Highlights from 27th Annual AIMSE Conference
May 2 – 4, 2004

Session Highlights

Industry Leaders Look at the Investment Management Business
Moderator: Victor A. Zollo, Jr., *DePrince, Race & Zollo, Inc.*
Panelists: Andrew Barth, *Capital Guardian Trust Company*; Mike Cosgrove, *Chartwell Investments*; William Turchyn, *Mariner Investment Group*

- Traditional assets will continue to be melded into alternative asset classes
- Positive market rebound
  - Aging population = strong demand of wealth management
  - New rules for transparency and control of fees/costs
  - Better oversight demanded
- There will be a need for cultures of unyielding compliance and integrity vs. casual compliance
  - Relationship-driven sales and marketing vs. product-driven
  - Focus on clear, consistent philosophy and repeatable process vs. benchmarks
- Regulatory changes
  - Too much change could micromanage our industry and be counter-productive to the interests of those for whom we are managing money
- Positive responses to the bear market include:
  - Moving away from putting managers in a box
  - The idea of absolute return strategies is good for the industry
  - Getting back to market expectations as a lower percent is a positive (one manager believes in delivering low double digits or high single digits over the long term)
  - Best way to add value is to remain focused
- For smaller firms, having a diverse ownership structure helps each owner watch each others' backs
  - Integrity and friendship are key – have mutual respect and trust for each other
  - Research and development group is important for small firms, especially when a cap is reached for core products
  - When you have a new product, communicate that you have the appropriate resources
- Hedge funds today:
  - There's growing acceptance
  - Structured products are driving asset growth (rapid growth in assets under management)
    - Investable indices
    - Principal-protected products

        - Leveraged investments
        - Insurance wrappers
    - There is a migration of talent from traditional shops to hedge funds
    - Portfolio managers move to hedge shops so they will be compensated for their individual performance:
        - Can use all financial tools available (shorting, derivatives, etc.)
        - Better lifestyle
        - Less bureaucracy
    - 5% to 7% of hedge fund managers control 30% of assets
- When selecting a hedge fund manager, look for:
    - Cycles of performance/consistency
    - People behind them
    - Strong research capability
    - Sound structure of base to work from
    - Ask yourself, "How much can I lose?"
        - Look at their worst periods of performance and find out what they did and why
- Hedge fund observations:
    - ERISA regulations are different and create capacity issues
    - Liquid strategies seem to attract most capital
    - Convergence of private equity and hedge funds

Straight Talk: The Consultant Roundtables

Searches

- Many searches now are due to failed expectations; some due to scandal issues
- Real estates searches are up/interest is steady

Client Issues

- Many clients are pulling in their desires and avoiding products that are at the extreme ends of the spectrum
- Client challenges:
    - Higher absolute returns needs
    - Help me with my bonds
    - Actuarial assumptions are higher
- Looking for smaller managers to blend with larger managers since so many managers on the equity side are closing
- Some clients are looking at municipal markets; many are doing asset allocation studies
- People are giving thought to liquidity – using it to rebalance
- Public funds are considering big allocations to TIPs
- Seeing interest in convertible bonds

- Trying to get clients to think more broadly (diversify) – international small, emerging markets debt, convertible bonds

What's hot now:
- Esoteric strategies – alpha strategies; they do not have to fit with other asset classes – consultants do this by pairing up client needs with strategies
- Global research and global stocks – key to success is an integrated research platform (can be done by smaller firms, but is a challenge)
- Pension risk management
- Structured manager programs have led to an up tick in consultants' businesses
- Some interest in global in the US but more in the UK
- Concentrated portfolios <40 or <50 holdings
- Portable alpha
- Clients hedging portfolios

Not hot now:
- Emerging markets (need to reeducate your clients now); EAFE index funds; regional international programs (like Japan-only); non-US fixed income; large cap value

On Managers
- Starting research on emerging manager firms (move out of category at $3-$4 B)
- Not steadfast about a 3-5 year track record – thinks new teams of highly experienced professionals are great and would give them a strong look
- Including hedge funds in asset allocation studies – maybe 5%

Trends
- In low-yielding environment, advising clients as a substitute to fixed income:
  - High yield
  - Hedge funds or hedge fund of funds to a degree
  - TIPS, they are unwinding though
  - Real estate
- Fixed income – discussing matching liability box to fixed income allocations
- Multicap and allcap go in consultant's "other" category; demand is not high

Meet the Plan Sponsor Roundtables

Hot issues
- Changes to corporate governance – it is important for managers to know their firms' positions and proxy voting records (working with Taft-Hartleys)
  - If you can defend your vote, that is perceived as a strength
- Some plan sponsors looking at consultants who sell services to investment managers and assessing if they will continue to work with them
- Looking at new asset classes – hedge funds, currency overlays, global allocations

Working together

- It is key to meet the Executive Director or know a Trustee
- Important to know who the leaders are on a Board; know longevity and how much time they are involved in the Board on a regular basis
- Demand for reporting from managers will increase
- When working with clients, have a checklist to choose from in terms of what client would like to receive monthly, quarterly, annually. Have checklist signed; verify needs are being met.
- Some plan sponsors take a more tactical approach and when a product performs well, they take money from it and reallocate
- Behavioral finance is of interest – review manager data/statistics; in addition, focus on the manager's current active bets as well as process and research
- Some plan sponsors are more amenable to new manager meetings when referred from another plan sponsor or manager has a long, strong track record

The State of the Industry: A Peer Review
Moderator: Keith McDowell, *McDowell Consulting*
Panelists: Jeff French, *The Duke Endowment*; Eve Guernsey, *JPMorgan Fleming Asset Management*; Paul Troup, *Callan Associates Inc.*

- Peer Review: survey of the attendees found the following:
  - What is your primary strategy for calling on consultants?
    - Of the 116 respondents, half have a dedicated consultant relations team
      - Duke Endowment does not use a consultant for manager searches. They use a database service and meet with managers daily.
  - What is the most effective way to meet consultants?
    - Top responses included:
      - Research meetings or direct meetings with consultants
      - Through a plan sponsor referral
      - Lunch meetings
  - Of the 116 respondents, how many attend a consultant-sponsored conference?
    - 58% - Do
    - 42% - Do not
  - Was the investment of attending worthwhile?
    - 59% - Yes
    - 41% - No
      - Those that responded it was worthwhile said they were able "to meet the consultants" but not really able "to talk about products."
  - What's the most important aspect of consultant access?
    - Agreeing to meet with you

- Providing information before finals
  - Of those who follow up and ask for feedback after a final, 62% feel they get adequate information back
    - Do they receive honest and constructive feedback after finals?
      - 34% - Agree
      - 44% - Somewhat agree
      - 14% - Disagree

    Paul Troup shared that a client may fall in love with a manager and that can drive the decision. He added that 10% of managers ask him for feedback after a final, and fewer ask for feedback if they have won.

- Sales – how are you compensated?
  - 35% - Salary plus discretionary bonus
  - 54% - Salary plus fee-generated bonus
  - 5% - Commission only
  - 7% - Other
- What are the main criteria behind your discretionary bonus?
  - 23% - Assets raised
  - 7% - Number of calls
  - 5% - Number of finals
  - 37% - All of the above
  - 26% - No formula
- Is client service compensation tied to sales/asset growth?
  - 51% - Yes
  - 31% - No
  - 18% - Do not know
- Is client service bonus tied to fees maintained?
  - 74% - Yes
  - 26% - No
- Within your firm, are portfolio managers directly compensated for sales and increasing assets?
  - 35% - Yes
  - 59% - No
  - 6% - Do not know
    - Does this impact the sales process?
      - 35% - Yes
      - 65% - No

Developing a Marketing Plan – A Market Segment Approach
Moderator: John Brown, *Putnam Investments*
Panelists: Michael E. Fisher, *Barclays Global Investors*; Eugene M. Waldron, Jr., *Capital Guardian Trust Company*

Eugene M. Waldron, Jr., *Capital Guardian Trust Company*

- Capital Guardian Trust Company takes a segment approach when marketing to public funds. The coverage is complex and includes:
  - Staff
  - Consultants
  - Trustees
  - Close-knit community
  - Commonality of issues
- Segment division includes:
  - Large >$1 B
  - Medium $500 M - $1 B
  - Small $0 - $500 M
- Coverage – Relationship Managers' geographic coverage is loosely defined – the relationship is the key factor and leads the decision on who covers who. The next layer is determined by product.
- Regions are defined as Northeast, Midwest, Southeast and Northwest. They look at the asset size in each region.
  - When a plan sponsor moves to another firm, CGTC hands off the relationship to whomever covers that firm
- Success is measured by number of hires, fires and meetings held
- The issues of defined benefit plans leaving the public fund world will be many years down the road; a 20+ year cycle
- Compensation is completely subjective with no fixed formula. CGTC has recently changed their compensation structure. It is now more objective and includes an internal client satisfaction survey (completed by peers). On average, compensation has gone up within the new structure; it helps to smooth the impact of loosing a big account and also helps to bring junior professionals' salaries up quicker.

Michael E. Fisher, *Barclays Global Investors*

- Mike has led the charge to build BGI's Exchange Traded Funds (ETF) business. They created a new product for a diversified audience. ETFs are index funds that trade like a stock, and compete with futures, program trades, and traditional index funds. Currently, there are 106 ETFs in the U.S.; BGI manages 81 of the 106 through their iShares program.

- BGI's internal comparison of business segment success drives:
  - Business Lines
    - Institutional Indexing, Active Management, ETFs
  - Key Success Drivers
    - Scale, product quality, pricing
    - Research, performance, unique product features
  - Partner with SEI – channel/partner management capabilities, service differentiator, exclusive licenses, product depth/speed to market
- Alternative Model for ETFs business
  - Create a supermarket for ETFs
  - Substantial promotion – marketing and education
  - Exclusive index licenses
  - Heavy reliance on outsourcing
- BGI drives a broad product line through an efficiently managed set of intermediaries (individual and institutional)
- Growth in ETF industry:
  - In 1999, there was $23 B in assets, today there is $170 B. BGI has $80 B; Q1 04 they had inflows of $11.9 B. They book $1 B a week net, currently. 45% is institutional and 55% is retail. BGI will exit 2004 with a run rate revenue stream of $300 M.

John Brown, *Putnam Investments*

- 80% of searches are tied to consultants; 75% win rate when tied to consultants in the defined benefit market. Putnam found 90% of their wins came from the top 12 consultants in the industry.
- Investment consultant model – John believes in a comprehensive coverage approach:
  - Executives
  - Business group
  - Field consultants
  - Service providers
  - Future influences
- Segmentation:
  - Focus on top 12 consultants
  - Opportunity coverage elsewhere
  - Update and maintain all databases
- Value-added service
  - Thought leadership
  - Leg-work support – provide extra work when requested
  - Provide top-down and bottom-up coverage – it's a robust approach

- Have a dedicated team of 12+ people who all are CFAs or MBAs (not typical "sales" people). Five senior people – three for defined benefit and two for defined contribution. Have one single individual cover a consultant including the research and field contacts.
  - Three junior in-house/field people
  - Separate Taft-Hartley coverage
  - Develop an annual account plan for every consultant (same as a sales plan)
- Benefits versus tradeoffs
  - Single contact point for the research and field specialists at consultant firms is very difficult
  - Segmentation versus broad coverage/boutique focus
  - Comprehensive communication versus selective
  - Access/transparency versus proactive/reserved

Alternative Investments: An In-Depth Look
Moderator: Venita L. Olson, *AllianceBernstein Institutional Investment Management*
Panelists: Joseph S. Nankof, *Rocaton Investment Advisors, LLC*; Bill Lee, *Levi Strauss & Co.;* James Clarke, *Ewing Marion Kauffman Foundation*

Joseph S. Nankof, *Rocaton Investment Advisors, LLC*
- Today, nearly half of Rocaton's clients have allocations to absolute return strategies
  - Placed over $8 B since April 2002
  - Allocations typically range from 5% to 20% of plan assets
- Strategies utilized are a mix:
  - 50% - 60% hedge fund-of-funds
  - 30% - 40% multi-strategy hedge funds
  - 10% - 20% direct strategies
- 80% are implemented through portable alpha
- Advantages of investing in hedge funds include:
  - Diversification
  - Expands opportunity set
  - Risk/return characteristics
  - Hedge funds attract top investment talent
  - Massive opportunity – over 50% of pension assets are allocated to highly efficient markets
    - Absolute return strategies could consume a meaningful portion of these assets in the next five years
- Markets will evolve – hedge fund managers will embrace more institutional practices (e.g., transparency, fees); traditional managers will discover ways to build absolute return products

- Hedge fund assets have grown from $50 B in 1990 to over $750 B in 2003 (Source: TASS)
  - Spreads may compress as investors increase their allocations to arbitrage opportunities such as convertible arbitrage and merger arbitrage. Therefore, absolute return strategies deriving alpha from deeper, more liquid markets may become increasingly important.
  - Demand for absolute return strategies could be for the following areas:
    - Fixed income, currencies, commodities, equity long-short
- Market Composition

  Hedge Fund Investors – US Demand for Hedge Fund of Funds

Client	**2000 $US B**	**2005 $US B**
HNW Individuals	43.1	132.2
Endowments	8.0	27.5
Foundations	7.8	26.6
Corporate	6.9	28.2
Public Funds	10.6	35.6
Insurance	2.0	9.0
Total	**78.4**	**259.1**
Source: Freeman & Co.		

- Where do hedge funds fit?
  - Portable alpha
  - Alternative investment
  - Fixed income substitute
- 60% of hedge funds that fail are operational in nature
- Long-only shops that have a hedge fund
  - Quantitative managers are in the best position
  - Fundamental managers have other issues – have to have all your questions addressed beforehand like a start-up would do
- Multi-strategy firms are more attractive
  - Diversification by strategy not manager
  - Single layer of fees
  - Moderate investment flexibility across strategies
  - Universe of firms is somewhat limited

Bill Lee, *Levi Strauss & Co.*

- Works with three committees within Levi Strauss – he makes the case for them to have interest in real estate, hedge funds and private equity
- DeMarche is Levi's consultant

- During the evaluation and selection process of fund of funds managers, they will review:
  - Consistency of correlation patterns through a variety of market cycles
  - Risk management background and techniques
  - Risk management can take place of less transparency
  - Organizational structure of the fund of funds managers
  - Amount of personal net worth invested; who is invested at the firm?
  - Who are the professionals, their backgrounds?
  - What is the structure of the incentive pool?
  - Assets under management need to be strong, consistent, stable
  - Presence of other institutional investors is important
- Tough questions such as: What has been your worst experience? What was your worst/best drawdown period? What has been your biggest mistake?
- Goal is to be comfortable with manager, their philosophy, process, people

James Clarke, *Ewing Marion Kauffman Foundation*

- $1.9 B with 3½ full time staff
- Have a heavy venture bias but are scaling back; 20% allocation to hedge funds; also in real estate and natural resources
- Foundation has no gatekeeper, and they do not rely on consultants; they take a direct route approach
- James is responsible for private equity, which is split with hedge funds. This is a tough category to staff.
- Private equity
  - 1999 had a 54% allocation
  - 2001 and 2002 were triage years
  - 2003 – things were hopeful (there was a change in outlook and philosophy)
  - 2004 – the early signs were positive; wait and see
  - Currently working through issues; know they are two to three years from being out of the woods
- For hedge funds, there is a concern that a correction is coming
- Like to spend time with principals and the layer of professionals below
  - Want to learn how they know each other, how they work together

The above notes are from sessions attended at the 2004 AIMSE Annual Conference. Any errors of fact or interpretation are our own. The brilliant insights and comments are those of the speakers.