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Larger Managers Struggle to Match Agile Boutiques

By Michael Shagrin April 22, 2014

The diversity of money managers' organizational structures provides an overall benefit to the industry, but those rewarding staff with equity stakes and clearer corporate agendas offer advantages larger conglomerates struggle to match.

Experts interviewed by *FundFire* are inclined towards corporate structures that grant employees attractive equity stakes in their firms, a characteristic more typical of boutique managers than firms owned by large financial conglomerates.

TIAA-CREF's planned $6.5 billion purchase of Nuveen Investments has renewed debate about which model best serves both investors and executives. Following the deal's announcement, senior management at TIAA-CREF touted Nuveen's multi-boutique model, and said it would operate the newly acquired firm as an autonomous subsidiary, as reported.

When *FundFire* asked readers last week about which type of manager is best positioned for growth in 2014, the poll respondents were decidedly split. The multi-product independent structure was the poll's top response garnering 34% of the vote, while the multi-boutique firm was picked by 23% of respondents.

Managers backed by a large financial services firm placed third, receiving 19% of the vote in last week's poll.

Regardless of the operating model, experts say, there are certain problems that rear their heads repeatedly.

"The best organizational models don't try to be all things to all people," says **Ben Phillips**, partner at Casey Quirk & Associates."They focus on prioritizing opportunities and best supporting the firm's competitive advantages."

For an independent firm or a boutique structure, this core competency is usually tied to manufacturing innovative investment products in one or two key strategies, he says. Conversely, firms tied more intimately to a larger financial services business usually have the upper hand when it comes to specialized distribution channels, like wholesalers targeting brokerages or a system that can handle outsourced CIO (OCIO) business.

Despite divergent attitudes on these structures, executive compensation is one area where experts find common ground.

This is particularly relevant for managers housed within large financial services firms where competing

corporate interests may restrict best practice for asset management.

Employee ownership is another differentiating factor for the smaller firms.

"Most successful money managers, in terms of continuity of management and consistency of long term investment returns, are those firms where management has a significant equity ownership stake," says **Darlene DeRemer**, managing partner and head of advisory practice at Grail Partners. "We're not big believers in financial conglomerates where there's a challenge for alignment of interests."

While large financial services firms must chart their organizational course with a diverse range of businesses in mind, more autonomous asset managers like independent multi-product firms or boutiques can more easily build an incentive structure that squarely aligns the interests of the company and its investors, DeRemer says. The simplest and oftentimes most successful organizational scheme is employee equity ownership where if a portfolio manager does well for himself, so too will he do well for investors. Even more, this is something that pension consultants and institutional clients recognize, she says.

Data compiled by Casey Quirk supports this thesis. "Employee-owned independent asset managers tend to have the best ability to retain talent because they can pay with ownership," Phillips says. "It doesn't mean a bank or public company can't replicate that, but it's generally a big advantage to the employee-owned firms."

A successful method of imitating the independent ownership model at asset management subsidiaries is the "phantom equity stake," says Phillips.

"Even though that's not the same upside you get from a fully-fledged M&A, there are a lot of ways you can mimic an equity stake," he says. This can be done by valuing the asset management business by some internal market model, though firms have been known to get creative. One example is tagging an executive's equity stake to a derivative structured on the real M&A demand for asset management firms on the open market, according to Phillips.

The general issues accompanying executive incentives at managers owned by large financial services firms may only be a symptom of a larger operational incongruity, since the priorities of parents and subsidiaries are not going to always naturally align.

However, independent managers will justifiably be attracted to the impressive distribution and operational infrastructure in place at financial conglomerates. These are some of the benefits touted by State Street Global Advisors' president and CEO, **Scott Powers**.

"SSgA is an important asset to the broader State Street business," he said in an emailed statement. "This relationship with State Street provides strong benefits to SSgA, allowing our dedicated investment professionals to focus on our first priority – providing investment insight, innovative solutions and cutting edge products to meet our clients' changing needs, while also providing our portfolio managers with the ability to nurture talent and expertise. In addition, we share many clients in common and benefit greatly from synergies on the operational and technology initiatives currently underway."

When faced with the opportunity to join a large bank or insurer, firms are at risk of not giving due consideration to impacts on the quality of investment offerings. But, a sense of urgency is understandable—an asset manager with subpar outreach to investors and their agents will have trouble surviving.

"Gone are the days when a PM believed 'if you build it, they will come.' It generally doesn't work in money management," says **Elizabeth Nesvold**, a managing partner at Silver Lane Advisors, an M&A advisory firm specializing in the asset and wealth management industries. "You can have the best [investment] idea since sliced bread, but if the world doesn't know you exist, you won't gather the assets. As a result, every manager dreams of connecting to massive distribution."

While these arrangements can sometimes yield a winning chemistry, they make both sides of the deal susceptible to short-term thinking at the expense of the long-term viability of the acquired-acquirer relationship.

“Sometimes firms transact when they are trying to address a particular shareholder need, like a founder’s liquidity dilemma, and they don’t spend nearly enough time thinking about governance and how they’ll truly work with a new partner,” says Nesvold. “Often acquirers don’t think about what it would take to build a pipe between what the manager can do and what the parent can deliver via channel distribution.”

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