FOSTERING INDEPENDENCE IN THE INVESTMENT MANAGEMENT INDUSTRY

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My talk today is about the importance of, and ways of achieving and maintaining, money manager independence. But before I dive into that, given the current economic and financial crisis, I think I need to express my view of the future business and investment environment. After all, we are not going to have a flourishing, or perhaps even viable, investment management industry unless the economic and financial background upon which the industry depends is healthier than it was in 2008 and is currently.

We are clearly "coming off" a 10 to 15 year period of increasing leverage in the U.S. (and in fact the world) economy. It was also a period of diminishing regulation of financial markets. Now excessive regulation of any market clearly suppresses creativity and growth. But I think we have found (always the hard way) that as we approach no, or negligible and ineffective, regulation the result is a tendency of red blooded humanity to operate with excessive animal spirits and unrestrained short term self-interest. This is often dangerous, destructive and not in the interests of the greatest social good.

Today, in order to correct these problems of excess, we are embarked, as a society and as an economy, on a great experiment in economic and, yes, social, engineering which is informed by a vast amount of scholarship, investigation and prior experience but is still not a sure bet, either conceptually or politically.

But I believe that we have arrived at a remarkable juncture of recognized crisis, political consensus and technique development that can and should produce more or less the desired outcome. That outcome should be a moderately resurgent U.S. economy and better than moderately resurgent markets.

To be sure, we are going to have to deal with the effects of deleveraging for several years to come as the superleveraged, pro-risk environment of the last decade is brought down to earth. That should dampen the growth rate in the economic recovery but it need not dampen the growth rate of the markets as higher PE ratios, connoting higher quality earnings, appear on the investment horizon.

I, for one, feel that we will recapture the market losses of the last six months much more rapidly than might now be imagined because of this quality of earnings/lower leverage combination as 2009 and 2010 unfold. On the other hand, we do run a longer term inflation risk as we apply vigorous fiscal stimulus in the presence of much enhanced liquidity (and its accompanying extremely low interest rates for qualified borrowers). I also expect housing volumes and eventually, to some extent, prices to recover as qualified home buyers find extremely attractive financing options available.

In this setting, stock prices should recover and the money management industry should prosper once again if, and for as long as, inflation stays under control. The trauma experienced by the industry in 2008 should bring about some changes, however. One of the changes I do <u>not</u> expect is the dissolution of the hedge fund industry or even the seemingly derivative “fund of funds” industry. I do think, however, that the liquidity problems which have always been present in private equity investments and were unexpectedly present in some hedge funds will be more of an issue.

By and large, the average hedge fund declined much less in 2008 than the average long only manager. That was to be expected. But how then explain the greater fear of redemptions being felt by many hedge fund managers? The basis for this fear seems to lie somewhere in the gap between actual performance and client expectations, in client composition, and in fee structures and unexpected liquidity issues.

In my view, the greatest reality check for today’s sophisticated institutional investors (read large endowments and foundations) has been the shocking impact on their operations of the illiquidity of wide swaths of their portfolio holdings. I predict a profound movement over the next several years by these institutions to improve the marketability of their portfolios. We are already seeing attempts by some of them to sell, even at deep discounts, some of their non-marketable securities.

Therefore, I think one of the characteristics of the resurgent money management industry of the next several years will be a much greater preference by clients for liquidity (or ready marketability) in portfolio holdings.

A second characteristic is likely to be sharply reduced use of leverage in investments and portfolios, if for no other reason than that leverage on a scale comparable to the recent past will not be available from banks and other, now chastened, lenders.

But professional money management isn't going away. There is simply too much accumulated capital in the hands of institutions and high net worth individuals (not to mention 401(k) and mutual fund holders like the rest of us) which needs to be productively managed. There is no alternative. In the present and forthcoming low interest rate environment for "safe" investments, which is being created by the Fed, professionals who offer a reasonable expectation of much higher returns will be as much needed as ever.

But what of the shape of this resurgent money management industry? In the late 1990's everyone felt they knew the future shape of the investment management industry. It was going to be a retail, mass market industry dominated by a small number of giant commercial banks, insurance companies, brokers and investment banks who sold investment management on a vast scale and then managed the money "in-house." With this image in mind, these giant institutions not only built up their internal money management organizations, they began to acquire formerly independent money managers which had been generating outstanding results.

But a funny thing happened on the way to dominance of the investment management business by the giants. The clients, the consultants who measure performance, the outstanding performers among the managers, even the giants themselves discovered that the culture of outstanding investment managers seems to be remarkably independent, entrepreneurial, idiosyncratic, even rebellious at times.

Somehow large scale bureaucracy, armies marching to a drumbeat, mobilized big production goals and the unique culture of independent, top performing investors didn't fit together.

At the same time large clients and influential consultants began to develop improved capabilities for ferreting out good managers on their own. They required less reliance on the large scale, mass market distributors to find the outstanding managers they needed. And as these large distributors came to understand their cultural incompatibility with the iconoclastic nature of great investment performers, they began to accept the idea that they were more likely to be able to reach out to clients successfully as a platform for other providers than to be able to satisfy clients' need for superior results by themselves.

They began to slow and even reverse their movement toward acquiring independent firms. The firms themselves (and their clients) began to doubt the efficacy of seeing their managers become part of a distribution goliath.

The large institutions even began to create platforms to offer their clients the services (and superior results) of independent, non-affiliated managers. Then, in several cases, they began to sell or spin off their internal investment management organizations. Citibank sold its money management arm to Legg Mason. Merrill Lynch spun off its investment management group to BlackRock. PNC had previously spun off BlackRock as an independent firm.

But independence has its challenges too. The greatest of these is to achieve and maintain that independence over time and through generations. As firms mature and grow reasonably successful, they naturally create “ownership crises.” These ownership crises have to do with creating liquidity for aging principals of the firm, financing transfer of ownership from generation to generation, facilitating the achievement of full independence from a corporate parent, taking out retired partners and early backers.

Unfortunately, accomplishing these worthwhile objectives while keeping the firm independent has been very difficult to achieve. Selling all or part of the firm to outsiders can solve the liquidity issue but destroy or severely compromise achieving the other goals.

The ways of solving the problem wholly internally, with no loss of independence or control, have presented a Hobson’s choice. Either the older partners receive an uneconomic valuation for their ownership by giving it away or selling it at a greatly reduced price to their less wealthy younger partners and other employees; or the firm takes on much greater risk by borrowing to effect the transfer and provide liquidity to the older owners.

Fortunately, the evolution of ownership structures in the investment management industry over the past 25 years or so has begun to produce solutions to this problem of perpetuating independent ownership, or even creating it where independence has not existed before.

As far back as the early 1980’s, during the era of consolidation, new holding company structures were created as an improved consolidation device. Two such holding companies emerged. They carried the names United Asset Management and Affiliated Managers Group (UAM and AMG for short). Both succeeded to the point of becoming public companies with revenues of over one billion dollars each and market capitalizations of $1-2 billion or more.

I had the privilege of serving as founder and, for 20 years, CEO of the first of these, United Asset Management. In order to make the holding company structures work, we created a mechanism called “revenue sharing” as a way to receive the benefits of ownership from these otherwise fiercely independent and entrepreneurial firms. Revenue sharing, as defined here, doesn’t work for everyone or in every industry. It requires an industry model which has high margins and low fixed costs. It also requires individual firms which have reached critical mass, i.e. sufficient size, profitability and maturity to support a revenue sharing structure.

Revenue sharing in this context means having the owner receive his return from the money manager in the form of a percentage of top line revenues, rather than as a percentage of profits. This simple transformation of the profit model has a profound effect. It simplifies the relationship between the owners and the workers. Incidentally, it does not prevent an owner from being a worker or vice versa. Employees and managers receive salaries, bonuses, and other rewards for their work and performance. As owners, they (or others) receive a predetermined percentage of top-line revenues. More commonly, of course in the holding company structure, these roles are separated. This was an improved ownership model, as far as it went.

But the challenge is to preserve ownership, preferably <u>all</u> of it, for the talented people who run the firm. To that end, a new organization was created about five years ago called Asset Management Finance (AMF). AMF was premised on an equally simple conceptual advance: The belief that revenue sharing could be separated from ownership and could be profitably redesigned and refocused solely as a capital source for investment management firms.

This new model not only separates revenue sharing from ownership but creates it only for a fixed term. In this case, seven to twenty years in length. So, in the event, AMF provides risk capital to a firm in return for an RSI (revenue share interest), i.e. the right to receive a fixed percentage of revenues for a finite number of years. AMF is not an <u>owner</u>, the ownership rights belong to the leaders and employees of the firm. It is not a <u>creditor</u> either. AMF’s sole right is to receive a percentage of top line revenues for a predetermined period of time. If the revenues rise, that is good for everyone. But if they fall, AMF’s right to receive some of those revenues means its receipts fall too. In the ultimate test, if the firm’s revenues disappear, the claim of AMF disappears as well.

AMF enables the principals to preserve the full range of future strategic options, including selling the firm if and when they wish to do so.

With these new elements, revenue sharing becomes extraordinarily useful and extraordinarily flexible, all the while maintaining complete independence for the firm and a total absence of fixed principal debt or any equity transfer to the RSI holder. Incidentally, transactions of this kind normally do not require client consents because there is no change of control of any kind.

Ironically, these transactions are something that firms have wanted to discuss with clients because they show that the firm is evolving without impairing its autonomy and while preserving its management continuity.

Specifically, the kinds of transactions that these RSI's can support include the following:

- Liquidity events for the principals of the firm
- Transfers of equity from generation to generation
- A spin-off of the firm from a parent company
- A recapitalization of the firm, taking out original backers, etc.
- An important growth initiative or a key acquisition
- Situations where the firm needs to commit capital in order to co-invest with clients

The time period is flexible and, as I said earlier, can be as short as 7 years or as long as 20 years.

The amount of capital advanced depends on a number of variables, including:

- The length of the revenue share period
- The percentage of gross revenue purchased (typically 5% - 25%)
- Historical and anticipated asset growth and volatility of the firm
- Asset mix and fee stability of the firm
- Qualitative factors such as management depth and infrastructure

Advantages of RSI's include:

- Risk sharing – the RSI investor is truly a partner in the successes and disappointments of the business
- Terminating revenue participation – full upside of the business reverts to the owners without any balloon payment after the RSI period expires
- Owners never give up control – AMF owns no equity in the firm
- The RSI is normally not a recourse obligation of the principals
- The RSI investor is truly a silent financial partner – management has autonomy and fewer restrictive covenants
- Owners enjoy the benefits of margin expansion during the RSI period
- Structural flexibility to meet the manager's objectives – possible follow-on or serial transactions

I also believe that this is a good time in the development of the investment management industry to sponsor mechanisms which preserve independence and autonomy:

1. The experience of consolidating acquisitions in the 1990's was extraordinarily poor for buyers, sellers and clients. There is a natural backlash in progress which I believe will lead to an accelerated pace of spin-offs/divestitures of money managers by large corporate owners.

2. Clients are thirsting for unique, highly skilled and completely autonomous firms as a better way to achieve their performance goals. Never has so much sophisticated money worked so hard to find new and exciting firms with whom to entrust their accounts.

3. Distribution is often a problem for medium-sized, independent firms. But today:
    a) Large, sophisticated and experienced clients are willing and able to search out smaller "unique" firms.
    b) Large, powerful distributors are more often separating their distribution function from the investment management function – for the betterment of both. The performance is better and, as a result, the sales of the product are better.

I believe that moving in this evolving ownership direction has profound implications for the industry:

To begin with, it can be a "perpetual motion machine." The endgame does not have to be a conventional sale of the firm. The process of creating expiring RSI's can continue indefinitely as long as there are margins to support it. The RSI investor should limit its percentage of revenues to one-half, or less, of the firm's natural margins. This is in order to assure that the firm's management has strong incentives to perform and grow and the resources to withstand margin shrinkage if and when it occurs.

RSI's are extraordinarily flexible. They can be used on a "project-by-project" basis to liquefy owners partially or completely, one by one, or in groups; gradually year by year, if desired. And with liquidity for some can come transfer of equity to others.

Since RSI's expire, they can, in effect, be recycled.

Now let's discuss some of the special features of RSI's:

1. They are not appropriate for start-up firms. The models require at least five years of history. In addition, a start-up firm has no profits to capitalize.

2. Generally firms will need at least $500 million to $1 billion of assets under management in order to have adequate margins.

3. RSI's can be used with private equity firm investments in money managers. When the private equity firm invests, the RSI investment can provide a form of mezzanine financing – much more flexible and sophisticated than bank debt. When the private equity firms wants to cash in (5 to 7 years later?), RSI's can be used by the management to take them out and restore full management control.

4. RSI's can be useful to take out original start-up investors (backers) when the firm becomes more mature or take out retired partners when they are no longer active.

5. RSI's have some attractive tax features. In most cases, if the original payment made by the RSI investor is removed by one or more of the principals, they will receive capital gains treatment. Also in most cases, 85 to 95% of the subsequent revenue share payments made by the firm to the RSI investor will pass before the tax line.

I believe that the natural market for this product is some 2000+ independent investment management firms, including hedge funds and alternative asset managers, with $500 million to $40 billion under management. In addition, there are an unmeasurable number of subsidiaries, affiliates and divisions of large financial institutions which are candidates for divesture.

The majority of these firms emphasize institutional investment management, but high net worth managers and mutual funds may also present significant opportunities. The list includes scores of non-US firms: in Canada, the UK, Continental Europe, Australia, perhaps even other far eastern countries.

Studies seem to indicate between 100 and 150 transactions a year in the investment management business over the last 3 to 5 years. One could easily believe, given the non-invasive nature of an RSI transaction, that RSI's could double the number of annual transactions in the industry.

Another feature which may enhance the use of RSI's is their ability to be executed in small units once the original research and due diligence has been completed on a firm. Liquidity events and equity transfers can be undertaken for a single partner of a firm and executed on a serial basis.

My hope is that RSI's represent an instrument that will revolutionize the ownership structure and pattern of the money management industry; changing it from a consolidating industry into one where permanent independence with evolving and renewing leadership is not only possible but prevalent. Where creativity, client focus and high levels of satisfaction for clients and professionals alike is the rule rather than the temporary exception.

But to paraphrase and old motto: "the big will always be with us." By that I mean that investment management activities conducted by large financial entities are not going away. In a relative sense, they will still be thriving. The long-term growth of "assets under management" in the money management business will continue, despite the present interruption, at rates equal to or, more likely, greater than the growth of the economy as a whole.

Therefore, major financial institutions are going to continue to aspire to a share of this growth. The Bank of America's, JP Morgan's, Prudential's, Met Life's of the world will continue to grow in this attractive industry, even if their shares of market do not.

But, in my view, the era of their dramatic growth in market share ended in the late 1990's or early 2000's. This is not to say that relatively large firms devoted almost entirely to money management such as BlackRock, Legg Mason, Fidelity, The Capital Group, T. Rowe Price will not continue to thrive. But despite the occasional Bernie Madoff, the market share of independents will grow.

However, the character of the industry will evolve as individual money managers become more complex and capabilities which today tend to be separate and specialized, come together in larger independent firms. In addition, certain trends of the last 20 years will change, if not reverse outright. Among these are trends toward accepting reduced marketability, using more leverage and ever higher fees and more exotic investment instruments.

The traumas of the past two years will undoubtedly lead to a certain degree of reform in regulation, client discipline and manager discretion. I have to believe that this is all to the good. We've continued to be reminded periodically that completely untrammeled capitalism is not usually best in the long run. And in no industry does the client need clear ground rules more urgently than where the management of his or her assets is involved.

After all, we are talking about the “life savings” of individuals and institutions who often cannot easily replace major losses. Capital has become the source of more than protective reserves as it was 50 or 100 years ago. Today, for many it is the source of daily support to vital and meritorious operations and activities. Think daily survival of a lifestyle. Think education of scholarship dependent students. Think charitable activities of foundations.

So the future money management business I see from here will face certain changes which may look as follows:

1. More, but hopefully, <u>wiser regulatory protections for investors</u>. Not guaranties against losing their money. These are, of course, impossible. But protections against many types of fraud, excessive use of leverage and non-transparent illiquidity.

2. <u>Limitations on the use of certain types of “toxic” derivatives</u>. Banning derivative products willy nilly would, of course, be absurd. Many provide useful hedging opportunities, especially to professional investors and traders. But the use of nuclear armed, highly leveraged instruments in cases where a more public participant is ultimately at risk will become unacceptable.

3. <u>A decline in the use of leverage in portfolios</u>. In many cases most of this leverage has been invisible from the surface view of the clients It has been deeply imbedded in underlying investments and sub-portfolios. These instruments will be reformed and “tamed” to reduce their potency if things go wrong. This will, of course, reduce the positive impact when things go right. But that will be deemed to be an acceptable tradeoff.

4. <u>Greater portfolio liquidity</u>. This is a pet peeve of mine. Early in my career as a money manger, I took over a fund which held a meaningful percentage of private placement fixed-income securities. The conclusion which I and my bosses reached was that the inability to dispose of these holdings when we chose to was worth more than the somewhat higher current returns they produced. Our conclusion was to sell them.

   Beginning 20 years ago or so many endowment and foundation clients became convinced that accepting illiquidity in investments was an acceptable trade off for higher returns. At that time it was, and they were rewarded. But now, and with much less leverage available to private equity investors, the worm seems to have turned. The private equity game has become tougher and the rules have changed. Greater liquidity in investments will be more prized in the future.

5. More regard for "black swans" and "fat tails." Probably the biggest investment story of our time is that just because a sequence of events has low probability doesn't mean it can't happen. The biggest stories of 1998 and 2008 were probably that the unexpected can, and eventually will, happen and portfolios need to have enough resilience built in to survive these events periodically. Not in someone else's lifetime but in ours.

6. Finally, candor and evenhandedness was too often suspended in the recent bull market for money management talent. I believe in this talent, but I worry that the quest for outsized rewards for successful managers has led to overpromising in the interests of extracting higher fees. The result may be what we have now. Hedge fund managers, by and large, performed pretty well in 2008 but their promises were for even better performance (in order to justify ever higher fees?) and those even better results didn't happen. The future will require more candor and more reasonable rewards for the new breed of managers.

Thank you for letting me share my thoughts with you. As you can tell, I believe that the culture of outstanding investment management performance demands freedom, independence and entrepreneurial instincts in its practitioners. But I also believe that freedom can't translate into license. Reasonable regulation and responsible restraint will be part of the future of money management. With these reforms in place there will still be lots of opportunity for solid client performance and attractive investment manager rewards.

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