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Perspectives on the Investment Industry

EXPLORING HOW TO EFFECTIVELY BUILD
AND GROW A BUSINESS

Asset Grower: The Ideal Blend of Asset Gatherer and Investor

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Executive Summary

Investment management firms are commonly labeled as asset gatherers or investors. As the names imply, there is an assumption that a manager focuses either on raising assets or managing money, but not both. Of course, both steady, sustainable asset growth and competitive investment performance are necessary for lasting success, so is either approach realistic and reasonable? No, we believe a blended approach—‘asset grower’—that balances the primary objective of investment performance and the secondary focus of controlled business growth is the ideal model for long-term success.

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The Perfect Firm

Investment firms are often categorized as either asset gatherers or investors. Asset gatherers are those firms with the primary goals of raising assets and increasing revenues, with a secondary focus on investing. Investment-driven firms, on the other hand, are those whose goals are guided by the desire to outperform benchmarks and achieve their clients' return/risk objectives. While each approach may initially yield desirable results, they are not only extreme depictions, but are also unlikely to lead to long-term success.

So, is there a right approach? Yes, we believe in a third approach we call 'asset growers': firms that balance the primary objective of investment performance and the secondary focus of reasonable business growth.

Let's take a look at the individual models, starting with asset gatherers.

Asset Gatherers

Asset gatherers are generally thought to be in constant pursuit of assets under management (AUM). In reality these firms may not necessarily be driven solely by AUM (or revenues), but rather a blend of these and other goals. Whether or not a firm is chasing assets, asset gatherer is a term that widely carries a negative connotation.

Generally speaking, large publicly held companies are under pressure to increase earnings, so they are more likely than their employee-owned counterparts to seek incremental assets. Companies actively seeking to build assets can pursue several paths including:

- ▶ sell existing products
- ▶ add new products
- ▶ buy new capabilities through lift-outs or M&A activity

Sell Existing Products

In the case of investment strategies that benefit from scale, such as government bonds or other broad-based fixed-income strategies, a significant increase in AUM can boost a firm's bottom line without necessarily impacting the returns of those investments. Conversely, asset growth can diminish returns, especially in capacity-constrained categories. Two common perceptions of these firms is that they increase assets at the expense of their clients' returns, and they are more likely to accept sub-optimal business including lower fee levels, which can dilute their profitability.

Add New Products

Adding a new product can be an effective way to raise assets, provided the new product is a natural and logical expansion, both in terms of internal capabilities and the market's acceptance of the product. The more closely a product aligns with a manager's core strengths, the greater the opportunity to add value. However, there is always the risk that the manager will feel pressure to raise AUM before the product has demonstrated its long-term value-added potential.

Buy New Capabilities

Firms can also bear fruit with the purchase of new capabilities through lift-outs or M&A activity when the teams' cultures and products are complementary. Successful M&A's are those in which culture clash and employee distraction and disruption are minimal, the merged product sets translate into cross-selling opportunities, and the investment personnel's capabilities are enhanced.

Franklin Templeton is one of only a few examples of a successful merger of significant asset managers. Templeton's

equity business complemented Franklin's fixed-income business, and senior management skillfully facilitated integration, while allowing necessary autonomy. Unfortunately, this scenario is uncommon because there is often a lack of synergy between the firms or stress of growing the merged business, with unrealistic expectations of growth and timeframes.

Potential Pitfalls

An excessive focus on asset or revenue growth can be detrimental to investing success because it places a significant amount of power in the hands of the business people, while the true value added and ability to attract assets over the long-term is driven by the performance generated by investment personnel. Investment teams within this model inevitably feel too much pressure to market, distracting them from their primary—and often preferred—role of managing money. Asset gatherers also often expand beyond the point of fostering an entrepreneurial environment.

For these reasons, teams are frequently tempted to spin-off to start their own firm. In fact, a majority of firms with fewer than 100 people are founded by an investment team that had the desire to return to an investment-focused approach—both from the perspective of their specific roles and ability to share in the profits.

An entrepreneurial spirit is most important to active strategies, such as hedge funds, that rely heavily on the skill sets of a few people to add significant alpha. Meanwhile, it is less critical to firms focused on passive investment strategies that often benefit from lower trading costs due to scale associated with large positions and the ability to cross-trade.

Entrepreneurial environments can also breed creativity in compensation. For

example, large banks or subsidiaries of insurance companies rarely offer pure equity ownership, which carry associated incentives; therefore, they need to offer phantom equity/options.

Investment-Driven Firms

Firms focused exclusively on performance generally experience both greater gains and losses tied to returns, particularly firms that charge performance-based fees. Management at these firms is highly motivated to ensure that the portfolio managers are focused on delivering returns, without distraction to market or sell products. In this case, smaller teams are often more cohesive, focused and nimble.

Potential Pitfalls

In theory, a client wants a firm's goals to be aligned with its own, so a firm with a singular focus on delivering investment performance is understandably attractive. In reality, however, a pure investment focus may not be in the client's best interest. Investment teams that are over-confident in their investment skills, which according to behavioral economists is human nature, may not be sensitive to the client's individual goals, sometimes straying from investment objectives and guidelines.

While performance is critical, the manager must invest to meet client objectives. Also, performance fees are used to align client's interests with the manager. However, if 100% of clients are on performance-based fees and the firm underperforms, it may struggle to retain key personnel.

Investment-driven firms are more likely than others to adhere to capacity targets and constraints. The shadow side of this benefit is that at its extreme, excessive internal focus can lead to a higher likelihood to either ignore or pay little

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attention to industry trends. For example, many investment-oriented firms in the Defined Benefit space did not recognize dramatic changes in the marketplace, specifically its shrinking demand for certain asset classes, such as U.S. large-cap growth or value. With dwindling demand and no alternative path for growth, future revenues and viability of the firm's product line are jeopardized. In turn, firms are unable to attract and retain talented employees with the lure of asset and revenue growth.

A degree of distribution orientation and respect for the internal staff with insights to market trends can be necessary to capitalize on opportunities and to prevent a firm from becoming too inwardly focused. For example, a firm experiencing investment performance challenges is more likely to recognize the reality of the issue if it has, and respects, external input.

Excessive investment orientation can also lead to class/generational conflict within firms, and possibly to long-term performance deterioration as skilled personnel retire, leave or are recruited for better compensation and/or opportunities. At the same time, firms with no eye toward business growth are likely to experience intense internal friction during difficult times. It is, after all, easier to agree on how to share a growing pie rather than a shrinking one.

Fact or Myth

Research to determine the correlation between firms with significant asset growth and investment success is scarce—if not non-existent. However, the market still maintains the belief that smaller funds have outperformed their larger counterparts across many strategies. Broadly speaking, institutional consultants and pension

sponsors favor boutiques, and fund-of-funds focused on emerging managers prefer small, investment-driven firms with \$5 billion or less in AUM.

A number of platforms, such as Progress Investment Management, are built on the premise that emerging managers outperform larger managers. Another common view is that much of the value added of outstanding funds is gained early in their lifecycles, when asset bases are small.

Our research of both institutional separate accounts and retail mutual funds revealed no credible evidence to support one approach over the other. In fact, the idea that a firm is either an asset gatherer or investor appears to be an oversimplification of reality, with the former carrying a significant stigma.

A Blended Approach

We compared several well-known mutual fund families, including certain public companies not expected to feel pressure to gather assets, and found that contrary to expectations created by the currently accepted views, those with the gatherer mentality did not necessarily manage the lowest average Morningstar-rated funds. In fact, some of those firms managed higher-rated funds, perhaps because of their understanding of the importance of performance.

Vanguard, for example, offers both low fees, placing their performance at less of a disadvantage on a net basis versus an index, and a keen eye toward returns. We also found that investment-driven firms, such as Artisan and Dodge & Cox, ranked in the upper tier of average rankings. Broadly speaking, this is not an indication that investment-driven firms manage higher-rated funds. In fact, other

investment-driven firms were among the lowest-ranked fund families.

Finally, some of the highest asset gatherers certainly are excellent investment firms. For that reason, we consider them ‘asset growers’: they combine strong investment cultures and results with the discipline to track the pulse of the marketplace to help grow and retain assets.

An ‘asset grower’ can both generate impressive investment results and grow business, while maintaining the clients’ needs as a priority. These firms are also likely to attract and retain diverse talents and perspectives, which will serve them well over the long-term.

The blended approach, while highly effective, is not the most advantageous solution for every firm. For example, in the institutional segment, an investment-driven approach is more sensible for small-capacity and high value-added niches, such as small cap rather than large asset classes. In contrast, firms that offer scale benefits to clients, such as S&P 500 passive approaches, and those that offer broad-based, one-stop-shop services to retail clients will benefit from a distribution-led strategy.

Our evaluation of institutional separate account data, specifically gross returns unaffected by fees, revealed no connection between low AUM and investment performance. Conversely, in many cases, a small asset base is a direct result of poor past performance. While reversion to the mean might point to superior performance going forward, all things being equal, there is no clear-cut relationship.

Also, the data that exists is subject to survivorship bias: only managers that have exceeded certain performance thresholds have survived and maintained their clients’ mandates.

Conclusion

The notion that investment firms can use one of two extreme approaches—asset gatherer or investor—to build and sustain a business is both unrealistic and overly simplistic. Individually these approaches cannot facilitate long-term success, as both asset growth and solid investment performance are necessary for initial growth, client retention and sustained vibrancy. That is why firms that adopt the blended ‘asset grower’ mentality are best positioned for lasting success. ■

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