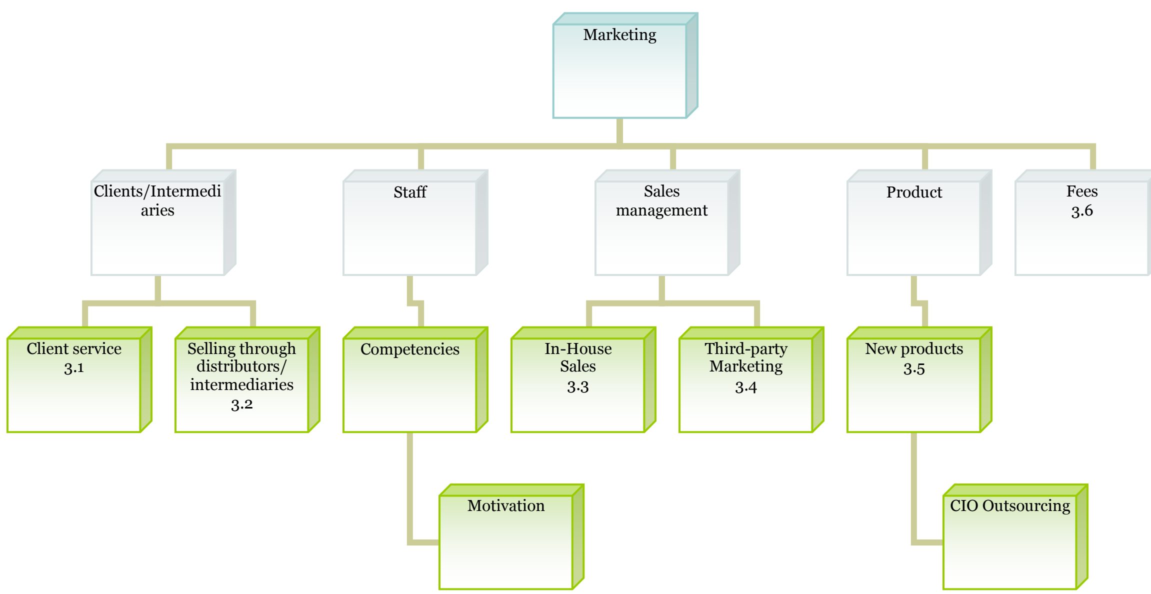
Cornerstone

Three

3.0 Marketing

After a firm has been established for any amount of time, the most frequently encountered issue that arises is - how do we get more clients? We'll first address how to keep clients, before turning to how to find more clients. We'll then review selling to related distributors, and intermediaries in the process (e.g. investment consultants). We'll also discuss fees – a key variable affecting profitability. A discussion of new products picks up on our introduction to the topic in the previous cornerstone on Investments.



3.1 client service

The old cliché is that keeping clients is easier than getting new ones. Reputation and brand is essential to build and keep business.

3.2 selling through distributors

Often sales to end clients are handled by third-parties that may be independent or only partly within the firm's control.

3.3 sales management

Sales management is often the difference between successful sales efforts and missing opportunities.

3.4 third-party marketing

An alternative to internal sales efforts is to hire a third-party marketing firm.

3.5 new products

New product development processes lead to long term success for the firm.

3.6 fees

Fees are an often over-looked source of weak profit margins.

3.6 special topic: reputation

Negative reputational issues can be reversed but they require a specific mind-set, and determined efforts.

3.1 client service

- Does your firm have updated job descriptions for each client service position?

- What are the inherent competencies of your firm's best client service staff?

- What are your firm's expectations for client service staff? Eg. Cross – selling?

- What does your client service staff expect from the firm both personally and in terms of support for their efforts with clients?

- Does your firm have high turnover in your client service staff – if so, why?

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- If turnover is an issue, could these jobs be redesigned?

- How promptly and thoroughly does your staff resolve problems and meet requests from clients? How is this measured?

- How easily can client service staff access needed information?

- Does your firm have an escalation process to respond to client service crises?

- Does your firm increase contact with clients during difficult periods?

- Does your firm comprehensively review client relationships at least annually by examining complaints, errors, requests, concerns, business risk and related issues?

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3.2 Selling through distributors/intermediaries (eg. consultants)

- What expectations do you have of the distributor, and do you discuss these openly with them?

- Do you need to modify your product or packaging to better suit the particular distribution platform?

- What educational/training assistance are you providing?

- How can you encourage stronger personal relationships between staff at your firm and the distributor's/intermediary's staff?

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3.2 sales management

- Why did your existing clients hire you?
  - Investment performance
  - Investment style
  - Relationship
  - Referral
  - Connection to consultant
  - Previous client
  - ...other reasons?
- Why do they continue to retain your firm?
- Do existing clients recommend your firm to others?
- Is your pipeline of new client opportunities growing or shrinking?

○ Which channels, segments, geographies is your firm currently targeting. Which other ones could you target specifically?

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○ Describe the characteristics of the next client/clients that your firm will win.

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Slow growth?

○ Which intermediaries (eg. consultants) have not approved your firm, and why?

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○ Which prospective clients have rejected your firm, and why?

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○ Do your salespeople have robust products to sell? If your products aren't ranked amongst the very best of your peers, prospective clients are unlikely to even give your firm a chance, in any meaningful numbers.

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- What is the current status of your firm's products in relation to client demand?

Product needs improvement/other products in demand Prospects willing to purchase	Product in demand Prospects willing to purchase
Product needs improvement/other products in demand Prospects unwilling to purchase	Product in demand Prospects unwilling to purchase

- If your products are out of favor, what other opportunities have you considered pursuing – eg. Product, client segment, geographic region, distributor?

Connection to portfolio management?

- Do your firm's investment professionals look, act and communicate as if they are the top-performing investment professionals in the world?

- How does your firm reconcile disagreements between portfolio managers and marketing staff ?

- Has your firm prepared a thorough due diligence report on your own firm?

- How effective are the portfolio managers at communicating the investment process to others?

Brand?

- How strong is your firm's brand? How does your firm measure brand?

- How does your firm promote its brand, and what are the highest impact and most cost-effective ways?

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- What business partners does your firm have that strengthen your brand?

Intermediaries?

- Which intermediaries (eg. Consultants) have been the best at delivering revenues to your firm? Can you find others with similar characteristics?

- What pressures do your most helpful intermediaries face, and in what ways can you help them? How are their firms changing?

- How can your firm stand out from competing investment management firms and products?

Salesforce?

- How motivated are your salespeople today on a scale of 1 to 5? Are they motivated by results?

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- Are you investing in newly emerging channels of distribution? Do you have staff who have skills with these new channels?

- Are there opportunities to cut administrative burden away from your sales staff so that they can focus their efforts on selling?

- Do you insist on, and review formal sales reporting? Can it be simplified?

- In what ways can you as a leader, contribute to sales performance – both directly (eg. via regular client contact) and indirectly (eg. influencing sales management practices)?

International distribution?

- Have you aligned your firm with local firms?
- Are your products presented and priced appropriately across all markets?
- Have you made a great first impression?
- To what extent are you accommodating local needs?

- Is expanding internationally worth the costs, risk and effort required for your firm?

3.4 third-party marketing

- What are the benefits, costs and risks of using 3pm for all or some of your firms products, instead of internal sales people?

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3.5 new products

- Who likes your current products, and what are the common characteristics of these clients/intermediaries/prospects?

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- Have you considered copying the new product development process and products of competitors who have a successful track record of introducing new products?

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- Are your salespeople supportive, and capable of selling each specific new product?

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3.6 fees

- How many of your clients pay fees based on a prior fee schedule?

- How many of your clients pay less than your current fee schedule?

- Does your firm offer fee discounts? To who and why?

- Who approves fee discounts in your firm?

- How often are existing fee discounts reviewed?

- Is it fair to all of your clients if some clients pay lower fees for simi9lar services?

- Are you charging enough given your limited capacity?

- What is your current operating profit margin? If fees were charged what would the firm's operating margin be? What is this gap between the actual and potential profit margin?

- Will currently existing fee discounts enhance the long-term value of your firm?

- Consider the positives and negatives of having performance fees for traditional investment products.

  Positives include: additional revenues during periods of outperformance, better alignment with clients, meet client demands.

  Negatives include: increased revenue and earnings volatility, when markets decline performance may need to surpass the high water mark in terms of client asset values, when markets decline clients hate paying additional fees, not highly valued when measuring a firm's economic value.

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3.8 special topic: reputation

Issues affecting your firm's reputation may arise for many reasons:

- ☐ Acquisitions or mergers
- ☐ Financial problems
- ☐ Poor investment performance
- ☐ Client/staff departures
- ☐ Regulatory issues
- ☐ Lawsuits

How can you respond?

- ☐ Rally supporters
- ☐ Seek help from associated companies
- ☐ Leverage remaining clients to endorse your firm
- ☐ Begin again with small to midsize consultants and other intermediaries
- ☐ Consider replacing sales staff
- ☐ Seek new channels, segments, needs, geographies

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Your insights from Cornerstone#3 - Marketing

As a result of your review, what action steps will you commit to take as a leader. List each step that you plan to take below. Score each one on a scale of 1-5, with 5 being the highest potential contributor to a sustainably successful firm. Remember, there is no limit to the number of action steps that you list, or how you score each.

- **Score ( )**
- **Score ( )**
- **Score ( )**
- **Score ( )**
- **Score ( )**

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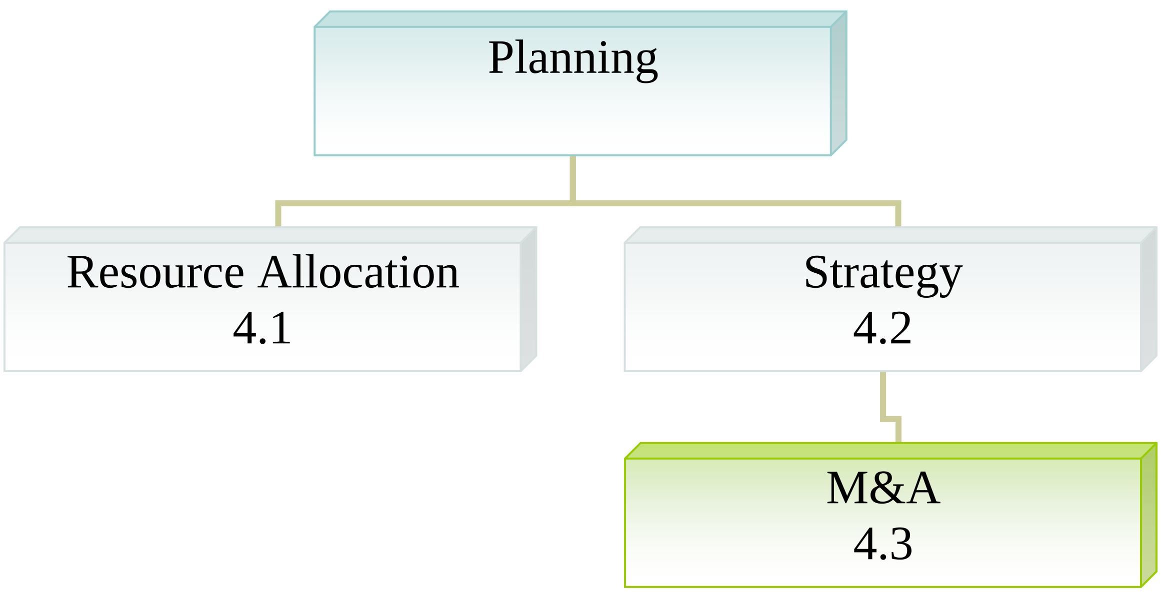
Cornerstone

Four

4.0 Planning

How you allocate your resources currently is typically a great indication of your thoughts and plans for the strategy of your firm. Considering a move in a new direction should be the result of a combined effort by all of the key employees of the firm.



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4.1 resource allocation

Your firm's current expenses are a strong indication of your firm's priorities. If a new path is desired, scarce resources must often be reallocated.

4.2 strategy

Strategic plans should be driven from the bottom-up by the people who will be responsible for implementing the strategy.

4.3 mergers and acquisitions

M&A is fraught with hazards which strongly cautions against overpaying.

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4.1 Resource allocation

- Do your firm's expenses reflect your priorities? What do you spend your money on in relation to your competitors?

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What products, services, client types, segments, distribution channels, geographies contribute the highest current profit, and expected long term profit (columns 2+3)

Enter product/ service/ solution, <u>or</u> client type, <u>or</u> client segment, <u>or</u> distribution channel, <u>or</u> geographic region	Current Profit	Estimated Long term profit potential	Closely connected to existing business or gateway to…	Future option potential …	Overall attractive-ness rank
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- How are your different products, services, client types, distribution channels, segments and geographic regions inter - connected? Which ones are gateways to other opportunities? (column 4)

- Which of these is a small part of the firm today, but is potentially a large contributor to future success? (column 5)

- How should you address the areas of your firm that are contributing the least to profitability, are largely unrelated to the rest of the firm and have minor long-term potential? What are the implications of exiting a part of your business in the long run? Is it likely that it would close off future opportunities, and reduce long-run profit?

- Challenge those responsible for these areas to think creatively about how to increase short-term profit, long term profit, connect to other businesses.

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4.2 strategy

- What is contributing to the current success of your firm and what isn't?

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- How can your team enhance what is working, and either improve or remove what is not?

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- Does your firm have specific goals?

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- Is your firm adequately prepared to grow?

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- What actions need to occur first in order to be ready to grow? Can your team work on these actions in parallel with the growth of the firm?

- Which of these parties cares deeply about your firm?

  - ☐ Employees
  - ☐ Communities
  - ☐ Shareholders/Directors
  - ☐ Creditors
  - ☐ Investors/Owners
  - ☐ Customers
  - ☐ Suppliers
  - ☐ Government regulatory agencies
  - ☐ Government legislative bodies
  - ☐ Industry trade groups
  - ☐ Professional associations
  - ☐ NGOs and other advocacy groups
  - ☐ Prospective employees
  - ☐ Prospective customers
  - ☐ Local communities
  - ☐ National communities
  - ☐ Public at Large (Global Community)
  - ☐ Competitors
  - ☐ Schools
  - ☐ Future generations
  - ☐ Analysts and Media
  - ☐ Alumni (Ex-employees)
  - ☐ Research centers

- What is your strategy to serve these stakeholders?

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- Which of these parties has power over your firm?

  - ☐ Employees
  - ☐ Communities
  - ☐ Shareholders/Directors
  - ☐ Creditors
  - ☐ Investors/Owners
  - ☐ Customers
  - ☐ Suppliers
  - ☐ Government regulatory agencies
  - ☐ Government legislative bodies
  - ☐ Industry trade groups
  - ☐ Professional associations
  - ☐ NGOs and other advocacy groups
  - ☐ Prospective employees
  - ☐ Prospective customers
  - ☐ Local communities
  - ☐ National communities
  - ☐ Public at Large (Global Community)
  - ☐ Competitors
  - ☐ Schools
  - ☐ Future generations
  - ☐ Analysts and Media
  - ☐ Alumni (Ex-employees)
  - ☐ Research centers

- How will your strategy address the demands from each of these groups that have power over your firm?

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- What resources are available, or can be readily acquired, to assist you with implementing your firm's strategy?

  - ☐ People
  - ☐ Technology
  - ☐ Data
  - ☐ Basic research
  - ☐ Distribution
  - ☐ Management
  - ☐ Other....

- How can you better focus all of the resources that you have available on your strategy?

- Is your firm a public or private company? Does the firm's ownership structure influence your thinking about your business?

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- Is your firm primarily focused on creating value for stakeholders? If not, what else is a focus?

- Do you have joint ventures or minority interests? How much effort is required to manage these? What are these interests contributing to the long term value of the firm?

- Do you need to create, or be in a position to realize economic value in the near future?

- What could your firm be worth under the right conditions? What are the external factors preventing your firm from achieving this value? What internal factors are within your control?

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- What are you hoping will happen in the external environment to help your firm succeed?

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- What is within your control to help your firm succeed?

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- What additional capabilities do you need to acquire in order get to the valuation you believe that your firm deserves?

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- Are you building an enduring company or are you primarily focused on a particular product? Do these two objectives overlap?

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- Is your firm aligned and focused on delivering exceptional results to clients?

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- Is it the firm's priority to generate strong investment performance above all else, or to increase sales and revenues? Or both?

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- Does your firm utilize the talent in your firm to develop strategy and to ensure that the plans can be implemented and also pulling together staff. Leaders should set the goals and shepherd the process but allow staff to develop the plans to achieve the goals.

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4.3 mergers and acquisitions

- Acquisitions – ask yourself: why are they selling?

- What will be the compensation expected by the newly-acquired staff post-sale – can your firm afford it?

- How long are key employees likely to stay engaged? How much of the purchased goodwill is tied to these employees?

- What cultural challenges are you facing in acquiring the new firm?

- How will you engage the hearts and minds of the non-owners to stay?

- How will you maintain and grow purchased goodwill value?

- How can your firm realistically continue to build value in the acquired firm?

- What if investment performance deteriorates post sale? How will you make any needed changes without further eroding firm value?

- Will this investment generate an economic return under a wide variety of scenarios?

Your insights from Cornerstone #4 – Planning the Business

As a result of your review, what action steps will you commit to take as a leader. List each step that you plan to take below, and score each one on a scale of 1-5, with 5 being the highest potential contributor to a sustainably successful firm. Remember, there is no limit to the number of action steps that you identify, or how you score each.

- **Score ( )**
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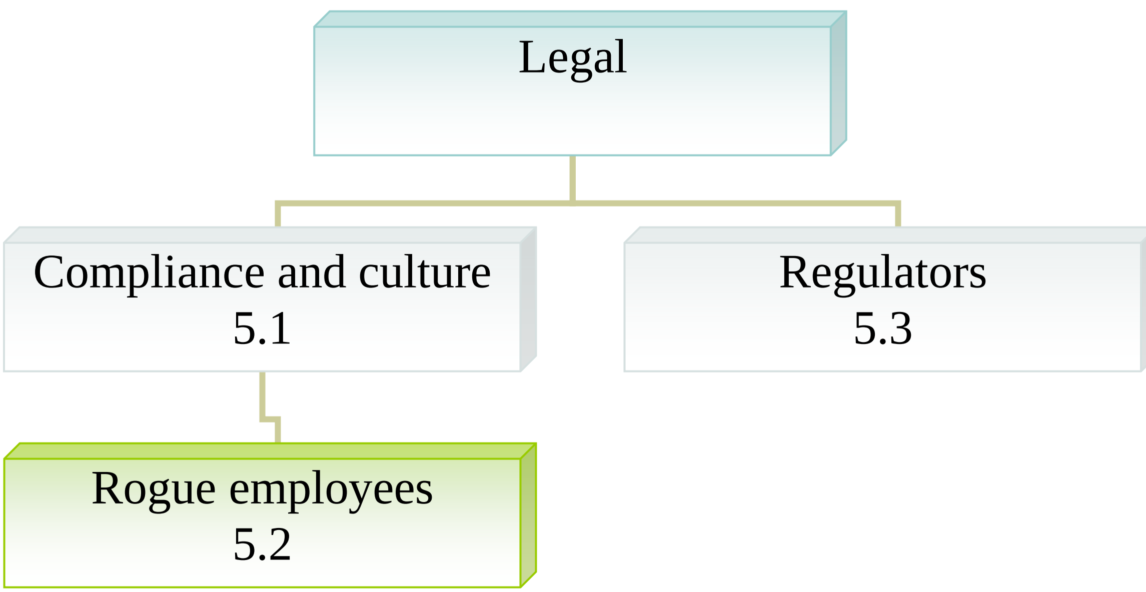
Cornerstone

Five

5.0 Legal & Compliance

Legal and compliance issues are present from the inception of a firm, but they grow increasingly complex as the firm grows. Addressing the ever-changing demands requires a culture that is mindful of the deep needs.



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5.1 compliance culture

The firm's culture is the first line of defense in meeting compliance requirements.

5.2 rogues

The explicit costs and negative reputational impact of a rogue employee can forever damage a firm.

5.3 regulators

Regulatory demands are a moving target and there are changes worldwide as well that need to be respected.

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5.1 compliance culture

- Does your leadership team set the right tone, and signal commitment to meeting the spirit and the requirements of the laws and regulators in every area of your firm?

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- Does your leadership team model appropriate behavior? In what ways?

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- Does your leadership team:

  - segregate key functions?
  - provide real oversight?
  - take accountability seriously?
  - utilize automation to monitor activities?

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- Does your firm provide adequate resources to compliance, audit and risk management? How is this adequacy measured?

- Does your firm support actively seeking to identify problems and remediating them (without hiding issues)?

- Are you always on the lookout for conflicts of interest and mis-directed incentives in your firm in order to disclose or minimize even the appearance of conflict?

- Are there any "secret" processes that your leadership team is not fully familiar with?

- How do compliance, risk management and audit support the business and your culture?

- What new or broader contractual obligations have you agreed to accept from clients in recent years? What new business risks has acceptance of these obligations introduced?

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5.2 rogue employees

What do you do to minimize the risk of rogue teams and employees?

☐ Background checks – including social media.

☐ Formal exit interviews with all staff.

☐ Formal investment process review in order to avoid "secret processes", also consider alternate and low probability investment scenarios, use reasonableness and common sense tests.

☐ Pay attention to rumors, devil's advocates, skeptics, the outspoken and draw out the introverts for their views.

☐ Compliance should have a standing invitation to attend any meeting.

☐ Carefully review customer complaints - not just written, but also complaints that are verbal. Rumors about your firm and the threat of broader industry issues should also be carefully considered.

☐ Checks and balances, dual controls, mandatory vacations.

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5.3 regulators

- Who are your primary regulators – how are they similar and how do they differ? How does your compliance effort reconcile the different perspectives?

- Does your firm have specialized expertise available to meet the expectations and requirements of each distinct regulator?

- What have regulators recommended to your firm as best practice, and what has been your response?

- Does your firm try to anticipate the future concerns of regulators/legislators?

- How does your firm formally evaluate the quality of your legal and compliance people?

- What is the quality of your compliance team's relationship with the regulators?

- Does your compliance team exercise business judgment in their recommendations to you?

Your insights from Cornerstone#5 – Legal & Compliance

As a result of your review, what action steps will you commit to take as a leader. List each step that you plan to take below, and score each one on a scale of 1-5, with 5 being the highest potential contributor to a sustainably successful firm. Remember, there is no limit to the number of action steps that you identify, or how you score each.

- **Score ( )**
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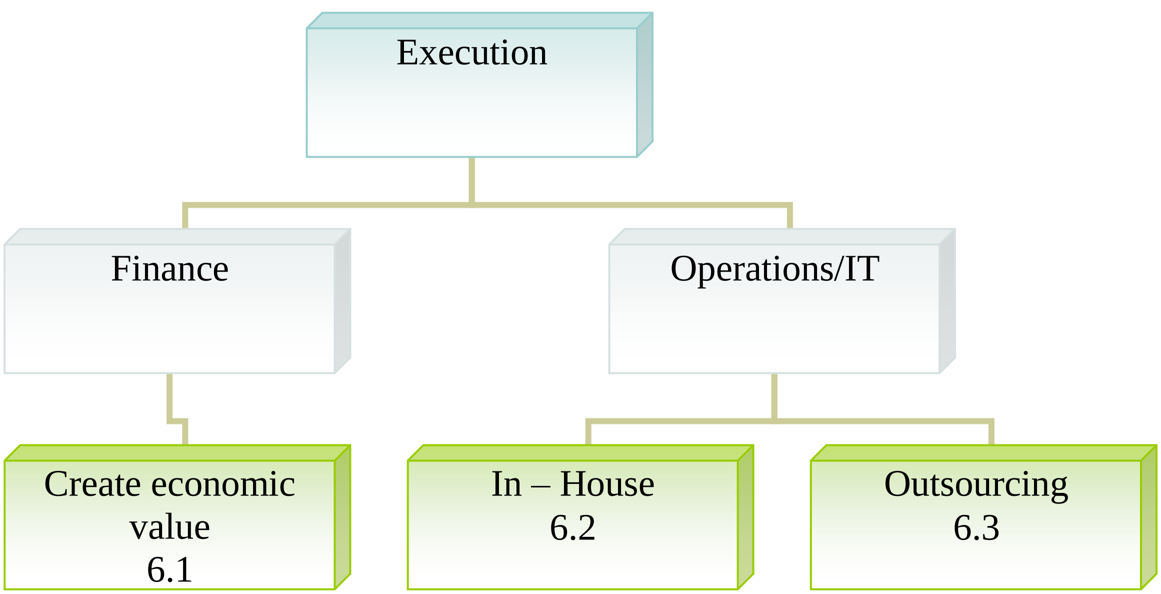
Cornerstone

Six

6.0 Execution

Finance, operations and technology are the backbone of our firms, and often lead efforts to improve efficiency.



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6.1 finance

High profit margins historically meant that making money was often taken for granted in the past. Good financial discipline has become increasingly important.

6.2 technology and operations

Investment and sales people are often at a loss as to how to manage the middle and back office.

6.3 outsourcing

Many firms already outsource significant parts of their operations and technology. How to manage outsourcing is the focus here.

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6.1 finance

There is increasing downward pressure on investment firm profitability. In addition, even the active owners of independent firms are increasingly sharing their profits with other owners who are not actively involved in the business. The result is that there is more attention being paid to increasing and sustaining adequate levels of profitability.

- Rank the key financial drivers of your firm

Rank

  - New sales
  - Growth in revenues
  - Operating profit
  - Fixed expenses
  - Compensation
  - Variable expenses
  - …
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- Key performance indicators should focus on profit – which KPIs do you use, how many are financial in nature?

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- Does your firm rigorously challenge the parties responsible for achieving financial results regularly.

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- Does your firm monitor the correlation of revenues across your firms products/services? Truly diversified revenue streams help to maintain stable levels of compensation in the short run and contribute to higher economic value in the long run.

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6.2 technology and operations

- How effective is your firm at managing projects?

- What are the benefits and risks of increasing technological complexity? Are these benefits and risks weighed differently if the technology supports clients directly?

- How do you store, retrieve and use data?

- Are operational risks identified, tested and monitored?

1.2 Outsourcing

If you're already outsourced, what should your firm monitor?

- Larger service providers may have communication breakdowns between service groups. Your requests may be treated as one-off costly exceptions, when numerous clients of the service provider are encountering similar issues.
- An inability of the provider to accommodate your new products, new geographic regions or even new processes eg. meeting new regulatory requirements.
- Delayed delivery of projects.
- Unanticipated staff turnover. Retraining staff at your outsourcing provider's firm to meet your specific needs may be costly.
- Flattening of cost savings over time, with any further savings accruing to the benefit of the outsource provider only.
- The service provider must meet their own needs for turning a profit. The outsourcing services provider may choose to invest less in people and technology over time in favor of investing their resources in other more profitable business opportunities.
- Few service quality enhancements over time.

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Your insights from Cornerstone #6 - Execution

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- **Score ( )**
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Summary: Your Action Points and Scores

You were encouraged at the beginning of this workbook to write down your action steps at the end of each cornerstone section. Now you can insert the names of each of the action steps that you have written down in this workbook, in the first column starting at the lower left hand corner of the table on the nest page. You can then either enter the score for each action step, or the total score for each cornerstone by shading the rows. Begin each column at the next highest row from left to right. The purpose is to create a cumulative picture of your action steps and their relative importance.

(An example is shown below: 1 action step in leadership with a score of 5. Fill in 5 rows up from bottom of leadership column. Next, 1 action step in Staffing with a score of 3. Fill in 3 rows in Staff column beginning at next highest row). Total score for both action steps is 8.

Example:

Insert Action Steps Below	Your Leadership	Staff
2. eg. Seek personal coaching for subordinates		
1. eg. Meet with peers regularly		

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Once you've completed the table on the next page with your own action steps, you'll have a clear picture of the opportunities for your leadership to create value in your own firm. The action steps and cornerstones of highest value will be evident, and should be your highest priority.

Action Steps	Your Leadership	Staff	Investment	Marketing	Planning	Legal	Execution	Total Score of All Action Steps
Action Step 12.								
Action Step 11.								
Action Step 10.								
Action Step 9.								
Action Step 8.								
Action Step 7.								
Action Step 6.								
Action Step 5.								

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Action Step 4.								
Action Step 3.								
Action Step 2.								
Action Step 1.								

Leadership Agenda

	Timing	What you as a leader need to do	What others need to do
Staff			
Investment			
Marketing			
Planning			
Legal and compliance			
Execution			

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Summary

Congratulations! You have now examined your firm in an integrated way considering the firm's goals, capabilities, resources and opportunities. The readings which begin on the next page will provide you with additional insights into the challenges of leading investment management firms.

Additional Readings

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Marketing

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Legal

Execution

[Staff](#)

Matrix Management 12-26 S

Someone once told me that no leader, who had ever worked in their career in an organization with a matrix structure, would impose a matrix after they became leader. A matrix has its challenges.

Why shouldn't firms just hire the best people and not bother with thinking about bureaucratic organizational structures, like a matrix? One key reason is that while all investment management firms have lots of individual expertise, they often struggle with coordination. If sales slump for example, portfolio managers will have little to contribute to the discussion if they have not had much ongoing involvement in thinking about broad sales issues. A matrix structure helps bridge these differences.

A related reason is that building leadership skills in everyone is much easier in a matrix, because of the need for individuals to consider broader interests than simply their own technical role.

The leadership role is a crucial one in a matrix as leaders must be the high priests affirming the goals and focus of the organization. Creating a tone of cooperation, and encouraging frequent communication, is also part of every leader’s mandate in a matrix.

Leadership is everyone’s responsibility. For example, in a crisis, tough decisions may need to be made rapidly. If we are working together in a room and a fire breaks out, there would be no time to convene a meeting, follow procedures or a particular leader’s directions. Someone would probably just yell at everyone to get the heck out!

One of the biggest complaints about matrix organizations is that there are no clear lines of authority and responsibility. But as the previous fire example suggests, the person with the best information often has to be trusted to make a decision for the group. And that won't always be the same person. Importantly though, even if an individual makes a key decision, the leadership group as a whole still shares responsibility for all decisions. The consequences and rewards follow that joint responsibility.

Does this sound complicated and risky? Most firms begin with a few people assuming multiple roles. Doesn’t that sound like a matrix structure? And even as a firm grows, a matrix is the best possible organizational structure given all the other possibilities. Understanding its challenges can help a leader to ensure that a matrix organizational structure contributes to building value in the firm.

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Making Cross-Border Teams Effective 12-27 S

According to a recent survey that I conducted of more than 50 investment management firms, the most popular major initiative is global expansion. Today, there are firms that distribute in more than 50 countries around the world, and many firms are striving to catch-up with them.

While not all firms have internal staff in each country, there is often a need to coordinate teams across multiple geographies. How can firms address the challenges and opportunities of having these virtual teams work together more successfully?

There is a large body of research and practice on creating and sustaining successful teams. But the literature on virtual teams is sparser. Here are some issues and answers:

- ☐ Maintaining trust is extremely important for virtual teams.
- ☐ Keeping people informed helps trust and means that regular and frequent communication in a variety of forms is necessary.
- ☐ National cultures and ethnicity affect communications. For example, non-native English-speakers may have a slightly different interpretation of an English word, which can lead to misunderstandings. It is important not to assume, but instead confirm, understanding.
- ☐ One key purpose for communicating is to establish and maintain focus on specific goals, objectives and tasks, but this is tougher with virtual teams. Keep minutes of meetings, and ensure that actions agreed upon actually get implemented.
- ☐ After any group meetings, it can be helpful for the leader to talk to each of the participants to ensure that they are recognized for their contribution, or made aware of their lack of contribution to the group.
- ☐ Sharing best practices virtually can be assisted by encouraging people to work together via informal advisory committees from different locations and across different functions.
- ☐ Remember to celebrate successes, and have regular face-to-face get-togethers.
- ☐ Extra effort is needed to both encourage, and allow for social interactions.
- ☐ Individuals who are not located in the main office may feel that they are out of sight, out of mind with the

firm's leaders. Actively solicit input, and recognize individual contributions.

- Respecting time zone differences, and recognizing that different cultures perceive time at work differently, as well as being mindful of local holidays and customs, requires continuous attention.

The truth is that not everyone is cut out to be a member of a virtual team. We'll discuss this in future reports.

Finally, as you may have noted, it's more important to have structure and process in a virtual environment than for teams in general. Formality can help to make up for the lack of proximity.

Strategic Initiatives in Investment Management - Staffing 12-17 S

If you review the recent public statements of leaders of investment management firms, few reference any significant new initiatives that relate to their human resources. This brief report highlights why firms may be doing themselves a disservice by not publically talking about their future plans for their staff.

I have reviewed the recent public statements of more than 50 investment management firms, and focused on references to strategic initiatives. I then sorted these statements into 6 categories. These 6 categories include: **S**taff, **I**nvestments, **M**arketing, **P**lanning, **L**egal and **E**xecution. Collectively, these constitute a "**SIMPLE**" model of any investment management business.

This week, we'll discuss what investment management firms are saying about their **S**taff initiatives.

It wasn't easy to find many public statements from firms about their people. A small number of the firms that I reviewed, did make a point of stating that they have great people. Other firms described new product, marketing or operational initiatives that implicitly, will demand additional skills from either existing or new staff.

But very few of the firms that I reviewed, have spoken publically and directly about any new staff initiatives for 2012. Initiatives that could be mentioned, might include high level discussions of enhancements to hiring processes, staff development and retention, or succession plans.

Given the overwhelming importance of talent in this business, it is surprising to me that firm's don't openly discuss new staff initiatives.

If you are leading a public company, shareholders are likely to be very interested in staffing issues. Even in a private firm, talking about new initiatives can help to attract and retain talent.

Perhaps the leaders of investment management firms are uncertain about how their current staff will interpret public statements. Or maybe, leaders fear that competitors will steal their proprietary ideas, or even hire their people.

After the fact, many companies are quite willing to describe layoffs, pay reductions – the bad stuff. Leaders can choose to play up the good stuff that they are doing for their staff, and give shareholders, employees, clients and other stakeholders more confidence in their firms.

Here are three important reasons to talk openly about new staff initiatives.

First, employees are probably the most important audience for public statements. While internal communication efforts are necessary, public statements are powerful ways to motivate your staff. Your first client is your staff. If employees aren't happy, it seems likely that clients will also be unhappy.

Second, leaders might also consider publically discussing how their firm is improving its ability to acquire new talent, which may help to attract great talent.

Third, leaders might also consider being open about the efforts that are being made to develop and retain talent, as well as succession planning efforts.

Clients, employees and other stakeholders want to know that you have plans for improvement in order to feel confident that your firm is going to continue to be successful.

Setting standards, modeling desired behavior and learning from experience can be significant contributors to skills development.

4. Incentive compensation should be transparent and motivating. If the incentive program isn't clearly supporting profitable growth, it needs to be changed.

5. Do all of your staff contribute to your firm's success? Each person must deliver a clear benefit to the profitable growth of your firm.

6. Some jobs in your firm may have a history of high staff turnover. If this is unacceptable, you should consider a restructure of the requirements and expectations of the position.

7. Sometimes it is the perception of clients and intermediaries about the continuity of your firm's staff that hurts your chances to win clients. Through effective recruiting, staff development, an effective incentive program, and thoughtful consideration of the needs of your firm over the long term, you can both ensure organizational stability and success, and provide comfort to your clients.

7 Tips to Improve Your Team 12-8 S

1. What is it about your best staff that makes them substantial contributors to your firm? When hiring, look for people who either share, or supplement the positive characteristics of your best staff to take your firm to the next level.

2. Use the characteristics of your best staff as a checklist for recruiting, along with behavioral interviewing techniques to reduce the chances of hiring mistakes.

3. Continuously develop the technical, sales and leadership skills of your staff to remain competitive, and to provide an incentive to your staff to stay with your firm.

Hedge Fund People Issues 11-25 S

With the continuing growth of the hedge fund industry, recruiting has become more complicated. The historic source of new recruits has been sell side proprietary traders, but there will be fewer recruits available from this source. With the global hedge fund industry exceeding $2 trillion however, larger firms in the business may increasingly choose to recruit and train internally. One of the issues that they will have to address however is how to discern talent that may not have a verifiable track record in proprietary trading. One element that may be helpful is to objectively, and carefully assess the qualities of the firm's current top performers in order to identify the specific competencies that are table-stakes for any new hire.

Industry resources required to pay for additional talent are certainly available as funds flows remain significant into the hedge fund space. However, most of the new revenues to the industry are going to the largest firms. In addition, competition, mainly in the form of fast-rising compensation for available talent, is also strong.

On the operations side, expectations keep rising for strong compliance skills as hedge funds have been folded under the umbrella of the SEC or equivalents elsewhere. Client and consultant service skills also need to be first rate in order to meet the rising demands from these sources. While the need for transparency in information puts a lot of pressure on operations people, these experts also need to be able to present themselves well to prospective clients.

I once won a $500 million investment mandate based on our firm's investment capabilities, subject only to an operations audit. However during the course of due diligence, the client reversed their decision after finding that the presentations by our operations people didn't meet their expectations.

Another issue is less pressing but deserves reflection. The largest firms are maturing and the owners of these firms are aging. The issue of succession planning is starting to appear on the radar screen. This is not just a question of ensuring the legacy of the firm but it's also a matter of ensuring the continuity of the business so that the current owners can get paid fairly for the value that they have created. If the inheritor of the business is worried that if the owners leave, investment results will deteriorate, they will be reluctant to pay up for the enterprise.

Incentive Compensation 11-39 S

Some incentive compensation programs are primarily reward schemes for long service or seniority. This bias may be unintentional but it is important to recognize that an incentive program should be primarily about motivating your most critical staff who significantly contribute to profit. Your best people – the ones who are most vulnerable to being hired away – like to know what they're getting paid for, and what it takes to earn more. Bonuses are beginning to rise once again, but there seems to be little change in compensation structures, which is setting the stage for potential employee departures.

Overall, there are three considerations in creating an incentive compensation program. These include the individual's effort, their contribution to their team, and their overall contribution to the organization. As a leader, we will spend our entire careers finding the appropriate balance between these three, but there should be some recognition of each in the structure of our incentive compensation program.

Of course, bonuses can only be paid from the appreciation of the economic value of the company, as usually reflected in earnings. If there isn't enough money to pay bonuses, this presents a challenge. In these circumstances, senior leadership at some firms is willing to accept a lower bonus, in order to free up funds to compensate lower paid staff. A better solution often, is to create a more variable cost structure in the firm in order to absorb lower profits.

In recent years, the trend in the industry has been somewhat away from objective toward subjective bonuses, partly because of diminished profits.

There is no doubt that primarily objectively driven incentive programs are superior at driving preferred behavior, versus primarily subjective, or discretionary bonuses. People want to know what the rules are. Otherwise, incentive payments appear to fall from the sky, and the individual feels no sense of control or influence over the outcomes that lead to the bonus.

Admittedly, even objectively determined bonuses have flaws. There is a limit to the number of metrics that can be effective in driving behavior. As a result, there is a risk that what you don't incent may deteriorate, and cause headaches for the company later. I suggest tweaking the incentive program nearly every year, to ensure that you continue to align behaviors, as well as long-term desirable outcomes. The small changes each year must not be seen as unfair or punitive. One way to ensure that this process is fair would be to solicit suggestions for changes from incentive compensation program participants.

Ideally, the structure of the incentive program should be something that people can measure easily, so that in fact it does incent them every day of the year.

You should also consider what the consequences are for individuals who fall short of the metrics that drive bonuses. A modest or no bonus for an underperformer may not be enough. Termination of the individual is one option, but it is a drastic step. Think about how the program can be adjusted to encourage and reward better behavior so that falling short of goals doesn’t happen. A typical example is a longtime employee who may have originated and/or inherited a number of relationships, and feels that their job is secure as a result. While the bonus structure is not the full answer to this common problem, you need to craft both carrots and sticks to move and keep people on a path which leads to business success. People are smart, and they adjust their behavior if they believe that doing so is in their best interest.

There also has to be a balance between short-term considerations and longer-term considerations. Short-term incentives in some sales positions can be as frequent as monthly, but quarterly or annual is more typical for most employees. Long-term usually means 3 to 5 years performance, but some advocates recommend even longer time horizons.

The forms of bonus can be either cash or non-cash. Compensation experts have created a wide array of non-cash type bonuses. The general consensus in our industry is that owner equity is most highly valued. Whatever structure for non-cash bonuses is selected, the intention should be to provide an incentive that mirrors owners’ equity.

People respond to carrots and sticks, but it's not always obvious what those carrots and sticks are. What are you incenting exactly? Why are people doing what they are doing? Incentive compensation is not the only way to motivate a workforce, but we all recognize that it plays an important role. Is it working should be the sole criterion for judging the effectiveness of your firm's incentive program.

Identifying Portfolio Manager Competencies – an example 11-19 S

Many of us use job descriptions, and most of us conduct employment interviews, but I've seen little evidence that either of these make any difference in predicting on-the-job performance. Version 2.0 of recruiting is to try to identify the competencies of people who are successful in a particular job, and then use behavioral interviewing techniques to try to tease indications of these required competencies out of individual interviewees before hiring. I've personally had success with version 2.0, so I'll vouch for it. Here's an example.

Portfolio managers are probably our most difficult recruiting challenge. Not only are they distinctive characters as employees, but a hiring mistake can be devastating to an asset management firm.

One firm that I know had the luxury of training their own portfolio managers, and they had access to the best and brightest business students in the country. But the best and brightest don't always become the best portfolio managers for many reasons. The firm's leadership felt that they could do more to try to identify candidates with the best chances of future success as portfolio managers.

They hired a psychologist to identify the competencies of the best portfolio managers in the firm. Then, in order to provide some perspective, a number of top performing money managers from other firms were asked if they would be willing to be interviewed and tested and they agreed. This allowed the firm to benchmark the competencies of their own portfolio managers, with the additional external perspective. The result was a set of competencies that could be used to screen new hires.

There were also factors identified that the psychologist referred to as enabling factors: passion and drive, resilience, work life discipline (not balance – just able to set priorities/competencies). These enabling factors were prerequisites of all of the best portfolio managers. These enabling factors were non-negotiable.

So what were the key competencies? Keep in mind that this was a custom set based on the character and positioning of a particular organization. The competencies were determined to be the following: driving curiosity, both detail and big picture oriented, firmly decisive and flexibly creative, thinks out to the future, detached objectivity, independent-minded, calculated risk taker, skilled at interpersonal questioning, and competitive yet collaborative.

As you may have noted, many of these competencies are combinations of traits, for example, competitive and collaborative at the same time. The compound nature of some of these competencies represents the character of the portfolio management talent that this firm had already and that it was seeking.

This firm utilized the competencies so identified, and developed behavioral interview questions to help them with their recruiting. An example of a question to test detached objectivity might be to ask an interviewee, "Tell me about a time when you sold a security position despite your having a personal familiarity with the executives of a company."

Determining needed competencies and behavioral interviewing are powerful techniques to reduce errors in the hiring process.

Investment

Current Strategic Initiatives of Firms - Investment 12-18 I

After reviewing the recent public statements of leaders of more than 50 investment management firms, there are numerous initiatives underway by firms to expand investment capabilities. This brief report summarizes what new investment initiatives are being targeted, and what more could be considered.

I have sorted the public pronouncements about strategic initiatives into 6 categories. These 6 categories include: **S**taff, **I**nvestment process, **M**arketing, **P**lanning, **L**egal and **E**xecution. Collectively, they constitute a "**SIMPLE**" model of any investment management business.

This week, we'll discuss what investment management firms are saying about their plans for new **I**nvestment initiatives.

Most investment management firms that have publically mentioned their efforts to enhance their investment capabilities are focused on adding new capabilities to their firm. These include product line extensions from existing investment teams, and acquiring teams and their capabilities from other firms.

The most-often mentioned specific product to be added was alternatives capability. Since nearly two-thirds of investment management firms are traditional long-only firms and clients are still pouring money into alternative managers, the move to add alts capabilities isn't surprising.

Recently popular capabilities such as income strategies, global credit, and emerging markets equity are next in line as products being introduced by firms.

While most firms indicated that they were seeking to add brand new capabilities, some simply generally indicated their plans to enhance efforts to enhance the innovation of new products.

Not every firm was focused on growth in capabilities and products however. Several firms acknowledged their weakness in investment performance, and indicated that improving performance was their highest priority.

We wonder whether these firms plan to take drastic action such as seeking new hires, firing existing staff, closing the capability or product, merging the product or perhaps are considering selling the capability.

Or perhaps, these firms may just be tweaking their investment process.

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Lean thinking in asset management 11-22 I

While lean techniques are a proven practice in manufacturing, I wondered how these techniques might be helpful for an asset manager in their investment efforts?

All asset management firms have highly skilled portfolio managers and strong investment processes. Generating alpha is a challenge given the number of competitors with capable people and robust processes. Millions of investors worldwide also compete for investment opportunities with your firm.

Enhancing team skills and continuously improving investment processes is a way to differentiate your firm from the rest of your competition. The objective is not to just be at or above a benchmark. The objective must be to rank in the top three to five players offering whatever service you are providing. If you are not amongst the top rank in your field, you will not be considered by most prospective clients.

The lean management approach rests on applying the methodology of scientific investigation. Here are some suggestions to spur your thinking about how you can utilize your firms capabilities more effectively by examining your investment process more closely and continuously.

- ☐ How deeply rooted is your investment process in economic theory? Is there a foundation for what you do that will persist beyond this economic cycle?
- ☐ Do you use evidence from academic research to channel your decisions? At a minimum, your efforts shouldn't be at odds with the evidence. There is a large and growing body of research that can help to establish the boundaries of your investment process.
- ☐ Are conversations with the managers and sponsors of investment opportunities that you examine structured to meet your needs? How much of your conversations are purely social and time-consuming without being productive?
- ☐ More generally how much of the information gathering process of your firm is burdened by unproductive social activities?
- ☐ How long does it take from the germination of an investment idea in your firm through to trade execution. How can this time, as well as errors, and costs, be reduced?
- ☐ Are investment recommendations made in writing in your firm? How much

time does it take to prepare these reports? Can they be condensed, or prepared more quickly in some way?

How many of your firm's investment ideas are dismissed rapidly by a more senior or experienced professional in your firm, after one or more of your people have spent significant time and effort? Could training, or setting standards for recommendations reduce the wasted effort by your staff?

Your investment product has poor performance – now what
11-37 I

At what point should a leader become concerned with investment underperformance? How much underperformance constitutes a problem, and how long can you afford to wait before it needs to be addressed? At some point, action may be necessary.

What has happened to performance can be objectively analyzed using statistical and quantitative diagnostic tools examining macro factors, style, capitalization, sector/industry weights, leverage and so on. But this only addresses the manifestation of the investment process.

Who is responsible for the underperformance? Was it a team issue, a process breakdown, or was it due to an individual? Reviewing responsibilities, decision-making authority, and whether to restructure, hire, fire, or add staff, are all possibilities to consider.

More drastically, you might need to consider merging, closing or selling the capability, if the negative reputational impact arising from underperformance is significant enough.

But before considering taking such drastic action, here are some considerations. The first, of course is to craft an honest explanation for clients of what happened. Perhaps the underperformance was within reasonable limits in relation to investment style, for example?

The second possible step is to refrain from altering the investment process. However if the underperformance has been significant or persistent, it may be too late to not take action. Portfolio managers are bound to be psychologically affected by portfolio underperformance, and they may be paralyzed, unable to make decisions. Others, both internally, and externally, such as clients and consultants, will be expressing their skepticism openly adding further pressure to the team. As a leader, at the very minimum, you have to make sure that the underperformance has not undermined the ongoing ability of the portfolio managers to do their job.

Look at the diagnostics, and listen to consultants and client criticism for any additional clues. You should also consider the possibility that the team has a blind spot. When I started managing bonds in the early 1980's, none of my peers in the industry had seen a bull market in their entire career, and yet here we were on the cusp of a bull market that's lasted 30 years. Things do change, on a semi-permanent basis.

Changes in the market place may trigger the need for temporary adaptations in the investment process. For example, many investment managers are aware of the risks of financial leverage at the end of economic cycles when interest rates are high. And they may temporarily adjust their investment process to reflect this.

What are the strengths and weaknesses of the investment process? Is there a clear path from investment insight through to outperformance? Are there inefficiencies in the process that can be corrected?

Again you'll want to look at the team responsibilities and authority for decision-making. One investment counseling firm, without changing the members of the team, or its investment process, reconfigured the decision-making authority three times within the same number of years.

If investment process changes are made, you'll have to consider secondary impacts both internally and externally. Internal staff may be concerned about the implications of any changes for their own careers. Also consider the impact on your firm's reputation, if for example, you were to replace individuals, or consider any other significant modifications to your investment process.

The impact of social media on investment decision-making 12-10 I

Social media is a hot topic in our industry, and Facebook, YouTube and Twitter have been added to our repertoire for marketing investment services. But the use of social media for investment decision-making is newly emerging, and offers intriguing possibilities. Social media increasingly influences markets, and investment processes may be obliged to respond. Utilizing social media content in the investment process may also require further investment in systems to monitor, store and analyze massive amounts of information.

When I was an analyst in the 1980s, Value Line was our research department. Once I identified a stock worthy of further investigation, the first step was to call the company's shareholder relation's department, and request that the last three years of annual reports and 10K's be mailed to me, and usually most of the requested information would arrive several weeks later. Access to information has improved somewhat since that time (!), and social media has accelerated the trend.

In recent years, there have been at least 10 academic studies about the usefulness of Internet search data in improving upon forecasting models for economic indicators. For example, the volume of Internet searches for jobs and housing often lead official reports of trends in these categories, which could be useful for timing security purchases and sales.

More recently, at least a half a dozen academic studies have suggested that search data can also provide useful information for anticipating stock-price movements. The promising results suggested in these studies have spurred the development of an increasing number of services built on social media that are currently available to professional investors.

There are online communities (Stocktwits), crowd sourcing (Wikinvest), buy-side networks (Seeking Alpha), models/replicators (Alphaclone), blogs (Jim Rogers), money flows (EPFR, Evestment), instant news (Twitter) and social media sentiment tracking. Titan Trading Analytics and GNIP MarketStream provide services to portfolio managers to track market sentiment across various social media.

Much of the early research, and usage appears to be targeting short time horizons. But there are indications that social media may also provide information that can be helpful to the fundamental or quantitative analyst. For example, one academic study suggested that Internet searches for a company's most popular products are better than analyst forecasts for predicting earnings surprises.

The social media resources available to investors today are uneven in quality, and there are reasons to be cautious. Not only is the lead-time generally short, there is the potential for the information to be deliberately misleading and untrustworthy, or even just noisy, with low information content.

From the days of my tedious efforts to find information, to instant news on twitter is a long way. But I think that there is an enormous amount of data available to us that can be filtered and categorized to reveal secrets that will contribute to investor performance in the future. This is just another example of how a philosophy of continuous investment process improvement needs to be embedded in investment firms.

10 Ways to Enhance an Investment Process (plus 11 more...!) 12-15 I

The process used by portfolio managers to select investments is central to the success of every investment firm. Formal reassessments of an investment process often only occur when there is change in team leadership, or when there is an issue with not meeting portfolio objectives. Embedding continuous improvement of the investment process is an alternative to occasional, formal reassessments. Here are some suggestions to improve your investment process.

Let's start with items that are less often encountered, and that likely have a modest impact on performance in the short run.

1. If decision-makers reject investment ideas from their staff regularly, internal research effort has been wasted. For example, let's assume that the rejections are consistently those presented by an individual who is competent, but perhaps new to the firm, and not yet familiar with what it takes to have an investment approved. New hires may be very smart, and in some cases, very experienced, but they are working in a new culture. Good investment process design can help speed the enculturation process. We might consider some form of mentoring, training or standard-setting in order to improve the productivity of a new hire quickly.

2. In larger organizations, there are often multiple investment teams, sometimes located in numerous offices across the globe, who may share investment ideas or even have overlapping portfolios. Carefully designing virtual team interactions is needed to derive benefits, and avoid frustration.

3. There are often administrative errors of various kinds that require the intervention of portfolio managers. Minimizing these interventions through middle and back office improvements to address frequent errors can enhance portfolio managers' ability to focus on managing the portfolio.

4. Technology can help to reduce wasteful manual processes. In any process, unanticipated issues require manual workarounds, and these manual processes tend to accumulate over time, slowing the investment process, and potentially affecting investment performance.

Now let's look at some issues that occur more frequently, but in the short run at least, may have only a slight impact on performance.

5. Motivating staff is something that should happen every day – even simply expressing thanks for people's efforts, for example. If efforts to motivate fall short, the impact on investment performance probably won't be right away. However, not having

well-designed monetary and non-monetary incentives in place will eventually lead to employee turnover, and disrupt the investment process.

6. Often we are burdened by an excessive amount of unnecessary and inefficient communications, for example, e-mail and meetings. Spending time thinking about ways to enhance the contribution/eliminate the distraction of communications to the investment process can be valuable.

7. Unstructured conversations and social time with the sponsors, managers and promoters of investment opportunities reduces productivity. While improving the quality or efficiency of these conversations won't have an impact in the short run, the information gathering process of your firm shouldn't be slowed by unproductive social activities.

Now let's turn to look at elements that either occur less frequently, or are subject to modification less often, but may have a high impact on performance in the short run.

8. Most investment ideas require some investigation, and in some firms these ideas require a lengthy proprietary report, in order to support a decision. How long does it take from the germination of an investment idea through to its inclusion in your portfolio, on average? Security price movements may be too rapid, and overtake a relatively slow investment process. A good buy idea at $10, may not be such a good idea at $20. Not being able to respond in a timely way will have a meaningful impact on portfolio performance. Do you insist on lengthy written reports for recommendations? If so, how timely is the preparation of these reports? Are there exceptions to this process? Does having lengthy reports demonstrably add to investment performance? As an aside, do you also prepare reports when adjusting positions, or when you sell or close out positions?

9. Deciding when to put risk on or take risk off is generally not an event that occurs every day. However, decision making and execution of risk on/risk off decisions should be efficiently processed.

10. Hiring the wrong person is costly to any organization. It is difficult to calculate what impact a mis-hire has on investment performance, but clearly a poor hire is disruptive in the short run. Carefully determining needed competencies which support your best talent, and behavioral interviewing are powerful techniques to reduce errors in the hiring process.

11. Professional staff departures may have a dramatic impact on portfolio performance, and an employee retention strategy is important.

12. Managers may be tempted to adjust portfolio risk to either "lock-in" gains, or elevate portfolio risk in order to recover from under-performance. These actions are not only highly risky from an investment perspective, but they may also jeopardize the firm's reputation. Unusual deviations in risk should not be permitted in a portfolio, for any reason, other than investment opportunity, or at a client's request.

13. The investment process must be flexible and responsive enough to support a move in a new direction quickly. For example, towards the end of economic cycles, the financial leverage of companies and the portfolio is of increasing concern to most portfolio managers. If a portfolio manager wishes to reduce the exposure to financial leverage in the portfolio, is there a process to quickly alter the portfolio's characteristics? If not, there may be significant effort required to make the desire changes, and a decision risks being untimely.

14. Succession happens rather infrequently, but your clients care about how you intend to seamlessly transfer responsibility for a portfolio from the existing staff to others. If your succession transition process is not seamless, the impact on performance may be severe.

Our final set of suggestions for enhancing the investment process are those items that have a potentially high impact on performance in the short run, and occur, or are subject to influence, relatively frequently.

15. If the batting average for investment ideas is declining from an individual or a team, it is obviously important to dig in and understand why this is the case, and to try to identify and eliminate the causes of weakening individual performance.

16. Portfolio managers need to be able to evaluate as many relevant potential opportunities as possible quickly. Time management is a key skill.

17. In recent years, there has been a lot of work done on behavioral biases, which need to be anticipated and guarded against within your investment process.

18. Many firms have teams of individuals who work together, and superficially share an investment style. For example, a value investing team may include individuals who believe in a wide spectrum of different sub-styles within the value domain, which may cause personality clashes, and performance issues. These issues need to be resolved immediately.

19. Clients are increasingly demanding to see portfolio managers, and this demand for more frequent contact detracts from spending time on managing the portfolio. Managing client demands has long been an important skill set, but it is becoming ever more important.

20. Not all security selections in a portfolio always follow the precise investment process described to clients. There are always exceptions to the rule. The question is, are these selection exceptions making a sufficient contribution to the portfolio, and does the portfolio' performance improve enough given the extra risk to compensate for the breach of process?

21. Every investment process should incorporate a feedback loop from both successes and failures in order to further refine the process over time.

Marketing

Current Strategic Initiatives of Investment Management Firms– Marketing 12-19

Based on my review of the recent public statements of leaders of more than 50 investment management firms, new marketing initiatives are by far the most frequently discussed item. This brief report summarizes what new marketing initiatives are being targeted, with a focused look at the number one initiative and the challenges that firms face in achieving positive results from their foreign efforts.

I have sorted the public pronouncements about strategic initiatives from more than 50 firms into 6 categories. These 6 categories include: **S**taff, **I**nvestment process, **M**arketing, **P**lanning, **L**egal and **E**xecution. Collectively, they constitute a "**SIMPLE**" model of any investment management business.

This week, we'll discuss what investment management firms are saying about their plans for new **M**arketing initiatives.

Most firms have plenty to say about new marketing initiatives, in contrast to all of the other areas that they could be discussing. The marketing initiative that is most widely discussed is extending geographic distribution. Firms that are domiciled in one region are making efforts to extend their distribution reach globally. According to surveys, there are firms with distribution in as many as 50 countries, and almost all of the top 50 firms operating across borders are distributing in 20 or more countries.

There are numerous challenges in the long-run from pursuing global asset management activities which I'll come back to later on in this report.

There is a tie for the second most frequently discussed marketing initiative. Retail-oriented firms are seeking institutional clients more aggressively. In many markets, the differences between retail and institutional buyers are disappearing.

Services like investment solutions and asset allocation strategies, are tied for second on the agenda of many firms.

Next in line are efforts to develop new products such as ETFs and collective trusts, as well as deepening client relationships by enhancing web-based services, for example.

Global Distribution

Coming back to the most frequently mentioned strategic initiative, which is the effort to extend and deepen distribution on a global basis, leaders of firms may encounter many issues.

One example is staffing in foreign markets. Hiring local talent is often necessary and in many locales, it may be difficult to hire highly-skilled locals. Compensation may need to be higher to attract talent.

Retaining talent, without a clear development plan for the career ambitions of their local staff, may then become a problem. Not only do local hires see limited upward mobility while working for a foreign affiliate, firms often miss out on opportunities to develop talent. They should consider succession planning on a global basis.

Effectively integrating virtual teams is also a challenge for organizations with staff located in multiple offices.

Another large set of issues is marketing.

- Local distribution networks in all markets are undergoing change and who you choose to align with may preclude other opportunities. In the U.S. by way of example, there has been a significant shift in asset flows in recent years towards RIAs, and away from wirehouses and trust departments.
- In the institutional market, global consultants will expect consistency in how you present your firm to clients everywhere.
- Product pricing will have to balance local norms, with typical pricing in your home market.
- You will have usually one chance to make a first impression as competition is fierce, particularly in more mature markets.
- Your new product development process should consider local needs subject to profitability. You will also need to consider the cost (or not eg. UCITS) of legal structures to meet local needs.
- Global service providers who you use for operational outsourcing may be able to help your firm to accelerate the introduction of market-ready new products.

Organizing global distribution should not be an afterthought. Most firms quickly understand that their business is changed every time a border is crossed.

Lastly, managing growth is important to ensure success in the context of your firm. If internal political struggles, reduced profitability and many long nights of effort of your staff are required to deal with the additional complexity of foreign operations, then this may not constitute success, and therefore trigger other management problems.

Seven Tips for CEOs to Improve Your Firm's Marketing 12-16 M

Investment professionals often lead their firms, and some may wonder what salespeople do all day! As one CEO once said to me, "As far as I can tell, the best salespeople sprinkle magic dust over prospects in order to turn them into clients."

The best salespeople are more talented than some people recognize, but there are also important ways that CEOs can influence and enhance overall sales performance.

In general, CEOs can make or break their firms by leading a culture that respects client needs, managing sales efforts, presenting products well, working with all suitable channels, developing new products and smart pricing.

Here are some specific suggestions that can help to grow sales for your firm.

- ☐ Monitor regularly how motivated your salespeople are. People's motivations change over time.
- ☐ Identify and target your next most likely prospective client segment to help focus your firm's efforts.
- ☐ Create your own detailed question-and-answer due diligence report. One executive I know has a list of 1000 questions. Having good answers before meeting a tough prospect or an intermediary can be the difference between winning business or not.
- ☐ Consider focusing on the 60+ firms that offer CIO outsourcing and manager-of-managers services to their clients, and try to become a manager for a part of these portfolios. These accounts will be relatively stable clients over time, and will become strong endorsements of your investment capability. CIO outsourcing is growing extremely quickly.
- ☐ Plan your entry into new markets, whether new geographies, new client segments or new distribution channels carefully, as early missteps may not be reversible. Prospects don't have time to reconsider managers who failed to meet expectations the first time.
- ☐ Both clients and intermediaries are demanding increased access to your investment professionals. Prepare to accommodate these demands without diminishing your investment results, and explain to prospective clients how you'll accomplish this.
- ☐ Staff turnover and firm ownership loom large in the evaluation of firms. What can you do and say to alleviate these concerns?

Seven tips for CEOs for enhancing your marketing 12-9 M

One. Monitor closely how motivated your salespeople are. People's motivations change over time.

Two. Identify your next most likely prospective client segment to help focus your efforts.

Three. Create your own detailed question-and-answer due diligence report. One executive I know has a list of 1000 questions. Having these answers and practicing responses before meeting a tough prospect or an intermediary can be the difference between winning business or not.

Four. Focus on the 60+ firms that offer CIO outsourcing and manager-of-managers to their clients, and try to become a manager for part of these portfolios. These accounts will be relatively stable clients over time, and will be strong endorsements of your capability. CIO outsourcing, in particular, is growing extremely quickly.

Five. Plan your entry into new markets carefully as early missteps may not be reversible.

Six. Both clients and intermediaries are demanding increasing access to your investment professionals. You will need to figure out how to accommodate these demands, without diminishing your investment results.

Seven. Staff turnover and firm ownership loom large in the evaluation of firms. What can you do to alleviate these concerns?

Product line extensions 11-40 M

Most asset management firms want to grow, and one alternative is to expand the lineup of products. Given the preference in recent times for hedge funds and non-U.S. investments, product line extensions may be defensive steps for a traditional domestic money management firm. For example, large capitalization long only equity managers, may choose to create a new product based on companies that they have observed and found of interest in their investment analysis, but that failed to meet the minimum capitalization threshold required for their large-cap portfolio. So they create a mid-cap capability. Alternatively, they may choose to add shorting skills to their capabilities in order to access hedge fund opportunities.

At the other end of the capitalization spectrum, a small capitalization stock manager may choose to move up the capitalization scale to offer a small mid (SMID) product. Or they may choose to offer an international small cap product in order to access non-U.S. mandates.

There are marketing advantages for those managers with solid capabilities, who choose to add new product lines. Certainly, a large-cap manager already approved by major consulting firms, will have an easier time introducing new products than a brand-new standalone manager. Often the product line extension has overlaps in terms of people and process, which facilitates getting consultant approval for the new capability.

You can't always be certain that the new product will get a free pass just because the firm has already been approved. The people/teams involved, and processes, and finally track record, usually need to be affirmed. This new capability cannot be a weak sister of the core capability. It must have the resources needed to be successful on its own.

It may be helpful for your sales team to think of the new product as a startup – one with some advantages over a pure startup - but still fighting to gain recognition as an independent capability.

There is another perhaps surprising challenge awaiting money managers seeking to extend their product lines. Often the selection of a new product arises from the manager's own preference or skills without much thought as to whether there is any market demand for the product capability. There are multi-year trends towards certain asset classes, and away from others. Investment management leaders may be

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disappointed by how long it takes to gain traction for the new capability.

You may also find that your best distribution channels are indifferent to your new product. If the capability is compelling however, there are hundreds of other consultants and other intermediaries to talk to, as well as new distribution channels, and new geographies to consider. There are over 500 consulting firms in the U.S. alone, of which 60 specialize in alternatives consulting, for example.

Your product line extension will offer new challenges which will require patience from your team. I encourage you to be bold in your selection of a product line extension. It will take you many years to establish the product as a robust offering, so why not introduce a capability that is likely to be in demand for the long run? For example, large-cap managers often immediately look at mid-cap as their next logical step, when acquiring shorting capability may open up new opportunities for their firms sooner. Similarly, in this era of the globalization of portfolios, small cap managers focused on domestic equities may be squeezed out over time, if they lack international capability.

A return to basics? Or just part of the cycle? 11-23 M

We have all been through a lot as investors, and as leaders in recent years, and we have all struggled to adapt. There is a temptation for some to believe that our current responses to these events are appropriate and satisfactory, and that they represent permanent changes in our approach.

For example, there is now heightened attention to asset allocation by our clients. Tension continues between matching liabilities, on the one hand, and maximizing investment returns, with a current tilt towards the former. As we move forward, I believe that clients will again prefer to seek maximum return. From an asset management perspective, it would make sense to develop or refine our asset allocation skills in anticipation of a reversal of client preferences once again. The current trend towards launching so-called, "go – anywhere" funds, is a positive development for deepening asset allocation talent, in my view.

Another unsurprising reaction to recent events is that clients expect more asset bubbles in the short term. To me, as an investor, this is good news! A bubble in one asset class, or even multiple asset classes, or even bubbles happening with greater frequency than before, means that market returns will be higher in the future! What some clients are missing is that we need to think about both upside and downside risk in future periods. Eliminating all risk prematurely may also limit the realized long-term return as well.

One current response to risk is to emphasize absolute returns in investing. This amounts to market timing in my view, and should be resisted.

More generally, time horizons have shortened as if some believe that reacting more quickly will help clients dodge bullets.

On the other hand, there are those who are suggesting that we should extend our investment time horizons and ignore bumps in the road like say, 2008! It is true that the liabilities for many institutions are exceedingly long term. It was just in the last decade that the last U.S. Civil War pension was paid to a surviving spouse of a combatant.

Risk management should be thought of as a method of managing the upside as well as the downside. Risk management techniques definitely need further development, and asset management firms are well positioned to lead this effort.

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Rapid diversification efforts have been part of the effort to manage risk almost to the exclusion of everything else. You could, I suppose, enhance diversification by throwing your money down a sewer drain. The correlation would be low, but so would the investment returns. It sometimes seems to me that diversification is being pursued nearly without regard for the return prospects.

In summary, we are seeing some odd, and I think shortsighted responses to difficult times. Investment firms should prepare for the next wave of opportunities from clients. Asset allocation skill, risk management talent, and rational responses to the current market environment are in short supply, and represent opportunities for your firm.

Risk needs to be considered more deeply at the business level as well. There are some embedded risks in every firm's business model that should be unearthed, and examined, and mitigated, if necessary.

Finally, regulation is also going to create opportunities even as it narrows the room for maneuver of existing firms. Regulators will force clients in certain directions, and asset managers should be prepared to respond and benefit.

Building Blocks for Sales Leadership 11-21 M

I talk to many firms who struggle with how to increase sales. In larger firms, you hire quality sales managers who in turn hire salespeople with track records of sales success. In a smaller firm, you are either directly hiring sales staff, or you are personally responsible for sales. In spite of your efforts to have the right people in place, there often seems to be a missing ingredient, and sales just don't materialize. Here are some suggestions for where to find the switch that triggers higher sales.

Bring together your investment staff and salespeople on a regular basis to formally discuss your products and their characteristics. It's important to reconcile the market's perceptions of your product as conveyed by your salespeople, with what your investment people believe to be true about the product. Often there are subtle changes in the investment process, or even just its description, that can change a product's appeal to prospective clients. Not all issues can be reconciled this way, and in some cases sales and investments have to agree to disagree. Historic performance is one example of something that can't be changed. But even without unanimous in-house agreement, products don't have to be perfect to be successful in the market - if effectively sold.

There are many examples of imperfect yet successful products across all industries. Many of the market leaders in many product and service categories do not have the best product by objective standards. However, they lead their category by having a total offering that exceeds the competition. Even if your investment product has a blemish or two, there are ways to create a fulfilling offering for clients. Many of the largest fund managers have brand names that carry them through times of investment underperformance, for example. Smaller managers, or those firms with less prominent brands can offer access to portfolio managers and be perceived as more strongly service oriented.

Another way to invigorate sales efforts is to first understand why your clients hired you in the first place, and why they remain clients. This understanding can offer clues as to your firm's appeal to particular market segments. For example, clients who are inclined to be more aggressive investors, may not care about volatility in your investment results, if longer term returns are strong.

But you may find that the market appetite for your core investment products is slow at a moment in time. Intermediaries like consultants, channels and certain geographies may have particular preferences. Use this time to explore possible product extensions arising from your core capabilities, new distribution channels and new geographic regions for sales.

Next, examine the competencies of your sales staff. Believe it or not, not everyone asked or hired to sell likes selling. If they don't want to sell, they won't. And yelling at them or providing attractive incentives won't help. If you press these reluctant salespeople, they'll give you 100 excuses why clients are not buying your product. Your salespeople have to have a desire to sell in their heart, and it's up to you to identify and confirm that you have these people at all times. You also have to be realistic that only a minority of your sales force will meet your expectations. Relying on past sales successes to identify talent isn't always effective. People's personal goals sometimes change over time, and people can burn out.

Here are some additional suggestions:

- ☐ Set goals for your salespeople. The expectations will then be clear, and conversations about progress can be more centered.
- ☐ Assess the burden of administrative tasks that occupy your sales staff. Cut these tasks away from your salespeople in order to simplify their life, and free up their time to sell.
- ☐ Sometimes people who really don't want to sell will bury themselves in administration. They will resist if you try to pull them away from this work. Then you'll know that they should not be in sales at all.
- ☐ The rewards for sales results should be clear, and any incentive program should not create disincentives for your salespeople. Sounds obvious, but I see it all the time. Examples of this include caps on incentives, or no incentive for particular products.
- ☐ Focusing on the next best prospective clients is important. It is easy to be sidetracked by talkative prospects, or worse, people without hiring authority, or even influence. It is important to have your salespeople focused on the most likely, next client for your product.
- ☐ Lastly, simple and regular reporting of key drivers such as the number and quality of contacts and next steps for pipeline reports can help to keep everyone aligned.

To a firm struggling with poor sales, it sometimes feels like there are no answers. Turning around the sales force and growing your sales is within your grasp if you closely examine the elements suggested here.

Investment Consulting Today 11-20 M

Like any consulting business, investment consultants try to steer their clients in certain directions, but they are also subject to the shifting demands of their clients. Clients continue to strongly influence consulting business models Volatile markets, underfunding, and increasing regulation are just a few of the pressures that impact clients. Asset managers should remain aware of the dynamic changes that are occurring between consultants and their clients.

- The Madoff experience and the failure of some hedge funds has heightened clients' awareness of the need for due diligence reviews of the operations of their money managers. But many consultants are ill equipped for this effort, and a number of specialty firms have also risen to meet this need for more in-depth due diligence.
- There are more than 50 consulting firms who specialize in alternatives managers. The due diligence effort required for alternatives managers is substantially greater.
- Risk management consulting is also a growing trend. Again, many traditional consultants don't have this specific expertise available in most cases.
- Clients are also seeking more investment diversification and this has pushed consulting research costs up even across traditional asset classes.

The increasing need for specialization and more in-depth research has pressured consulting profit margins in recent years. One significant offset has been the trend towards CIO outsourcing, though not all consulting firms, nor clients have embraced this trend. However a significant number of clients are willing to pay more to consultants who are capable of relieving their fiduciary and operating burdens.

The incremental change towards CIO outsourcing is part of a more general trend in clients insisting on consultants taking more responsibility for their recommendations. We have seen some clients take this insistence on responsibility a step further, and even lawsuits in some situations where the client felt that the consultant should have recognized and protected the client from a risk.

Lastly, clients want more frequent communication from their consultants. The demand for in-person meetings has increased. Clients are also insisting on more timely and frequent written communications.

All of the foregoing suggests that costs are rising for consultants. With the exception of CIO outsourcing, consulting fees are not moving upwards to offset their increased costs.

As a result, the economic value for firms in the consulting industry is declining. This is not a prediction of the imminent demise of the consulting profession. But many asset managers have a renewed opportunity to cherry-pick the most attractive parts of the investment consulting business such as CIO outsourcing, as well as alternatives and risk management consulting.

Asset managers can afford to invest the resources to meet clients evolving needs, and also prosper further from a deeper relationship. There have been shifts in client requirements arising from many influences that are altering the consulting business model, and I believe that asset managers are well-placed to respond and benefit.

Product innovation 11-7 M

A number of truly innovative products have been introduced in this industry in recent decades. Examples include index funds, ETF's, and discount brokerage. These products were more closely aligned with client needs through a thoughtful re-design of the features and benefits of a given product or service.

Structuring your company to create these game changing products is itself a

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challenge. Staff and leadership, investment process design, marketing, adequate resources, compliance and execution are all issues to be addressed.

- ☐ Does your firm have the talents/skills for true innovation?
- ☐ Is your firm ready to pursue, implement, and succeed with disruptive product innovation?
- ☐ Evaluating and confirming the investment process will be hard work and you should solicit independent external verification of the robustness of your product. Products may carry risks that are hidden from their developers.
- ☐ While identifying the most likely early adopters of a new product is always a challenge, the ramp-up time for an innovative product or service is further elongated by the need for missionary work to educate prospective clients about the benefits.
- ☐ How much can you afford to spend on ground-breaking innovation? Short-term profitability may be unlikely even if long-term profitability may be substantial. Introducing a new product also has the potential of cannibalizing your existing business, but this should be of lesser consideration given the competitiveness of this business.
- ☐ Legal and compliance concerns are also likely to slow your efforts, and increase the expense of introduction to the market.
- ☐ It is very important to have input from areas such as IT and operations early in the process of creating a disruptive product, as it is likely that structural changes in the firm will be required to support the new product.

Truly new product innovations are a dramatic way to affect the economic value of your firm. Having your organization aligned to originate, implement and prosper from disruption is a major challenge for asset management firms.

CIO Outsourcing 11-8 M

CIO Outsourcing is a fascinating trend that has gained momentum in recent years. The central idea is that those who are entrusted with overseeing a pool of assets as directors or trustees, should take a step back from the asset allocation and manager selection process. Instead, they should have a chief investment officer who has day-to-day responsibility for these efforts. The rise of outsourcing came about because of the difficulty for most clients to attract and retain CIO talent.

Many firms have entered this space. Some large asset management firms now offer investment outsourcing to institutional investors, but the field is crowded with other providers as well. Large investment consulting firms have strong client relationships which give them credibility, and many consultants have established outsourcing groups. Some CIOs from major endowments and foundations have also gone out on their own, and staked their claim as CIO outsourcers.

While some firms have been offering these services for decades, clients are displaying a greater interest in the service partly because of the rising challenges of keeping up with the growing universe of thousands of money managers and investment products. Volatile financial markets and weak investment performance has also encouraged the trend.

However, along with this rising interest, more scrutiny is being directed at the providers. If version 1.0 of CIO outsourcing was built on the credibility of the outsourcer and trust, version 2.0 is likely to be built on investment performance, risk management, investment process differentiation, and a sustainable platform. In other words, the demands are rising.

I believe that there is a large opportunity for existing and new players in this space. But few have recognized or responded to the challenges of making CIO Outsourcing offerings as robust as the traditional investment offerings from the premier investment firms.

It took many years for investment counselors and hedge funds to mature into the industries that they are today, and CIO Outsourcing is on a similar path towards professionalism. There will be breakout firms however, who will establish an early lead in this industry.

Cross-selling investments by brokers to bank clients 11-9 M

Cross-selling of investment products to bank customers is a difficult knot to unravel for most banks for a number of reasons. Cross-selling is certainly a logical path for the banks to consider, as they have an impressive customer base, and all of the expertise and systems they need to make this effort work. There is also no doubt that the economic value of distributing investments is relatively high compared to most bank products because of high margins, lower risk, and modest capital requirements. So why do banks struggle to cross sell, and what could they do differently to make it work?

In spite of having a large customer base, the opportunity for sales of investment products by most banks is limited by the lack of sufficient large prospective clients. A lot of work is still needed to deliver investment services efficiently to customers who have small portfolios to invest.

There is also a challenge in trying to reconcile the command-and-control culture of most banks with relatively freewheeling brokers.

But there are a number of steps to consider that can help cross-selling become a reality for the banks.

- Middle managers in banks have been trained historically to ignore the value of selling investments to customers. They need to be better educated about the value of these products to the customer, and the bank, the larger benefits of deepening the client relationship, and the very different characteristics of these products.
- Personal relationships are critical. The bankers and the financial advisors have to get to know and trust one another. For both sides, lifelong business relationships are at stake, and each party has to be conscientious.
- There is a need to develop a platform for small bank customers to address their needs more efficiently and cost-effectively.
- It will take some effort to change frontline people and the processes of the bank for customers to begin to recognize that their investment needs can be satisfied in a bank branch.
- It's not just a problem with providing sufficient incentive compensation. Almost every leader that I've met assumes that the lack of productivity and cross-selling can be resolved by increasing individual compensation. If front-line people don't want to sell, for whatever reason, they won't sell – no matter how much you offer them.
- Incentives provided to middle managers however is a different matter. If the manager's incentive pay is tied explicitly to cross-selling goals, and if it is substantial enough, this can make a difference to sales.

In summary, cross selling has to be perceived as important by bankers and brokers alike. It has to become part of the cultural fabric of the organization. Bankers and advisers need rewards for practicing the right behaviors, but more importantly supervisors and managers need to be educated and given goals that demand cross-selling. They will then transmit their newly-found passion to their staff.

A step further would be to turn your bank into one that is primarily driven by distributing investments. There are strong economic reasons to do this, but most traditional commercial banks are reluctant to make this leap.

Client Service Teams – Is it all about the Benjamins? 11-2 M

Some industry participants believe that it is difficult to attract and retain good client service people because of compensation issues. It's surprising to me that in an era of high unemployment, some firms find that it difficult to recruit, but such appears to be the case. Secondly, it seems to me that employee retention in this environment is generally good also because of the strained economic conditions. But what is most interesting to me, is that these discussions about people issues so quickly turn to focus on money. Money is rarely the number one issue for people, unless the pay is way outside the norm. That's not to say that pay is irrelevant, or can be ignored, however.

But any leader knows that there is more to this story. Any job has to meet a broad array of needs for the individual as well as the firm. Let's look at the firm's perspective first. What are the firm's expectations for the individual working in client service? Often there are expectations that not only will the client be served at the highest possible level, but firms often expect that their client service teams will cross sell other products. This may be an issue for your staff.

From the individual's perspective, client service staff may be looking for opportunities for career development. Alternatively, they may be quite satisfied with simply performing their day-to-day tasks, and meeting their obligations with little interest in career progression. The pressure of cross selling may not be compatible either with the desires of many employees, and no incentive plan will change their minds. If they don't want to sell - if it is not in their nature - they just won't do it.

Personality traits, like having a desire to cross sell, are called competencies. There are certain distinctive competencies associated with every position. Most formal or informal position descriptions describe tasks, occasionally general attributes of the incumbent, and educational and experience requirements related to the position. This is rarely enough to ensure that the individual in the position meets the needs of the firm. It's not unusual to see people who meet the qualifications, fall short of what the firm really needs and they feel unhappy in their jobs.

Instead, try to determine what core competencies are characteristic of those who are successful in the position. For example, what is it about your top client service people that really makes them stand out with clients and with internal staff? Try to use the competencies of your best people as a standard by which you recruit client service people in the future.

Once you've relevant competencies, you can use behavioral interviewing techniques to ensure that the competencies are present. For example, one of the competencies identified could be paying attention to detail. While almost anyone can worry about the details for a short time, sustaining that interest is not for everyone. Anyone can say that they pay attention to detail, but through careful questioning, you should be able to understand whether that is a practiced response for interviews only, and does not reflect the person's fundamental nature.

Retaining people though is not only about the individual however. Some job positions have to be carefully designed so that a reasonably intelligent person can learn and perform the tasks in a short period. Some positions appeared to have turnstiles attached to them. There is lots of turnover and this creates issues not only from an internal perspective but also with clients. If the position has limited upside potential and the individual is ambitious, good people may become disenchanted, and leave the position and the firme. This might suggest to some that one of the competencies required is a willingness to stick with a dead-end position! Another response might be to redesign the job so that the position does not become a bottleneck for the individual or for the firm. Another alternative is to lay out a clear path of progression for incumbents.

Having the right person in the right box also affects employee retention. Money may not be enough if someone is deeply dissatisfied with their job. This dissatisfaction will also influence the character of the service provided to clients and affect the value of the firm in the end.

I have mentioned the impact of turnover on the quality of service. Turnover should be one of the metrics used to judge service quality. Evaluating the engagement of staff with the mission of the company is another metric that can be helpful. Engagement surveys have demonstrable correlation to financial results. Ultimately, of course the responsiveness of your staff to resolving errors on a timely basis should be a key metric for your clients service team.

However, it's not only the individual or the team that affects a firm's ability to deliver premium client service. Sometimes major process improvements are required to give your client service people the answers that they need. Client service people may be dependent on others for information and they need to have confidence that the information will be available to them.

There is a famous story about train conductors in France. There was a time when trains broke down with some frequency, and the problem was that when this occurred, the conductors on the train left the scene of the breakdown. They would call friends or family to come and pick them up! The conductors left the passengers on the trains stranded, and this was a public relations nightmare for the train company. Why would conductors leave the scene and abandon passengers? Various studies of the situation posited different theories but none seemed satisfactory. It turns out that the reason the train conductors left at the time of an accident was that they were unable to deal with passengers and their questions. Passengers were quick to pick up their cell phones on these occasions and start calling everyone including the head office of the train company. As a result, some passengers had better information than the conductors. For example, some passengers might be aware that an alternative form of transport was on its way, or that some other resolution was pending. At the time, there was no effective communication mechanism in place to inform the poor conductors. As a result, they were unable to help uninformed customers, and they appeared stupid to those passengers who had more information than they did. The absence of information was embarrassing to the train conductors and therefore they exited the scene as quickly as possible. The process for informing conductors needed fixing. This was a process problem, not a client service team issue.

Do your client service people have the support that they need to serve the customer in the best way possible?

In summary, people respond to stimuli. If the client service position is a dead-end job, and that's not what people are looking for, or people are being asked to cross sell when that is not inherently what they like to do, or there is a misfit of their basic human competencies with what the position requires, or if they are on the front end of a process which inadequately services the end client, the job becomes impossible. This will affect employee retention and ultimately your ability to attract people to these positions. Sure, excessive compensation can fill the gap temporarily, but if there are fundamental deficiencies, this won't make for a happy client service team, and ultimately your clients won't be happy either.

Third party marketers survey - January 2012 12-5 M

Third party marketers (3PM) are a helpful sales alternative for some asset management firms. Due to their positioning in the industry as independent sales reps, their perspectives on current trends are also interesting to follow.

I recently surveyed ten 3PM firms. All of these firms are currently open to considering, and possibly representing, additional money management firms. Their specific product interests vary somewhat, although there is a strong consensus around two major product areas.

Currently, 3PM's most frequently cited area of product interest is hedge funds, with global/international mandates a close second. Many of the 3PM firms also have an interest in representing managers in a wide range of other very specific product niches. These product sales preferences mirror the asset allocation trends of institutional investors who continue to seek broad diversification.

I also asked the firms for their predictions of the most likely best-selling product categories in 2012. Not surprisingly, they expect strong industry demand for hedge funds, which mirrors their own current interest in representing hedge funds. They are only slightly less optimistic about industry demand for international products in 2012.

3PM firms face numerous challenges, but according to them, the biggest remains finding managers and investment products to represent who can be successful. Finding investors is the second biggest challenge for 3 PMs, as search activity has declined. Also, investors' risk aversion has risen, and this has led to an investor preference for larger asset management firms with robust operational support. Regulatory challenges are the third most-often mentioned concern in the survey, as various federal and state regulators have imposed new requirements in recent years.

Third party marketers are worthwhile considering as an alternative to an in-house sales effort for asset management firms with very strong product capabilities.

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How much should you charge for your products and services? 11-14 M

Pricing is a big issue. I have spent a lot of time studying this issue, because it is, in my view, the most important driver – at least in the short run – for improving firm profitability.

This topic can become very esoteric very quickly, so I'll try to address the issue of pricing in bite – size pieces.

- ☐ How much should I charge? My first response is, look at how much you charge today. What is/are your fee schedule (s)? Do all of your clients pay full fees? If not, what are the reasons for these exceptions? If your company has been around for a while, some clients are probably paying fees based on out – dated fee schedules.
- ☐ Reviewing the fees paid by your current clients in relation to your up-to-date fee schedule is an important first step in evaluating pricing. Then you need to look at the exceptions. Why were exceptions granted? Does your firm understand that every fee discount is a direct reduction of profit? Your firm needs to minimize exceptions and not allow them to become the rule.
- ☐ If your firm discounts fees regularly, it is important to recognize why these discounts occur. The only reason to discount fees is to enhance the long-term economic value of the firm. Otherwise, why do it?
- ☐ Why should some clients pay less for the same products or service from your firm? It is only fair to all of your clients that they each pay fair market value for the same services.
- ☐ I've encountered firms that were superb at asking for, and getting full fees. That is great. My question to them is, are they charging enough? If the firm is an extraordinary generator of alpha, or has limited capacity available to investors, then there could be an opportunity to increase fees.

While there are many more aspects driving the pricing of your products and services, I recommend examining the fees paid by your current client list first. This

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apparently simple first step can make an enormous difference in your firm's profitability if you take steps to reduce fee discounts, or look to increase fees where opportunities exist. In one organization for example, I was able to increase profits by over 80% in the first year mainly by increasing fees. I'll discuss how to implement fee increases without jeopardizing client relationships in a future report.

Morningstar: From Stars to Medals 11-29 M

In 2011, Morningstar released a supplementary, more qualitative approach to their classic stars for mutual funds, which have tightly directed the flows of client assets by category for many years. They call this new approach an "aptitude test". Funds are rated Gold, Silver, Bronze, Neutral, or Negative based on a forward-looking perspective of each mutual fund manager.

There are five aspects that are assessed in order to judge how the manager is ranked. Historic performance, people, portfolio, parent, and price are the major areas of assessment. The mutual fund analyst will review why the fund behaved a certain way in different markets for example. People will be a judgment call by the analyst of the perceived talent of the fund's managers. Portfolios will be reviewed for consistency of the application of their strategy to the actual holdings, and how the funds reacted under extreme market conditions. Parent or fund families will be assessed for their approach to stewardship and salesmanship. Lastly, the analyst will decide if the fund represents a good value proposition in relation to other funds that can be purchased.

Not all mutual funds are covered, and Morningstar indicates that they have no intention of equal weighting categories, or creating any sort of bell curve.

The implications of this new approach by Morningstar in the mutual fund category are uncertain but intriguing. Morningstar promises that the mutual fund analyst will not be swayed by other financial relationships that Morningstar has with fund managers. There will be a lot of judgment exercised by the mutual fund analysts using both qualitative and quantitative methods. Surprisingly to me, the approach does not appear to rely heavily on academic research. There is some really good evidence in the literature about what kinds of managers do well that I think should be used to provide guidance to the recommendations. The heavy qualitative influence may not be consistently helpful and may mislead investors, but we'll see.

We won't know how this will affect the industry, or if it will even catch on. It's difficult to know if this approach will serve to entrench the firms gathering the majority of the assets in recent years, and continue to marginalize many talented fund firms. Hopefully, the emphasis on a more forward-looking assessment will eventually reduce the heavy flows towards four and five star funds which subsequently underperform, and offer opportunities for more fund firms with superior future potential to gather assets. Asset managers should monitor these newer fund metrics carefully for their impact on customer behavior. It may present a new opportunity for fund managers who have been shut out on the sales front.

CIO Outsourcing and Rising Expectations 11-18 M

In recent years, investment outsourcing by institutional investors has risen as a result of fiduciary concerns around issues such as volatile financial markets and the increasing complexity of investment products. Amongst the most aggressive vendors of investment outsourcing have been firms with a current, or a historic, business as institutional investment consultants, and former CIOs of major endowments and foundations. Their efforts have been welcomed by clients who trust these advisers.

However, I believe that asset managers are better positioned to provide these services although few managers have stepped up to the plate thus far.

This is not to say that asset managers will soon dominate this industry though, as consultants and former CIOs have deeper relationships with their clients, and have the upper hand, at the moment. However, institutional clients are increasingly focusing on investment performance, supported by asset allocation and manager selection skill, risk management, and the highest level of compliance including avoidance of conflicts of interest. As this trend continues, I believe that asset managers will dominate version 2.0 of investment outsourcing as they possess superior capabilities in these areas.

Money managers have track records of investment performance that have been scrutinized and their investment processes have been finely honed. Even though the investment outsourcing business is relatively new to them, investment firms have the expertise and cultures to dominate this emerging business opportunity.

Let's look at how institutional requirements are evolving. First, asset allocation was historically focused on the long-term and has therefore been strategic i.e. static for most clients. There has been some evidence of an evolution in thinking in recent years however. There are baby steps towards liability matching on the one hand, and more tactical short term approaches, such as rebalancing, on the other. The reason that these feel somewhat tentative is a rightful wariness by institutional clients given the weight of evidence against the effectiveness of tactical asset allocation. I feel however that there is asset allocation skill available in the market, but that it is rare. Those asset managers that can demonstrate this talent have a tremendous opportunity ahead of them. Asset allocation skill on a global basis is the new frontier, and investors will seek managers who demonstrate skill.

Secondly, money manager selection skill is also rare. Some money managers have proposed investment outsourcing using only their own proprietary funds, but this will not be widely accepted by clients. Instead, asset managers should offer to select external money managers.

I think that there are new paradigms for investment management firms to explore in manager selection. Numerous studies have shown that institutions and individuals are very poor at selecting money managers who subsequently outperform. Investment consultants tend to rely heavily on historic investment performance, and a wide array of other unproven but popular quantitative and qualitative factors. Unfortunately, there's little evidence that their track record in manager selection is any better as a result of their review of such indicators.

In recent years, research has suggested a number of variables that do provide information about prospective investment performance. For example, high management fees, and manager and portfolio turnover, are on average associated with money managers who subsequently underperform. There is room for further research in this area, and more accurate diagnoses of money manager acumen.

Relative to the current competition for investment outsourcing mandates, many asset managers already have strong risk management and operations experience as well.

Finally, money managers can readily apply their hard-won efforts to remain compliant with all of the regulators, as well as the media and the public, which will provide assurance to any institutional investors who may lack confidence in their current outsourcing partners.

And it goes almost without saying that money managers are superb marketers who will be able to transmit their outsourcing message to institutional investors highly effectively.

Money management firms are extremely well positioned to dominate the investment outsourcing trend in the future. More will choose to move in this new direction using the capabilities that they have already developed.

Private Equity Managers versus Clients? 11-28 M

A joint SEI/Greenwich survey in 2011 called "Searching for Alignment" focused on private equity managers. Private equity managers believe that they are providing all of the information that clients and their consultants need. In fact, less than one half of clients agree with that belief and very few of the surveyed consultants. Private equity managers believe that clients and consultants are just asking for too much.

These managers are committed to providing what they think their clients want, which they believe is mainly industry and sector information about the private equity portfolio.

However, what clients and consultants are reported to actually prefer is information on leverage, and return volatility. This mismatch in what private equity managers think their clients want, and what the clients actually want, indicates a clear lack of understanding of institutional client needs. I am old enough to remember when money managers in the traditional equity and bond asset classes were also opaque in their communications.

The mismatch also reminds me of my discussion with a chairman of a large public company some years ago who bragged about how his board got the mushroom treatment from him – they were kept in the dark and fed manure. Things have changed considerably since the bad old days.

Client service and paying attention to client needs is crucial to long-term success, and all private equity managers have to recognize this truth.

Private equity managers are improving their operations in order to meet their own efficiency needs, and to meet regulatory demands. But there is also a need for them to enhance their reporting, and look more like a mainstream institutional investment provider.

There are other challenges for private equity managers beyond reporting as well. Clients are perturbed by the amount of un-invested cash currently held by some PE managers. PE managers in 2011 were finding it difficult to discover good new investment opportunities, but perhaps the market is changing. From a client perspective this under-investment has also been exacerbated by often disappointing performance.

If your investment performance is weak, prospective investments are few, your fees are relatively high given your large un-invested cash position, and you are not meeting your clients' reporting expectations, the cards begin to be stacked up against you.

Your new product launch 12-2 M

Congratulations! Your new product has passed all of the legal and operational hurdles, and is ready for launch. Of course, you have thought about the likely response of prospective clients, but how robust is the sales plan? Your new product may be launched in the midst of shifting client preferences, and in the face of equally hungry competitors.

If you do not have a track record of performance for your new product, how will you attract prospects? If you do have a portable track record, or a reputation to rely upon, you are fortunate. You may still have work to do to ensure that the link between historic performance, and your new product, is clear to prospective clients, as well as to intermediaries who are doing their due diligence.

Do you have solid marketing materials to support your sales effort? With so many competitive products available, the process of choosing a product is often one of exclusion, not inclusion. Prospects look for reasons to disqualify a product from further consideration as quickly as possible, because they have so many products to review.

Is your product up to the rigorous due diligence challenges? Marketing a new product is not just about beating the bushes looking for clients. It's also about ensuring that your investment process is robust enough to not only generate strong performance, but also be credible enough to sustain interest.

How does your sales team feel about representing this new product? Your sales team will have to fill up the databases of hundreds of consulting firms and other intermediaries, and attract their attention. Your teams need to be highly motivated and ready to attack specific client segments, distribution channels, and geographies.

If the product is very different from what your firm has offered in the past, these segments, channels and geographies may be new to your sales team. Has your firm prepared adequately to address these challenges? How will your team choose which prospects to solicit first? Every firm has limited resources, and cannot approach everyone simultaneously.

If your new product is very similar to the capability that your current clients utilize, then you could analyze your existing client base to identify the characteristics that encouraged them to hire you. Similar characteristics can then be sought in new prospects.

Here's a test. If you wanted to finance your firm's launch of your new product, would you have a compelling story to tell a banker, for example, to convince them to lend you the money for your product launch?

Frontal Attack on Investment Management Fees Not to be Ignored 12-32 M

Charles Ellis, the founder of Greenwich Associates, recently wrote a guest editorial for the Financial Analysts Journal (published by CFA Institute). The article is called, *Investment management fees are much higher than you think*. The Wall Street Journal has quoted this article and further elaborated his views, and I am concerned that this article is going to go viral.

Ellis directly attacks the "very high fees" of the investment management industry.

He is partly right. There are mutual funds that are too expensive. And yes, it is difficult to outperform standard benchmarks.

But he doesn't stop there. Instead, he floridly states, "...our industry-wide compensation is in a global bubble of our own creation..."

Ellis argues that while fees for active management may be low based on assets, fees as a percentage of investment returns are too high. Given that the fees for index funds are much lower, he then suggests that, " investors should consider fees charged by active managers ... as incremental fees versus risk-adjusted incremental returns above the market index..." His startling conclusion is that, "incremental fees are somewhere between 50% of incremental returns and, because a majority of active managers fall short of their chosen benchmarks, infinity."

Here is what he is missing.

1. While index/passive funds have their place in the industry, many investors are no longer simply seeking returns at the heavy cost of market risk. For example, since 2008 many investors have made efforts to reduce volatility. This has led to an unprecedented and rapid increase in diversification. Investors have added many new asset classes, and adopted a wider range of investments and approaches within asset classes. Investors want radically different combinations of return and risk in their portfolio, which investment management firms are providing. The benchmark is no longer an index, the benchmark is now the investor's goals.
2. I own an automobile that exceeds the cost of basic transportation. Some people may purchase a luxury car that costs many times basic transport. Investors are also willing to pay more for intangible benefits – in this case, higher investment performance in the future. For some investors, though not all, this turns out to be a good bet. Small amounts of annual outperformance add up to very large increases in the future value of an investor's assets. Managers who fall short of expectations eventually lose assets and their jobs. Based on the evidence, investors have been very willing to move their assets to other mutual funds if they aren't happy. Some luxury car owners are equally troubled by the cost of maintenance of their car, and trade it in for another model.
3. Investors are willing to pay portfolio managers even higher fees for reshaping return patterns using leverage, shorting and other techniques.

The days of clients solely focusing on beating the S&P 500 benchmark are fast disappearing. Instead, there is a growing demand for better answers. This has led to an upward trend in the seeking and offering of solutions and advice, some of which are embedded within the structure of products (e.g. target date funds).

There is a bigger issue at stake here too. Are passively managed funds a great answer in the long-run for capitalism? There will always have to be some investors who actively manage money, in order to ensure that there is market efficiency so that passive funds can get a free ride. Active managers will always demand and receive fees that are commensurate with the effort needed. Perhaps part of the rapid growth in hedge funds and higher fees charged to investors in the last decade, has been a response to the demand in earlier years for passively managed investments.

Passive funds have a place in investors' portfolios. And investors can expect more good news. In the future, the fees charged for passive management are likely to fall further, given that the marginal cost of investing for passive funds is not far from zero. But even at zero cost, passive products provide only a few answers for investors.

Does investment performance matter to clients anymore? 11-35 M

Location is to real estate selection as investment performance is to money manager selection, crucial. But just as the importance of location has been swamped by the effects of higher unemployment and foreclosures, investment performance has also been diminished in importance in recent years by other concerns.

Of course, investment performance still matters. But changing client needs, disappointing investment results, and modest capital market return expectations have taken some of the focus off of investment performance.

After the 2008 debacle, and with market volatility remaining high, fund sponsors are preoccupied with bigger issues. They are focused on their total fund results, and they are less consumed with hiring the next top manager. Sponsors are pursuing diversification across a broader array of asset classes in order to lower their fund's correlations with existing asset classes, particularly equities. Alpha is still (always) important, but it really is a secondary consideration.

The high correlations of asset classes during bear markets reminded plan sponsors that beta swamps most alpha driven strategies during bear markets. With capital market expectations continuing to be low for the foreseeable future, alpha would be nice to have, but fund sponsors are skeptical that they can identify it in advance, or that it will make a significant difference to total fund returns (compared to the influence of beta).

In order for sponsors to derive any comfort from managers promising positive alpha, there is also deeper scrutiny of the sources and likely persistence of the manager's return. Sponsors are also stepping back, and looking at the underlying factors that result in high correlations of returns between asset classes, securities within asset classes and also between managers.

Fund sponsors are trying to understand, though not eliminate, their exposure to risk. They seek greater transparency, not only in the reporting of results, but also in understanding more clearly the strategies of their managers including hidden exposures to factors such as equity risk, leverage, illiquidity, currency and so on. They just don't take managers at their word about exposures any longer.

In this post-Madoff era, the scrutiny of operations and general compliance has also moved up the list. I once won a significant mandate exceeding several hundred million dollars for my firm based on the investment merits of my firm's offering, conditional only on a due diligence review, which I assumed would be a piece of cake given that my firm was large, global organization. However, I was shocked when the win was vacated after the operational due diligence review. The prospect's view was that we were unable to meet their information needs. To me, no investment firm should fail a prospective client's operational review (the firm I was with is no longer around). We work so hard to generate investment performance by competing against the best in the world, and to fall short because of reporting deficiencies is embarrassing.

So the answer is yes, investment performance still matters, but the number itself is only a starting point for broader and deeper discussions.

Do All Alternative Managers Want Institutional Clients? 12-12 M

The relatively sudden influx of institutional money into alternative asset classes has stretched the marketing skills of many alternative asset managers who often struggle to meet the expectations of institutional investors. Whether independent, or part of a larger organization, leaders of alternative asset managers need to be sure that they meet client expectations with a disciplined, respectful effort, softened by a dose of humility, as they learn more about what clients need.

Here is an example of how private equity managers fall short – and they are not alone in the alternative space.

A joint SEI/Greenwich survey last year, "Searching for Alignment", focused on private equity managers. The survey concluded that these managers believe that they are providing all of the information that clients and their consultants need. Private equity managers believe that their clients need mainly industry and sector information about the portfolio.

In fact, less than one-half of clients agree with that view, and even fewer consultants agree with the managers' views. The response of private equity managers to this insight? <u>They believe that clients and consultants are just asking for too much</u>.

What clients and consultants are reported to actually prefer is more information on leverage, and return volatility. This mismatch in what private equity managers think their clients want, and what the clients actually want, is an example of the failure of alternative managers to understand institutional client needs.

I am old enough to remember when money managers in the traditional equity and bond asset classes were also opaque in their communications, and often disrespectful of clients and consultants behind closed doors. Things have changed considerably, mainly because of a shift in the perspective of traditional managers. If they wanted to win mandates, they needed to be more responsive to client needs.

According to the survey, private equity managers are willing to spend on improving their operations in order to meet their own efficiency needs, and to meet regulatory demands. But, there is also a need for them to enhance their reporting, in order to look more like a mainstream institutional investment provider. Client service and paying attention to client needs is crucial to long-term success, and some alternative managers have yet to recognize this truth.

It isn't only private equity managers who are falling short of meeting the needs of sophisticated clients. Alternative asset managers who make a determined effort, and who are willing to learn and also, respect the needs of clients and consultants will enjoy rapid growth in their assets and profitability. It will take oversight by determined leaders to ensure that efforts are made to realize a firm's potential.

CIO Outsourcing - An Opportunity for Investment Firms 12-14 M

CIO Outsourcing is a fascinating trend that has gained momentum in recent years. The central idea is that those who are entrusted with overseeing a pool of assets as directors or trustees, should take a step back from the asset allocation and manager selection process. Instead, they should hire a chief investment officer who has day-to-day responsibility for these efforts. The rise of outsourcing came about partly because of the difficulty of attracting and retaining CIO talent.

Clients are displaying a greater interest in the service, partly because of the challenges of keeping up with the growing universe of thousands of money managers and investment products. Volatile financial markets offering modest returns has also encouraged the trend.

Some firms have been offering these services for decades. Amongst the most aggressive vendors of investment outsourcing have been firms with a current, or a historic, business as institutional investment consultants, as well as former CIOs of major endowments and foundations. Their efforts have been welcomed by clients who trust these advisers. Consultants and in-house CIOs have much deeper relationships with clients than most money managers.

Some large asset management firms now offer investment outsourcing to institutional investors. I believe that asset managers are better positioned to provide these services, and the door is wide open for superior providers of these services.

There are a number of decisions that need to be made by a new entrant into this space. For example, should only proprietary funds be offered? The major benefit is that the knowledge of the investment teams is high as is the ability to control risk. On the other hand, utilizing other managers' products is attractive to clients as it suggests an effort is being made to use best-in-class. Lastly, there are also varying degrees of discretion offered and requested by clients.

If an open source model is used, this will mean that there will be a need for a due diligence effort for manager selection which can either be built in-house or potentially out-sourced.

I think that the benefit of doing manager selection in-house is that there are new paradigms to explore in manager selection. Numerous studies have shown that institutional investors and their advisers, and individuals are very poor at selecting money managers who subsequently outperform. Investment consultants tend to rely heavily on historic investment performance, and a wide array of other unproven but popular quantitative and qualitative factors. Unfortunately, there's little evidence that their track record in manager selection is any better as a result of their review of such indicators.

In recent years, research has suggested a number of variables that do provide information about prospective investment performance. For example, high management fees, and manager and portfolio turnover, are on average associated with money managers who subsequently underperform. There is room for further research in this area, and more accurate diagnoses of money manager acumen.

While everyone likes to talk about manager selection, the issue of asset allocation is by far more important. While traditionally, asset allocation has been focused on the longer-term and has been therefore strategic i.e. static for most clients. There has been some evidence of an evolution in recent years however. There are baby steps towards liability matching on the one hand, and more tactical short term approaches, such as rebalancing, on the other. The reason that these feel somewhat tentative is a rightful wariness by institutional clients given the weight of evidence that asset allocation is difficult. I feel however that there is asset allocation skill available in the market, but that it is rare. Those asset managers that can demonstrate this talent have a tremendous opportunity ahead of them. Asset allocation skill on a global basis is the new frontier, and investors will seek managers who demonstrate skill. Risk budgeting and risk parity strategies are examples of emerging efforts to enhance the all-important asset allocation process.

Along with the rising interest in outsourcing, more scrutiny is being directed at the providers. If version 1.0 of CIO outsourcing was built on the credibility of the outsourcer, and a trusting relationship, version 2.0 is likely to be built on investment performance, risk management, investment process differentiation, and a sustainable platform. In other words, the demands are rising, and asset management firms are better suited than consulting firms to meet client needs.

It took many years for investment counselors and hedge funds to mature into the industries that they are today, and CIO Outsourcing is on a similar path towards professionalism.

There will be breakout firms who will establish an early lead in this industry. The current slate of consulting firms will fall short of meeting the needs of clients who have entrusted them with CIO Outsourcing. Investment managers are more likely to develop robust offerings on par with traditional investment offerings from the premier investment firms.

This is not to say that asset managers will soon dominate this industry though, as consultants and former CIOs have deep relationships with their clients, and have the upper hand, at the moment. But, money managers have track records of investment performance that have been scrutinized and their investment processes have been finely honed. Even though the investment outsourcing business is relatively new to them, investment firms have the expertise and cultures to dominate this emerging business opportunity.

Investment managers have advantages that range beyond asset allocation and manager selection as well. Relative to the current competition for investment outsourcing mandates, asset managers have stronger risk management and operations experience. Money managers can readily apply their hard-won efforts to remain compliant with all of the regulators, as well as the media and the public, which will provide assurance to any institutional investors who lack confidence in their current outsourcing partners.

It goes almost without saying that money managers are superb marketers who will be able to transmit their outsourcing message to institutional investors highly effectively. It will be interesting to see how consultants respond to the likely upsurge in competition from investment management firms for these mandates. The fact that they already have inside information about investment management firms gives them a competitive advantage and clients should be wary about the conflicts of interest. Consultants may also unconsciously remove you from the buy list if you compete with them for these highly lucrative mandates that are far more profitable than traditional consulting.

Money management firms are extremely well positioned to dominate the investment outsourcing trend in the future. More will choose to move in this new direction using their investment and other capabilities that they have already developed. Clients are desperate for this expertise and investment firms are best positioned to contribute and profit from this need.

How to Break Through and Capture Flows 12-25 M

The largest asset managers continue to garner the spoils, and leave the rest of the industry in the dust. Around the globe, across asset classes and investor types, assets flow into too few hands. How can the rest of us break through this barrier, and be counted amongst the elite, to get more than our fair share of the assets that are available? Here are some ideas to win a greater share of the flows.

- ☐ In most asset classes and client segments, only the top few are offered a chance to even compete for business. A consulting firm once rated my money management firm 18th out of 200 managers for a client mandate. Being 18th best did not get us a chance to make a presentation to the client. There was no practical difference between being 18th or 200th. My point is that many money managers benchmark themselves against median or top quartile benchmarks. Whether it is investment performance or operational efficiency, benchmarking isn't enough to put you in the finals for a mandate.
- ☐ It all starts with people. Your portfolio managers have to be more than just smart. They have to be articulate and have a sincere interest in learning about clients. Their intellectual horsepower must be on display and they must be passionate about continuously enhancing their investment process.
- ☐ Often the best money managers are better off left alone or in small groups, and not forced to work in artificially-created teams.
- ☐ You need to distinguish your firm by being innovative – even in traditional products. Continuous investment process improvement is one way to stand out.
- ☐ Your marketing people must be nearly as knowledgeable as your portfolio managers.
- ☐ Your client service also needs to be faultless. This means that your client service people must have access to the information that they need to be responsive

to clients immediately. You should also review client accounts comprehensively at least annually.

- ☐ Don't spend marketing money on fluffy events, but instead invest in one-on-one relationships.
- ☐ Seek ways to help intermediaries, such as consultants and managers of managers, to do their job better. Participate in client forums that can help the entire industry achieve its goals.
- ☐ Align your organization around your focus.
- ☐ Learn from the best competitors and also target them from a marketing standpoint. Strive to achieve absolute standards, as your competitors are getting better.
- ☐ Identify and utilize skills that your firm has available. Focus on what your firm does better than any other firm in the world – and build on that.

Planning

Creating investment management firm value in 2012 12-13 P

Investment management firms with public shareholders are trading at relatively low values. Transaction values for acquisitions of private firms have also declined towards historic lows. Private firms may choose to ignore currently depressed valuations, unless a succession event is looming.

Most of the valuation weakness is related to the perceived struggle to grow revenues at historic rates. For some firms, revenue pressures have been even more acute. There have been some notable stumbles of firms in recent years who have either lost assets to managers offering passive, alternative or international expertise, or lost assets because of poor investment performance or reputational issues.

The number of mergers and acquisitions, even at current depressed prices, also remains low. Buyers with money are selective, and focused on particular asset classes and channels. Motivated sellers are trapped by their memories of what valuations used to be, and sometimes their firms' investment capabilities are not in high demand by buyers.

With numerous motivated sellers, low interest rates and available cash, there are financially attractive opportunities available. The Wall Street answer to elevating revenues has been to encourage firms to diversify their investment capabilities quickly, which usually means an acquisition.

But acquisitions carry their own set of challenges. including introducing new complexity to the acquiring firm, and the risk of clashes in culture. Even asset management firms that acquire minority ownership stakes in unrelated firms are on the wrong track. Looking for diversification via firms that offer different investment approaches to the core business may make financial sense, but they are best suited to a financial buyer.

For most investment management firms, they are better off creating sustainable future economic value by strengthening and extending their core investment and sales capabilities.

They should first direct available resources (time and money) to a continuous and unrelenting focus on investment process review and enhancement. Deliberate efforts to continuously improve, are much better than waiting for leadership changes or risking a collapse in investment performance before taking action.

Secondly, in spite of their reluctance, traditional firms, such as long-only managers, need to expand their product capabilities. Long only managers often have a lengthy list of reasons of why they want to remain in their niche. There is however one good reason not to remain stuck, in my view. Clients' needs are evolving. Investment management firms should consider and carefully examine opportunities to develop hedge fund and other alternatives, emerging market expertise and even perhaps consider creating a CIO outsourcing capability. Not only are all of these in hot demand today, these capabilities are likely to remain on a strong growth trajectory. There is also room for many more competitors as well in each of these areas.

On the sales front, leaders need to pay close attention to the continuing engagement and motivation of their salespeople. They also need to invest in emerging important channels of distribution. For example, consolidation in the broker-dealer channel has coincided with the rise of independent RIA's who are growing quickly, and who present a very different marketing challenge.

When will 60/40 come back? 12-11 P

I have spoken to a few traditional long-only domestic equity managers recently, who were reminiscing about the days when equity markets were buoyant, and their clients had 60% or more of their assets in equities. High returns for customers, growth in assets and attractive fees allowed investment management firms to enjoy great profits. But those days seem like long ago now for a number of reasons:

- The rise of passive management, that at a minimum is competitive, if not superior, to active management.
- The impact of two bear markets in the last 10 years.
- The level of underfunding of pension plans, and the resulting need to diversify away from risky equities.
- The rise of hedge funds with compelling stories.

Some traditional asset managers have been slow to respond effectively to these challenges. Yet, I believe that they have terrific capabilities that can be utilized in new ways.

Even the most negative prognosticators believe that future stock market returns will be positive, and more importantly higher than fixed income returns. The link between capitalism and equity returns, in exchange for businesses assuming risk and contributing to economic growth, is not broken.

But will clients soon add more equity exposure back to their portfolios once more?

The fact is that the overall exposure to equities for most institutional funds remains high. However, how clients invest in equities has expanded well beyond long domestic public equity. Equity exposure now includes international equity, hedge funds, real estate, private equity and many other alternative categories. Even for those funds who have cut back their exposure, few would dispute the belief that equities offer high potential returns.

So the question is, will long only domestic equities ever again become the dominant asset class?

Given the need for current income, coupled with the opportunities arising from economic growth in other markets, it doesn't look like traditional money managers are likely to see this trend towards the diversification of equity risk reverse.

What could change this scenario? Over the long term, perhaps a restoration of economic growth in mature markets for example, could again draw clients' attention and focus on their own home markets.

But for now, how should traditional long only equity managers respond to this shift away by clients?

One possible response is to add additional capabilities across the spectrum of capitalization. There appears to be continuing demand for managers of small capitalization stocks, for example.

- Peers don't always have validated answers – what was the context of their answer?
- They offer anecdotes
- Your situation may be entirely different
- Their advice needs to put your firm in the top three or on an approved list
- Their culture clients geographies segments are all different
- If your organization is focused, certain elements may be suboptimal in order to support the whole
- Peers answer may upset a delicate balance in your firm
- They have prejudices and preferences
- Why are they telling you this?

Peer to Peer Learning 12-28 P

There are many benefits arising from learning from your peers in the industry. They are in a similar business, often have similar personal backgrounds and you feel comfortable with and trust them.

However there are a number of issues that you need to keep in mind when speaking to a peer about an issue.

- They are possibly in a different institutional environment

Long only managers fondly remember the good old days 12-3 P

Many traditional institutional asset managers have been slow to modify their business models in response to changes in the investment environment, client needs, and aggressive competition.

For example, as the world's capital markets have become more integrated, some managers are changing how their investment teams are structured. For example, historically, a small team would be responsible for a single country in a global portfolio. Some firms are merging these country teams into much larger regional teams.

There has also been a tendency for many managers to act passively in the face of bear markets, as they anticipated a rapid return to normalcy. While this may have been acceptable behavior in the past, particularly given the rapid recoveries in markets that we've seen historically, this passivity is now considered unacceptable by clients.

Most clients have looming liabilities and liquidity needs that have raised the stakes. This has pushed them out of the arms of long-only constrained managers as clients aggressively seek the free lunch of diversification, and they are less interested in highly specialized long only strategies with little hope of generating alpha, coupled with rudimentary risk management techniques.

In general, the competition from passive management, less correlated asset classes and particularly hedge funds, has eroded opportunities for traditional institutional asset managers.

The response of traditional managers has been slow amid falling assets and client count. It doesn't have to be this way. Clearly these firms have built powerful investment processes. These processes just need to be applied more broadly – across more capitalization ranges and geographies, and also un-tethered from the traditional institutional long – only constraints.

These firms also deserve stronger business management in this era of muted market returns, clients struggling with pressing needs and much tougher competitors.

Diversified financial institutions can compete with independent firms 12-4 P

Independent asset managers have had the advantage in recent years, as diversified financial services firms have been weighed down by leveraged balance sheets and weak asset prices. Some have argued that this trend favoring independent firms will persist.

If we have relearned anything in recent years, it is that trends have a way of being rudely disrupted. The next few years may see a move away from independents. Instead we may see a return to a more prominent market share for diversified firms with an investment management division.

Some, but importantly not all, independent firms have experienced terrific growth over the last decade. In my view, they may be pressing the limits of their business models. In search of continuing fast growth, some are acquiring or financing the growth of much less profitable, albeit related, businesses, which also happen to require significant capital. Successful independent firms should be careful not to confuse their historic success, with making wise investments in new businesses for the future. Some independent firms have benefited from their participation in the growth of hedge funds and international investing. However, these growth areas are now highly competitive and client needs are rapidly maturing.

I'll admit that the recent news for diversified firms has not been supportive of an imminent turnaround, as banks and insurance companies continue to struggle with their capital needs, which are triggering staff layoffs and even asset sales for some, including their high-value asset management divisions.

However, not all diversified firms are so affected by this desperate need for capital and are forced to sell the family jewels.

Diversified financial services companies have been taking steps to improve their positioning in the investment management space in a number of ways:

- better leadership in the investment management group
- more effective efforts – eg. enhancing incentive compensation
- distribution strength, and passively managed products playing to the strengths of diversified firms
- improved cross-selling internally
- using multi-boutique structures

This is not to say that all these diversified firms have all of the needed building blocks in place. Further efforts are needed.

For those diversified firms that have recognized the potential for economic value creation from asset management, we can expect a greater allocation of capital to their investment businesses.

In summary, some of the largest and most successful independent asset management firms may be at a tipping point, and a combination of a maturing industry and business mis-steps risks eroding their future economic value.

Diversified financial services firms on the other hand, have lagged the growth of the investment management industry in recent years, and many of these are firms still have financial hurdles to overcome. The next two years may see more restructuring amongst these diversified firms, but for those who can afford it we'll also see an increasingly aggressive effort by diversified firms to reclaim lost market share.

Acquiring an asset manager 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 they are professional buyers and sellers of stock. While my cautions here are intended for acquirers, potential acquirees might also reflect carefully on 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 have forgotten 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 problem. Performance can decline unexpectedly, either because of market conditions or weakness in relative performance. If this happens, the financial people often begin to suggest 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 your 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.

Industry trends for the rest of us 12-1 P

There are numerous industry surveys, and their sponsors summarize the trends for us, and then offer us their forecasts and predictions. I think that there are at least two fundamental problems with these prognostications that diminish their value for the majority of investment management firms.

First, the survey results often only reflect the views of a small number of asset managers, typically the largest firms in the industry. The result is that the trends will be relevant to only the very largest firms.

For example, a survey sponsor might conclude that ETFs are a hot trend. Is this helpful in any practical sense for all of the 20,000 firms in the industry, or just some smaller number (say 5 or 10) firms? Realistically, if you are not amongst the market leaders today, it's going to be an uphill climb to compete directly against the multitrillion dollar asset managers in many of the fast growing trendy categories.

Second, these studies usually project trends on a straight-line basis from today to the future. Did any of the surveys in the past project a 2008 event, and the subsequent shift in client needs and desires that has occurred since 2008?

For the 99% of firms that aren't currently positioned in the trending product categories, and who live in the real world of discontinuity and change, how can they plan for the future?

Fortunately, this is a business which is both highly competitive and quite profitable, and it offers wonderful opportunities at all times for all sizes of firms. Here are some proactive suggestions that may help to create an organization that is able to absorb uncertainty and respond to opportunity.

Staffing – leaders should anticipate key staff turnover, and build resiliency into their investment process, and marketing efforts.

Investment – your investment process should be continuously improved to stay ahead of the competition, structural market changes, and long-term client needs. Secondly, while you might not want to stray too far from your core investment capabilities with your existing team, you might consider adding investment capabilities with additional new hires in areas such as alternative investments, asset allocation and risk management. These areas are the building blocks of most client investment portfolios today.

Marketing – firms with fewer resources cannot afford sophisticated new product planning efforts. You might consider piggybacking on some of the new product ideas of firms that have been historically successful at launching new products, and also consider monitoring promising, innovative startup firms.

Marketing efforts might also be stepped up by continuously searching for new distribution channels for your products. In the U.S. alone, there are 500 consulting firms, 60 databases which gather money manager information and numerous addressable client segments. Many managers are finding ways to extend their reach globally as well.

Lastly, if you or someone in your firm is so inclined, you may wish to create a method for scanning the environment, and seeking opportunities to shape, and not just respond to trends that fit with your firm's unique skills. Having an advisory board with external industry experts could also help to draw your attention to opportunities for your firm's leadership to consider.

Matching your skills with client demands will be significantly less frustrating and more profitable than trying to follow trends that will benefit few firms and may also have a short shelf life.

Dimensional Fund Advisors – Some General Observations 11-33 PIM

For many years, I've been impressed by the design of DFA's investment processes, and the way that they tell their story. DFA's experience offers great lessons in how to sustain a successful firm.

We are all aware that this is a competitive business. By one count, there are more than 20,000 institutional quality asset management firms who are targeting institutional clients. Your firm is not alone.

Try sitting in the chair of a major consulting firm's manager research group, and you will understand that the manager selection process is a misnomer. It is a manager rejection process.

Top quartile performance and preferably, consistent results are just table stakes. You need a lot more to make it through the filters of manager search professionals. Here's some ideas of how to break through.

1. Your investment processes should make sense to the layperson, and the investment expert alike.

2. Continue to demonstrate that your investment process adapts over time as capital markets evolve.

3. The best money managers recognize that where they have no clear advantage, they need to take risk off the table. As an example, DFA owns 12,000 stocks so they don't bet on stock picking.

4. Be relentless at seeking out pockets of inefficiency and opportunity in the markets that your capabilities have prepared your firm to exploit. For example, when markets collapse, value managers may have an advantage in finding quality investment opportunities at a bargain price.

5. Be transparent in telling clients your strategy, and demonstrate that you manage risk well. What did you learn from the financial market collapse of 2008, and how does it affect your investment process now?

6. Have compelling stories and tell them well. If you're not sure if you do this, ask.

7. Be focused and align your firm to serve the client segments that you seek.

8. Is anything changing in your organization that is raising questions for outsiders. For example, turnover of people, changes in the firm's ownership? Your story must resonate well or reputational damage may be long-lasting.

9. Your story must convince others that you will be around in the long term.

10. 2008 changed clients. Do you understand how their feelings and responsibilities have changed, and how you can help?

The Future Face of the Wealth Management Industry from the RIA Perspective 11-34 P

I think that there are 5 overlapping waves that are changing the wealth management business for registered investment advisers.

1. Let's begin with discussing changing client needs. There are two large segments that have been affected by their experience in the capital markets in the last decade. First, I think that Generation Y will carry

scars for many years, as they lack personal familiarity with a bull market, and they are likely to be reluctant to be as aggressive in their investments, as was the case for investors in prior decades.

The largest group of investors, Baby Boomers, on the other hand, are also de-risking their portfolios. They are doing so partly because of their experience in the equity markets, but also for structural reasons – they are hitting retirement age. Their focus is shifting from the accumulation phase which has been consumed with asset allocation and stock picking, to the distribution phase of their financial lives. Their interest has turned from capital gains to income generation, which is not easy to find in traditional, high quality, lower risk asset classes these days.

Product allocation is becoming more important than asset allocation to Baby Boomers who are now more concerned with products like long-term care policies, and products that help them to manage longevity risk, which is the risk of outliving their money. Estate planning also looms larger in their lives.

2. The second wave is the shifting investment opportunity set. We are all well aware that investment products have proliferated. They offer additional diversification, different degrees of liquidity, different amounts of leverage, different fees, can be actively managed or passive, and can serve to reshape risk in client portfolios.

Taxes are likely to rise, and so tax efficiency will be of increasing interest to all clients. Some are making the move to lower tax jurisdictions.

3. Staffing is the third wave that is directly affected by the changes in client needs and the investment universe referred to earlier. The changing psychological and lifecycle needs of RIA customers, coupled with higher taxes, a low return market environment, and revolutionary product and service variations have increased the demands on staff. It has become more difficult for staff to convince clients of the need for accepting risk in their portfolios in order to meet their long-term return requirements. Staff must manage customer behavior in the face of constant and often troubling news flow. RIA staff also are being required to offer advice, and often a delivery channel – either directly or through alliances for a wider selection of products, for example insurance, banking and trust products which meet the broader needs of their clientele.

Shifting from allocating to traditional asset classes and stock or mutual fund picking, to analyzing hedge funds, factor exposures and risk management will be a journey for both staff and customers.

It will be a technical challenge in addition to needing clear communication of the benefits of these investments to clients will be a challenge. Ensuring that the client service experience is of consistently high quality will continue to be important. More frequent and rapidly responsive communication is already required and the demands for more transparent reporting and risk management will rise.

4. The pressure on profitability in the 4th wave. The easy pickings of clients from trust companies and brokers will slow in coming years, as the competition is responding more effectively to the RIA challenge. A common fiduciary standard will eventually also help level the playing field for brokers. Sales management in the face of a more competitive environment is becoming more important.

Along with tougher competition, higher tax rates and lower forecast capital market returns are likely to slow revenue growth for RIAs as clients' portfolios grow more slowly and assets are spent by the inheritors. The costs associated with adding new staff with technical skills and providing more services, and ongoing compliance costs are also likely to squeeze profit margins.

5. The fifth wave is succession. I'm concerned that aging owners of RIAs may be reluctant to spend on additional infrastructure with their retirement on the horizon. Of course outsourcing may be relied upon even more heavily in the future.
The preferred scenario for them is to hand off the ownership of the firm to the next

generation. Industry consolidation may also provide an exit alternative, for larger firms. Roll-up firms have been active, but the history of roll up strategies in other industries is not good. Alliances and mergers are also becoming more prevalent, and are perhaps a healthier development for the industry.

American Century CEO Interview 11-32 P S

American Century has moved in recent years from being a mainly retail-focused, US growth equity manager towards offering a more diverse array of products. Fixed income assets in 2011 represented 36% of its $103 billion in assets, international assets are about 6% of the total, and alternatives such as gold, real estate, market neutral, and strategic inflation funds are about 3%. They're introducing a global tactical asset allocation capability which should continue to be an attractive investment class. Not every firm will succeed in this asset class but I think that nearly every firm should try to develop or acquire asset allocation skills. Post-2008, it should be clear that asset allocation matters most of all.

One of the reasons for diversifying their business was to smooth out the earnings volatility of the firm. This was certainly an important reason for the firm's major shareholders, but the CEO has said that this is also important to clients, which I find puzzling. There is so much competition in the industry, and other competitive products that it seems unlikely that clients are overly concerned about a fund management company's earnings consistency. They know that a $103 billion fund company also probably makes a lot of money, so clients won't have many sleepless nights worrying about their fund manager’s viability. The reasons for diversifying the product mix are likely related more to business than client imperatives.

The CEO also asserts that institutional investors sell assets as prices rise in order to rebalance their asset mix. Perhaps this is true at the margin, but I don't believe this discipline is widely practiced in the industry. He goes on to suggest that retail investors on the other hand, buy when prices in an asset class are rising. I'm not sure that institutional investors in general are that much more clever and disciplined than retail investors. I've not seen any research that supports that assertion.

I do agree with his view that institutional investors are the most demanding however of investment process quality standards, and reporting generally. Their higher standards are applied across all client segments by American Century, which is smart in my view.

The CEO was asked about staff compensation, and his response focused on the broadening of equity ownership in the firm. While generally, equity is important in this profession, this particular company has a unique ownership structure that changes my usual perspective. 45% of the firm's shares are owned by a foundation and another 41% is owned by a Canadian bank that we are told, has a long term horizon - but I think that this is likely to change over time. I am very familiar with banks, Canadian banks and this bank in particular and would not be surprised to see a strategy shift. It appears that the remaining shares are held by the employees. Given the very different perspectives of these three shareholder groups, I am curious about how share ownership can lead to long-term wealth creation for the employee. This compensation program may still need some additional tweaking in order to retain talent for the long run.

Hedge Fund Observations 11-30 P

Staffing. The fact that proprietary trading desks are being shutdown at the major banks actually helps recruiting for hedge funds, at least in the short run. Longer-term, a great source of trainees for hedge funds will dry up.

Hedge fund firms are also concerned about the burnout factor in this business. Succession planning is becoming recognized as an important issue for these firms.

Investments. Recently there've been noticeably higher correlations within, and across asset classes. High correlations generally mean fewer opportunities to find alpha and therefore, weaker relative hedge fund performance as the result. At this time, hedge funds are reaching for more diversification by geography, asset class, and even by security complexity in an effort to enhance returns.

Another concern affecting the capital markets is the impact of forthcoming changes in regulation. For example there is a concern that shutting down proprietary trading desks will reduce liquidity and widen bid ask spreads.

Clients. Many institutional are concerned that hedge fund investment processes have apparently not evolved much since 2008. It's important for hedge funds to recognize that clients are concerned. Clients want to know how your fund provides downside protection.

On the marketing front, copying your most innovative competitor might be a smart strategy.

There is concern with the survivorship bias in databases and indices which affects things like studies of the performance of different segments of the industry.

Since due diligence is so important for investors these days, it might be worthwhile to create your own due diligence question-and-answer piece to allay fears right up front.

You have to build your reputation in sub-communities, for example Taft-Hartley, family offices and others. Be sure not to surprise your clients in these communities, with unexpected actions, or your reputation will be mud across the group.

Consultants expect that if you are a global organization, your messaging will be consistent everywhere. While there may be regional or country variations, you should present the same core messages to global consulting firms everywhere.

Both clients and consultants want more access to your investment professionals, transparent and frequent communications and evidence of risk management.

Finally, business models are a quite unique between firms. There are no industry standard solutions for a particular firm.

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underlying hedge funds have again attracted assets since 2008. Clearly something is slowing down the growth of FOHF.

The study reported that the additional layers of fees imposed by FOHF eliminated any added investment performance earned by the underlying funds, and the study's authors detected no discernible level, on average, of skill in either manager selection, or timely allocations to hedge fund styles.

Some managers do outperform. We have also seen that the industry is developing additional opportunities for adding value to their customers. Plain-vanilla FOHF are evolving sub specialties in, for example, seeding emerging managers, long short strategies and build to suit portfolios. I believe that FOHF will continue to exist, and have an important place in the investment industry.

Do Funds of Hedge Funds Add Value? 11-31 P

An unpublished study (i.e. not yet peer-reviewed) that posited that funds of hedge funds (FOHF) are little better than a random selection of hedge funds. FOHF offer diversification for smaller clients without the attendant costs of researching money managers and structuring a portfolio. In many cases, they may also offer access to managers not otherwise available. The due diligence and monitoring done by FOHF cannot be underestimated either, in this post Madoff era. The FOHF industry has not rebounded however, in the way that

Challenges of Foreign Expansion 11-26 M P

The US China Business Council annually publishes its “China Operations Survey” and it includes both manufacturing and service industry perspectives about doing business in China. A number of the challenges noted affect asset managers operating in China as well. The survey reminds us of some of the challenges that asset managers encounter not only in China but pretty much anywhere outside of their home market.

Hiring talent is a challenge for foreign firms in China, and many other places. A shortage of skilled talent is compounded by the unwillingness of some prospective domestic employees to work for a foreign company.

Building your brand in a new market always takes a lot of work. There is somewhat of a natural preference for buying from domestic companies in China based perhaps on nationalism, but also trust in local enterprises plays a role. Consumer education and global brands will help to remedy this over time. The effort required to persist with this education, and overcome domestic competition is worth it because of the significant asset management opportunity arising from an underdeveloped pension and health-care system in China.

In planning your entry into a newer market like China, it should be no surprise that considerable amounts of resources will be required. In China, however foreign companies are usually limited to a minority ownership position and distribution is largely controlled by a few big banks. If disposition of the minority stake is required later, liquidity may be an issue. Also, I am not sure how helpful a minority stake will be for a firm's brand in the long run.

The legal and regulatory environment in China is new and immature. Intellectual property protection for example, is new in this country. While new laws are in place now, the judiciary system is not experienced with these issues. More generally, how decisions are made is difficult for foreigners to understand, and the bureaucracy further slows down the process.

Lastly, inflation is rising quickly in China, but costs are being offset by rapid gains in revenues.

The Chinese market has many more idiosyncrasies, but this just highlights the need for a well-planned assault when considering entering any market outside of your home country. Every country's uniqueness looks like a headache to foreign asset managers.

Multi boutiques 11-24 P

Multi-boutique investment firms come in many flavors, but there are some issues that are common challenges for all of them. The degree of centralization versus decentralization is an example. Some owners insist on greater centralization than others, based on expectations of improved efficiency.

Efficiency is a tricky argument, however. I once (jokingly) suggested to the artistic director of a major theater company that the profit maximizing way to run the company would be to stage only popular musicals, with fewer than the usual number of actors, and reuse the stage sets from show to show.

He quite correctly responded that he would rather resign.

Running an asset management firm for efficiency can also ruin the firm. How far to go with centralizing marketing, sales, operations and other aspects of the firm needs to be deeply considered – and not only by the parent company's leadership.

Coordinating where it makes sense, controlling if necessary (for example, compliance) and letting go, all have to be negotiated between the center and the boutiques.

Of course, the biggest issue is how to share the economic rewards. Ownership incentives, and even control over the basic aspects of compensation, can either help or hinder the overall success of the firm.

One of the bigger challenges in the long run is when one of the boutiques comes to dominate the economic value of the overall entity.

The multi-boutique model is a challenge for asset management leaders to manage and create sustainable economic value. But there is no doubt that it answers many of the issues associated with large firms. It can also be a solution for smaller firms looking to benefit from larger scale operations, for example, to access a larger distribution network.

Where should we spend our money? 11-15 P

A company's strategy is often a reflection of how its leaders choose to invest the company's resources. If the majority of new hires are in sales, clearly sales is a strategic priority. I also believe that all of the firm's expenses are an investment in the future. New sales hires are not only a strategic investment, but also a financial one.

The decisions made as to how to allocate resources are fundamental to creating economic value in a firm. How does your firm make these decisions?

Over the years, I've developed a framework with four essential elements to decide how to allocate expenses/investments.

The first two elements involve profitability. Before making these decisions, you must be able to breakdown the current profitability of your firm. Ideally, it is helpful to know the profitability of the various product segments (assuming you have more than one!).

Using this profitability information, array these segments from highest to lowest based on normalized current profitability. Then try to determine what the long-term sustainable expected profitability will be for these products. At first blush, short and long-term profitability could be the end of this discussion, because shouldn't all of your resources go to the best opportunities identified by this analysis?

There are two other elements however, that I suggest be considered. One is the connection between segments. For example, say you had a global fixed income capability which was an outgrowth of your domestic fixed income capability. If your domestic business was unprofitable, it might lead you to consider closing down the capability. But, if you were to close your domestic unit, the global group might suffer. So 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 a profitable segment. 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 final element to consider is whether a segment is a gateway to future success. On the surface, a particular business line might not be profitable now. It might not even be linked to any other current products segments. But perhaps this product segment is a necessary step that needs to be taken in order to be a player in a particular segment in the future. For an example of this idea from another industry, a manufacturer can only expand their plant once they've built the plant in the first place! An investment

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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 without acquiring the short-selling skill set, the firm might not be able to compete in the hedge fund space in the future.

So using these four elements – short and long-term profitability, the connection between segments, and the contribution to the future, leaders of investment firms can prioritize where they expend the firm's resources. How each of these four elements are calculated and weighted, will vary between firms.

So what do you do with the segments that end up at the bottom of the list that should apparently be starved of resources. Sure you could close them down, merge, or sell them off, if they are standalone. But sometimes these are strategically important in some way because of the connections with other segments, or their potential for future contribution. My suggestion is to challenge the manager responsible for these units to creatively figure out ways to enhance profitability, which often means breaking industry conventions. The challenge of performing in the face of the imminent demise of a line of business often inspires fresh thinking and creates value for not only the segment, 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 real difference in the development of your firm's economic value over time.

Creating a sustainable firm 12-22 P

Addressing these five principles is a quick simple way to evaluate your firm's business strategy.

1. Business strategy: Principle #1 Be honest about what is working and what isn't. What does the marketplace accept from your firm today? Be honest about what is working for your firm and what isn't. What is the marketplace accepting from your firm today? For example are there employees that you have delayed confronting, investment capabilities that have failed, do you have unmotivated sales staff, or is there a lack of

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results in some area. You can fool other people don't but don't fool yourself. Your firm's next stage of growth will be from the foundation of what you already have built. Are you prepared to grow?

2. Business strategy: Principle#2 What are the dead-ends for your business in the long-run? And what can you do about it? Are there client segments or investment products that you need to either consider closing, restructuring, selling or perhaps you need more resources. Eventually your current product array will peak and decline. What can you do now to prepare for this and continue to grow?

3. Who has the power over your firm, for example intermediaries, clients, regulators, and what are they willing to accept as legitimate efforts from your firm? Which other firms have you aligned your firm with, for example distributors and how might they be limiting your firm's growth?

4. Business strategy: Principle #4 What do your people believe and want to do? You need to hire for belief and attitude, embrace a bottom-up strategic planning process, and manage sales people. If your staff don't want the firm to grow, their attitudes will drive the direction of the firm.

5. How can your firm mobilize all available resources more effectively? You may need to reallocate resources for example. You'll need to access, then focus and align every resource that you can in order to grow your firm.

Federated… In a Quandary 11-16 P

One of the challenges for Federated is low interest rates, which means low revenues for this firm that has a large exposure to money market funds. Fee waivers, in consideration of the low yields earned by clients, have further pressured revenues. And regulators are threatening to make changes which could which could either end, or materially change the money market business.

Federated has indicated that they may seek to roll up smaller rivals, but this seems risky given the uncertain outlook for the money market business. Perhaps additional diversification makes more sense. They have considered opportunities for international acquisitions, especially in equity and fixed income.

However, acquisitions are difficult to find in traditional asset classes like equity and fixed income as many candidates have historically been part of larger financial services conglomerates in many countries. The difficulty of assimilating any asset manager, whether foreign or not, should also cause Federated's leadership to reconsider acquisitions as a key element in their strategy.

So what can Federated do? They have approximately one quarter of their business in non-money market assets like equity and fixed income, and these clients represent one half of the firm's revenue. Organic growth of these asset classes may be the future of the firm which I'm sure they hope and recognize. What else can they consider? Alternatives are the fastest-growing area of current investment interest, and with their name recognition and solid platform could represent a potential area for growth.

But the elephant in the room is that three quarters of their assets that are in money market funds. The good news is that this anchor on Federated, and its stock performance, probably looks like a sail to a major bank. After all, it represents nearly $200 billion in deposits! Any bank that had access to such a substantial deposit base could offer ancillary banking services and generate fee income that would constitute a substantial franchise. The timing would have to be right, but if the regulators continue on their current path towards crimping the ability of money market funds to compete, the best option for Federated might be to find one or more major banks as a partner.

Try to fix everything... and tell the media what you are up to! Are you this brave? 11-10 P

Many leaders can sympathize with the challenges that a firm encounters in its history. These challenges may result from a change in leadership, or in more diversified firms, a shift in the strategic direction of the parent company which then triggers major changes in products, people, and client prospects.

One common challenge for a can be a shortfall in asset growth. One response by firms can be to shift clients and the asset base towards higher-margin equity products. In advance of any such attempt

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though, there should be a thorough reassessment of the people, processes and resources of the firm. The structure of the firm may support primarily the current product set, and it will be no small task to shift the internal processes. We also must not neglect the perception of existing and future clients who may be uncomfortable, even skeptical, of any proposed shift. How you plan to win their hearts and minds is often the question. It will take planning and preparation to do so.

What if you have decided to emphasize equity products yet the investment performance of your equity offering is subpar! This presents an enormous near term challenge. This may mean that you need to either fire equity staff, hire additional talent, restructure or perhaps even acquire a firm to kick-start the organization in a new direction.

If the strategic direction is clear, then the resources will need to be dedicated to supporting the new direction so acquisitions should be on the agenda. The cultural issues which generally concern me when acquisitions are made, are less of a concern in this situation, because the intent is to craft a different culture in the firm consistent with creating higher economic value.

Culture change means people will leave. People changes are likely when this dramatic a shift occurs.

A key focus of the leadership of this firm should be to understand the new competencies required of their professional staff in considering a new strategic direction.

Overhauling a global asset manager 11-11 P

Kevin Parker of Deutsche Asset Management has undertaken a major reorganization of the group since he joined in early 2005.

The first thing that always strikes me is the background of the people involved. In this case, Kevin came from the investment banking side of Deutsche to oversee asset management. Regrettably, at least to me, the asset management business has not been focused on developing strong leaders and managers. As a result, particularly in large financial services companies, we often see managers parachuted into the CEO role for asset management units because of the absence of management talent that is "home – grown" from the asset management ranks. It's a shame because I believe that there are subtleties to this business that only managers with deep industry experience can appreciate, and leverage to the benefit of the firm.

Nonetheless, Mr. Parker has had a number of apparent wins that are good lessons for asset management leaders. The turnaround also has had its share of setbacks, some preventable.

- He reorganized the firm's structure to focus on distinctive client and product types – retail, institutional, alternatives and insurance companies. There are many ways to organize businesses but a simple, client centric approach is often most effective.
- He cut the workforce by over 50% over the last 6 years, while assets under management were down less than 5%, so productivity increased enormously.
- More than 25% of the assets under management were nonstrategic, and these businesses were either sold or closed over the period.
- Organic growth in the remaining businesses recovered most of the losses in assets arising from the closures.
- No acquisitions were made. I believe that acquisitions are difficult to successfully engineer, and I am generally cautious about recommending them.
- Profitability metrics were not available to Mr. Parker initially, and he took steps to better understand business line profitability, and the general strengths and weaknesses of the various businesses.\
- He also looked at taking the core capabilities of the firm in new directions. For example, the firm sought new accessible distribution opportunities, and repackaged existing capabilities into new products.
- Finally, strategic planning in this firm involves more than 10% of the people in the organization on an ongoing basis. This type of "bottom-up" strategic planning is effective at unifying the firm, and bakes in the implementation, in my view.

I did however note certain weaknesses in Mr. Parker's efforts to renew the firm. Not all weaknesses are preventable, but there are some general lessons for leaders.

- Asset growth has been negative overall in the last six years. While there are explanations, and while revenues and profits may have improved, the lack of asset growth is troubling for the long run.
- One of the reasons for declining assets was that they sold off their unprofitable UK business. This is worrisome to me because the UK is a large, professional market, and once you've exited, it may not be possible to return for a long time because of the reputational damage. This is one of those situations when maintaining a low profile, rather than closing a business might have left the firm positioned, at a modest cost, with a platform for future more promising opportunities, in a high-profile market. Experience in very professional markets also hones your firm to continue to compete against the top global players wherever you meet in the world.

- There was another downsizing that raises concern. It appears that equity investing has been de-emphasized. Since equities offer high returns over time, the present value of fees from an equity capability is high. With the move towards long/short strategies in the traditional long only space, and the use of equity capabilities or stock beta, in many hedge funds, it may also prove shortsighted to minimize the resources expended on the firm's equity business.
- The firm has a minority stake in a large, fast-growing Chinese asset manager. While the stake was apparently a great investment, they will have to figure out how to exit the holding to capture the value created.
- And I'm not sure that this holding has any real strategic value. The minority position doesn’t represent a sustainable Chinese franchise for their firm as it does not appear to be branded for the firm's benefit, especially if the firm wants to develop a more substantial presence in China in the future.
- There are several businesses discussed that appear to be growing very nicely, but they are really quite small in the context of the firm.
- One business grew quickly, and then lost nearly half of its assets. This business deserves careful scrutiny. Business fads come and go, and this may be a unit that should be sold. Some firms are more cautious about introducing new products that are likely to have a limited shelf life. But this is a decision that each firm must evaluate on its own.

Overall, the effort of Mr. Parker has been clearly transformational. Profitability is much improved. But revenue drivers need more attention for the future if the firm wants to move beyond a turnaround story to a sustainable success.

Managing Hedge Funds in a Diversified Firm 11-6 P

It's certainly true that every new investment vehicle has to work through its own growing pains, and the ramp-up of hedge funds in recent years has been accompanied by its own share of trials. Hedge funds have been tested rather thoroughly by a volatile market environment over the last decade, including a couple of significant bear markets. The hedge fund pros have had to relearn the downside of financial leverage, and what happens to correlations and liquidity during bear markets. Investors, on the other hand, discovered new exotic domiciles for their money, unimaginable frauds, and high fees.

With maturity and the increasing institutionalization of the hedge fund industry, the benefits of hedge funds have become evident to investors with diversification being perhaps the most obvious.

Now, leaders of firms that include hedge funds amongst their array of offerings to investors, need to address hedge fund 2.0 issues.

- On the people side, recruiting people with the right competencies, and retaining their talent, continue to be challenges. In some ways, recruiting and retention in the hedge fund space are more difficult than in traditional asset management firms. The economic value created by high-performing hedge fund teams can appear quickly, and trounce short-term earnings contributions from other products. Whether this value is sustainable is however an open question. Maintaining a team and its alpha generating capability is never a sure thing. The demands for compensation from these high-octane managers also have to be balanced against the demands of the firm's other product portfolio managers as well.
- The investment process of hedge funds, at the margin, is also evolving with lower financial leverage, more diversification, risk management and greater liquidity. These are welcome enhancements to investment processes. Leaders of firms with hedge fund capabilities need to protect not only the specific hedge fund offering to the extent possible, but also must be cognizant of the impact on the firm's reputation of a hedge fund failure which may spill over and spoil the reputation of the firm's other investment processes.
- For firms with a fund of hedge funds capabilities, differentiation is a challenge in this competitive space. The historic emphasis within these vehicles has been manager selection, and this may have to give way to more aggressive and tactical asset allocation, for example. Certainly, there is a general desire from clients for improvements in asset allocation.
- Institutions have pushed hedge fund marketers to become more professional, as these investors now represent a majority of hedge fund assets, and they are still growing rapidly in importance to hedge fund firms. Institutions are more demanding clients in some ways and prone to lemming-like waves of discontent. But the asset management industry has a multi-decade long history of working with, and financially benefiting from, institutional investors. Hedge fund managers will continue to learn to tailor their approach to craft a mutually beneficial relationship.
- Interestingly, there is increasing appetite for more liquid versions of hedge funds, such as institutional share classes of mutual funds. Those with broad mandates, either within an asset class such as fixed income, or "go anywhere" type funds are becoming particularly popular with institutional investors.

- Another challenge for leaders is the increasing weight of evidence that smaller hedge funds deliver better performance. This introduces issues of the limits of scalability and your distributors will clamor for the scant capacity. On the one hand, this may give some limited opportunities for higher fees, but a frustrated distribution network is never helpful. One way to satisfy both the distributors and capitalize on this small hedge fund manager performance advantage, is to continue to seed new hedge fund products, and create a diversified portfolio of capabilities for your asset management firm to offer to its customers.

Legal

Protecting your firm against rogue employees 11-4 L

A miniature industry of investigators has arisen from the Madoff scandal that is trying to understand how this situation could have happened, and what institutions and individuals can learn to prevent re-occurrences in the future. What I'd like to focus on are the implications for asset management firms and their leaders to protect against rogues. There is of course no perfect way to do this. Every so often people will attempt to fool us in new ways, or we may be forced to relearn lessons about what not to take for granted.

But rogue employees, to varying degrees, are more common than you might think. Issues that arise may be quietly disposed of before they come to the attention of outsiders. As usual, I believe that it all starts with due diligence into the backgrounds of your people. Vetting new employees should include thorough in-depth background checks, and the current trend of checking social media activities adds another interesting, and potentially helpful, layer of security. At the other end of the employee lifecycle, many companies have policies that require 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. Even if some of the comments are one-sided, a third party like a human resource professional or a retired officer of the firm can sometimes link these comments to other discussions, and perhaps help to piece together the mosaic and identify problems.

Next, you need an independent review of your investment process. Not all investment processes are robust or sustainable. There is a famous story that suggests that if you were to write put options on the S&P index, you would collect the premiums and virtually guarantee strong performance and a high Sharpe ratio, at least for a while. That is until the strategy blows up. Collecting premiums would generate a steady flow of 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 performance history would be out the window. The point here is that the leadership of the firm cannot just accept an investment process at face value. You need to look at scenario analysis, reasonableness tests, and third-party confirmation of the quality of the investment process, and use every tool at your disposal to ensure that the process is robust.

Clearly, the reason for the seemingly intense effort needed to evaluate the people and the investment process of your firm is that the impact of a slip up in these areas on the firm's reputation is devastating. Asset management firms create enormous economic value for their owners and to have it destroyed by a rogue individual or faulty investment process is terrible. From a marketing perspective, the firm's reputation may be irretrievable.

It is important to engage in a dialogue on a regular basis with staff about the firm's operations. Through the course of this dialogue, issues may be identified that may surface potential wrongdoing within the firm. The rumor mill may hint at some of these issues but this is not nearly good enough. It's important to have a formal get-together to ensure that the business continues to move forward on a mutually agreed course. Also hopefully the spotlight will shine on any issues that need to be addressed. Leaders need to listen carefully to the devil's advocates, and the skeptics, and the outspoken, for cautionary flags that need to be further addressed.

These meetings should also include your compliance staff. In fact, compliance people 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. Of course, crafty rogues will always find a way around them. And because these policies and procedures are so commonplace, people sometimes let their guards down.

Outsiders may also be helpful in identifying potential rogues. Auditors and regulators often lack the depth of investment experience needed to evaluate a firm. There are third-party firms though, that can look for weaknesses in the organization and processes.

Pay close attention to customer complaints whether they be verbal, implied, street rumors, and of course written complaints. Often there will be clues in these comments that will suggest the need for further investigation.

Encouraging free communication, and paying attention to what's going on with your people, processes, reputation, internal dialogue, external views and commentary and enforcing rigorous controls can help to avoid the rogue who may be bent on destroying your firm.

Regulatory Tsunami 11-17 L

There is a wave of regulation coming which is the legacy of Madoff, and also the volatile financial markets of recent years. Custodians are deeply involved in interpreting the new rules, advocacy, risk monitoring and compliance which also affect asset managers in many ways.

In recent years, custodians had been successfully pressured to reduce fees, but there is now pushback from them as they deal with increasing demands on their services, the need for more capital to support their business, and the cost of strengthening risk management capability in response to increased regulation. Each custodian has a different negotiation strategy to address these fee and service trade-offs with their customers.

The impact of new regulations on money managers is also significant to the degree that they work with custodians, or require custodial services. The rising regulatory burden has encouraged asset managers to revisit outsourcing. Custodians have the scale to accommodate the rising regulatory burden that most asset managers do not, but the cost of the services is unlikely to be a bargain as it once was for asset managers. There will be a delicate ballet between asset managers and custodians to access services at a reasonable price for both parties. Buying power will vary in each negotiation.

At the present time, SEC representatives are doing out-reach to answer questions about how they regulate, and prepare firms for the next step. The next step starts in October, and will probably last two years. The SEC will conduct a nationally coordinated, narrowly focused and deep review of targeted areas. It appears that each advisory firm will have one or two of these areas as a specific focus for their firm's own review.

Here are some of the areas that will be considered for review:

- ☐ Side letters
- ☐ Disclosures
- ☐ Trading
- ☐ Soft dollars
- ☐ Cross trading
- ☐ Best execution
- ☐ Trade allocations
- ☐ Code of ethics
- ☐ Personal trading
- ☐ Front-running
- ☐ Custody
- ☐ Performance fee calculations
- ☐ Net asset value calculations
- ☐ Audit reports

My suggestion is to identify, disclose, self remediate and document. And don't be too over-confident. Trust me, your compliance program is not perfect (how could it be?). If you don't know this or won't admit it, the SEC will find some issues for you. This probably isn't the best way to find out that you have problems.

New to the SEC? Get ready! 12-35 L

With the introduction of Form PF, the SEC now has oversight of an additional 1400 firms. At the same time, a few very small advisors were shifted from the SEC to state regulation. In addition to the 1400 new firms to the SEC, the agency has something under 13,000 other firms to regulate. The agency has a total of about 300 examiners – far too few to effectively regulate. The majority of the new firms reporting to the SEC are located in New York and Boston.

SEC National Seminar – Notes for CEOs 12-7 L

The SEC hosted a full day outreach seminar on Tuesday, January 31, 2012. Historically, this seminar has been described as a chief compliance officer (CCO) outreach program, but the SEC made a point of indicating that this time, they were attempting to reach beyond the CCO to CEOs and other stakeholders. The full-day seminar covered many SEC hot button issues, but I'd like to highlight a few points that I thought should be of particular interest to CEOs.

The SEC is increasingly incorporating CEOs into their examination process. Their belief is that CEOs set the tone for their organizations, and that they should signal the firm's commitment to a strong compliance culture. CEOs can demonstrate their commitment in activities as varied as strategic planning (e.g. new product process), capital allocation (e.g. providing sufficient resources to compliance), and evaluating their people. One of the SEC representatives described culture as putting client interests above all, in all decision-making.

A representative from a major investment advisory firm took this a step further, and said that a fiduciary culture incorporates modeling appropriate behavior, segregating key functions (e.g. portfolio management, trading), meaningful oversight, robust accountabilities all the way up to the Board level, and automation to enable monitoring.

Compliance and risk management should support the culture of compliance as a second line of defense, with internal audit providing additional support.

CEOs can't be expected to anticipate every possible risk. CEOs need to have the governance structure in place to be able to identify, escalate and respond appropriately to compliance issues whenever they occur. Self-identification and remediation plans for issues are recommended. SEC examiners indicated that they are skeptical if told that there aren't any compliance issues.

One of the enforcement examiners suggested that conflicts of interest are at the heart of most of the issues that they see. Enforcement issue cases rose 30% in 2011 versus 2010 as the SEC is now targeting specific issues, and specific firms, referring cases that they discover to enforcement more quickly, and responding to tips. There are seven whistleblower calls per day received by the SEC, and the examiners' perception is that these tips are generally highly credible.

There was some discussion of the role of boards of directors, and how independent directors' responsibilities include not only overseeing management, but also ensuring that the triumvirate of risk management, compliance and internal audit work effectively.

The SEC expects that there will be roughly 9000 registered investment advisory firms with $43 trillion in assets this year, after some 3,000 are shuffled to be regulated by the states, and about 1,000 previously unregistered firms are added. Historically, firms have on average, been examined once every 11 years. This is unacceptably low, and the SEC will be stepping up the number of exams from its current level of 1400 exams per year. The examination teams are no longer exclusively regional, but are now customized, draw on the SEC's national resources, and assembled to reflect the business of the advisor to be examined.

Here are some examples of enforcement issues discussed during the seminar. One examiner referred to a case involving a quantitative manager, and he indicated that he had a general level of concern over how quant managers may be siloed within their organizations, and lack appropriate compliance oversight over their often "secret" process. On a related note, high-frequency/algorithmic trading now constitutes over 70% of the trading on the exchanges, and one of the examiners expressed his concern that the typical compliance department may not up to the challenge of monitoring these processes.

With mutual funds, the top issues appear to be the level of fees of all types, and the valuation of securities.

Even the obscure topic of custody rules, which were modified in 2009, are ensnaring money managers. Roughly, 15% of advisers have related parties who are custodians of client assets. Further, almost 1/3 of all advisers are caught by the new custody guidelines, beyond simply being in a position to deduct fees from client accounts.

Identifying risks, creating policies and procedures to address your particular risks,

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reviewing the effectiveness of your policies and procedures, and being proactive with the SEC were all strongly encouraged.

Execution

High asset class correlations risk firm revenues 12-6 E

Most investment firms feel compelled to diversify their product lineup as they grow. For example small-cap specialist managers often naturally look to add smid capability, because they have an opportunity to extend their investment capabilities to slightly larger stocks, and in their view this also has a salutary effect of diversifying their firm's business risk.

The very largest money management organizations often tend to be more deliberate about their business diversification. But the effort is usually not well integrated. The effort to diversify is driven by current or prospective client demand, competitor actions, or current or easily acquired investment capabilities. While these are all good reasons to expand the business portfolio, leaders need to manage the resulting structure of the overall business portfolio.

Just like an investment portfolio, the effectiveness of business line diversification relies on less than perfectly correlated businesses. At this time we are seeing a much higher degree of correlation between asset classes has been true historically. When another bear market occurs, investment firms are at a high risk of declining revenues and squeezed profits in spite of their attempts at diversification.

Sales growth and relative investment performance may be insufficient to sustain revenues during a bear market.

The fact that correlations are persistently high recently should be raising warning flags for large asset management organizations. Historically, correlations have generally tended to rise during bear markets so the current situation is unusual.

The fact that correlations across asset classes are high and may rise further during a bear market may pressure assets under management and cause revenue problem's for firms. As long as the bear market is not here there is time to respond.

How can leaders respond? Treasury bonds had a low correlation to most other asset classes during the last bear market so considering additional products in this asset class could be a part of a diversified investment business. Other products that would have that will carry lower volatility might include stable value, money market and other lower volatility asset classes. Also asset classes with lower correlations to traditional equity and debt include commodities, infrastructure, tips and other illiquid investments carrying slow changing net asset values and therefore relatively stable revenues.

Performance fees could also help to mitigate the impact of reduced assets on the assumption that you outperform.

Monitoring correlations of assets under management, revenues and especially profit would be useful in your business. A more advanced approach might be to look at factor exposures across asset classes, for example macroeconomic sensitivity and leverage.

Earnings volatility resulting from high asset correlations during bear market is not just a concern for quarterly earnings sensitive publicly traded companies. The ability to retain staff and clients and your firm's reputation relies to some degree on stability in your financial position.

I would not suggest the diversification be a solitary objective of your firm. But your business does not need to be a passively obtained collection of exposures either.

Are Asset Managers Really Depressed – Should They Be? 11-5 E M

As investor preferences change, money management firms have to decide whether to respond. Are investor preferences at the margin just a short-term reaction to recent events? Recent shifts include the move towards alternative investment and pressure to lower fees.

Some firms have responded by reducing fees as returns have fallen, or they've introduce new products such as ETFs, which carry lower fees. Managed ETFs and liquid alternatives offer a version of active management at a lower cost to the investor.

Innovative new products may also provide at least a temporary boost to revenues, as limited competition allows for higher fees.

Another way to address shifting client preferences is to advise clients on the risks, costs, opportunity cost, and liquidity issues associated with shifting their portfolios.

Cutting costs is another response under consideration by many firms. Improving efficiencies is always important for asset managers, but lower market returns and therefore sluggish fee growth have drawn the attention of the asset management firm's accountants and given them more power to push for lower fixed costs in these firms.

Making acquisitions in an effort to improve efficiency and potentially enhance revenues, is problematic. While it may be possible to gain some modest efficiency, you also will need to spend a lot of time on complicated and distracting cultural and leadership issues.

Asset managers are generally optimistic folks, so hearing that they are glum these days strikes me as odd. There is lots of room for optimism about the growth of assets to be managed in the future, and there is steady movement towards privatizing government-run funds, all of which should benefit money management organizations. There's no need to be too depressed about the prospects for asset management profitability. These firms have shown remarkable resilience in recent decades. High-fee alternative investments have helped to offset the rise of passively managed low-fee funds for example.

I would argue that fees have upside potential from today as well. There are talented people for example, who can deliver exceptional performance – I call them generators of "rare alpha". They deserve compensation at a significantly higher level than what they receive today.

For example, if investors can identify asset allocation talent in advance, nearly every investor would want to hire this talent and would be willing to pay top dollar for it. As more firms focus on global asset allocation, and as outstanding practitioners become more widely known, this talent will continue to be in short supply, and the fee for acquiring this talent will skyrocket.

Asset Management and Technology 11-27 E

We've all had times as leaders when we wanted a new report that, in our minds, seem like a simple request. But our systems either didn't capture the data that we were looking for, couldn't retrieve it quickly if at all, or didn't automatically report the data in our preferred format. So managing and extracting data in a form that aids decision-making and reporting continues to be a challenge.

As products are added, and methods of distribution expand, business and technological complexity also increase. Often systems are used that fit perfectly with the needs of particular product categories or distribution channels. But when you try to integrate them across categories and channels, that's when things break down and complexity rockets upwards. There is therefore a continuing tension between having solutions that meet the needs of different products/channels, and single solutions. When you add different geographical regions into the mix, a single solution answer is even more remote.

Demands from investors and regulators continue to drive technology spending by asset management firms. But these demands are coming during a time of downward profit margin pressure for asset managers. They need to make these investments however, in order to manage risk for their own firms, meet regulatory demands, as well as respond to investor due diligence requests.

Technology, costs and risk 11-12 E

When asset management firm margins are squeezed, do your thoughts turn to technology innovation, cost reduction, and managing risk? No doubt, there are many priorities clamoring for your attention. But let's just focus on these three for a moment.

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- To reduce your burden, perhaps you should be more wary of the adoption by your firm of small-scale technology innovation. There are always noisier bells and whistles to whet the appetite of professionals in your firm, but making new technologies fit with your existing IT apparatus is often costly, time-consuming and awkward. And if you're going to allow this, be sure that the sexy new toy builds tangible value for your firm.
- Acquiring new technology in an effort to reduce costs is risky. Every purchase, IT or otherwise, needs to be an investment in your firm's future. Cost reducing purchases may narrow expenses in one area, and push costs higher elsewhere, for example, by requiring additional training, thereby negating the promised benefit.
- Risk management is unlikely to be a priority area in the current environment. But maybe it should be. Operating risk is not just about keeping the regulators happy, or ivory tower musings about the odds of swine flu pandemics.

Instead risk management is a lot of small, or rare risks. How are you prepared to respond to the threat of an exodus of customers, for example? What if your phone system goes down because a rat chewed through a critical wire? How long will it take for you to be online again? Virus attacks are always a threat. What about a series of media reports castigating a pillar of your business? Risk management is broader than some think, and more micro than others believe. It's not a tick the box effort, and it needs to be owned by the leadership of the company – no delegating. Priorities will change and attention is continuously required.

Blackrock thoughts...Yes again! 11-13 E

I believe that everything good and bad in this business starts with people. No surprise, poor management at one particular ETF fund caused a sharp reduction in inflows to Blackrock's ETF platform for a period of time in relation to competitors. The poor management i.e. the investment process caused the ETF to trail its benchmark substantially.

Client sentiment shifts are another major issue for investment management firms. We have recently seen a shift of client assets towards lower risk and by implication, lower margin assets. In an ideal world, we'd array our businesses to be exposed only to the highest margin, fastest-growing business lines, but at least for a company with public shareholders like Blackrock, this is difficult to manage in the short-run. Only marginal shifts between short run and long-run opportunities can be made. And some investment products complement other products, so that removing one product risks eroding the franchise of others. Finally, some innovative products are needed just to have a future platform for capturing market share in the long run. These products are really table stakes to be in the game in the future.

What about controlling costs as a response? Reducing expenses is a risky game with many unintended effects, if it is just a short-term response. Clients, employees and many others may be impacted by expense management in unforeseen ways.

What is more helpful in my view is allocating your resources, and therefore your expenses to the lines of business that have and will have the highest economic value. If you want or need your firm to be more responsive in the short run, then the proportion of variable costs should be increased in your business model. This is a better answer, and for a public company in particular, this is probably the best solution.

Key Metric – Operating Margins 11-3 E M

The operating margin is argueably the most important financial metric for leaders of an asset management firm to monitor. It gives you a great snapshot, at least in the short run, of the performance of your firm. We are fortunate that this business is so uncomplicated and that relatively few financial metrics give us a terrific picture of the performance of the enterprise. Unlike most businesses, we don't have to worry about inventories, and items like receivables and significant depreciation are uncommon in this business.

I have been responsible for asset management businesses with operating margins as high as 75% – and this was after paying each of the partners seven-figure compensation. Admittedly, this particular business was at the peak of its life cycle but the margins were astonishing nonetheless. At the other extreme, I was responsible for a business that fell into negative territory from an operating margin standpoint in 2008. The severe stock market decline in 2008 triggered a fall in assets under management and revenues, and since we couldn't adjust our fixed costs fast enough, this downturn erased profitability. While margins in the industry have been in decline for a number of years, on average, asset management firms continue to generate 30% or higher margins.

What are the most effective ways to improve operating margins in the short run? When market environments like 2008 hit, action is required to protect the business. In 2008, a relatively small number of asset management businesses responded adequately to the downturn in revenues for their firms. In fact, most businesses hardly responded at all. The reactions were largely passive as the partners or owners of these businesses absorbed lower profitability in their own compensation over the period. Few asset managers made changes to the fundamentals of their business and instead hoped that the downturn in revenues was a short-term issue. With the rebound in the financial markets that we've seen since 2008, perhaps these leaders were right to delay responding.

However, I believe that it's important to run a business profitably, sustainably, and consistently over time in order to create the maximum economic value for the firm. This isn't just about money. Without a strong financial foundation and some consistency in the available pool for compensation, you will eventually see employee turnover, deterioration in your firm's investment performance, and clients and prospects walking away in favor of your competitors.

Sometimes long-term shifts in economics are the result of turning points, which perhaps 2008 represented. It is possible that our business won't ever be the same again, and we shouldn't be counting on a reversion to mean in terms of operating margins. Perhaps we need to rethink our business model. I'll leave that discussion for another day. However, there are things that we can do in the short run to respond to declining operating margins and to position us to be it ready to respond to possibly a major change in the economics of this business.

In 2008, for those few asset managers that made an adjustment to their operating model, the most frequent response was to cut costs either across-the-board or selectively. Cutting expenses is a reflexive reaction that may help a firm's short term financial position, but it comes at an enormous cost.

A better first step is to examine pricing. Pricing is a powerful short-term lever for enhancing operating margins. I would argue it that it is the single most important element for ensuring a healthy profit margin. It is also probably the most overlooked element in the asset management leader’s toolkit. Pricing is such an important issue that I will discuss this topic in much more depth in other reports.

Here's something that you can do immediately to improve revenues.

- □ Are all of your clients on your most recent fee schedule? If you have been in business for a number of years, it is likely that some of your clients are paying fees based on previous fee schedules. This means that they are getting a bargain compared to your other clients. You need to migrate all of your clients towards paying fees based on the same current fee schedule.
- □ If you were to list all of your clients by the fees that they pay in relation to your current fee schedule, how many are getting a discount? I realize that there are always exceptions, and that some clients receive a discounted fee.
- □ Who approves the fee discount? Fee discounts should be the exception not the rule. The leadership of an asset manager should determine what class of client receives any discounts.
- □ Leadership should then review and re-approve all fee discounts on an annual basis.

Keeping clients with a fee discount to a de minimis level is crucial to profitability. Fee discounts are a flat out reduction of profitability.

Updating fee schedules and strictly limiting discounts can enhance profitability significantly. This is not to say that there will not be pushback from your own internal client facing staff, as well as clients themselves, but in my experience in implementing these changes at several firms, the positive impact on firm profitability far outweighs the costs. Even some client losses are acceptable if the impact on overall revenues and profit is a net gain.

Implementing fee changes can be accomplished while minimizing any negative impact.

Another way to influence the operating margin in the short run is to reduce costs. However cutting expenses sends very negative signals to your internal constituencies as well as clients and prospects. In a business where your reputation is everything, cutting expenses is terrible public relations.

Does this mean that I am not recommending cutting costs? Not at all. Cutting costs that don't seep back into the system is an important lever in managing a business. I also believe that every cost/expense is an investment in the future. Therefore, if you are cutting, you must consider how this action is affecting the future economic value of your firm.

A Dozen Ideas for Asset Management Leaders in 2012 11-36 S I M P L E

The end and the beginning of every year is a time for reflection, with its invariably mixed bag of positives and negatives. 2011 began with great promise, but our hopes were dashed, and we've had to wait until next year. I am hopeful that economic conditions will improve, so we need to remain nimble to take advantage of opportunities. But leaders of investment management firms must be prepared for multiple scenarios. We need to build resiliency, and the ability to thrive in all conditions, into our organizations.

Here are a dozen ideas for your consideration in 2012 that address six major elements of an asset management business. Alternatively, you can think of these ideas as one for each of the twelve days of Christmas, or perhaps the pool from which you draw your New Year's resolutions. In any case, these are meant to be practical suggestions that you might consider, and that can make a difference in 2012 for your firm.

<u>Staff</u>

1. Identify the personality characteristics that are shared by your staff who contribute the most value to your firm. Recruit only the people who share these key characteristics in order to sustain your firm.
2. If you feel that you need to change your culture in order to have a more successful firm, you will have to replace people, and you should start making these changes now.

<u>Investment</u>

3. When trying to fix investment under-performance, most firms carefully review and adjust their investment process. However, people create processes, and people may be at the root of the problem, and changes in staff or their roles may be needed.
4. Clients expect you to manage portfolio risk today much better than in 2008.

<u>Marketing</u>

5. Examine the characteristics of your existing clients to understand what attracted them to your firm, and use this information to find prospective clients who share these characteristics and are also likely to want your service.
6. Retain salespeople who currently exhibit the attitude and behaviors required to be successful.

<u>Planning</u>

7. In a private company, start building the capabilities today that you'll need to remain successful after your firm's current owners retire, in order to ensure that the firm has transferable economic value to the next generation, or to another buyer.
8. Reallocate resources to the best future opportunities that are unique to your firm, don't just cut costs uniformly. Consider investing some of your available resources in ideas that run counter to current industry trends and forecasts.

Legal
9. Be sensitive to any indication that your clients are not completely certain that you act in their best interest.
10. Actively anticipate future regulatory compliance requirements.

Execution

11. Key people in your firm who are responsible for leading the execution of plans need to be included in the planning phase as well.
12. As a general rule, most asset management businesses should keep fixed costs low, and variable costs high in their business model.

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. If your firm is acquired or merges with another firm, this can raise concerns about possible employee departures, and future investment performance. If you have a parent firm, and if it is struggling financially, this can also raise eyebrows. Regulatory issues or lawsuits may draw negative attention as well.

The challenges are daunting even if the right steps are taken. In recent years, one large asset manager took a giant hit to its reputation. The firm had to undergo 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.

On way to rebuild your firm's reputation, is to leverage the fact that suppliers and providers to your firm are continuing to do business with your firm, and they remain comfortable with the stability of your organization. If true, this fact should be communicated to clients and prospects, and other intermediaries to give them confidence.

If related companies such as sister firms or a holding company show their financial commitment to your firm, this will also help to rebuild your reputation 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. By one estimate, there are 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 were also weak at the time of the hit to your reputation, this will help to push your firm further down their preferred list.

To rebuild your relationship with consultants, you have to act as if you are a startup again. Target small to midsize consulting firms to restart the momentum. Be alert 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 credibility will have been damaged by the negative impact 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 productively 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.

14 Lessons from Steve Jobs for Investment Firm Leaders 12-20 E

Walter Isaacson is the CEO of the Aspen Institute, and he has recently written a very popular biography of Steve Jobs. The quotations are those expressed by Steve Jobs, as related by the author. My comments follow the quotation.

"Making an enduring company, was both harder and more important than making a great product." In our business there will always be periods of underperformance for even the best investment products. Product innovation is also a continuing challenge as we've seen with the evolution in passive products, international investing, and alternatives. It is easy to recognize the wisdom of building an enduring company over any particular product.

"Deciding what not to do is as important as deciding what to do...The main thing I stressed was focus." Many firms try to diversify their product line-up, when greater focus may be a more fruitful strategy. You can only compete at the highest levels if you are focused. If you aren't in the top rank of your peers, prospective clients will not give you a chance to even present your capabilities to them.

"It takes a lot of hard work to make something simple, to truly understand the underlying challenges and come up with elegant solutions." Today's clients demand solutions that are simple, yet effective. ETF's are one example, is CIO outsourcing another? Stripping away complexity, and aligning your organization to deliver exceptional results is a way to move ahead of your competitors.

"People are busy. They have other things to do than think about how to integrate..." Investment firms are increasingly presenting integrated investment solutions to clients.

"If we don't cannibalize ourselves, someone else will." With a majority of investment firms still offering long only products, there's ample opportunity for them to not only catch up, but overtake the competition, by considering the addition of alternative strategies.

"I have my own theory about why decline happens at companies. They make some great products, but then the sales and marketing people take over the company because they are the ones who can juice up profits. When the sales guys run the company, the product guys don't matter so much, and a lot of them just turn off." Many thought leaders in this industry agree with this sentiment. When the leadership priorities tip toward sales, investment quality suffers.

There's no doubt that the heart of this industry is investment capability. However, Steve Jobs also said that the product needs to be "insanely great". Just because investment people are in charge, doesn't mean that they have a hall pass. Their responsibility is to deliver a first-rate product to the sales force, and more importantly, clients.

"Customers don't know what they want until we've shown them." Market research can take you only so far. Instead your firm should build investment products that your own staff is willing to buy.

"If it would save a person's life, could you find a way to..." Could your firm build an investment product that meets every single need that your clients have? "Don't be afraid" to try.

"People do judge a book by its cover." Does your marketing effort represent the quality of your product in the best possible way? Do your investment professionals look, act and communicate like the top-performing investment professionals in the world?

"I didn't sleep last night, because I realized that I just don't love it." Do you also absolutely love the quality of your firm's investment products?

"I've learned over the years that when you have really good people, you don't have to baby them. By expecting them to do great things, you can get them to do great things." Do you have “A” players on your team, and do you hire only people that will reinforce your “A” team?

"Creativity comes from spontaneous meetings, from random discussions." Is your firm’s organizational layout configured to bring team members from across the firm face-to-face frequently?

"... I read something that one of my heroes, Edwin Land of Polaroid, said about the importance of people who could stand at the intersection of humanities and sciences, and I decided that's what I wanted to do." Investment markets and client needs continue to change and require investment firms to evolve as well, by advancing both the art and science of investing.

"... The people who are crazy enough to think that they can change the world are the ones who do." Even if it's only the investment world! What can your firm do to improve realized investment outcomes for clients?

Capital Market Risk and Profitability 12-23 E

One of the lessons for institutional investors from the severe 2008 bear market was that their exposure to a single investment factor accounted for most of the weakness in their fund’s performance. The equity factor represented over 90% of the return volatility of a typical institutional portfolio.

Investment management firms felt the pain of declining profits in 2008 as their revenues are largely based on the value of assets under management. Analyzing and managing a firm's exposure to stock market volatility can help leaders to prepare for, or at least respond to, significant future declines in revenues, profitability and employee compensation.

In 2008, some firms responded to the market decline by restructuring their firms, while others chose to ignore the short term impact.

Less revenue, and a reduction in available compensation should be of concern to all firms. If you want to retain and motivate your staff, keeping the compensation pool reasonably steady should be a priority.

There are some ways to partially shelter profits from market storms.
If your firm is gaining market share in assets/revenues, or has a high variable/low fixed cost business model, these may cushion some of the damage to profits from bear markets. Another way is to diversify your product line-up away from exposure to the equity factor, but this is increasingly difficult.

Managers emphasizing equity products are not the only ones whose profits are affected by bear markets. Since correlations between asset classes have risen over time, offering a wider variety of products may not be enough. It is important to analyze revenue correlations between your firm's products in order to understand the likely total impact on profits.

There is another type of correlation that may affect profits. Correlations of securities within asset classes have also trended higher, and correlations tend to be particularly high during bear markets. Fewer opportunities to generate alpha mean lower performance fees, and if your firm relies on performance fees, this can accentuate the decline in revenues.

Indirect Impact

Market weakness affects profits directly, but it can also trigger clients to reassess their needs. Stock market declines may coincide with clients either withdrawing assets from the manager to meet obligations, or reallocating their assets towards lower fee/margin products.

A bear market may also impact long-term profitability in another way. Many firms own minority interests in investment management firms in the hope of creating additional economic value for the firm. But in general, minority interests often consume a disproportionate amount of management time, and may not significantly build brand value for the total firm. And a minority interest is unlikely to remain part of the firm in the long-run.

When the time comes to consider a divestiture of the minority interest, stock market conditions may not be favorable, which could affect the realized terminal value of the holding. Bear markets usually mean a reduction in the number of bidders for firms. Strategic buyers are harder to find, and financial buyers are less willing or able to obtain financing. At a minimum, bear markets trigger a widening of the bid ask-spread, fewer transactions and lower realized prices. If owners of minority interests considered the most likely scenario for the terminal value of their investment, as well as the total cost of managing these interests, they might consider an earlier divestiture.

Summary

Some leaders may feel less compelled to respond to short-term swings in profitability and liquidity. In the long run, however, all firms should be concerned with building transferable economic value. Limiting profit volatility and retaining key staff by preserving a reasonably stable pattern of compensation will help to build value for your firm.

So your options include ignoring capital market risk, reconfiguring the business to diminish risk, or hedging some or all of the capital market risk.

Calculating and monitoring your firm's profit sensitivity to movements in equity prices, monitoring correlations between asset classes and securities, and considering the likely terminal value of minority interests should be on a leader's agenda.

After You've Outsourced Your Operations – Now What? 12-21 E

There are many reasons for investment management firms to consider the outsourcing of operations, and many firms have chosen to outsource some or all of their back and middle office. Even front office activities are candidates for outsourcing. Marketing support, sales and client service, risk management, compliance, and even investment research can be outsourced.

Once outsourcing is in place, often you can only hope that your relationship with the outsourcing provider(s) will not deteriorate. Contracts and service level agreements will partly protect your interests. Penalties for nonperformance or lawsuits can only go so far to compensate for failures to perform.

Since not everything can be written down in an agreement, and since circumstances change, leaders should anticipate the potential for future issues.

Examples of issues that may arise include:

- Larger service providers may have communication breakdowns between their own service groups. Your requests may be treated as one-off costly exceptions, when numerous clients of the service provider are in fact, encountering similar issues.
- An inability of the provider to accommodate your new products, new geographic regions or even new processes eg. meeting new regulatory requirements.
- Delayed delivery of projects.
- Unanticipated staff turnover. Retraining staff at your outsourcing provider's firm to meet your specific needs may be costly.
- Flattening of cost savings over time, with any further savings accruing to the benefit of the outsource provider only.
- Keep in mind that the service provider must meet their own needs for turning a profit. The outsourcing services provider may choose to invest less in people and technology over time in favor of investing their resources in other more profitable business opportunities.

- Few service quality enhancements over time.

In order to anticipate and prepare for these issues, it is worthwhile to consider ways to protect your interest. These could include:

- Using multiple outsourcing providers. However, managing multiple providers carries additional risks and potentially higher costs.
- Contractual guarantees and penalties.
- Regular meetings between leaders of both firms to conduct formal reviews of the relationship.

How's Your Firm Doing So Far This Year?
Here's 12 Ideas to Keep on Track.
12-31 S I M P L E

Since mid-year is fast approaching, leaders often like to review the progress year to date, and consider whether there are any adjustments that need to be made. At the beginning of this year, I offered 12 ideas for your consideration, and I thought that they might still be helpful. As I mentioned then, leaders of investment management firms must be prepared for multiple scenarios. We need to build resiliency, and the ability to thrive in all conditions, into our organizations.

<u>Staff</u>

1. Identify the personality characteristics that are shared by your staff who contribute the most value to your firm. Recruit only the people who share and support these key characteristics in order to sustain your firm. Identifying core competencies and using behavioral interviewing techniques can help your firm to recruit even more effectively.
2. If you feel that you need to change your culture in order to have a more successful firm, you will have to replace people, and you should start making these changes now. Individual employees and even teams today are thinking about whether they should stay with their current firm, or look for a better culture. Leaders should be regularly making the same assessment of their staff.

<u>Investment</u>

3. When trying to fix investment under-performance, most firms carefully review and adjust their investment process. However, people create processes, and since people may be at the root of the problem, changes in staff or their roles may be needed.
4. Clients expect you to manage portfolio risk today much better than in 2008. Has your firm enhanced risk management in meaningful ways this year?

<u>Marketing</u>

5. Examine the characteristics of your existing clients to understand why they continue to be clients. Use this information to find prospective

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For questions, email: campbell@yoursecondopinionllc.com
Or call 312-343-0079

clients who share these same characteristics, and are therefore, also likely to want your service.

6. Retain salespeople who currently exhibit the attitude and behaviors required to be successful. Are your sales people motivated and engaged now?

Planning

7. In a private company, start building the capabilities today that you'll need to remain successful after your firm's current owners retire, in order to ensure that the firm has transferable economic value to the next generation, or to another buyer. Public companies have the same need to build capabilities, but often with greater urgency.
8. Reallocate resources to the best future opportunities that are unique to your firm. Consider investing some of your available resources in ideas that run counter to current industry trends and forecasts.

Legal

9. Be sensitive to any indication that your clients are not completely certain that you act in their best interest. How can you measure trust?
10. Actively anticipate future regulatory compliance requirements. What is in the headlines now, will surely be part of the next series of regulatory sweeps.

Execution

11. Key people in your firm who are responsible for leading the execution of plans need to be included in the planning phase as well. Consider broadening the sources of input from your staff.
12. As a general rule, most asset management businesses should keep fixed costs low, and variable costs high in their business model. With higher asset class correlations in recent years, and likely to rise further during future bear markets, most firms need to work hard to adjust to a variable cost model.