CHAPTER 1

Characteristics of Successful Asset Management Firms

COPYRIGHTED MATERIAL

Generally speaking, employees and clients of asset management firms are looking for rewarding, long-term relationships with superior organizations. While newspapers and other media outlets provide frequent, often daily, scorecards of asset manager investment performance, determining superiority is difficult, requiring a long period of analysis. What does it mean to be superior? Identifying, understanding and implementing the characteristics of superior investment management firms is the key objective of this book.

Throughout this book we will relate a number of observations, some general and some very specific about various investment management firms. We will point to qualities of these firms that we, or those we interviewed, identified as positive or generally negative or disadvantageous. We are not however making recommendations for or against investing with these firms. The due diligence required to make such recommendations is beyond the scope of this book. We will simply use these firms as examples to identify and discuss the qualities that our research has identified as important for success.

Every investment firm performs two basic functions: the business function (marketing and client relations) and the investment function. We refer to firms that focus most energy on the business function generally as "product-driven" and those that focus most energy on the investment function generally as "investment-driven." These two functions often operate at cross purposes. Superior investment performance tends to attract assets from clients seeking attractive returns. This in turn may encourage product proliferation that feeds the business beast but undermines the sustainability of investment performance. A very small number of firms are built on a foundation that harmonizes the two functions. Vanguard is a product-driven firm with a low-cost business model. It delivers superior investment performance by distributing "passive" investment vehicles and avoiding the high

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

fees of actively managed vehicles. We say "passive" in quotations, because the overwhelming majority of passive vehicles are benchmarked against active indexes. It might be more appropriate to call this activity "index fund" investing. Deciding which index fund to invest in is an active decision. However, once invested in an index fund, the fund itself employs a rule-based active strategy. The rules may include capitalization, credit rating or style tilt, among others. Unless the index comprises the entire capital market, it is active. Regardless, following market nomenclature, we use "passive" and "active" in the more pedestrian sense. Passive strategies are those with close adherence to any benchmark or index. Active strategies, by most definitions, are those that take positions different from such an index with the goal of producing an attractive risk/return profile relative to the index.

Superior investment performance through active management is, on average, not compensated. After fees, active management, in general, is negatively compensated. Further, the skill required to add value through active investing is very hard to identify. Finally, finding the skilled managers who do exist is a daunting task. Vanguard is a safer alternative for those without the knowledge, experience, or resources—the vast majority of investors—to identify investment skill. This is not to say that index funds come without risk. Understanding the basic risk characteristics of various asset classes and index funds, or relying on an experienced advisor, remains a prerequisite to investing in any investment vehicle, active or passive. Despite the fact that we characterize Vanguard as a product-driven firm, John (Jack) Bogle, Vanguard's founder, speaks to the importance of client outcomes by admonishing the industry to prioritize stewardship over salesmanship. He deserves credit for undertaking this important endeavor and executing with excellence.

Capital Group is an active, investment-driven firm whose business model revolves around the delivery of superior long-term client outcomes. As Charles Ellis points out in *Capital: The Story of Long Term Investment Excellence*, "Capital Group, especially the American Funds mutual fund subsidiary, puts sound investing well ahead of sales or marketing in every business decision."[1] Charley goes so far as to say that Capital is paternalistic in its relationship with clients and potential clients. If an investment product is very salable, but not in the best interest of potential investors, then Capital will not sell the product. Capital has earned a reputation of operating in the best interest of current and prospective clients.

Why do some investment-driven and product-driven firms provide successful long-term employee and client relationships while others do not? It is impossible to provide a recipe for success, but it is possible to identify certain characteristics of successful firms. We identify five critical aspects of asset management firms that we believe significantly influence

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

superiority and success:

1. Strong culture
2. Limited size and complexity
3. Clear governance of the business and investment functions
4. First-rate (non-hierarchical) investment leadership
5. Integrity

We surveyed investors, spoke with industry leaders, and drew upon our collective experiences with multiple product- and investment-driven firms to assess the importance of each characteristic in determining superiority and success. Each is covered in detail below.

This chapter, and much of the book, argues that unifying culture among a team of individuals from diverse backgrounds and educations is indispensable to the long-term, sustainable success of asset management organizations. Due to its importance, we begin with a discussion of culture and follow with a major challenge to its survivability—the allure of size—and to critical contributors to its sustenance: strong governance, capable leadership, and integrity.

YOU CAN TAKE THE BOY OUT OF THE CULTURE, BUT YOU CAN'T TAKE THE CULTURE OUT OF THE BOY

The culture of a firm is defined by the total set of shared and socially transmitted attitudes, values, aspirations, behaviors and practices of its employees. Superior asset management firms, whether product-driven or investment-driven, exude strong and positive cultures.

Consider two very different firms, both with strong and long-standing cultures. Vanguard's culture is one that includes cost-consciousness and client outcomes. Its Internet home page states, "Investment costs count: Keep more of what you earn. The average mutual fund charges six times as much as Vanguard does." Vanguard's desire to deliver strong client outcomes is enshrined in its structure; mutual fund clients are owners of the firm.

Jack Bogle espouses the interests of Vanguard's clients through the delivery of a range of low-cost investment vehicles. Jack is noted for his frugality. When an individual joins Vanguard, there is no question of the firm's strong culture. Prospective employees know that if they are hired, they are unlikely to be jetting around the world in private jets or vacationing on yachts any time in the near future.

Some shrug off the importance of a strong and positive culture as having no place in the hardened, individualist world of investment professionals.

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

This sentiment is unwise. While culture involves much more than just legal behavior, the U.S. legal system does not support the bravado of these investment professionals. The U.S. Department of Justice says, "A corporation is directed by its management and *management is responsible for a corporate culture* in which criminal conduct is either discouraged or tacitly encouraged."[2] The guidelines for determining culpability direct judges to evaluate whether the culture encourages ethical conduct. The upper echelon of asset management firms should not be cavalier about the cultures that they promote.

> *Cowardice asks the question – is it safe? Expediency asks the question – is it politic? Vanity asks the question – is it popular? And there comes a time when one must take a position that is neither, safe, or politic, nor popular; but one must take it because it is right.*
>
> —Dr. Martin Luther King, Jr.

A strong culture does not arise from just the encouragement of legal behavior; it comprises positive values, attitudes, and performance. However, the backbone of a strong culture in any organization is its values. In 1963, Thomas J. Watson Jr., the former CEO of IBM, wrote of the firm's core values (beliefs) in the booklet *A Business and Its Beliefs:*

> *I believe the real difference between success and failure in a corporation can very often be traced to the question of how well the organization brings out the great energies and talents of its people. What does it do to help these people find common cause with each other? . . . And how can it sustain this common cause and send of direction through the many changes which take place from one generation to another? . . . [I think the answer lies] in the power of what we call* beliefs *and the appeal these beliefs have for its people. . . . I firmly believe that any organization, in order to survive and achieve success, must have a sound set of beliefs on which it premises all its policies and actions. Next, I believe that the most important single factor in corporate success is faithful adherence to those beliefs.*[3]

If values are so important, why do they seem to be the same, or at least very similar, for most firms? Moreover, firms of limited integrity often espouse positive values while ostensibly functioning free from their influence. This is no more clearly demonstrated than by reviewing the values of the now defunct firm, Enron Corporation. Enron collapsed after a long-term pattern of unethical and illegal behavior was uncovered. Figure 1.1 displays Enron's values.

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

Communication
We have an obligation to communicate. Here, we take the time to talk with one another…and to listen. We believe that information is meant to move and that information moves people.
Respect
We treat others as we would like to be treated ourselves. We do not tolerate abusive or disrespectful treatment.
Integrity
We work with customers and prospects openly, honestly and sincerely. When we say we will do something, we will do it; when we say we cannot or will not do something, then we will not do it.
Excellence
We are satisfied with nothing less that the very best in everything we do. We will continue to raise the bar for everyone. The great fun here will be for all of us to discover just how good we can really be.

FIGURE 1.1 Enron Corporation's Statement of Corporate Values
Source: www.enron.com (circa 1999)

Including the word "integrity" in Enron's values would be comical had its behaviors not destroyed the lives of so many employees and investors. The firm collapsed under the weight of executive fraud and conspiracy. Integrity is a value that Enron stated, but not one that it lived. While illegal behaviors are rare, values are more often stated than lived. We observe that many asset management firms create and display a set of values because it is a good marketing tool rather than any true set of guiding principles. One difference between firms with strong and positive cultures and other firms is the fact that their employees live the values that the firms display.

Case Study: Culture, a House Built on the Values Foundation

If a homebuilder starts from scratch, virtually any materials can be acquired and used. Eskimos in frigid environments use ice and snow. Native Americans used natural caves and cliffs or wood and animal skins. Similarly, the culture of a new firm can be determined at the outset and established by its initial and founding employees. Bill Hewlett and David Packard started Hewlett Packard with a clear set of values, the HP Way. The HP Way emerged from "deep convictions about the way business *should* be built. . . . [These convictions are] held *independent* of the current management fashions of the day."[4]

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

If a construction project is a renovation, then the builder is constrained by the existing structure, characteristics, and materials. Similarly, the materials for growing a firm, its people, must be consistent with what is already in place. Once a firm is established, the cumulative discussions and actions of every employee constitute a shared set of values and a culture that dictates recruitment, hiring, evaluation, and termination decisions.

A firm's values are not the firm's culture; they are a small aspect of the culture but arguably the most critical. Values comprise a small set of guiding principles of the organization. Capital Group, noted for its strong culture and superior mutual fund performance for example, has a culture that arises from its values. The Internet home page for Capital Group states that it offers "challenging opportunities in a highly collaborative, respectful, state-of-the-art environment."[5] Job candidates are told that Capital Group seeks individuals with specific characteristics common to all its employees: integrity, collaboration, respect, curiosity, accountability, detail-orientation, and humility.

And the Survey Says...

To test our hypothesis that firms with strong and positive cultures provide superior client outcomes, we segmented all firms into either the investment-driven or the product-driven category and queried investment professionals from around the world through surveys and interviews regarding superiority of the firms within their respective categories. Investment-driven firms are those with realized generally strong investment performance and a high potential for sustainable, superior investment performance. Product-driven firms have high client satisfaction based on offering features other than but not excluding investment performance. The non-investment features behind product-driven firms are low fees, client service, advice, diversification, and breadth.

We were not surprised to find that our queries confirmed the hypothesis. Superior firms, whether investment- or product-driven, generally possess strong and positive cultures that support their missions. In fact, of the firms covered in our research, culture was the most consistent and important differentiator of the quality of a firm. Of course some firms with strong cultures fail and others with weak cultures thrive for a period of time. However, it appears that a strong positive culture is a necessary, if not sufficient, characteristic of long-term superiority of asset management firms. The anecdotal evidence from our interviews suggests that these firms' leadership teams were able to develop shared values and culture while also maintaining and encouraging the individuality of the team's members.

Our findings are not unique and should not surprise readers familiar with extant literature. In *High Performing Investment Teams*, Jim Ware

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

identifies key factors that help the best firms attract, retain, and motivate top talent. Among these factors are 1) leadership credibility and trust and 2) organizational culture and purpose. Further down the list is total compensation.[6] Jim observes that *values* motivate *behaviors* that in turn drive *results*. These values and behaviors are manifestations of culture.

Blake Grossman, CEO of Barclays Global Investors, observed in a presentation at the 2008 CFA Institute Annual Conference that innovation success factors at asset management firms include culture and evangelism. Readers are well advised to regard Blake's observations. He has built an organization that attracts and retains talent and continues to innovate products that target client needs. Barclays Global Investors has been a success story under Blake's leadership.

The American Funds subsidiary of Capital Group has a long history of strong investment performance and superior client service. Its culture has remained consistent since the beginning:

> *We are protective of the way we do business. For more than 75 years, we have remained single-minded in our desire to do right by our investors without compromising our desire to do right by our associates. We invest in our associates using the same thoughtful, deliberate approach we use to invest in companies.*[7]

The legacy and heritage of American Funds is clear, but perhaps investors should begin to be concerned. The Capital Group home page explicitly states that American Funds is "one of the three largest mutual fund families in the U.S."[8] Neither size nor growth is a foundational value of the American Funds unit that generated a long history of superior investment performance and client outcomes. Size is often an irresistible siren's song that draws many asset management firms away from their founding and successful cultures. Has this allure become too strong for American Funds?

The Capital Guardian and Capital International institutional subsidiaries of Capital Group define their missions as superior investment performance. Unlike the American Funds subsidiary, however, they curiously do not mention client results. Perhaps this is one reason why the success of Capital Guardian and Capital International have been limited and varied, especially relative to the mutual fund unit.

SIZE MATTERS, BUT NOT IN THE WAY MOST PEOPLE BELIEVE

While it is not difficult to identify the incentives that drive asset management firms to grow beyond their optimal size for superior performance, it is

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

difficult to discern whether an asset management firm has grown beyond its optimal size. Consider two $25 billion asset management firms, one with a single capability that is $25 billion and one with 250 different capabilities each with about $100 million in assets. Both firms manage the same amount of money, but the former can manage a simple, liquid strategy without much distraction as there is only one set of investment characteristics and all clients receive identical performance and very close to identical service and communication. The latter suffers from myriad distractions that include multiple investment objectives, varied client communications, untold hours of contract negotiations and back office chaos. Size is determined not only by the assets under management, but also the number of different capabilities the firm manages.

Returning to the American Funds example, they have grown to have quite a large asset base, but have done so with relatively few capabilities. Similarly, Dodge & Cox delivered superior investment performance as it grew to be large on a limited set of capabilities. During the credit crisis of 2007 and 2008, however, Dodge and Cox stumbled. Perhaps it grew too large in assets under management (AuM) despite a limited set of capabilities. Perhaps this is nothing more than the inevitable stumble incurred by all but the luckiest of truly superior active investment managers and firms. American Funds and Dodge & Cox are examples of investment-driven firms that may have expanded beyond the viable size for maintaining investment superiority. By limiting the number of capabilities that they manage, both firms have been able to sustain tremendous AuM growth. But, all good things must come to an end, and their growth rates have potentially given them too much of a good thing.

Vanguard, on the other hand, seems to be able to grow far beyond the size of other asset management firms in both AuM and number of capabilities. Unlike American Funds and Dodge & Cox, Vanguard is a product-driven firm. It uses size to maintain or lower costs, as a benefit to its clients. Perhaps there exists a viable limit to Vanguard's growth, but for now it seems to know no bounds in the growth of its low-cost, passive business.

As in Technology, Small is Good

Size matters for investment-driven firms, but it does so via the confluence of AuM and the number of capabilities. Product-driven firms, especially those of the passive variety, can grow to be very large in both AuM and capabilities without compromising client outcomes. Our research confirms the hypothesis that asset management firms with a large number of capabilities and high AuM are either product-driven firms or investment-driven firms that have evolved, despite the inevitable protestations, into product-driven

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

firms. Unlike those that start as superior product-driven firms, large investment-driven firms struggle to generate superior client outcomes. As investment-driven firms grow, they become product-driven and ultimately provide poor investment performance and substandard client service.

Charley Ellis confirms this to be "the major problem that confronts, and often confounds, most investment management organizations: Investment success leads to asset growth that eventually overloads the organization's capacity to produce superior investment results."[9] However, total assets under management seems less of an investment performance inhibitor than the number of capabilities. Currently, most diversified investment-driven firms in excess of $25 to $30 billion find it difficult to maintain their investment edge. Over time, with capital market growth, trading platform improvement, and trading simplification by more sophisticated derivatives, the size limit for superior investment performance will grow. For a multi-asset investment firm, these factors should lead to growth of the size limit by about 7 percent to 9 percent per annum. In 2009, the cap seems to be around $25 billion. If capital markets grow at a normal rate, then in 2015 this cap will grow to something on the order of $40 billion. Of course, this is a generalization. The size limit that begins to erode performance of a firm is dependent on the firm's structure and approach, its investment process, complexity and the liquidity of its positions and strategies.

Complexity is the true Achilles heel of size. A firm's AuM can grow, but, by limiting the number of capabilities, an investment-driven firm can often retain focus and expand beyond the limits of firms that allow product proliferation. The same can be said of pension plans, endowment, foundations, sovereign wealth funds, individuals, and other multimanager investment structures. As the number of managers increase, complexity grows and investment focus often diminishes.

Perversely, when manager research teams identify a superior investment firm with a strong culture, they often direct such a flow of funds to that firm that they sow the seeds of their own demise—the firm grows beyond its optimal size. Perhaps that is why investment awards, consultant buy lists, and 5-star Morningstar ratings, are often seen as kisses of death for investment-driven firms.

Figure 1.2 provides confirmation from the perspective of the multimanager environment of manager research teams. As the number of investment managers increases, distraction as measured by additional man-hours spent *per manager* increases. The result is less focus on each investment manager.[10]

The constraint is not the number of people employed by the multimanager investment firm. Complexity diminishes the fiduciary time spent on manager research and selection as the number of managers grows. Increasing investment staff and indefinitely expanding back-office capacity is not an

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

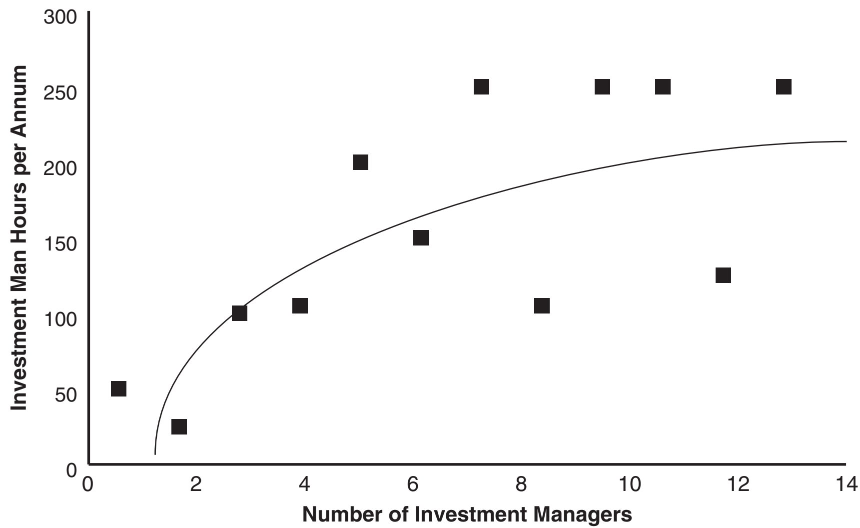

FIGURE 1.2 Application to Investment Management Structures
Source: Watson Wyatt Global Asset Study Survey, 1999.

option. As a rough guide, our research and experience suggests that about 15 to 25 capabilities is the maximum for a typical multimanager investment-driven organization. To be effective on a larger scale is possible, but it requires resources dedicated and specialized by discipline. However, for most multimanager firms 25 capabilities is the point the organization begins to migrate into a high-cost, product-driven operation. Again, this number is a generalization. With multimanager firms the capability limit is dependent on the skill, experience, history, process, and strategies employed by the firm. A few institutionally focused, investment-driven firms have demonstrated the ability to consistently deliver successful client outcomes by covering more than 25 capabilities, but they are the exception, not the rule.

The dividing line of size between investment and product-driven firms is fuzzy. Firms within a relatively wide size and capability range can be either investment or product oriented. We find that firms with few capabilities and less AuM will generally be investment-driven firms with the potential to deliver superior investment performance. Our research led to a matrix that can help guide clients in distinguishing between investment-driven and product-driven organizations.

Figure 1.3 portrays the size and capability characteristics of investment-driven and product-driven firms. The demarcation lines are not precise and firms between the dashed lines can be either investment- or product-driven. Generally speaking, superior product-driven firms can be about any size,

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

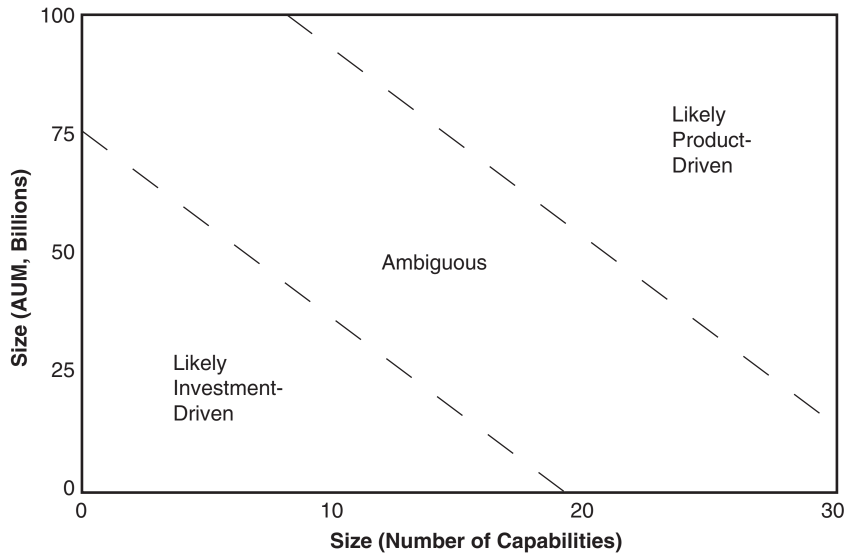

FIGURE 1.3 Investment-driven vs. Product-driven firms

from small start-up to Vanguard-like behemoth. Thus Figure 1.3 applies to investment-driven firms that evolve into product-driven firms as they grow. Notice that the capability constraint is much more restrictive than that of AuM.

Case Study: The Trojan Horse of Client-Centricity

In the mid-1990s, Gary Brinson sold Brinson Partners to Swiss Bank Corporation (SBC). At the time, the firm had less than $50 billion in assets and a limited number of capabilities. Gary was the guardian of a strong and positive investment culture and an undeniable culture built to deliver superior client outcomes. Several years after the acquisition, in the summer of 1999, Gary asked Peter Wuffli, SBC's CFO, to take over as CEO of the asset management division. Much to his credit, Peter allowed the culture that was Brinson Partners to remain intact. A further combination with Union Bank of Switzerland and the existence of "The Three Tribes"—Brinson Partners, Phillips & Drew and the Switzerland-based employees of the combined firm—created stresses that could not be contained. Capabilities began to proliferate as the temptation of revenue growth overwhelmed the investment focus. Shareholders' demands for short-term AuM and revenue growth obliged the shift to a product-driven organization.

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

But the pressures on the asset management division were stronger than those obliged by shareholder demands. UBS, after the combination with Swiss Bank, adopted a one-bank model that was client centric. This came to mean that the private bank division, because of its revenue generating power, dictated the culture of the entire bank, and a wide range investment product was created and sold in the name of client-centricity. The asset management division, which supplied product to the private banking division as well as institutional clients, could not contain the cultural spread of the private bank. The soldiers were loose inside the walls. Client-centricity no longer meant the quest for superior client outcomes; it became a thin veil for the satisfaction of client desire rather than client need. Salesmanship superseded stewardship.

The asset management division of UBS grew from 3 percent of the bank's income in the late 1990s to about 10 percent at the time of the credit crisis, but much like the investment bank, it became a "client-centric" product creator for private bank distribution. The cultures of the two largest independent investment boutiques that had existed within UBS were fused together. Brinson Partners, the fundamental value-oriented, investment-driven U.S. subsidiary and Phillips & Drew its counterpart in the United Kingdom, became a significant supplier of product to UBS's private bank. As the asset management division grew to more than $800 billion the previously strong investment cultures collapsed. Through no fault of anybody in asset management, it was simply impossible to sustain the independent investment cultures that had previously bred success. It was simply asking too much to limit AuM growth against the pressures of product-driven client-centricity and ever more shareholder value—or more precisely perhaps, *quarterly* shareholder value.

The long-term superior investment performance of Brinson Partners and Phillips & Drew were threatened on two fronts: weakening culture and rapid growth. No leadership team could hold back the private bank's cultural deluge. Superior client outcomes were trumped by shareholder demands for more value (in the form of a rising stock price) and the private bank's cultural influence. Only a governance structure and leadership team that prevented the merger in the first place could have prevented the decline. In the case of Brinson Partners, Gary was the governance structure and the leadership team. He saw the flood waters coming and decided it was time to head for higher ground.

GOVERNANCE: THE GUARDIAN OF AN INVESTMENT-DRIVEN FIRM

There is no way to prevent an investment-driven firm from becoming a product-driven firm, but there are ways to limit the possibility. This section

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

begins with an examination of a firm's mission statement before moving on to consideration of CEO and CIO authorities and responsibilities, as well as board of directors composition, and incentives. We provide practical recommendations for a governance model that sustains a growing firm's investment focus from one generation of leadership to the next.

Mission Statement

The articulated mission of a firm is important to both culture and governance. Top-performing firms use it to inspire a sense of possibility and to create organizational alignment. The best firms use it as the foundation of organizational planning, by asking how each individual and each team in the organization specifically contribute to the acheivement of the mission. For investment-driven firms, the mission plays an even more critical role in maintaing the integrity of the firm's approach.

The mission statement is the first line of defense against the deterioration of an investment-driven organization. The mission statement is a clear articulation of why a firm exists. For an investment-driven asset management firm, the mission statement clearly states that the firm's focus is superior investment performance. It will include phrases like "superior investment performance" and "the premier investment firm." The mission statements of firms that our research identified as the highest quality from the standpoint of culture share striking similarities in their focus on striving for excellence. While not all mission statements are clearly identified as such, the firm's mission is clearly understood by its employees and supported by the firm's employee and client communications.

GREAT FIRMS SEEK EXCELLENCE IN DELIVERING THEIR VALUE PROPOSITION TO CLIENTS

A number of firms in our survey were identifed as best in class with respect to their percieved focus on performance excellence. Some excerpts of their mission priorities are shown below:

- "Our investment teams are singularly focused on providing top tier investment performance." - Adams Street Partners

(*Continued*)

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

GREAT FIRMS SEEK EXCELLENCE IN DELIVERING THEIR VALUE PROPOSITION TO CLIENTS (*Continued*)

- "My overriding objective is excellence... I'll do whatever it takes to make the company great." - Bridgewater Investments
- "We see the firm's mission as the following, in order of importance: 1.) To deliver superior investment performance and advice to our clients." - GMO LLC

While these are just a few examples, what we see is a primary focus on generating superior investment performance. The best firms get their employees aligned behind the mission of performance excellence. They use the mission statement to inspire a sense of possibility and pride.

We will talk in greater depth about mission statements in Chapter 2. At this juncture it is worth following a short tangent to contemplate the precise wording of the mission and, more importantly, monitoring the mission statement for changes that signal cultural shifts.

The mission statement should be offered as the first and foremost marketing statement of an investment-driven firm. Mission statement prominence affirms the supreme investment focus of the manager and the employees. Clients should seek and confirm their mission alignment to a manager's before pursuing any other manager information. Consistency of manager and client mission statements forestalls future problems.

Hodgson, Breban, Ford, Streatfield and Urwin similarly recommend that the client or its proxy, investment consultants in their article, comprehend the asset manager's mission and governance structure.[11] The insight is important, but often the execution falls far short of the mark. Frequently, asset manager alignment is considered after the manager passes various consultant or client determined screens, primarily the three-year investment performance screen. Alignment of missions should be determined before screens of performance are considered.

More important, a prominent mission statement is more difficult to dodge or modify than an inconspicuous or nonexistent mission statement. As investment professionals, we have spent many days wrangling over mission statement wording with business management colleagues. We find that such wrangling is often the beginning of the end—especially when it contemplates dilution of the focus on investment excellence. In investment-driven firms, morphing of the mission statement is often motivated by a strengthening

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

business function as AuM grows. The mission statement becomes modified in a manner that allows the investment professionals and business function to claim congruence. Often the changes are subtle. The phrase "*the* premier investment firm" may be substituted with "*a* premier investment firm." Investment excellence may be diluted through adding emphasis to popular phrases like "client-centric" to the mission statement. There is nothing wrong with being client-centric, but such a change in the mission statement is a potential signal of more nefarious forces working in the background.

Board Composition

If the mission statement is a first line of defense of an investment advisory firm, board composition is the next barricade preventing an investment firm from becoming a product firm across leadership tenures. Best practices for board composition suggest assembling mostly independent directors in order to protect shareholder interests; but while an independent board is good for owner protection, it may not be appropriate for an investment firm.

Among the stakeholders of an investment firm are not only the owners, who are often the investment and business professionals themselves, but also the clients. Investment firm boards should be designed to protect the critical interests of owners and clients, both of whom want to retain an investment-driven culture.

In an investment organization, unlike a publicly listed company, management has a fiduciary responsibility to act in the best interest of its primary stakeholder, the client. Management is not and should not be prioritizing the interests of shareholders. Practically speaking, the supremacy of client interests means that investment-driven asset management firms should not be listed firms or divisions of listed firms. Otherwise, the primacy of client outcomes would be threatened and ultimately diminished.

In the case of many publicly registered mutual funds and even privately structured investment funds or offshore corporations, there are in fact boards of directors whose stated objective is ensuring that investors are treated appropriately and that the investment manager is acting in a way that maximizes results for all investors. In fact, these boards have the ability to terminate the investment management firm (or advisor) to the fund. However, in practice, we see very few instances in which this actually happens. In the world of hedge funds, we even see a number of professional firms who specialize in carrying out these directorial duties. These are firms that exist and are organized primarily to supply directors to the boards of hedge funds. These firms exemplify a common principal-agent conflict. These directors are hired by the principals of the advising firms. Further, some individuals are known to be directors representing 100 different boards or more.

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

2008–2009 CASE STUDY: INVESTORS UNITE TO DRIVE DIRECTOR ACCOUNTABILITY

In the hedge fund fallout of 2008 and 2009, we expect to see the issue of board independence gain increasing attention in the hedge fund industry. The independence of and incentives of board members will and should be highly scrutinized. Institutional investors and capital allocators are in a position to help push needed change in this area and to hold directors more accountable. One instance we are aware of demonstrates a case of positive change, and how institutional investors can help drive this positive change.

The advisor to a certain investment fund, organized as an offshore limited liability corporation, claimed that they were commited to working with their investors, and ultimately doing whatever their investors wanted for the fund. Through a period of very challenging performance, the advisor continued to cling to a losing investment strategy and suspended the ability of its investors to redeem from the fund, while continually destroying investment value. The advisor continued to take its management fee during this period of suspended redemptions. A group of the fund's investors united and brought a plan to the advisor to try to realign incentives and push for change. This included an orderly timeline for a winding down of the fund and a fee that was based on a percentage of capital that was returned to investors (as opposed to a regular management fee charged on assets under management each quarter). The advisor balked at the suggestions of the investor group.

The investor group comprised about one-third of the fund's investor base. They asked the advisor to call a shareholder meeting to discuss the plan with other investors. This call for a shareholder meeting was also stalled and ultimately rejected by the advisor. So, while the firm had an independent board of directors, the advisor itself would not take the investor group's recommendation for a shareholder meeting to the board. Ultimately, the group contacted the board members directly and at first had a similar result. The directors, despite having confirmation of the desire of at least a third of the fund to do so, were unresponsive to the request. Eventually the investor group was able to get the shareholder meeting called, but only by using their collective clout and applying pressure to the firm that supplied the advisor's board of directors.

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

We would not be suprised to see a more organized approach to these types of situations as a result of recent experiences. There is an opportunity for industry associations or perhaps organizations like proxy voting services to formalize processes such as these for identifying and coordinating activities among collective shareholder groups. Given the inherent principle-agent conflicts of existing board structures, this may present the best viable solution to protecting investor interests.

Corporations and Limited Liability Companies (LLCs) can have boards with governance authority. In theory, client representation on these boards would protect their interests. In practice, clients would spurn the legal liability of board membership. Limited Partnerships (LPs) do not have boards with governance authority. The general partner(s) manage the partnership along the lines of a corporate board. Thus, direct client involvement on governing boards is difficult and unlikely.

A common occurrence today is for investment firms to create an Advisory Board. These typically include insiders and clients, along with big-name academics and investors. This structure gives the appearance of enhanced client protection, but it generally does not protect client interests. Unfortunately, the Advisory Board concept is more often than not about appearances and motivated by marketing—clever and comforting, but ultimately ineffectual. Advisory Boards are good, but care should be taken to discern its role as a governing versus promotional entity.

We conclude these thoughts about boards by saying that undoubtedly, appropriately structured boards with true independence can help to protect investor interests. However, we must also note that experience has taught us that aligning client and manager interests is not necessarily best accomplished through board composition, but rather through significant manager co-investment. When managers have significant personal capital invested alongside clients, it can be a powerful driver of incentive alignment. We will reflect throughout this book on the importance of incentive alignment.

CEO and CIO Authorities

We found a strong preference among those we interviewed on the topic of CEO and CIO authorities. Simply stated: Firms that are successful, especially across multiple leadership generations, delegate CEO and CIO titles and authorities to a single individual. In many cases there is no CEO title, with the CIO taking on both sets of authorities. A critical separation is that of

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

CIO and Chief Operating Officer (COO). The COO has authority over and responsibility for managing the affairs of the investment business. The CIO focus on investment process and strategy, as well as policy matters that could threaten the firm's investment focus.

Investment-driven firms tend to have a single officer with authority over executive and investment activities. Since successful firms are typically small and simple, there is no need for separation. Product-driven firms, on the other hand, tend to be larger and more complex, requiring the separation of the CEO and CIO titles and authorities. Separation of these authorities provides yet another sign of a product-driven firm. Even if the firm is small and has strong investment performance, it is susceptible to shifting away from its investment kernel.

If for some reason the CEO and CIO responsibilities are separated, legal documentation ensuring the de facto alignment of CEO and CIO authorities with the investment-driven mission is appropriate. Unfortunately, these incentives are very difficult to craft without overly constraining governance documents. Firms with separate CEO and CIO titles can be extremely successful over a single generation of leadership. Firms like Arrowstreet Capital have alignment of objectives, desires and values, but Arrowstreet Capital's powerful and well articulated mission reflect the guiding principles of the CEO and CIO.

Incentives

The confluence of mission statement and values, board composition, and CEO/CIO authorities are the governance backbone of investment-driven organizations. Given a clear mission statement and unambiguously articulated CEO/CIO authorities, the board must act to incentivize congruent management behaviors. The CEO/CIO is responsible and must be remunerated for superior long-term investment performance, superior client outcomes, and guarding the mission and values. If the CEO/CIO begins to act in a manner that is incongruous, then the board should reduce remuneration and, if actions are not realigned, begin the process of finding a replacement.

Later chapters elaborate on how to define superior investment performance and client outcomes, and discuss reinforcement of and barriers to desired outcomes. Briefly, though, investment performance can be achieved by an investment-driven organization that objectively evaluates and rewards its employees. Chapters 2 and 3 provide a straightforward set of tools for creating appropriate incentives for all management and staff. The board incentivizes the CEO/CIO, and the Management Committee, using these tools, incentivizes all other employees, including themselves.

FOSTERING COLLABORATIVE FREEDOM: EVERYBODY IS A PEER

In the asset management community, as with many industries, professionals are promoted to management positions based on their investment or asset gathering success. As a result, the highest levels of these organizations are rife with individuals devoid of leadership or management skills. We have personally witnessed countless examples of this. The best investment professionals are often promoted into supervisory or leadership roles despite no experience or aptitude for leadership. Similarly, we have seen individuals with strong sales and client service skills promoted to lead business functions, devoid of the required leadership skills. Promoting the wrong individuals into these leadership positions is one of the most common and potentially negative drivers of firm performance. These decisions once made are difficult to undue and deserve much attention and planning. Our experience suggests that the fallout, more often than not, is that either arrogant coercion masquerades as leadership or anarchic complaisance precludes decision making.

The leadership spectrum ranges from hubristic control to detached anarchy, with control being more common. According to Gary Hamel, "Command-and-control systems reflect a deep mistrust of employees' commitment and competence."[12] We believe that Hamel is too strong in making this conclusion. The control leadership style results in compliance, but does so at the expense of creativity and peer engagement and contribution.

Military leadership, where individuals must act in concert or they threaten each other and the broad campaign, requires a firm leadership hierarchy and unquestioned compliance with leadership requests. Such a hierarchy does not preclude flexibility, but constrains it to occur within precise parameters. Additionally, processes or teams where individuals fill precise roles—with flexibility, innovation, and creativity of limited value—are amendable to command-and-control leadership styles.

Consider the leadership of Ross Perot, the founder of Electronic Data Systems (EDS), who started the firm in the 1960s and eventually left the organization in 1986. EDS provided technological and data management outsourcing for firms that needed to organize out-of-control systems. Control-based leadership was effective for EDS's assignments. The control environment is anecdotally supported by the strict dress code, including no facial hair. The Associated Press (AP) reported in 1997 on the loosening of a last vestige of Perot's leadership style. EDS relaxed its dress code to allow pantsuits for women. This aspect of the firm's strong culture survived for 10 years after Perot's departure.

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

Many of EDS's early employees, consistent with the firm's culture and Perot's command-and-control leadership style, came from the military, specifically the battlefields of Vietnam. These employees, and subsequent employees, function in a military-like environment. So much so that in the late 1970s EDS undertook a military campaign. In 1978, two EDS employees were taken hostage in Tehran, Iran. The U.S. and Iran governments failed to act on behalf of the hostages, so Perot and his leadership team launched operation HOTFOOT (Help Our Two Friends Out Of Tehran).

Perot recruited retired U.S. Army Green Beret Arthur D. "Bull" Simons to command a rescue mission. Perot slipped into Iran, posing as a news courier, and informed the hostages of an impending rescue mission. EDS employees were recruited for the mission, and the two hostages were successfully liberated.

According to Glenn Johnson, a member of the rescue team, the team executed the mission because it was something that needed to be done. Clearly, command-and-control leadership can be successful for teams with a precise mission and clear roles.

Leadership disengagement, at the other end of the spectrum, is spawned from either fear or complacency and nurtured in a power vacuum. The result is anarchy and an organization incapable of making decisions at all levels. Anarchy is not intentional. A former colleague of ours epitomizes leadership disengagement and demonstrated how anarchy evolves. This colleague espoused and supported whatever idea had most recently come across his desk. He was firmly behind the proposal and plan until the next distraction waltzed in front of him. As a result, none of his peers or reports could discern direction; he was a complete power void.

The "product" of an investment-driven firm is superior investment performance. The product is made differently every single day. The manufacturing environment changes every day. An investment firm is not a factory, and the CIO never knows which employee, from most senior to most junior, will offer a great investment idea or insight. In this regard, all employees are peers.

Whereas control is viable for precise missions and roles, and with a clear hierarchy, and anarchy involves the chaotic collection of individuals' independent endeavors, collaborative freedom is an important middle ground. But what does collaborative freedom mean to a leader?

Collaborative freedom is a leadership framework comprising mission, values, and objectives within which productive and creative activity occurs. The future, Hamel contends, will rely on more collaborative, peer-based leadership structures.[13] In the asset management industry, the real-time need for diverse perspectives and constructive disagreement suggests that leadership through collaborative freedom is of immediate importance.

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

This leadership style leaves tremendous authority to individuals. Individuals clearly see the desires of the leader and use this knowledge to plan and make decisions. The role of the leader is to establish evolving ends and allow management and staff a multitude of unspecified means with which to execute.

It may seem odd, but in 1944, near the end or World War II, a British economist published one of the best commentaries on leadership. Friedrick A. Hayek feared that the ideals of socialism and fascism, particularly in National Socialist Germany, the Soviet Union, and Italy, were too easily embraced by intellectuals around the world. He explored the manner in which these ideas adversely hijack the leaders and members of economic systems. Hayek's *The Road to Serfdom* is considered primarily a commentary on political systems, but the leadership ideas apply ubiquitously.[14]

Hayek could see the power of freedom and the greatness of leaders who afford freedom. He observed, "Whenever the barriers to the free exercise of human ingenuity were removed, man became rapidly able to satisfy ever widening ranges of desire."[15]

> *People ask the difference between a leader and a boss. The leader works in the open, and the boss in covert. The leader leads, and the boss drives.*
>
> —Theodore Roosevelt

In 1962, Alfred Chandler published *Strategy and Structure* about the organization of corporations, arguing that structure follows strategy. While the examples in Chandler's book argued that that strategy would lead to an organizational structure that facilitated successful implementation of the strategy, it identified a risk that such structure would subsequently dictate future strategies. Chandler reasoned that structure needed to be redesigned in order to support evolving strategy.[16]

Hamel also observed that

> *Management processes often contain subtle biases that favor continuity over change. Planning processes reinforce out-of-date views of customers and competitor, for instance; ... incentive systems provide larger rewards for caretaker managers than for internal entrepreneurs; [and] measurement systems understate the value of creating new strategic options.... Redistribute power to those who have most of their emotional equity invested in the future and have the least to lose from change.*[17]

While Hamel's use of the word "power" is somewhat amorphous, his thesis clearly points to the limits of command-and-control leadership and

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

the strengths of a collaborative freedom leadership system for fostering the continual change of structure to support evolving strategy. As Hayek observed decades earlier, "The fundamental principle that in the ordering of our affairs we should make as much use as possible of the spontaneous forces of society, and resort as little as possible to coercion, is capable of an infinite variety of applications."[18]

Bringing this theory back to reality today, our research is incredibly consistent. Top asset management firms embrace this type of transformational leadership. The culture of these firms emphasizes ideas over hierarchy and execution over intention.

Investment leadership depends on the voluntary cooperation of individuals, exploiting and leveraging each other's diverse skills and knowledge. A firm's culture, mission, objectives, and values define the framework within which this voluntary cooperation achieves desired outcomes for all employees and all clients. The leader identifies the ends while collaborative freedom determines the means and shapes strategy that in turn shapes the firm's

IDEAS OVER HIERARCHY

A number of firms in our survey were identified as best in class in hiring and cultivating talent. These firms are perceived to live the values they espouse as it relates to encouraging a peer-driven mangement style. The focus of these firms is on idea generation, collaboration, empowerment, and encouraging employees to openly debate and challenge one another in a constructive way. Creating this kind of culture is difficult, but the rewards for successful execution are evident.

- "Conflict in the pursuit of excellence is a terrific thing and is strongly encouraged, in fact demanded. There should be no (or as little as possible) hierarchy." - Ray Dalio, Bridgewater Investments
- "New hires often enjoy surprising amounts of responsibility, and we encourage collaboration, personal mentorships with senior team members, and the open exploration of ideas." - D.E. Shaw Group
- "Our primary goal is to recruit top-tier candidates, challenge their thinking, cultivate their talent, and ultimately help them succeed." - The Blackstone Group

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

structure. While there will always be leadership levels, each and every individual is a peer in the future of the organization. Chapters 2 and 3 elaborate on the implication of these concepts for the leadership and management of an investment organization.

> *Let a hundred flowers bloom and a hundred schools of thought contend.*
>
> —Chinese Proverb

Chandler's thesis is that execution is fostered by a structure that derives its form from the specified strategy. Culture, mission, values, and objectives lead to key performance indicators (KPIs) that provide continual guidance to all divisions, teams, and individuals to execute and make decisions consistent with strategy. Charley Ellis states that, "the long-term destinies of most investment management organizations are disproportionately determined by compromising decisions made during the very early years of the organizations history."[19] Ellis seems to be observing the fact that the initial strategy dictates a structure that later becomes compromising to the organizations.

In fact, he further observes that "success with a specific strategy all too often leads to the buildup of a corporate structure that gets more and more consistent and efficient—and eventually rigid. This appears to enhance efficiency, as reported results get better and better for a while. But over time, "the way we do things here gets celebrated and codified. . . . The organizational structure, with its familiar practices and comfortable practitioners, they reinforce rising rigidity."[20] The leadership team establishes the ends and, ultimately, execution becomes a form of organizational and individual commitment and integrity.

INTEGRITY: AN UNQUESTIONABLE CHARACTERISTIC OF SUCCESS

Among its definitions, "integrity" is typically understood to mean strict adherence to a moral code. To us this is only part of it. Integrity has a mechanical as well as a moral meaning that is important for high-quality asset management firms, regardless of their focus.

Consider a complex machine, such as a voting card reader. If the voting machine is to have integrity, it must meet certain minimum standards without error or failure. Similarly, a gun that functions time-after-time without error is a complex instrument that is said to have integrity.

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

The shortest and surest way to live with honor in the world is to be in reality what we would appear to be.

—Socrates

As a leader or employee, integrity is about doing what you say you will do. Your actions match your words, without error or failure. Your actions are consistent and predictable.

2008–2009 CASE STUDY: 50 BILLION LESSONS LEARNED FROM BERNIE MADOFF

There are hundreds of lessons in recent history that demonstrate just how difficult it can be to assess integrity. There is one from the recent period that deserves special attention. Bernard Madoff, a well-known industry professional, was exposed as a conman after committing a fraud of epic proportions. While the tallying is not yet complete as of this writing, it appears that he swindled private and institutional investors out of somewhere between $30 billion and $50 billion by convincing them that he had a strategy that could make money no matter what and that he had been doing so for many years. In reality, he was falsifying documents and perpetrating perhaps the greatest investment scam of all time. That is a staggering amount of money, and it is larger than the gross national product of more than 100 recognized countries.

Do you think that the hundreds of individuals and institutions that "invested" capital with Bernard Madoff believed that he was not only an individual lacking integrity, but also a sociopath capable of deceitful wealth destruction of the scale that appears to be the case? Of course not. For whatever reason, he had their complete trust. Sometimes the smartest, most charismatic, and persuasive individuals end up demonstrating a remarkable lack of integrity. And this is a lesson for us all. Integrity is something that must be demonstrated by actions across time. Investors cannot be afraid to ask for transparency and verifiable evidence in support of claims. And most important, investors cannot shortcut their own processes, as it appears many did. Despite the clear lack of integrity in the case of Bernard Madoff, an investor with any kind of investment process and integrity of that process would have been hard pressed to ever allocate money to him in the first place.

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

Real integrity evidences itself in times of organizational stress. Integrity is doing the right thing in the face of adversity, exactly when it would be easiest not to. It is holding fast to your beliefs and principles with the knowledge that doing so will certainly cause greater pain in the short-run. Throughout this book, we will come back to the issues and importance of integrity.

CONCLUSION

A strong and positive culture, limited size, strong governance for the protection of client interests, collaborative leadership, and integrity are all components of an organization that does right by its clients. For investment-driven asset management organizations, "hoovering" assets is not in the clients' best interests. Limiting growth and size requires an additional overlay of integrity, the integrity to say "no" to capability variations, to assets under management growth that becomes a drag on investment performance, to taking more risk than a client is comfortable taking, to anything that has the potential to impede investment performance in any non-negligible manner.

According to our surveys and interviews, some of the most consistent examples of investment-driven firms include Brandes Investment Partners; Bridgewater Associates; Grantham, Mayo, Van Otterloo (GMO); and Marsico Capital Management.

In the late 1990s, GMO held firm to its value-based fundamental discipline and refused to buy the high-flying TMT stocks. Many of its clients terminated their relationship, perhaps inevitable but a failure of communication nonetheless, and GMO's AuM was halved. After the TMT bubble burst, clients understood GMO's high level of investment integrity, enabling a doubling of the initial asset base.

The American Funds subsidiary of the Capital Group is a unique investment-driven organization in that it has an extremely large AuM, but it has a strong culture and has limited the number of capabilities that it manages. The strength of culture and limited capabilities, despite high AuM, have enabled American Funds to sustain an investment-driven existence for decades.

Among product-driven firms and former investment-driven firms that have shifted into the product-driven category are Fidelity Investments (Mutual Funds), Nicholas-Applegate Capital Management, Northern Trust, Nuveen Investments, Schroeder Investment Management Limited, and The Vanguard Group.

The powerful incentive of 2 percent management fees and 20 percent performance fees to grow assets and weak governance structures compelled many hedge fund firms that were otherwise investment focused and

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT154-Singer August 26, 2009 10:53 Printer: Courier Westford

possessed strong cultures to become extremely high priced, product-driven firms. Our survey identified a number of firms about which investors have growing concerns. Among these fallen angels, and avoiding the fraudulent, are Bear Stearns Asset Management, Goldman Sachs Asset Management, Highbridge Capital Management, and MAN Investments. Their actions, focus, and integrity in the days ahead will have a great impact on their ultimate success or failure.

Transparency makes ethics and integrity easier. The bright light of transparency prevents the shadowy presence of misaligned incentives to drive investment-driven asset management firms from their initial core purpose—investment performance and client outcomes. Absent transparency, the culture can change, size can become a priority, governance can falter, and leadership can wane. Justice Louis Brandeis coined a phrase that should garner our attention when he said, “Sunlight is the best disinfectant.” He was referring to transparency and honesty in public policy. But whether talking about the relations of a firm with its employees or with its clients, we would all do well to take heed.

In this chapter we have identified a number of characteristics of high-quality asset management firms. We focused on the importance of a strong culture and what that means for successful asset management firms. We also discussed the hazards posed by growth of assets and proliferation of products. Lastly we reiterated the importance of effective governance, leadership, and integrity. In Chapters 2 and 3 we will outline a more prescriptive framework for building a successful asset management firm. This starts with another detailed look at mission statements and values. However, we quickly move into a discussion of the practical considerations for setting up management and governance structures and identify best practices for execution of the mission.