

SEPTEMBER • 2010

Perspectives on the Investment Industry

IDENTIFYING FINANCIAL AND BUSINESS OPPORTUNITIES

Carpe Diem: Successful Managers Identify Opportunities – in All Market Conditions – then Seize

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Executive Summary

The investment management industry is crowded with managers offering comparable investment products and services. In this competitive and dynamic environment, the majority of managers can certainly enjoy a measure of success. Lasting success, however, is reserved for those managers that constantly scour the market for opportunities, and importantly, act in a timely manner.

Opportunities for investment managers—both financial and business—exist in all market conditions. Firms that capitalize on these opportunities rather than sitting passively on the sidelines generally will be rewarded over the long-term.

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Opportunities Exist in All Market Conditions

The investment management business lures talented, competitive professionals with its offer of a dynamic environment, intellectual challenge and lucrative financial potential. Not surprisingly, the industry is crowded, exerting pressure on managers to differentiate themselves from the pack. While investment performance is a key differentiator among investment firms, it's inherently cyclical. That's why managers that seek and seize opportunities in all aspects of their businesses achieve lasting success.

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Let's first consider financial opportunities.

MARKET CYCLES

Opportunities in Asset Class Ebbs and Flows

Over the past few years, real estate and mortgage securities have battered the U.S. and global economies, casting a cloud of uncertainty over the investment management industry. During this time:

- ▶ Hedge funds were hit with significant redemptions.
- ▶ Illiquid investments, such as private equity, created greater challenges because of commitments.
- ▶ Many liquid securities suffered losses far worse than expected as they were sold to raise cash for other obligations.

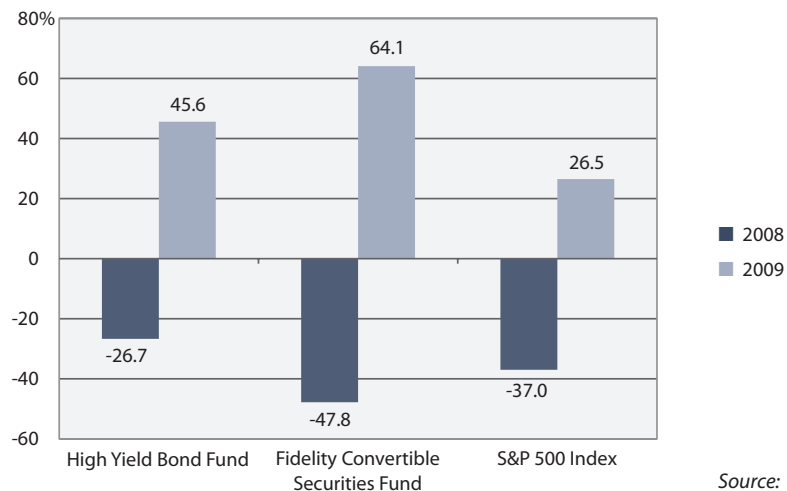
Then suddenly, low-risk and low-return vehicles—anything with a near-zero return during the 2008 collapse—became desirable. As with most bubbles, the release of pressure and resulting plunging asset values were extremely painful and more rapid than the build-up. Many managers are experiencing prolonged effects from this recent crisis due largely to their resistance to make decisions, resulting in missed opportunities.

While it's important for investors to act, they must resist the urge to act out of fear or pressure. A common mistake for investors is to react emotionally—panic—which often leads to a chain reaction in the industry: managers follow the crowd, and inevitably, suffer as a result. Rational investors understand that strategic thinking, sound investment policies and thoughtful decisions are critical to long-term success.

Successful managers remain level-headed as asset classes naturally cycle in and out of favor, understanding that severe losses often are followed by impressive gains. While market timing is intrinsically risky, the opportunities that exist after disappointments are undeniable.

As chart 1 illustrates, the average high yield bond fund lost 26.7% in 2008 then gained 45.6% in 2009. In 2008, convertibles declined considerably because of their equity-like exposure; Fidelity's Convertible Securities Fund fell 47.8% followed by a 64.1% rebound in 2009. In this environment, investors with the appropriate risk tolerance and financial security would have benefited from a rebalance toward convertibles. 2009 was also a notably strong year for equity markets on the heels of an abysmal 2008, with the S&P 500 Index posting a 26.5% gain, following a 37.0% decline.

Chart 1: Annual Returns (2008 and 2009)



Judicious growth equity investors often aim to take advantage of market meltdowns, which leads to a short-term opportunity to purchase stocks in attractively growing companies. These companies are commonly called ‘dream stocks:’ affordable stocks that had previously been too expensive. Ultimately, skilled asset managers add value to their clients by offering opportunistic funds and/or, identifying and investing in bargains created by market turmoil.

We’ll now shift our attention to potential business opportunities.

BUSINESS EXPANSION

Opportunities in New Businesses, Lift-outs and Acquisitions

In addition to capitalizing on dislocations in the investment markets, managers also have opportunities for business expansion through lift-outs, acquisitions and organic growth that require both thoughtful analysis and effective execution. Unfortunately, since 2008, a “hurry up and wait” mentality has permeated the investment industry; an experience akin to boarding an airplane. At boarding time, passengers proceed down the ramp, only to bump up against a mass of people waiting, often impatiently, to

board the plane. This painfully slow and frustrating experience is characteristic of most firm’s decision-making processes, with final action being deferred as long as humanly possible—resulting in missed opportunities.

Some investment managers are uncomfortable in the current environment. Many others are busy ‘hurrying up and waiting’—finally deciding to act then over-analyzing, and ultimately, acting so slowly that they lose momentum. Firms that correctly perceive the opportunity and act will succeed in the long-term, able to expand markets and capture significant market share.

Hedge Funds

Turning our focus to hedge funds, we see a group of managers often thought to harness money from other managers. However, as Richard Bookstaber noted in *A Demon of Our Own Design*, hedge funds supply liquidity for certain investments, which is an important role in the marketplace. By virtue of their construct, hedge funds tend to be nimble—even if leveraged—which means they often are able to take advantage of disequilibrium.

Hedge funds, which are typically less burdened by both internal processes and external factors than larger organizations,

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have more flexibility to capitalize on investment opportunities that are often fleeting. Large organizations frequently require more time to vet an idea, make a decision and act. In addition, large corporations are often more significantly impacted by external factors—political and financial. A recent example: Citigroup decided to rein in its risk-oriented posture and eliminate proprietary traders. Without hesitation, hedge funds identified this situation as a hiring opportunity, with long-term benefits.

New Businesses

Generally speaking, when a financial organization exits a business because it's unable to assume large risks, such as insurance, an opportunity arises for another firm. In this case, a smart competitor, willing and able to accept the risks, can expand its market share—and typically with the higher profit margins associated with less competition.

Lift-Outs and Acquisitions

In addition, money management firms can benefit from a lift-out or acquisition. As would be expected, multiples paid for investment firms decreased substantially during the economic crisis. According to Jefferies' "On The Road Again", the U.S. traditional public asset managers were priced at 18.9x forward P/E in 2007, declining to 11.0x in 2008. An agile firm with a solid sense of its goals and tactics can capitalize on this pricing to build long-term value. These multiples compare far more favorably than the deals priced during stronger markets, which means that companies can make acquisitions at prices that are significantly more reasonable.

To illustrate this point, let's look at Jefferies' deal value and assets under management (AUM):

- ▶ BlackRock paid \$9.38 for every \$1,000 of BGI's AUM in June 2009.

- ▶ This amount is half of the \$18.61 BNY paid for each \$1,000 of Mellon's AUM in December 2006.
- ▶ BlackRock paid roughly 25% less for 50% more AUM: \$13.502 billion for \$1.440 trillion of AUM versus \$17.619 billion for \$947 billion in the BNY-Mellon deal.

Firms interested in lift-outs or generating new businesses are encouraged to carefully explore these options; the strategy of paying for success—both in past performance and AUM—can certainly work well. Not unexpectedly, however, many investment firms prefer the predictability of knowing the up-front costs; the alignment of revenues and costs adds stability. This also can allow a company to close a deal, while others are waiting on the sidelines for a better situation, and consequently, missing opportunities.

PERSONNEL

Opportunities in Staffing

The same concept of waiting on the sidelines is happening in the hiring process. Economic conditions forced many firms to cut staff in 2008. A majority of these firms weren't ready to rebuild staff in 2009. The few firms that began to re-staff noted that given the employer-to-employee ratio, it was worthwhile to move forward cautiously; employers were able to hire from a large pool of qualified candidates at lower salaries than in the past.

2010 has seen an up tick in hiring, with the general opinion being that it's smart to defer decisions as long as possible. This mindset was sensible when the available labor pool was rapidly increasing and salaries were decreasing. However, a lengthy decision-making process—whether to hire or add resources—can delay a firm's ability to successfully implement strategic plans.

Furthermore, over-analyzing the hiring decision can increase the likelihood of either losing the right candidate or hiring the wrong person. Timely, yet informed decisions enable a firm to reap the benefits sooner.

REVENUES

Opportunities to Balance Excess Returns and Raising Assets

A constant challenge for firms in the quest to grow and sustain its business is the fact that revenues are primarily influenced by market returns, which are outside any firm's control. Successful firms both recognize and navigate this challenge, seizing opportunities as often as possible.

An equity manager's revenues are based on its assets under management, which will fluctuate based on a combination of:

1. **Returns:** equity market returns
2. **Value-added:** value-added to clients' portfolios relative to the market
3. **Changes in AUM:** percentage increase or decrease in assets due to flows from existing accounts, new accounts and terminations

The first factor—equity market returns—is a variable, yet critical determinant of current and future revenues. However, market conditions, which largely drive returns, are out of any manager's control. That's why managers should focus on the factors they can influence—adding value and AUM—with proper business planning and execution. However, it's important to realize that regardless of asset class, investment firms that are compensated on a percentage of assets face the conflict between the second and third factors: provide excess returns and raise new assets.

The inherent conflict between the pressure to provide excess returns and raise new assets is due to the fact that managers often focus on one at the exclusion of the other. For example:

- ▶ If a firm focuses primarily on performance—with an understanding of the importance to raise assets—most decisions will be geared toward generating outstanding performance. At the same time, there will be recognition of the need for the investment professionals to engage in some degree of marketing and client service.
- ▶ On the other hand, if a firm's main goal is to raise assets, the investment professionals will direct an inordinate amount of time to marketing trips and meetings instead of managing clients' assets. In this case, performance will likely suffer.

So, how's a firm to handle this challenge?

Time Horizon

First, firms should consider the time horizon. A money manager with a long-term focus that is both sufficiently diversified and confident, despite the ever-changing nature of the business, will win by building the business strategically with a far-seeing mindset. This vision pertains to decisions regarding product offerings, including asset classes and specific investment strategies, research and technology, and distribution capabilities. When opportunities to augment a firm's long-term capabilities develop, it's essential to seize them in light of time horizon. Of course, clients evaluate managers based on quarterly results or even more frequently; therefore, a sprinkling of shorter-term considerations is necessary.

For instance, when a firm commits to its real estate lease, it should consider the

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length of the commitment. Even a firm with a long-term view may benefit from employing a conservative shorter-term lease. As the firm grows, more space likely will be necessary; too long a lock-up may lessen flexibility. Furthermore, a shorter-term lease helps avoid a mismatched lease term and rent price relative to the firm's financial situation, as its assets under management fluctuate.

Variable Expenses

Second, firms will want to carefully analyze their revenue stream then structure as many variable expenses as possible. Several years ago, there was a movement among investment firms to outsource the operations function to firms with this expertise. Essentially, money managers can benefit from a high level of operational expertise that is difficult to build and maintain internally, while paying a variable rate.

The concept of variable costs is effectively used in distribution compensation whereby many organizations pay a reasonable base salary plus commission. Essentially, the commission structure aligns the interests of the organization with its sales people, rendering the costs more variable. Firms are increasingly applying this compensation structure to investment personnel who receive a substantial bonus for excess returns, but little or no bonus otherwise. Higher returns should lead to higher assets, albeit with a lag, so it can even make sense to apply a component of a longer-time horizon to this compensation structure. Broadly speaking, firms that implement variable cost pricing throughout budgets increase the probability that they can survive the long-term, which will inevitably include challenging periods.

Firm Culture and Structure

Finally, culture and ownership structures differ among firms, with partnerships more often formed with the intention to maintain a pre-determined size. This is an investment-based mentality, with the idea of keeping an eye on the proverbial ball of excess returns. While these firms often have a specific idea about maximum firm size, in terms of assets managed or employees, they must be mindful of the fact that a correction in their investment market can wreak havoc on revenues. As such, these firms should consider maintaining a cushion during times of strong returns, which is reinvested in their business.

Publicly owned firms and their subsidiaries often feel more pressure to grow the business, which exerts stress on the third component of the equation: asset gathering. However, firms need to balance this pressure with the fact that clients largely seek money managers that will add value through market outperformance. Mindful acceptance of limits for products is especially beneficial, and can direct these organizations to invest in new, promising products. By doing so, and by marketing strategies that offer a unique opportunity to clients, a firm can enhance its reputation as being client-focused and service-oriented.

Conclusion

Time is money—and of the essence—in the investment industry. Investment managers with staying power are able to both think and act in a timely manner instead of sitting passively on the sidelines missing powerful opportunities. A thought or idea, however, is only as strong as its execution. The sooner a firm implements, the sooner it will reach its goals. ■

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