

October 2003

# Success In Investment Management: Three Years Later

- **This is a continuation of our June 2000 industry perspective.** We confirm and enhance our earlier conclusions.
- **The investment management industry has entered its Third Generation.** This new environment will foster a significantly reshaped competitive landscape.
- **Five primary forces of change are driving this generational transition:**
  1. Extended duration of investors' discontent
  2. Evolving intermediaries
  3. Continued high mobility of talent
  4. Vulnerable competitors
  5. Activist enthusiasm
- **Business leaders must embrace five principles to navigate this new environment:**
  1. Investment quality reigns
  2. Efficiency energizes talent
  3. The Client-Partner-Competitor (C-P-C) paradigm connects us all
  4. Relationships matter
  5. Alternatives are mainstream
- **Successful firms will be "Complete Firms."** They will balance excellence in investments, distribution, and business management and will employ one of four basic business models that reflect their core competency.

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## Authorship

Casey, Quirk & Acito and the Merrill Lynch Financial Institutions Group jointly prepared this paper.

Casey, Quirk & Acito contributors include:

John F. Casey, *Chairman*  
Christopher J. Acito, *Principal*  
Jeb B. Doggett, CFA, *Principal*  
Kevin P. Quirk, *Principal*  
Mark C. Abrahamsen, CFA, *Senior Associate*

Merrill Lynch contributors include:

Gregory J. Fleming, *Managing Director,  
Co-President of Global Markets & Investment Banking*  
B. Andrew Hoover, *Managing Director,  
Co-Head of Global Asset Management*  
Richard Slimmon, *Managing Director,  
Head of European Asset Management*  
David N. Heaton, *Director,  
Co-Head of Global Asset Management*  
Richard Gibb, *Director*  
Jay Horgen, *Director*



### Casey, Quirk & Acito

Casey, Quirk & Acito (CQA) provides management consulting services exclusively to investment management firms. CQA specializes in business strategy and planning, developing and monitoring investment quality, and delivering market intelligence. CQA draws on 35 years of experience in delivering value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to create change within organizations.

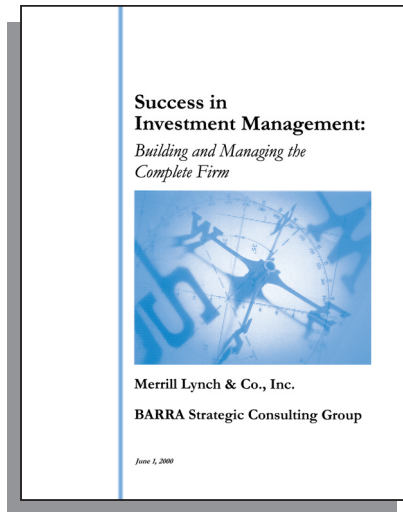


### Merrill Lynch

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## Introduction

In the fall of 1999, we set about examining how the investment management industry might evolve over the next decade. The result was a paper entitled *Success In Investment Management: Building and Managing the Complete Firm*<sup>1</sup>. To quote directly from its introduction:



*“This paper is motivated by our belief that the investment management industry is rapidly entering the next phase of its maturity. Over the past decade, the industry has enjoyed a period of extraordinary prosperity. The long bull market in equities and the increasing affinity for professionally managed investment products have allowed firms to grow assets under management and revenues with relative ease. An emerging competitive environment, driven by new technology and a reversion to more typical rates of market returns, will be far more challenging. Succeeding in this new environment will require the most significant shift in business management thinking since the first generation of investment managers emerged in the 1960s and 1970s.”*

– June 2000

At the time, June 2000, our thesis was controversial. The industry was by many measures incredibly strong, having enjoyed 25 years of relatively uninterrupted growth (1987 was a blip in retrospect), with the last several years providing exceptional prosperity. Such prosperity made it difficult to convince the leadership of most investment management firms that their businesses were not necessarily optimally configured to compete in the future. Every indication was to the contrary; virtually every business decision resulted in new asset flows. Few business leaders were willing to address some of the underlying inefficiencies in their own firms or in the industry as a whole. Few realized that the equity markets had peaked three months earlier, and even fewer predicted the bear market that would persist the next three years.

### WHY REVISIT THE PAPER?

Three years after the publication of that first report, why bother revisiting *Success in Investment Management*? Given all that has transpired in the markets and marketplace since the summer of 2000, and the very clear evidence that, in fact, many of the developments we had envisioned have come to pass, we felt that it was time to re-examine – indeed to challenge or reaffirm – the original paper. We also have developed a cumulative perspective which enables a far broader understanding of the industry and its trends.

<sup>1</sup> Our original publication was based in part on research and a series of interviews, which began in the fall of 1999. The paper was unveiled at the May 2000 Merrill Lynch Global Asset Management Industry Executive Roundtable and was published on June 1, 2000. At the time of the original publication, the senior members of CQA were part of BARRA Strategic Consulting Group.

## Acknowledgements

The authors presented the prelude to this paper at Merrill Lynch's 2003 Global Asset Management Industry Executive Roundtable in May 2003. The participants' insights were helpful in enhancing our conclusions.

In addition, 32 senior investment management professionals provided their thoughts in individual interviews in early 2003. We gratefully acknowledge their willingness to share their time and perspectives.

### INDIVIDUAL INTERVIEWEES INCLUDE:

John P. Amboian	President	Nuveen Investments
John M. Angelo	Chief Executive Officer	Angelo, Gordon & Co.
Keith T. Banks	Chief Executive Officer	Columbia Management Group
Jessica M. Bibliowicz	President & Chief Executive Officer	National Financial Partners
Charles W. Brady	Executive Chairman	AMVESCAP
John J. Brennan	Chairman & Chief Executive Officer	The Vanguard Group
Jeffrey A. Busby	Co-Chief Executive Officer	Brandes Investment Partners
Glenn A. Carlson	Co-Chief Executive Officer	Brandes Investment Partners
Robert A. Day	Chairman & Chief Executive Officer	The TCW Group
Richard M. DeMartini	President of Asset Management	Bank of America
Robert C. Doll	President & Chief Investment Officer	Merrill Lynch Investment Managers
Kenneth L. Dowd Jr.	Director of Investments	Citigroup Asset Management
Dr. Joachim Faber	Chief Executive Officer	Allianz Dresdner Asset Management
Tim Ferguson	Senior Managing Director	Putnam Investments
Martin L. Flanagan	President	Franklin Resources
Mario J. Gabelli	Chairman & Chief Executive Officer	Gabelli Asset Management
Blake R. Grossman	Global Co-Chief Executive Officer	Barclays Global Investors
Charles E. Haldeman Jr.	Senior Managing Director	Putnam Investments
Jeffrey B. Lane	President & Chief Executive Officer	Neuberger Berman
Robert Matza	Executive Vice President	Neuberger Berman
Duncan McFarland	Chairman & Chief Executive Officer	Wellington Management Company
William J. Nutt	Chairman & Chief Executive Officer	Affiliated Managers Group
Scott F. Powers	Chief Executive Officer	Old Mutual (US) Asset Management
Robert C. Puff Jr.	Chairman	American Century Investment Management
Robert L. Reynolds	Vice Chairman & Chief Operating Officer	Fidelity Investments
James S. Riepe	Vice Chairman	T. Rowe Price Group
James F. Rothenberg	President	Capital Research & Management Company
Timothy R. Schwertfeger	Chairman & Chief Executive Officer	Nuveen Investments
Jeffrey L. Shames	Chairman	MFS Investment Management
Perry M. Traquina	President	Wellington Management Company
Keith A. Tucker	Chairman & Chief Executive Officer	Waddell & Reed Financial
Thomas M. Turpin	Executive Vice President	Old Mutual (US) Asset Management

As noted in the Acknowledgements (page 2), we were aided in this initiative by interviewing senior industry practitioners from a diverse set of 26 firms whose insights and experience were helpful in testing the work we had done three years ago and the state of the industry today. We asked each to focus on a few key strategic questions, including:

- What have been the most dramatic industry changes over the past three years?
- What are the greatest opportunities and challenges?
- How is your firm addressing this changing environment?

We concluded that there were at least three good reasons to revisit *Success in Investment Management*:

- **Accuracy.** We discovered the fundamental ideas presented in the original paper continue to be sound. Our current edition, therefore, contains no intellectual backtracking; the report has been updated, but the core principles remain intact.
- **Timeliness.** The industry did not receive an epiphany at the top of the market in 2000. Rather, it has passed through three stages of grieving. An initial period of *denial*, dependent on a hope for recovery, was followed by a wave of *anger* in which short-term decision-making (such as cost-cutting) dominated. The industry has only recently entered a period of *acceptance* of a new competitive environment. Investment firms are beginning to re-address the core challenges of growing their businesses in what we believe is a real and fundamental “return to strategy,” whether it be developing new business plans, filling product and marketing gaps, or considering acquisitions. The “Third Generation” is no longer a forward-looking possibility, but is being accepted as a current reality.
- **Opportunity.** The third, and perhaps most important reason in terms of our decision to revisit these themes, is our sense that the new reality is offering enormous opportunities for well-managed, high-quality firms who are positioning themselves to take significant market share from weaker competitors.

Thus, we are pleased to re-offer *Success in Investment Management* as a practitioner’s guide to real business decision-making in the Third Generation.

## ORGANIZING OUR THOUGHTS

We organize our thoughts in three chapters, summarized in Exhibit 1 on the following page.

Chapter 1 presents five primary drivers of industry change. These are exogenous forces and secular trends that we believe will be the dominant influence on the competitive landscape for the foreseeable future. We call this new environment the Third Generation.

## Exhibit 1: **Outline of *Success in Investment Management***



Chapter 2 describes five key principles that senior leaders of all investment management firms must understand in order to navigate the challenges of the Third Generation. Applying these principles, we believe, will help senior executives in the investment management industry make better strategic decisions.

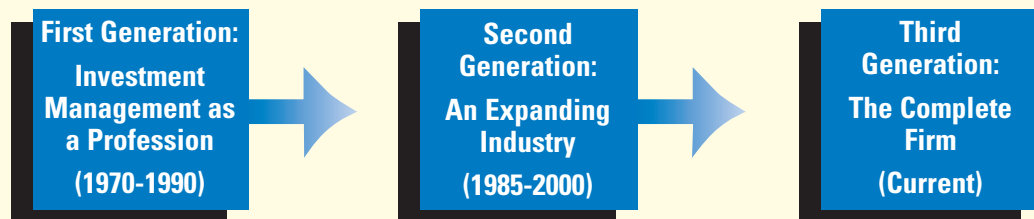
Chapter 3 summarizes the attributes that will characterize all successful Third Generation investment management firms – what we call “Complete Firms” – and presents four viable and distinct business models that these firms are likely to adopt to accentuate their core competencies.

It should be noted that, while we draw heavily from the U.S. experience, we believe our exposition to be applicable to all geographical markets and client segments.

## Chapter 1: Forces of Change

This chapter briefly summarizes the evolution of the investment management industry over the past thirty years. We organize our perspective in Three Generations (Exhibit 2). We then analyze the five primary external forces currently driving the transition to the Third Generation.

### Exhibit 2: Three Generations of Investment Management



### Three Generations of Investment Management

In the late 1960s, fifteen to twenty large banks, trust companies, and insurance companies dominated the nascent modern business of money management. For most wealthy individuals and institutions, “money management” consisted of only simple bond and equity portfolios often managed for little charge within the context of a broader relationship.

By the early 1970s, three events catalyzed the *First Generation* of the investment management business. First, was a growing realization in the U.S. that demographic trends would cause retirement systems to become vastly underfunded if action was not taken. Second, was poor stock market performance of 1973-74. Third, was the enactment of the Employee Retirement Income Security Act (ERISA) in 1974 that, among other things, required the prudent management of pension accounts.

The prototypical large financial institutions of these early days severely underperformed relative to investors’ expectations in 1973-74. As a result, institutional (and then individual) investors began looking for new service providers, creating a huge opportunity for those with investment management skills. Given the industry’s low barriers to entry, the First Generation was characterized by the birth of boutiques. These firms consisted of small teams of investment professionals, many whom had left the confines of larger financial institutions, and who typically focused on one style of management. Although a volatile capital market environment existed from 1977-83, many of these firms attracted assets based on their perceived professionalism and personae.

The *Second Generation*, which began in the mid-1980s in the U.S. and has lasted until very recently, was propelled by an enormous increase in the demand for investment management services. Sources of demand included the continued funding of both private and public defined benefit pensions, the advent and near universal acceptance of defined contribution plans, and the rise of mutual funds and the individual investor. In addition, the steady rise in the equity markets swelled existing assets under management.

In the Second Generation, investment managers were presented with unprecedented opportunities to expand their franchises. Many boutiques, founded by small groups of individuals and centered on a narrow product line, grew into complex business organizations, through rapid organic growth and acquisition. Numbers of personnel began to increase rapidly. For example, the emphasis on growing put a premium on pure asset gathering and, as a result, firms began to accumulate sales professionals. Additionally, firms that were previously focused exclusively on mutual funds began to develop relationships with the institutional marketplace (and vice versa).

The most significant expansion arguably has come within the investment functions. Many Second Generation investment management firms added teams to manage asset classes in addition to their original focused capability. Individual teams became larger in order to support a proliferation of products and to satisfy the demands of consultants (who began to expect significant depth within portfolio teams and research departments). New investment technology and quantitative research added still further to the investments infrastructure.

Yet, despite the increased organizational complexity, many firms managed themselves in a manner similar to the First Generation. Leadership was often provided by the most senior investment professional (typically a founding partner of the firm with little or no formal business management experience). Decision-making was too often either dictatorial or an inefficient consensus-building process among the partnership.

Second Generation firms are, therefore, broadly characterized by relatively overdeveloped, overstaffed and/or unnecessarily complex investment functions (relative to distribution), immature business management skills, high costs, and a proliferation of mediocre products.

**Bull markets hide inefficiencies**

How have the excesses (and limitations) of the Second Generation persisted for so long? Stated simply, the bull market's riches hid these inefficiencies. From 1982 through 1999, the S&P 500 produced an average annual return of almost 20% with only one negative year (-3% in 1990). Such success lulled clients into complacency and provided managers with little motivation to change their business practices.

We believe the investment industry in the past three years has begun a rapid transition to a *Third Generation* that reflects an inevitable industry maturation. Driven by a confluence of forces (each discussed in the following section), firms must confront a more challenging competitive environment in which markets may be less friendly, opportunities for new growth will be less frequent, and clients are significantly more sophisticated.

We believe that this generational transition will be seen in all geographies and is also applicable to all market segments.

## What's Driving Change?

Five forces are fundamentally shaping the industry's competitive dynamics and will profoundly influence the capabilities required for future success:

- Extended duration of investors' discontent
- Evolving intermediaries
- Continued high mobility of talent
- Vulnerable competitors
- Activist enthusiasm

We view these forces as the primary "facts of life" in the Third Generation.

## EXTENDED DURATION OF INVESTORS' DISCONTENT

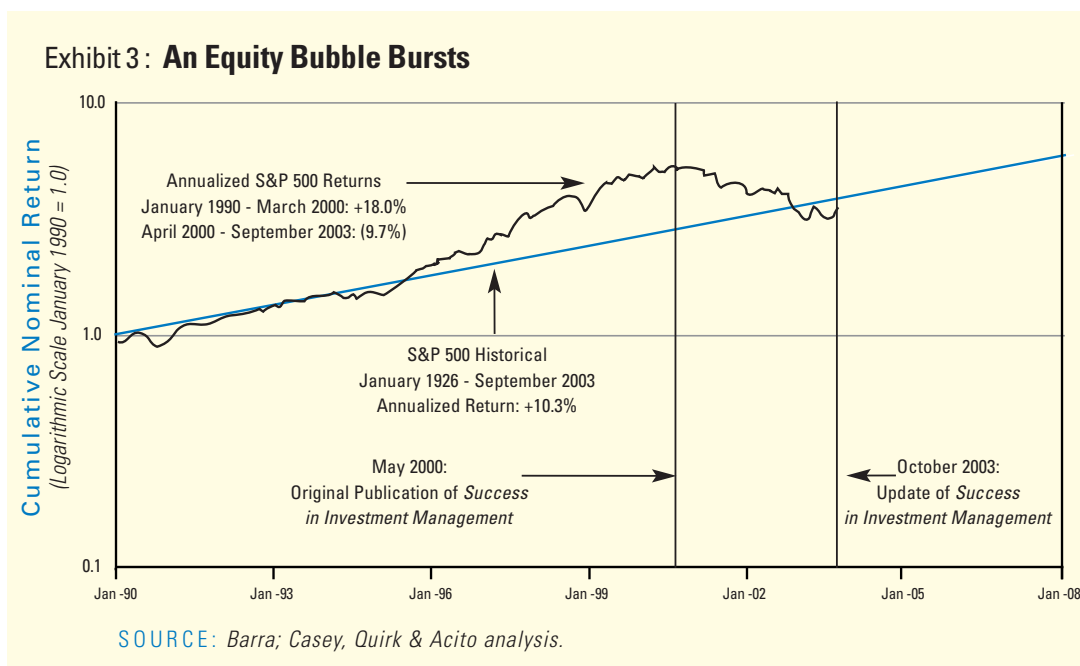
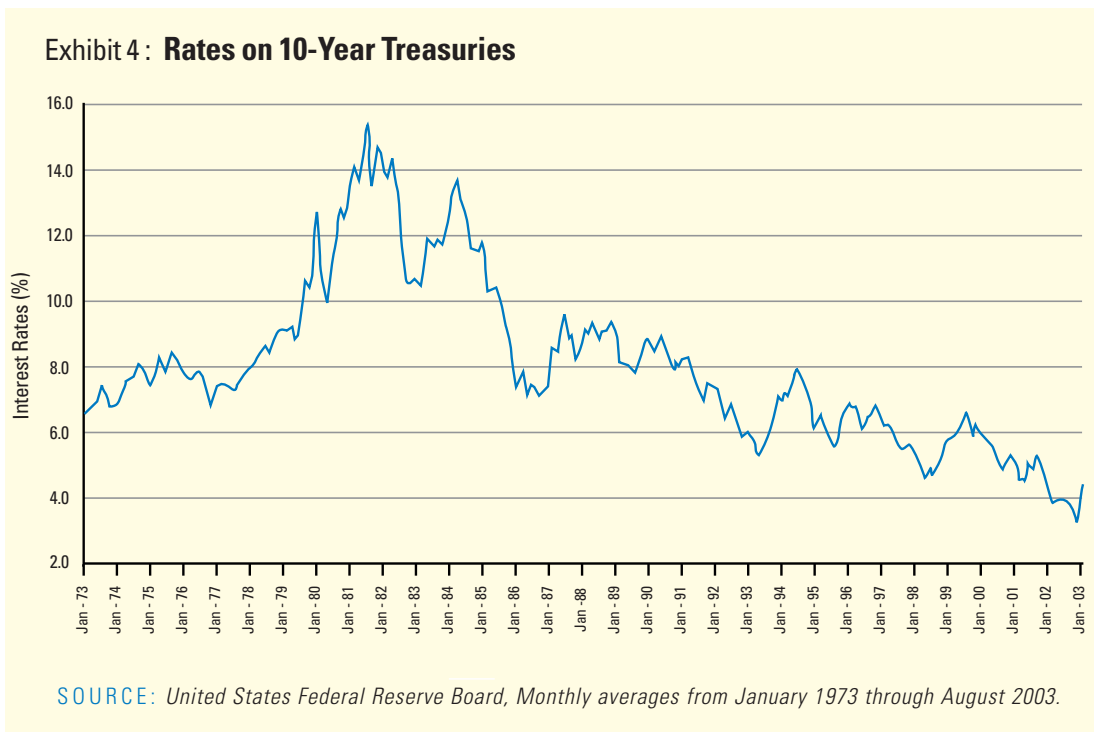


Exhibit 3 recaps the most dominant market feature of the past decade: the bubble in equity prices. The solid, gradually sloping line represents the average nominal return to the S&P 500 equity index since 1926, approximately 10% per year. The jagged line plots the actual S&P performance since January 1990. Clearly, the market had pushed well beyond its historic trend – remember that the scaling is logarithmic – reaching a peak in March 2003. The market then falls over the next three years, returning approximately to the historic trend line at the time of this paper's publication. (Readers can decide for themselves whether the fact that the peak and return-to-trend correlates closely to the initial and current versions of *Success in Investment Management* is prescient or coincidental!)

A long-term investor might interpret this chart optimistically: “equities are at levels I expected them to be when I made my investment years ago.” Also, since the historic record indicates that bubbles deflate over the approximately same length of time as their rise and do not typically go below the trend line, we might now expect historic rates of appreciation.

It is, unfortunately, difficult to be so sanguine about the past three years; rather, we believe that the impact on most investors’ behavior will be significant. The bubble’s burst was severe in both magnitude and duration, producing the first sequential years of negative returns since 1973 and 1974. Even for the longer-term investor, the volatility has been jarring. For the more recent investor, the experience has likely produced a great psychological shock. The consequences have been all too real: retirement, consumption, and planned giving have been postponed or forgotten; corporations have channeled earnings to cover gaps in pension funding.

Might our investing culture be abandoned, at least temporarily? There is precedence: the retail investor shied away from the equity market for most of the decade following the 1973-74 decline. Even a modest, near-term appreciation in the equity market may inspire investors to ultimately liquidate rather than put more money to work. An additional challenge is the realization that bonds have similarly enjoyed a “wind at your back” secular return environment. (Exhibit 4 reminds us how high bond prices currently are.) A decline in bond markets may be the final straw for some investors.



However, even if individuals and institutions remain fully invested, we are convinced that there has been a significant change in client preferences and outlook. As examples, we see fundamental re-evaluations of asset allocation tenets, increased demand for advice, and greater interest in solutions that provide capital preservation. The impact of this “duration of discontent” may be measured in years, not months, and has manifest implications for the industry.

The owners of investment management firms also directly feel the discontent. Compare the actual revenue performance at the end of 2002 to the typical three-year business plan created in 1999; for our hypothetical firm, projections fell short of past “conservative” expectations by over 30% (Exhibit 5). In addition, many firms have come to accept lower expectations for future growth, due not only to weaker capital markets but also less favorable demographic trends. The experience of the recent period is limiting appetite for new business activity.

#### Exhibit 5: Illustrative Business Projection: Investment Firm ABC

	1999	2000	2001	2002
<b>Projected year-end assets (as of 12/31/99)</b>	\$100,000	\$105,250	\$110,793	\$116,644
<b>Actual year-end assets</b>	\$100,000	\$96,086	\$90,345	\$80,173
<b>Projected yearly revenues (as of 12/31/99)</b>		\$360	\$380	\$401
<b>Actual yearly revenues</b>		\$339	\$315	\$277
<b>Revenue shortfall at end of each year:</b>		<b>-5.7%</b>	<b>-17.1%</b>	<b>-30.8%</b>

##### Assumptions:

- Hypothetical firm with \$100 billion AUM: \$75 billion equities, \$25 billion fixed income on 12/31/99, receiving fees of 40 basis points on equities and 20 basis points on fixed income.
- Projected scenario assumed to be created on 12/31/99. The scenario assumes 6% projected annual equity asset growth for 2000-2002 and 3% for fixed income.
- Actual asset returns are based on the S&P 500 for equities; Lehman Aggregate for fixed income.

SOURCE: Barra, Lehman Brothers, Casey, Quirk & Acito analysis.

How can this market-wide period of discontent be shortened? We believe a significant challenge of the new environment will be to resell the investor on investing. Quality firms will do the work necessary to win them back.

## EVOLVING INTERMEDIARIES

A broad range of intermediaries sits between investment management firms and their clients. These intermediaries include retail financial services firms and pension consultants. Investment management firms must recognize that the role intermediaries play for their clients is changing significantly.

Historically, the role of most intermediaries has been as a broker of financial services. The *broker model* has typically been focused on efficient intermediation, relying on the core skills of transaction processing, provision of data and research, and offering access to investment products. Payment for these services has generally been on a commission basis.

Currently, intermediaries are transforming themselves into advisors, providing comprehensive and holistic financial services planning services. The benefit of this *advisor model* is that it allows an intermediary to control a larger portion of their clients' portfolios. The transition is also a defensive one: technology and intense competition are commoditizing the broker's core activities, leaving objective advice as the primary source of value-added.

While this broker-to-advisor transition has been predicted for years, what is interesting and important is the speed at which it is occurring today. Why didn't the true advisor model develop earlier?

### Advisors are replacing brokers

There has been (until recently) little motivation for change. In the bull market, only a small premium was put on advice. Investing entailed seemingly little risk (i.e., all security valuations were going up), and there was little incentive for seeking professional guidance. The market returns over the last three years have changed this. The transition is no longer optional – clients are flocking to true advisors. Most intermediary groups are highly focused on managing this transition, though none view it as complete at the current time.

As the onus of objective advice is put upon intermediaries, they are applying greater scrutiny to the managers with whom they work, including those affiliated under the same brand name. Acting more as gatekeepers than conduits, intermediaries have accumulated significant resources dedicated to the evaluation and selection of investment managers and their products. Investment processes are being assessed with increasing rigor and professionalism, and advanced analytics are employed to properly assess historical performance. In addition to a higher quality investment product, investment managers must also provide greater and more sophisticated client service to their intermediary partners.

Not all current brokers will be up to the task of providing Third Generation advice. This will present opportunities for new market entrants to fill the gap between the increased demand for true objective guidance and the limited skills of traditional providers. For example, consider traditional pension consultants, particularly their manager selection and portfolio structuring activities. Many are coming under competitive pressure from the client advisory practices of money management firms, fund of funds, and capital markets desks. These non-traditional advisors are developing the skills to solve broader problems for institutional investors and have economic models that can support advanced technology and attract leading talent. Going forward, these parties will be proactively offering consultative client services – a heretofore taboo approach for fear of angering the important traditional players.

## CONTINUED HIGH MOBILITY OF TALENT

Beginning in the late 1970s, talent within the investment management industry has been highly mobile and able to seek opportunities that provide greater financial remuneration or professional satisfaction. Many have sought freedom from the inherent inefficiencies of larger, more established organizations. These opportunities have readily presented themselves in other existing firms or by starting new firms. Technology and the proliferation of outsourcing also are contributing factors in lowering the barriers to entry (or to moving) for talented professionals.

The portability of talent will continue to be a defining force in the development of the Third Generation. Witness, for example, the growth in the number of hedge funds, the number of venture

**True talent  
seeks maximum  
productivity**

investors willing to support new investment management firms, or the increasing use of “lift-outs.” Interestingly, aided by new technologies, we believe that there are also increasing opportunities for distribution personnel to work independently of the larger financial services houses.

In the Third Generation, investment management firms must be adept at creating the professional environments and long-term incentive alignments that are critical to attracting and retaining talent.

## VULNERABLE COMPETITORS

Today, we observe for the first time since the mid-1970s, a real and significant divergence between the strong and the weak in the investment management industry. Many firms are not well positioned for this new competitive environment. There are numerous root causes, including poor business leadership, quality of professional talent, and bureaucracy. Several firms are rather unstable, suffering from depressed cultures, lack of long-term financial alignment, loss of personnel, and damaged brands. Interestingly, some of the greatest second-generation success stories may be among the most challenged by the Third Generation.

**Complacency is  
risky in the new  
environment**

Healthy firms must now reverse their definitions of “aggressive” and “conservative.” With many competitors on their heels, we view a complacent business approach as high risk. Instead, it is an auspicious time to “double down” on investment in new and existing channels, products, and personnel. We believe this new environment will be unforgiving to lower-quality managers, who will no longer be sustained only through sizable equity market returns. Such an opportunity for taking market share hasn’t existed since the early 1970s.

## ACTIVIST ENTHUSIASM

It is clear from newspaper headlines that the investment management industry is under intensified scrutiny. Globally, such topics as soft dollar commissions, hedge fund oversight, capital requirements, mutual fund trading, trustee independence, and retail sales practices are being actively considered by regulators and other public authorities. In addition, managers are under pressure to exert influence on corporate governance issues.

Whether these actions will fundamentally transform the industry or prove to be minor changes to behavior remains to be seen. But potential disruption is significant and, at a minimum, the uncertainty of such changes is creating a much more cautious tone in business decision-making. We believe the industry will be well served by taking proactive steps to constructively address the activist agenda. An industry responsible for managing more than 20 trillion dollars globally cannot go unnoticed. For individual firms, the highest standards for professional behavior will be a competitive differentiation.

### How significant are these forces?

We believe that the industry is in a period of transformation. Arguably, the last time that we witnessed such a confluence of factors was in the 1970s: a three-year bear market, regulatory changes affecting both the buy-side and sell-side, new technologies, and changes in client demand. This earlier “perfect storm” resulted in a radical change in the industry pecking order. Though most pundits at the time predicted the opposite, the larger, more established industry players (mostly large banks and insurance companies) relinquished their position to smaller firms that were perceived to be more innovative. Draw your own conclusion as to whether we will see the same “shakeout” of vulnerable competitors today. (Later in this paper, we discuss the likely predictors of those who will survive – and even thrive.)

**Radical changes  
in the industry  
pecking order?**

## Chapter 2: Principles for Success

The previous chapter discussed the unique confluence of five fundamental and exogenous forces that are driving industry change. This chapter attempts to provide senior leaders of investment management firms with specific ideas for making strategic choices amidst the challenging dynamics of the Third Generation. We believe good decision-making will require a thorough appreciation and application of the following five principles:

- Investment quality reigns
- Efficiency energizes talent
- The Client-Partner-Competitor (C-P-C) paradigm connects us all
- Relationships matter
- Alternatives are mainstream

### INVESTMENT QUALITY REIGNS

We are witnessing an important definitional change with regard to “quality” in investment management.<sup>2</sup> In the Third Generation, we expect “Investment Quality” to be defined as a *manager’s ability to consistently meet stated objectives*. Success will require first setting objectives carefully with each client and then true investment skill to be applied diligently in an ongoing manner. It also requires absolute clarity about and confidence in a firm’s investment process and philosophy.

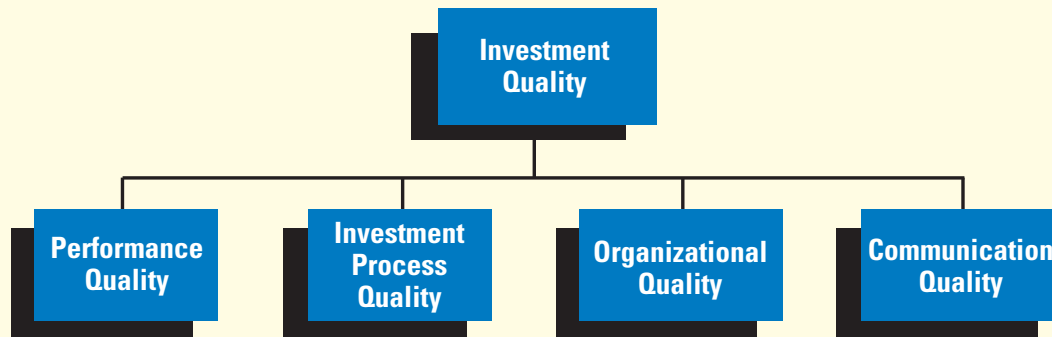
**Investment Quality  
is meeting  
client expectations**

This is not to imply that investment quality was ever unimportant. Through the Second Generation, however, quality had been largely associated with simple measures of relative performance. More sophisticated notions of “what makes for a great money manager” were not required: in an era of fast-paced capital appreciation, there was little reason to scrutinize a manager apart from gross deviation from benchmarks or broad peer groups. Finer gradations are less of an imperative in a bull market. Only in the late 1990s did investors begin challenging some of the conventional quality-rating conventions.

This richer (if surprisingly simple) definition of Investment Quality is driving *increased sophistication in manager evaluation*. As illustrated in Exhibit 6, the approach is now multi-faceted and robust, incorporating:

<sup>2</sup> See Casey, Quirk & Acito’s “The Search for Investment Quality,” June 2003. In a recent survey of more than 250 plan sponsors, consultants, and managers, more than 70% identified investment quality as critically important and many were re-assessing their standards for evaluating quality.

## Exhibit 6: CQA Investment Quality Assessment Framework



- **Performance Quality.** Evaluators are using techniques that scrutinize the sources of risk and return and clearly isolate skill from luck.
- **Investment Process Quality.** Managers are expected to have investment processes that are transparent, consistent, perceived to be repeatable, and risk-controlled (though not necessarily low risk). The investment philosophy and its implementation must be coherent, consistent, and compelling.
- **Organizational Quality.** Firms must provide assurances that high-quality and experienced investment professionals and teams will be stable over a long time horizon.
- **Communication Quality.** Marketing and investment professionals must be able to articulate their services and intended product attributes so as to set appropriate client expectations.

Importantly, we also see a *convergence of quality standards*. Whereas many of the quality evaluation standards described above have been initiated in the U.S. institutional markets, they are being applied to (and in some cases improved by) mutual funds networks, wrap programs, hedge fund evaluations, defined contribution programs, and other channels and segments. In many cases, these distribution channels have either hired traditional investment consultants for manager evaluation, or the channels have developed resources to do it internally. While the products required for each of these markets may differ, the frameworks by which they are being evaluated are converging to the highest common denominator.

Managers have a lot to gain by aspiring to the highest investment practices. Beginning in 2002, we observed evidence of a *flight to quality*. That is, a relatively concentrated group of managers, in both the retail and institutional markets, were the recipient of a disproportionate amount of asset flows. These perceived high-quality managers included both select long-only managers as well as hedge funds. We expect this flight to continue, and potentially intensify, if investors enter into a period of greater restructuring of their portfolios. This trend is in sharp contrast to the pervasive “rising tide lifts all boats” environment that persisted in much of the 1980s and 1990s.

We believe that the new criteria emerging today are likely to last for some time. Thus, there is an imperative for firms to focus on quality over the next several years.

## EFFICIENCY ENERGIZES TALENT

In the Third Generation, true talent will continue to remain a scarce resource in the investment management industry. As discussed in Chapter 1, mobility will remain high, providing employment alternatives. Individuals will continue to migrate to where professional satisfaction (including compensation, culture and caliber of colleagues) is maximized.

Unfortunately for many investment firms, it may not be as easy to meet this challenge. As described earlier, firms during the Second Generation became unnecessarily complex, with distractions from core business activities, bureaucracy, and a tolerance for letting less-skilled members slow down the fastest and most talented professionals.

In our 2000 paper, this was among our most controversial positions. Some five or six years ago, we observed that a “resource fetish” had developed among evaluators (clients and consultants alike) and investment managers themselves. It puzzled us then that all these resources did not appear to improve returns. The strong markets of the 1990s masked inefficiencies by making it far too easy to tackle problems by adding still further resources and to placate frustrated personnel with yearly cash compensation. Many confused quantity with quality, or complexity with competence.

To successfully compete for talented individuals and to generate better results, larger organizations must create a professional environment where talent is most productive. As a result, we expect to see greater *streamlining of organizations*. The reductions in personnel levels will be done not to lower costs, but to organize in far smaller units, increasing efficiency by removing encumbrances to high-quality professionals. Efficiency will be the hallmark of the most successful firms going forward.

**For efficiency, firms must streamline**

For many organizations, the greatest inefficiencies need to be addressed within the investments area. Many have created rather monolithic investment teams and research groups tied together with awkward investment processes. In such a regime, decision-making is slowed and accountability can be unclear. Even in larger organizations, we are beginning to see a return to smaller investment teams comprised of high-quality professionals. Research is often becoming more decentralized, with a stronger link to individual investment teams. (As a leading industry executive explained to us: “We need to remember the simple lesson: this industry was and should continue to be built around units of *three smart people in a room*.”)

To support and enhance their leaner ranks, Third Generation investment firms will find alternatives for the provision of some activities. With rapid advances being made in technology, the application of new tools will begin to leverage and, in some cases, substitute for human capital. For example, for investments, automation is being advanced in areas such as data collection and cleansing, client service report generation, portfolio construction, and trading. In the drive for efficiency, outsourcing must become more prevalent for activities that are not core competencies, possess true economies of scale, or where there are no competitive advantages.

## THE CLIENT-PARTNER-COMPETITOR (C-P-C) PARADIGM CONNECTS US ALL

Changes in the traditional relationships between clients, partners, and competitors will be part of the Third Generation. Specifically, firms that were historically competitors will recognize and take advantage of important opportunities for strategic relationships. These relationships can take the form of alliances, joint ventures, or general outsourcing to leverage the capabilities of other firms. Leading firms are now aggressively forming and managing these relationships to strengthen their competitive position, choosing to focus on what they are really good at, and finding alternative means for delivering the rest. Stated simply, these progressive firms have recognized that there are few rules (apart from the SEC!) that should dictate how they interact with other market participants. They are learning to simultaneously manage all relationships as clients, partners, and competitors.

A key tool in managing C-P-C relationships is measurement of the *balance of trade*, i.e., a clear accounting of all business flows among financial services firms. (The flows can include trading commissions, custody fees, distribution fees, M&A services, capital raising fees, etc.) The number of financial services firms (including investment managers) who, over the past two years, have developed processes for systematically scrutinizing their balance of trade impresses us.

C-P-C is also pressuring firms to *end cross-subsidization between investment and distribution functions*. Many organizations have developed unbalanced expertise in investing or distributing.

**Rational, not  
open, architecture  
will prevail**

In some cases, excellent manufacturers lacked the size and scope to be effective distributors. In other cases, excellent distributors often had a first-class client network in place, but were unable to manufacture a full range of quality products. In the Third Generation, investment manufacturing and distribution must function independently of one another. The efficiency of the C-P-C environment will require that distributors provide the best products, and quality managers have access to all channels. Distribution and investments must be independently exposed to market discipline because, in a C-P-C environment, there are always alternatives.

Finally, in a C-P-C world, we are seeing a retreat from the seemingly inexorable trend to open architecture. Open architecture, with its largely unfettered access to a multitude of investment products, is of lesser use to an advice-hungry investor base than is a carefully evaluated smaller set of quality options. We refer to this arrangement as *rational architecture*. It is rational not only for the investor, but also the intermediary, who is able to focus on working with fewer providers of investment management products.

## RELATIONSHIPS MATTER

Historically, distribution activities at investment firms have focused on finding clients for pre-defined products. More focus has been on sales, rather than relationship management; products, rather than customized solutions. The definition of “client service” has been narrow, focusing on the administrative aspects of supporting accounts. This product-and-sales approach has served the industry well throughout most of the last 30 years.

Unfortunately, the Third Generation will provide fewer untapped opportunities to raise assets. Going forward, the economics of investment management will be increasingly driven by client retention and cross-selling. Developing deeper client relationships is required both offensively (to raise assets) and defensively (to prevent others from taking them).

Developing richer relationships with clients will present challenges to most firms. Culturally, can the firm accept investing in relationships when the pay-off is uncertain and difficult to quantify? Is it willing to invest in better client service personnel and technology to support relationship building? Does it have the breadth of quality products required to cross-sell? Is it willing to tier clients into different service levels? Is it occasionally willing to tell a client “no”?

The focus on relationship development necessitates organizational changes as well. Historically, most investment management firms have been organized around product or service silos with different teams responsible for selling mutual funds, wrap accounts, defined benefit separate accounts, or defined contribution services. Clients and intermediaries are requiring investment management firms to approach them on a more integrated basis, providing a suite of products through one primary and accountable contact. The strict silo-based structure is being replaced with a more coordinated approach. We call this organizational principle *distribution without boundaries*.

We are already seeing encouraging results. For example, several firms over the last few years have increased their cross-sell rates substantially. Others have been able to raise their 401(k) rollover capture rates. The leverage within existing relationships is proving to be substantial.

## ALTERNATIVES ARE MAINSTREAM

The dominant paradigm for managing money has been “long-only, marketable securities, without derivatives or leverage, managed for a flat management fee, and measured relative to a benchmark.” Going forward, investors will require greater flexibility. Alternative asset classes (such as distressed debt, private equity, real estate) and alternative investment strategies (such as long-short, market neutral, arbitrage) are attracting significant attention and asset flows. This growth is the most obvious evidence for how alternative investments have become an integral part of many investors’ portfolios.

**Is “long-only” a niche strategy?**

The growth of, say, hedge funds, however, is only a simple measure of the mainstreaming of alternative investing. The bigger picture is more subtle and far-reaching. For investment management firms, the rise of alternatives will force reconsideration of conventional thinking about culture, compensation, attitude, product set, personnel, and a solutions-orientation towards clients.

There are multiple other manifestations of the “alternatives revolution.” First, we can see elements of alternative investing being incorporated more often by traditional managers. For example, many “traditional” products may become more absolute return oriented. This will require a greater emphasis on asset allocation (including taking greater cash positions when markets warrant), use of short positions to the extent they are allowed, and/or holding fewer securities. Above all else, it will require managers (and their clients) to buck the tyranny of existing style classification schemes<sup>3</sup>. As a result, clients may likely be willing to pay an incentive fee and use customized benchmarks to measure success.

Second, we see client demand for *separating alpha from beta*. Many investors are (implicitly and explicitly) viewing long-only management as an expensive way to get broad exposure to the markets. They would rather take market exposure through cheaper mechanisms (such as derivatives, exchange traded funds, or enhanced index funds) and incent active managers to deliver alpha above and, ideally, uncorrelated to the appropriate benchmark.

Finally, managers will have to respond by becoming more like solutions-providers to their clients, leaving behind decades of definitional concepts and rising above product categories. For example, we believe that fixed income managers have a great opportunity to recast themselves as “providers of low-volatility solutions.” Why? Most clients desire a strategic portfolio allocation to “low volatility” assets to counterbalance asset classes they perceive to be riskier. Over the last decade, a “core fixed income portfolio managed against the Lehman aggregate” has become synonymous with this notion of low-volatility. Unfortunately, we may be entering a period where the gap between the yield on traditional fixed income securities and investors’ funding requirements will be large enough to render them almost irrelevant. For many investors, it may be beneficial to allow their “fixed income” managers to actively allocate across fixed income classes or even to other low volatility asset classes (e.g., certain hedge funds strategies or real estate classes) when the return opportunities are superior.

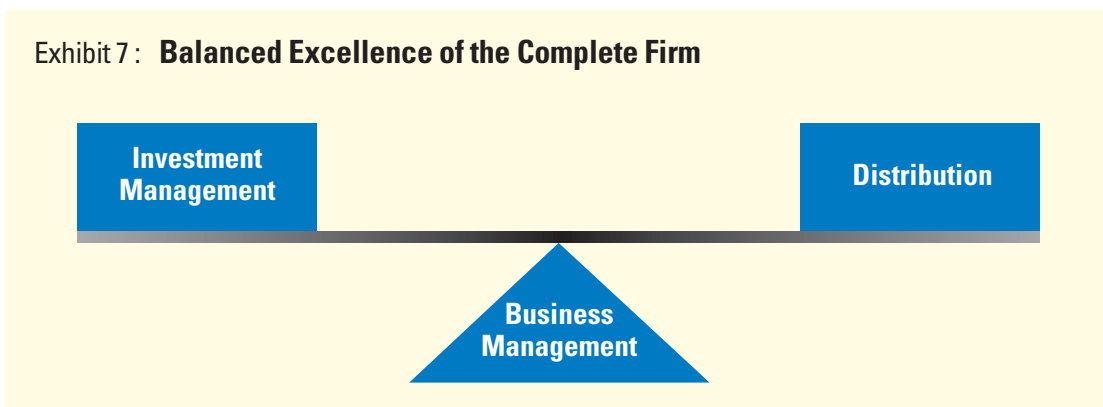
\* \* \*

We encourage senior leaders of investment management firms to understand these five principles. We believe that their application will aid in critical decision-making in the Third Generation.

<sup>3</sup> For a more detailed discussion of the likely evolution of style classification see Casey, Quirk & Acito’s “Style is Dead: Long Live Style,” August 2001.

## Chapter 3: The Complete Firm

What type of firm will be successful in the Third Generation? This chapter introduces the attributes that we believe will characterize *Complete Firms*. The defining features of a Complete Firm will be: balanced excellence in investments and distribution and strength in its underlying business management. This simple, but essential, concept is illustrated in Exhibit 7.



Beyond this important balance, Complete Firms will possess 13 critical characteristics, listed in Exhibit 8 and described throughout, this chapter. This list of investment, distribution and business management characteristics comprises a Complete Firm scorecard that can serve as a benchmark for evaluating a firm's future competitive position.<sup>4</sup>

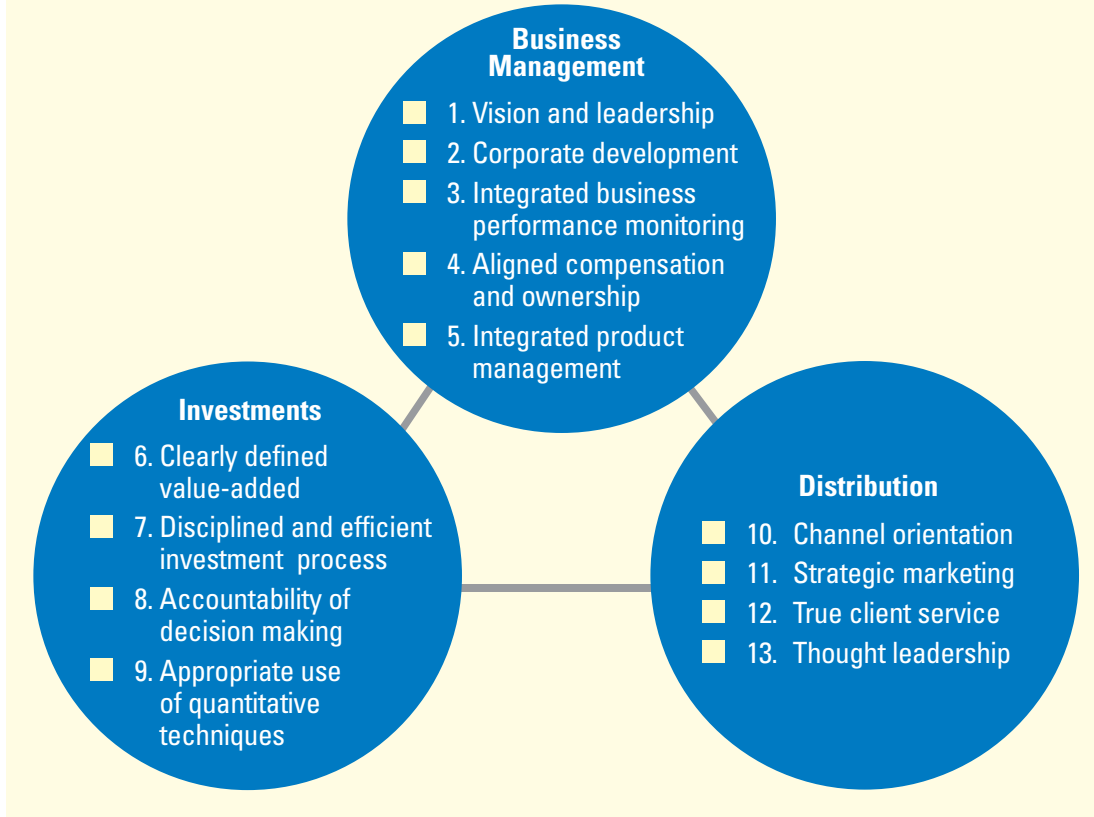
While these attributes are universal, we believe that Complete Firms will, by no means, be homogeneous. Later in the chapter, we discuss four distinct business models that we believe exemplify the various organizational structures that will likely succeed in the Third Generation.

### Business Management

Putting in place the appropriate business management resources will be a challenge for firms just now making the transition from the Second Generation. First, in our opinion, the industry's general business management skills are in short supply. Second, many of the investment professionals who dominate these firms are still reluctant to (or do not) recognize the increased importance of business management skills in the new environment. In today's world, investment management firms must be led with disciplined focus and professionalism. Complete Firms will possess the following five business management characteristics:

<sup>4</sup> Technology is not defined here as a separate capability. This is not to downplay its role; rather, technology is an implied component of all thirteen factors. Suffice to say, the Complete Firm must be fully technologically enabled.

## Exhibit 8: The Complete Firm Scorecard



### 1. VISION AND LEADERSHIP

Vision and Leadership are terms that are often viewed as very “soft” for this macho industry. However, our observations suggest organizations that have spent time developing these elements are currently enjoying an advantage in the marketplace over their peers.

Industry leaders must possess a clear and compelling vision of what will make their firm unique and valuable to clients. This vision will include a clear mission statement, a value proposition, clearly identified target markets and clients, and a well-structured business model. To date, many firms have been good tactical managers; exceptional market conditions required only adequate execution of duties to produce strong financial results. However, in an increasingly competitive business environment, a powerful vision is crucial in order to motivate employees, set strategic priorities, and remain flexible and responsive as a firm.

In addition to articulating a clear vision, business managers must also be leaders, acting decisively and with conviction, serving as the spokespeople for their organization and leading by example. This leadership should be reinforced by strong management skill throughout the organization.

### 2. CORPORATE DEVELOPMENT

The Client-Partner-Competitor (C-P-C) paradigm will provide unprecedented business development options, allowing firms to outsource capabilities, create strategic alliances, and acquire other firms.

Dedicated corporate development resources will be essential in the systematic search for such new opportunities and to evaluate risks. In this regard, traditionally insular investment management firms must challenge themselves to become as externally oriented. Firms must also recognize that there is enormous value in the corporate development process itself; even if C-P-C arrangements do not materialize, the firm gains significant market intelligence. Rigor should supercede perfection.

In addition to identifying new alliances, investment management firms must also become adept at managing these relationships effectively. Dedicated and focused alliance managers should have a detailed understanding of the goals of each relationship and its overall value to the firm. Clear expectations must continually be communicated to each partnership.

### 3. INTEGRATED BUSINESS PERFORMANCE MONITORING

Processes for developing, producing, and delivering high-quality information will be critical to maintaining the Complete Firm. This information includes client data and contact records, competitor and market research, investment performance, financial performance, and risk management. Such intelligence should be calculated on the enterprise level as well as for each meaningful business unit. To be effective, this information should be calculated in a consistent manner and delivered centrally through a common technology infrastructure. Leaders empowered with the highest-quality real time information can act quickly and decisively – a decided competitive advantage in The Third Generation.

### 4. ALIGNED COMPENSATION AND OWNERSHIP

Compensation must be aligned with longer-term goals for building the business, not just current performance. Key employees must have a direct financial stake in the long-term success of their firm. However, successful firms cannot simply extend equity ownership once; they must be prepared to regularly recycle equity in order to continually attract and retain talented individuals. We refer to this ongoing process as “dynamic recapitalization.”

In addition, investment management firms must be permitted the autonomy to make business decisions within a timeframe that is appropriate for this industry. For better or worse, investment management operates under unique constraints, especially that of needing strong, established, long-term track records with stable teams. The timing of business decision-making required to meet these needs effectively is often at odds with many financial owners, who are more focused on quarterly business performance. (Of course, autonomy is not a guarantee for success – it must be coupled with a talent for managing the business.)

### 5. INTEGRATED PRODUCT MANAGEMENT

To create a rational and high-quality product set, Complete Firms must employ a structured product development and management process. The process must create a strong communication and functional link between the investments and distribution organizations, providing ideas for new investment strategies and feedback on market trends. The product management team should also play an active role in the ongoing assurance of product quality. Historically, product management functions have sat with the investments or distribution teams; going forward, it will increasingly be a “front office” function, often independent of either group.

## Investments

Obviously, investment success requires consistently delivering performance in line with or exceeding a client's expectations. Complete Firms will have the tools and processes in place to assure superior Investment Quality. We believe these managers will share the following four investment characteristics (numbered 6-9):

### 6. CLEARLY DEFINED VALUE-ADDED

Complete firms articulate clear product objectives and characteristics. This sets expectations with clients and creates a point of reference from which to monitor performance. To be differentiated, value-added should be clear, proprietary, and validated. Competitive advantage can be generated through a variety of core skills including: screening, approach to research, quantitative modeling, or portfolio construction. It should be held together by an investment philosophy that investment professionals fundamentally believe.

### 7. DISCIPLINED AND EFFICIENT INVESTMENT PROCESS

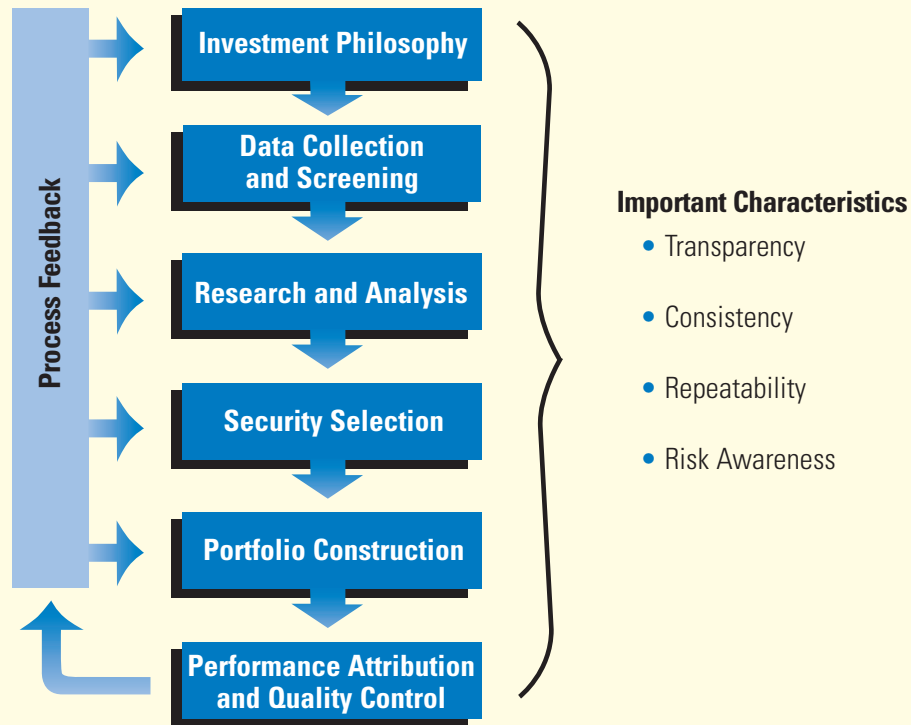
Complete Firms must have investment processes that are transparent, consistent, risk-aware, and perceived to be repeatable. A clearly structured investment process establishes credibility among buyers and intermediaries and raises confidence in the consistent delivery of performance within the agreed-upon risk parameters.

Complete Firms will be able to articulate how they can (or cannot) add value at each step in the investment process (as defined in Exhibit 9). Appropriate resources must be dedicated to each process step, particularly those where the firm expects to be differentiated in the marketplace.

Earlier in this paper, we have argued that investment professionals should be unencumbered so as to achieve their maximum potential productivity. This same principle holds for investment ideas. Efficient processes allow outstanding ideas to reach the portfolio (i.e., as an invested idea) as quickly as possible. Smaller, more focused teams (what we've referred to earlier as "three smart people in a room") often facilitate this. Hedge funds and other small teams utilize this efficiency to their advantage. (However, we do not intend to imply that efficiency equates to short-term trading – it is as applicable to long-term investing as it is for shorter-term investing.)

Embedded Alpha, which refers to the "frictional" costs of managing an investment portfolio, will also continue to be a critical part of the new efficiency. These costs include brokerage commissions, the opportunity cost of not equitizing cash, tax liabilities, and the negative market impact of trading.

Exhibit 9: **Investment Process Framework**



To date, many active equity managers have not explicitly managed Embedded Alpha. (Fixed income and index managers, for whom every basis point of excess return is crucial, have been the most conscious of these factors.) In the future, Complete Firms will diligently seek to minimize these performance detractors, as only a small amount of basis points separates top quartile from bottom quartile managers; Embedded Alpha costs can be large enough to systematically span this performance gap. These costs become even more relevant in a lower return environment.

## 8. ACCOUNTABILITY OF DECISION MAKING

Well-designed investment processes are not sufficient. Individuals must be responsible for assuring that quality inputs are created and sound decisions are made. Third Generation firms will define accountability for value-added at each stage of the investment process and design creative methods for measuring success. For example, paper (or real) portfolios run by research teams are increasingly being used to monitor analysts' convictions. Strong investment professionals will become the scrutiny.

## 9. APPROPRIATE USE OF QUANTITATIVE TECHNIQUES

Quantitative research skills and tools have taken on a significant role in the investment industry. They are not a panacea but can, at a minimum, provide leverage for the research and decision-making processes. Leading managers can integrate quantitative tools into several parts of the investment process such as:

- Screening and idea generation
- Fundamental research support
- Portfolio construction
- Attribution analysis and performance monitoring

Complete Firms should be able to master and leverage quantitative tools, even if their core research processes are fundamental in nature.

### Distribution

In general, we expect Complete Firms to be modern marketing organizations. Strategy development must begin with the target client's needs. Firms must be flexible enough to design the most appropriate products and services for these segments and to leverage the most effective channels for reaching them, both proprietary and non-proprietary. They will effectively manage and nurture their relationships with clients and partners and learn from their competitors.

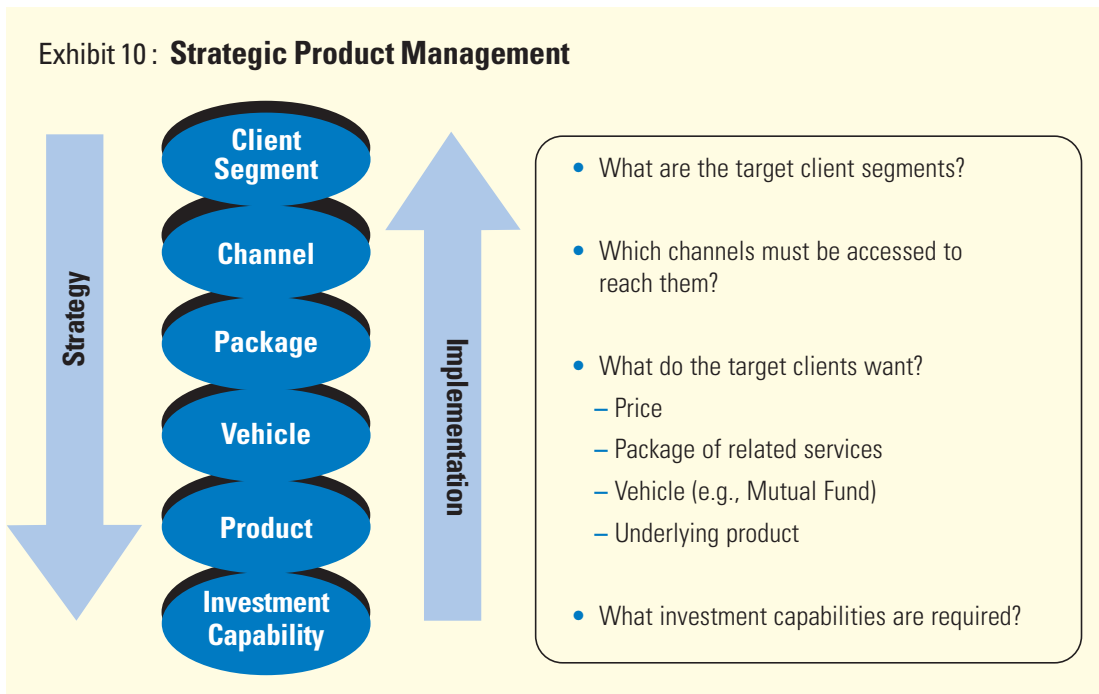
## 10. CHANNEL ORIENTATION

Complete Firms must present each of their target market segments with a coherent, coordinated identity and a well-defined product set. Distribution scale can be an important competitive advantage, due to the increasing cost of servicing clients. Both of these requirements imply a centrally managed, coordinated distribution organization across both retail and institutional markets. (We use "coordinated" to imply managerial authority. Our distribution structure does not, however, imply that all channel teams use the same brand or have a need for physical proximity.)

To achieve scale, channel and segment teams can serve all investment platforms, acting as a client's single representative for each of these underlying capabilities. They will work with investment personnel to understand the platform's products and underlying capability. This client-centric organizational design (described in Chapter 2 as "distribution without boundaries") stands in contrast to the product-centric approach that has traditionally characterized the industry.

## 11. STRATEGIC MARKETING

As industries mature, high-quality marketing skills become increasingly valuable. These skills allow firms to identify target markets, define their needs, and develop the appropriate products and services to serve them. Complete Firm managers will recognize the importance of this marketing function, acquire marketing staff, and define clear strategies for addressing their target audience. Importantly, these firms will define their products and services around the needs of their clients (Exhibit 10).



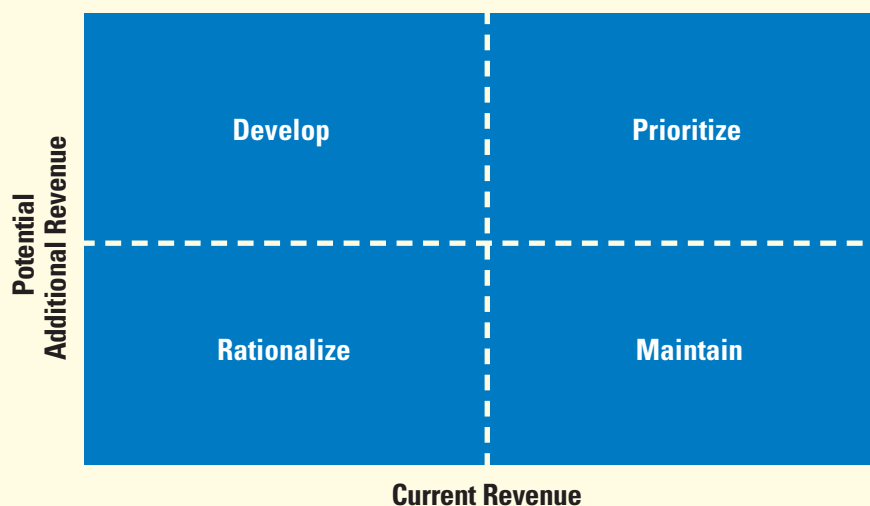
## 12. TRUE CLIENT SERVICE

Client service objectives change as organizations (and the industry overall) mature. The current business environment requires a tighter focus on client retention and cross-selling. Further, as clients and intermediaries alike continue to increase their sophistication and raise their standards, the new client service model requires meaningful resource commitment, credible investments expertise, value-added reporting, and a solutions-oriented “listening” approach.

Client service should be viewed broadly, containing all functions that proactively and reactively touch the client: administrative and operational support, relationship management, and advisory services. The benefits of a well-structured client service capability are twofold. First, it increases the probability of retaining clients. Second, and commercially important, it allows the sales force to focus on new business development, and the investment team on managing money.

Complete Firms will achieve a whole new level of excellence in client service – think Four Seasons concierge, not merely an administrator. We believe the best of breed will develop client service that is targeted and specialized. Of course, all clients should not receive the same degree of client service. To be most efficient, Complete Firms must segment clients and prospects, based on such criteria as current and potential opportunity (Exhibit 11).

**Exhibit 11 : Client Tiering Framework**



### 13. THOUGHT LEADERSHIP

Leading investment management firms will consult and educate their target markets and clients. Leveraging proprietary intellectual capital as a means of influencing the buyer and intermediary market will be an enormous competitive advantage in the Third Generation. Thought Leadership is the most effective “dialogue-generation tool” to reach the firm’s target audience, primary or intermediary, and an outstanding opportunity to further product development.

#### Organizing for Success: Four Viable Business Models

The previous section of this chapter described the attributes that will characterize successful Third Generation investment management firms. As we have previously stated in our 2000 paper, however, these shared critical attributes do not imply that Complete Firms will be homogeneous. In fact, we believe that four basic business models are viable. Leading firms will adopt one of these models or may employ several simultaneously. The following section describes these models and the methods by which they will achieve continued growth.

The challenge in adopting any of these models should not be underestimated, and many firms must undergo significant organizational change in order to implement one of the Third Generation structures. Developing the required attributes (e.g., functional specialization and pooling of distribution resources) will put significant strains on organizations attempting the transition. Nevertheless, the potential rewards of getting it right are quite significant.

## DISTRIBUTION SPECIALIST

Firms that adopt the Distribution Specialist model will use one or more proprietary distribution channels to supply primarily third-party investment products. (By definition, Distribution Specialists have minimal or no proprietary investment management capabilities.) To be successful, these firms must create a competitive advantage in the relationship management of one or more client segments, including both sales and client service. To meet the demands of their target clients, Distribution Specialists must also have a thorough understanding of and appreciation for Investment Quality; they must identify and represent only the highest-quality products.

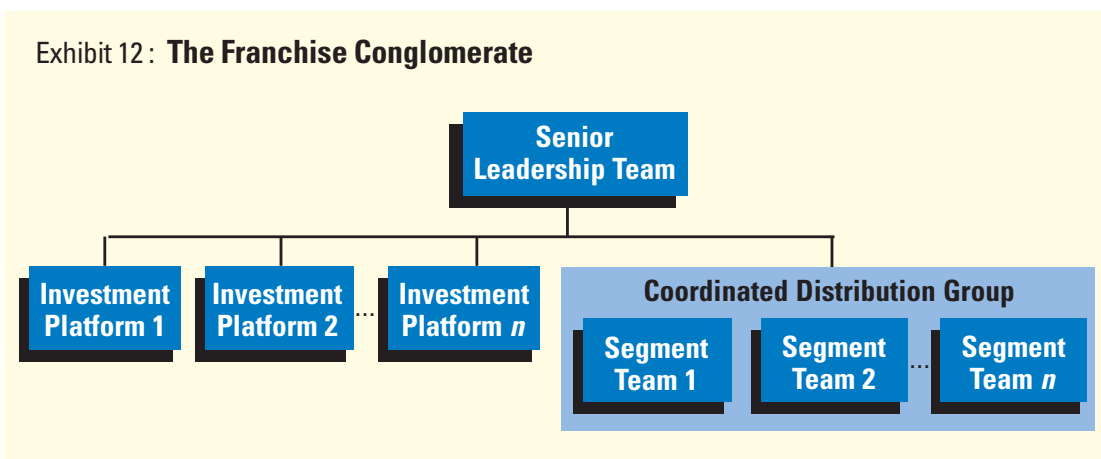
We believe that many multi-line financial services companies – including banks and insurance companies – will increasingly consider employing the Distribution Specialist model. Many of these institutions are concluding that their core competency is managing relationships, not constructing portfolios of securities. As a result, they will look to third-party product providers and, in some cases, consider divesting their investment management interests. (As many of these firms created investment management groups through multiple acquisitions, we refer to this new trend as “consolidation begets regurgitation.”)

## SINGLE-PLATFORM MANAGER

In the Third Generation, many firms will be organized around a single investment platform. To distinguish themselves in the marketplace, they will tend to focus on more specialized asset classes or investment approaches. Investment Quality will be the defining feature of Single-Platform firms. They will be dependent on intermediary channels (including fund-of-funds), as managing relationships with these open-architecture partners will be an essential core competency. (This acumen in managing relationships, along with “complete” investment management practices, will distinguish them from the traditional “boutique.”)

## MULTI-PLATFORM MANUFACTURER: THE FRANCHISE CONGLOMERATE

We use the term “Franchise Conglomerate” to characterize the multi-platform business model. The Franchise Conglomerate will incorporate two or more investment platforms that share a common distri-



bution organization (Exhibit 12). The multiple investment platforms can remain autonomous of each other. Each platform may have a unique brand identity, though a single brand will be most common. For efficiency, each platform should be largely unique; that is, each platform will have an effective franchise in a particular investment capability.

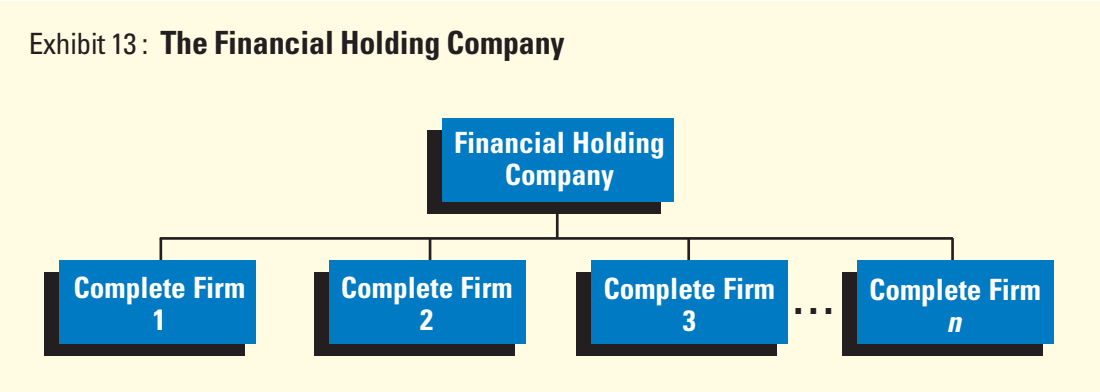
A single distribution group will represent all investment platforms to the marketplace with the channel/segment teams have monopolistic franchises in developing a unique set of clients. Which products receive the most distribution attention will be left to the discretion of the marketing strategy and sales force. This internal competition will enforce manufacturing quality standards and place an onus on the investment platforms to educate and service the sales force. In addition, we believe that potentially the channel and segment teams need not be dependent solely on internal producers; rather, they may source products from external providers if they deem the quality to be superior.

A well-resourced executive office is responsible for the coordination of all activities between investment platforms and centralized functions. This office provides leadership and strategic guidance to the overall firm. (As discussed in the first chapter, a significant shortcoming of the Second Generation firm was an inability to manage an organization of significant scale and scope.)

Relative to Single-Platform Managers, there are two primary benefits to having multiple platforms. First, to the extent that the platforms' performances are less correlated, business risk is diversified. Second, a larger product and asset base can support a larger distribution force. However, the costs of complexity associated with larger organizations can work to offset these benefits.

**FINANCIAL HOLDING COMPANY**

A final Third Generation business model is the Financial Holding Company. These firms build their relationships around a financial commitment to one or more investment management firms while taking only a limited managerial role. The core competency of these companies is to identify outstanding investment management companies, supporting their senior management ("affiliate development"), and creating the financial engineering required both to provide ownership liquidity and to assure continuity. The Financial Holding Company is not a Complete Firm per se; rather, it is a collection of Complete Firms (Exhibit 13).



Financial Holding Companies, by definition, will not work to centralize core activities (such as creating a single comprehensive distribution group), but they can benefit from limited coordination. For example, Financial Holding Companies can share technology support services, specialized channel teams (such as wrap wholesaling), and sharing best practices. Coordination should be based on the alignment of self-interest on the part of each affiliate. Distribution synergies will likely fall into untapped channels or segments.

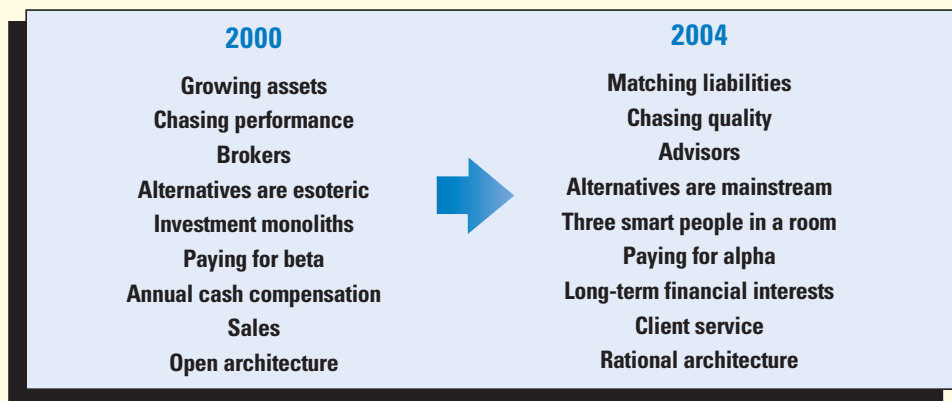
Third Generation Financial Holding Companies will not be limited to the “stand-alone” conglomerates. In fact, many large financial services firms with more than one investment management subsidiary may choose this business model over the Franchise Conglomerate. These firms will conclude (implicitly or explicitly) that the benefits of integration will be lower than the risks and costs.

## Conclusion

As the global investment management industry continues its transition through its Third Generation, we encourage senior leaders to take six actions:

1. Recognize that the competitive environment has changed. Exhibit 13 highlights some of the stark contrasts between the Second and Third Generations of the investment management industry.

Exhibit 14: **Second to Third Generation: What's Changed?**



2. Apply five principles to strategic decision-making:
  - Investment quality reigns
  - Efficiency energizes talent
  - The Client-Partner-Competitor (C-P-C) paradigm connects us all
  - Relationships matter
  - Alternatives are mainstream
3. Assess your firm against the 13 Complete Firm characteristics outlined in Chapter 3 and begin to address gaps.
4. Identify your core competencies. How can these core competencies be leveraged within and outside the firm? What alternatives exist for delivering non-core activities?
5. Align your business vision with one of four viable business models:
  - Distribution Specialist
  - Single-Platform Manager
  - Franchise Conglomerate
  - Financial Holding Company
6. Manage growth carefully and with conviction, maintaining a diligent focus on quality and efficiency.

\* \* \*

We are optimistic that, properly managed, the Third Generation will offer great opportunities for Complete Firms.

## Glossary of Terms

**Balance of trade:** the full record of financial flows between an investment management firm and another industry player, including such activities as trading, distribution commissions, and corporate transactions.

**Client-Partner-Competitor (C-P-C) paradigm:** the ability to simultaneously manage industry relationships as clients, partners, and competitors.

**Complete firm:** an investment management firm displaying 13 business management, investment management, and distribution activities. Complete Firms are well positioned to succeed in the Third Generation.

**Consolidation begets regurgitation:** the tendency for poorly organized (i.e., inefficient) investment management firms to lose their best talent. Often, organizational instability results directly from integration (i.e., consolidation) of one or more firms.

**Distribution specialist:** a viable Third Generation business model for investment management firms whose core competency is relationship building. Distribution Specialists rely significantly on third-party providers of products and services.

**Distribution without boundaries:** a business principle that organizes distribution resources around clients and channels (in contrast to organization around products and services).

**Dynamic recapitalization:** the process of providing meaningful long-term economic incentives to successive generations of professionals within a firm.

**Extended duration of investors' discontent:** fundamental changes in investor behavior resulting from the disappointing experience of the bubble in equity prices.

**Efficiency energizes talent:** the observation that, unencumbered by barriers to entry and exit, human capital will migrate to rewarding environments.

**Embedded alpha:** the opportunity to enhance investment returns by managing such factors as trading costs, slow decision-making, and unintended risk exposures.

**Financial holding company:** a viable Third Generation business model for investment management firms whose core competency is providing an effective ownership environment for Complete Firms.

**Flight to quality:** the disproportionate flow of assets to firms perceived to be exceptional skill (as measured on a multi-dimensional framework such as the Complete Firm scorecard).

**Franchise conglomerate:** a viable Third Generation business model for investment management firms who have a core competency in both investments and relationship management. In the Franchise Conglomerate, multiple investment platforms are represented by a single distribution organization.

**Investment Quality:** the perceived ability of a manager to meet its clients' investment expectations. In the Third Generation, Investment Quality will be measured along four primary dimensions: performance, investment process, organization, and communication.

**Rational architecture:** a distribution organization that provides multiple (though limited) numbers of vetted investment options to their clients. This stands in contrast to Open Architecture that is the provision of a large number of investment options without an endorsement of their quality.

**Separating alpha from beta:** the desire of investors to reward their managers on outperformance as measured relative to a relevant benchmark. Market exposure will increasingly be taken through relative inexpensive options such as Exchange Traded Funds, derivatives, and index funds.

**Style is dead, long live style:** the trend to understand the true characteristics of an investment manager, not simply its placement among popular manager classification schemes.

**Third Generation:** the emerging competitive environment in the investment management industry in which Complete Firms will be best positioned for success.

**Three smart people in a room:** the belief that small teams most effectively implement active investment management. This perceived superiority is due to efficient decision-making, high accountability for results, and limited dilution of outstanding talent.

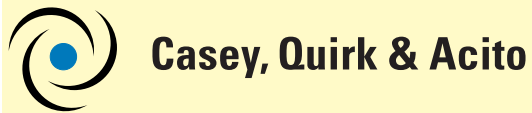




**October 2003**

## **Success in Investment Management:**

**Three Years Later**



Casey, Quirk & Acito (CQA) provides management consulting services exclusively to investment management firms. CQA specializes in business strategy and planning, developing and monitoring investment quality, and delivering market intelligence. CQA draws on 35 years of experience in delivering value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to create change within organizations.



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Casey, Quirk & Acito LLC  
19 Old King's Highway South  
Darien, Connecticut 06820  
203-899-3000  
fax 203-656-8124  
[www.cqallc.com](http://www.cqallc.com)

Merrill Lynch & Co., Inc.  
4 World Financial Center  
New York, NY 10080  
212-449-1000  
[www.ml.com](http://www.ml.com)