Introduction

A Sea of Changes and Waves of Opportunity

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The 2008 financial crisis roiled an already-turbulent environment. The authors review major elements of that pre-crisis turmoil as fiduciaries and asset managers confront their stewardship challenges. As John Minahan of New England Pension Consultants observes in Chapter 23 of this book, "In rapidly changing times it is especially valuable to examine one's beliefs in light of theory, evidence, and alternative points of view."

The decline of capital and credit markets across the world in 2008 and 2009 profoundly changed the landscape for institutional investors, but the obligations and commitments remained the same. The magnitude of change in the institutional investment industry continues to accelerate, creating a sea of challenges and waves of opportunities for investors, consultants, and investment managers alike.

In 1980, total pension assets were less than $1 trillion. According to Watson Wyatt, the world's 300 largest pension and investment funds grew to $12 trillion as of 12/31/07. But 2008 turned the investment world upside down. Let's compare and contrast the change from December 31, 2007 to December 31, 2008.

As of December 31, 2007, at least 12 firms reported that they managed more than $1 trillion, including one firm that managed over $2 trillion. December 31, 2008 showed the severe impact of the market declines. None of us would have imagined that Bear Stearns, Lehman Brothers, American Insurance Group, or Merrill Lynch would be out of business or purchased by competitors. The $50+ billion fraud engineered by Bernard Madoff took everyone by surprise, including the Securities and Exchange Commission (SEC) and industry experts. See Exhibit I.1.

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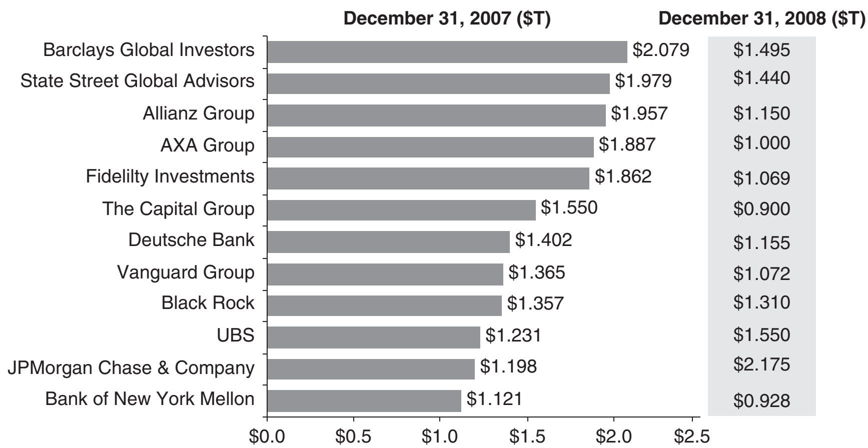

EXHIBIT I.1 Assets Under Management (in $T)
Sources: Nelson Marketplace, directly from managers, managers' websites, published articles, Watson Wyatt's The World's 500 Largest Asset Managers Year End 2007.

Institutional investors now face even more complex issues in managing their investment programs, achieving risk/return objectives, and meeting their actuarial assumptions, or payout and income needs. Investment managers face unprecedented needs to cut expenses and reduce staff, fierce competition, deeper scrutiny, and cumbersome, likely increased regulatory requirements. At the same time, investors and managers alike benefit from new asset-allocation tools, an abundance of innovative investment instruments, breakthroughs from academia, technology and mathematical science, and globalization. Debates over benefits, necessary regulations, reporting requirements, transparency, correlations, and costs abound. Opportunities are emerging from the collective efforts of governments around the world, as well as private sectors working together to resolve the 2008–09 financial crisis. We face a whole new world.

Our chapter is a random walk through seven major changes distinct from the 2008-09 financial crises that are literally transforming our industry as we write:

1. Restructuring of Investment Plans—Out with the Old; In with the New
2. Evolving Investor Skills and Preferences—The Climb to Higher Ground
3. Globalization—Broader Opportunity Set and Expanding Competition
4. Specialization in Professionals' Roles—Creating Barriers to Entry and a Stronger Foundation for Growth

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5. Advances in Technologies and Systems—Penny-Wise or Pound-Foolish?
6. Proliferation of Consultants and Their Changing Roles—Gatekeeper, Competitor . . . Friend or Foe?
7. Distribution Opportunities

RESTRUCTURING OF INVESTMENT PLANS—OUT WITH THE OLD; IN WITH THE NEW

It is not the strongest of the species that survives, nor the one most intelligent, but the one most responsive to change.

—Charles Darwin

Among the most profound changes in the past decade has been the redistribution of retirement assets. The growing pool of individual retirement accounts (IRAs) and employer-sponsored defined-contribution (DC) plan assets have overtaken defined-benefit (DB) plans, which ruled the institutional investment arena for decades.

While many have predicted the demise of DB plans, a sizeable asset pool of $2.4 trillion remained as of June 2008, and some even forecast modest future growth (Exhibit I.2). Debate over the expense and appropriateness of DB versus DC continues today, with one side arguing that DB is far too expensive a commitment for public and corporate America, putting them at a disadvantage to their global counterparts. IBM froze its $48.5 billion DB plan as of January 1, 2008; assets of all future benefits will be provided through enhanced 401(k) plans. Other large, well-known companies like Verizon Communications, Lockheed-Martin, and Hewlett-Packard announced that they are also phasing out their defined-benefit plans. FundFire in December 2008 reported proposed legislation in Ohio that would freeze all five DB plans to move to a DC plan to gain cost efficiencies. Arizona State in 2006 compared costs between DB and DC plans, and concluded

EXHIBIT I.2 Projected Growth of Retirement Market Assets ($Billions)

Retirement Markets	2006	2007	2008	2009	2010	CAGR 2006-2010
IRA	$4,127	$4,530	$4,962	$5,430	$5,941	9%
Defined Contribution	$3,693	$3,951	$4,211	$4,485	$4,756	7%
Defined Benefit	$2,221	$2,334	$2,463	$2,581	$2,736	5%

Source: FRC Monitor, September 2005.

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that not only were DB plans more cost efficient, but they were also better at protecting the downside. DC and IRA assets, nevertheless, are projected to win the future asset-growth race by a wide margin.[1]

It will be interesting to revisit Exhibit I.2 in light of the excruciating loss of wealth in 2008. The transition of investment decisions from DB plan sponsors to the hands of DC plan participants has led to new sets of investment solutions and challenges. With DB plans, employers make all the investment decisions—from investment policy, to asset allocation, to manager selection and termination—frequently with guidance from consultants who are expert in investment policy and manager research. Initially, oversight of the DC plan was often the responsibility of the company's HR professionals. Bundled providers who could offer plan administration, investments, and participant communications were favored. DC investment offerings commonly included company stock, "safe" capital preservation vehicles such as money market funds or stable value funds (often as defaults), and some traditional equity and fixed-income options. Little attention was paid to investment policy or specific asset allocations. Open architecture and the growth of the investment option–only business expanded the number and breadth of investment options for DC participants, which became overwhelming for participants in many cases.

As many as 30 percent of individuals who are eligible for 401(k) plans do not contribute to those plans. The 70 percent of individuals who do invest in 401(k) plans have not fared well overall because of poor asset-allocation decisions, market timing, cash flows, and lack of access to the diversity of investment opportunities available to DB plans due to the need for daily valuation and liquidity. Employers walk a fine line between educating their employees and giving advice out of fear of lawsuits if the employees fall short at retirement. Results have been murky, particularly in light of the 2008–09 financial market collapse. That is no surprise. Legislation has followed, and more is to come— again, no surprise.

The 2006 Pension Protection Act (PPA) contains provisions that affect the entire retirement system including DC, DB, hybrid plans, and IRAs. For DC plans in particular, the PPA creates a more reliable way for DC participants to accumulate retirement assets. The PPA offers 404(c) protection for qualified default investment alternatives (QDIAs) that can be used with automatic enrollment. The PPA's new criteria for QDIAs are that they must provide capital appreciation as well as capital preservation.

The new Department of Labor (DOL) guidelines for QDIAs, effective December 24, 2007, require that default options must be a target-date fund, a balanced target-risk fund, or a managed account to qualify for safe harbor protection. The new regulations provide grandfather protection for

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certain default investments in certain capital preservation funds (e.g., stable value) made prior to that date.

Target-risk and target-date funds, also commonly known as *lifestyle* or *lifecycle* funds, are attracting significant assets, and are the fastest-growing mutual fund category. In fact target-date funds gained $41 billion in assets in 2008, not accounting for market losses, according to *Strategic Insight*. There were 378 target-date funds available to investors at the end of 2008, with about $158 billion in assets. In 1997, these funds had only $2 billion in assets.

The new DOL guidelines are expected to generate a dramatic shift of plan assets from capital preservation funds to target-date funds, balanced funds, and managed accounts. This shift will create significant asset growth opportunities for managers with both core and specialty strategies. Many target-date funds are making greater use of specialty strategies such as emerging markets, REITs, high-yield securities, TIPS, and even hedge funds. Since these strategies are rarely used as standalone investment options in DC plans, managers of these strategies who previously stood on the sidelines can position themselves to participate in the target-date funds, embracing the diversification benefits of these strategies. In addition, new features and product innovations are increasing the demand for these products beyond 401(k) plans.

Changes at the plan and investment program level are not limited to migration from DB plans to DC plans. Public plans, endowments and foundations, sovereign wealth funds, and union plans are all undergoing enormous pressure and change. Many were forced to liquidate holdings at inopportune times just to fulfill obligations. With so little liquidity, many funds have incurred real losses. DB plan sponsors are grappling with actuarial assumptions, matching assets and liabilities, asset allocations, rebalancing, too much money chasing too few alpha opportunities, education of new board and committee members, and political pressures. Staffs have shrunk while funding levels have declined, and investment solutions have become more complex. Funded status of pensions at S&P 500 companies has dropped from 104 percent at the end of 2007 to 75 percent at year-end 2008.[2]

Questions on plan sponsors' minds include: How can I fulfill my liabilities with the existing asset base and uncertain markets? Where are the reliable opportunities given the 2008–09 collapse? Can active managers achieve their investment objectives, or should I move more to quantitative and indexing strategies to save costs and achieve consistency, predictability, and transparency? Are quantitative strategies now too closely correlated and likely to underperform collectively, as many did in the summer of 2007? Should plan sponsors move into alternatives, or is it too late, too

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risky? Are trustees doing the best job of allocating the investments they already have? How frequently should we be adjusting the asset allocations? How and when should I rebalance? How can assets earn better returns? Are we paying too much for beta? How do you discern a skilled manager from one that is unskilled or just plain lucky? How can all investors become better educated to make smart investment decisions, select the best managers, and successfully oversee investment programs that will fulfill their investment objectives? Keith Ambachtsheer of KPA Advisory Services, Ltd., advises ways to think about these issues in Chapter 2, ''The Sub-Prime Crisis as a 'Predictable Surprise': Strategic Lessons to Be Learned.''

The endowment and foundation investors, perceived by many as the leading-edge experts, fall into at least two camps—each having its own demanding challenges:

- *First camp*: High-profile mega-endowments and foundations that gained attention for their early advances into alternatives to capture high returns. But as DB plans and other institutional investors follow their lead, eleemosynary investors are pushed to find the next great waves of alpha—a feat not easily accomplished with the large assets under management at these giants. Of course, now they face enormous losses and have to review their liquidity needs against their investments. With many of the alternatives freezing redemptions and extending lockup periods, implementing desired shifts is difficult.
- *Second camp*: Hundreds of midsized and smaller endowments and foundations that were left out of their larger brethren's profitable early exploitation of alternative investment strategies. Smaller investment pools also need cost-efficient investment solutions that can reliably fulfill their needs. They may have more liquidity, but they still need growth and opportunities to offset the losses experienced from the 2008 market declines.

Other important influences at the investment program level are:

- *Adoption of the Principles for Responsible Investment (PRI)*: The PRI are designed to align institutional investment practices with the goals of the United Nations, including sustainable investing. As of January 2009, there were 458 signatories globally, including 153 asset owners, 215 investment managers, and 90 professional service partners. The geographic dispersion of signatories is shown in Exhibit I.3.

  Managers who integrate consideration of environmental, social, and governance (ESG) issues into investment decision making will have

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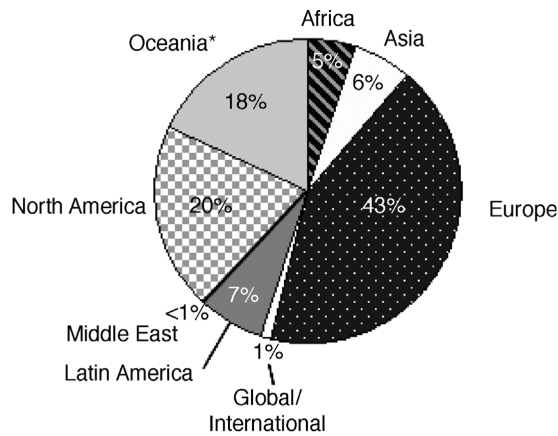

EXHIBIT I.3 Number of Signatories Has More Than Doubled Since 2007, When There Were 180 Signatories
Source: PRI Report on Progress 2008.

a distinct competitive advantage. You can learn more at the PRI website (www.unpri.org).

Sensitivity to the political environment, both for and against benefits, now and in the future, is also a charged issue. Will the public entities be able to fulfill their investment promises and obligations? Will public entities perceive the benefits programs as too enriched, a debate that is already becoming heated as states, counties, and cities suffer budget distress? Will public entities be able to confront the immigration issues associated with benefits? Do we grasp the implications of an aging population and the impact that aging will have on our society? These questions will continue to surface as major political issues, leading to unknown legislation, which in turn will cause more change.

- *Shareholder activism*: The increase in shareholder activism coincides with the development of the corporate governance movement. Increasingly, investment managers are under pressure from investors, as well as the United Nations, to exercise their responsibilities as owners of companies and be more active. One of the impetuses of increased shareholder activism may also have been the subprime credit crisis that began in the spring of 2008.

RiskMetrics Group, a leading provider of risk management and corporate governance services to the global financial community,

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examined shareholder responses to the crisis in which they identified the corporate governance factors involved in the crisis and how stronger provisions might have mitigated investor risk. The group looked at the ways investors are evaluating boards' risk management and disclosure practices. A major finding was that shareholder activism and litigation have increased as a result of the credit crisis. Ineffective risk management by corporations was considered to be a cause of the losses suffered by corporations due to the subprime mortgage crisis, and a majority of investors felt that board members lacked risk management expertise. Lack of transparency and poor pay practices encouraging short-term performance were also major concerns of investors. Activist managers are tackling these types of problems when investing in a corporation.[3]

- *Continued refinements to plan structure and asset allocation, further loosening of constraints, and the departure from traditional asset allocations*: Many plans are conservative, and although an investment option may appeal on a logical basis, the unknown risks prevent many from proceeding to more innovative structures and investment options. No matter the intent of an investment program, the lack of liquidity resulting from the 2008 financial crisis is impeding many investors' abilities to adjust their asset mix.
- *Increased attention to fees and costs*: Even without the high fees of hedge funds or the layered costs of funds of funds, institutional investors and consultants are all too aware of the costs. That is evident in the debate over DB versus DC plans, and the questions surfacing on hidden costs and on mutual fund costs. Control of costs will be mandatory in a future of compressed returns, and continued high actuarial needs.
- *Greater need for education of the stewards of institutional pools of assets*: As Thomas Mackell wrote in his insightful, "call-to-action" book, *When Good Pensions Go Away*, trustees must "ratchet up their education in this volatile and complex world in order to know what kinds of reports and guidance they will need, the right questions to ask to fulfill their responsibilities, and, hopefully, preclude any dramatic implosions within their retirement systems. The well-being of the plan participants' future benefits programs is in their hands. Strong self-imposed educational programs have to become the norm."[4] The staff of Fi360 discusses this further in Chapter 14 of this book.

  Seminars, conferences, whitepapers, and timely topical papers addressing economic, political, and social events and impact on financial markets, as well as new investment theories and practices, have become victory flags for managers who provide perspective and knowledge.
- *Outsourcing of investment management, in many cases, to manager-of-managers platforms*: Providers who offer investment policy assistance,

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> asset allocation, portfolio construction, manager selection and monitoring, risk management, as well as shared fiduciary responsibility, are a compelling solution for small to midsized plans. Even large corporate plans are choosing to outsource segments of their retirement asset oversight responsibilities.
>
> According to a recent Casey Quirk report, assets from U.S. investors outsourcing their entire portfolios have more than doubled over the past four years, from $97 billion to $195 billion as of year-end 2008. Assets from investors with partial outsourcing agreements account for another $5 billion. Initially, outsourcing was predominantly embraced by institutions with less than $1 billion in assets. An increasing number of larger investors, however, are now outsourcing.[5]

While plan restructuring is a significant trend, what has not changed is the need for reliable, repeatable investment results at increasingly precise risk levels. It is in all our best interests to see this relentless and important need addressed in our lifetime. While much progress has been made, there are still many risks, known and unknown, impacting achievement of fund objectives. It is reassuring to see many brilliant minds focused on yet-more-refined solutions, which will no doubt fuel continued plan restructuring.

EVOLVING INVESTOR SKILLS AND PREFERENCES—THE CLIMB TO HIGHER GROUND

While defined-benefit assets were predominantly invested in traditional balanced accounts and conservative fixed-income strategies in the 1970s, ERISA ignited change—a change that seemed slow at the time, but now looking back over three decades, clearly was the spark of a wildfire. The *prudent-man rule* demanded that institutional investors evaluate opportunities and risks in an informed, in-depth manner, spawning the birth of the independent consultant community, performance measurement and portfolio analysis tools, and an ever-expanding universe of performance benchmarks.

The 1980s brought academic studies to the forefront, creating the emergence of enhanced-index funds, style investing, quantitative approaches and specialty strategies like small-cap and mid-cap equity, and closed-end real estate funds. Nontraditional investments such as emerging markets debt, private equity, and venture cap gained steam in the 1990s. Academia joined with investment practitioners to develop increasingly sophisticated and rigorous investment solutions. In the first decade of the 2000s, alternatives with leverage and ever-more esoteric

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securities pioneered new, innovative approaches to asset allocation and security selection.

When traditional asset returns flourished, providing double-digit returns for much of the 1980s and 1990s, most investors—institutional or otherwise—stayed true to more traditional stock/bond/cash allocations. Then along came the tech bubble, 9/11, and various other global market events. After the equity market collapse in the early 2000s, alternatives, including real estate, private equity, hedge funds, and hedge funds of funds had an almost irresistible appeal.

Hedge funds, offering prospects of more reliable and consistent alpha, absolute return, less downside risk, and low correlations to traditional assets, presented nearly heroic solutions. The result? A swoon by individual and institutional investors. Before the systemic crisis achieved headway, aggregate assets in the hedge fund industry were approaching $3 trillion.

Outflows of $512 billion in 2008 were driven by investor redemptions and hedge fund liquidations, while losses suffered by managers accounted for another $535 billion drop in assets. That left industry assets down $1.047 trillion, or 36 percent, to $1.84 trillion, for the whole year, HedgeFund net said.

Those funds that successfully navigated the second half of 2008 have attracted almost immediate attention and continued asset flows. Some experts predict that the rapid growth of hedge funds will continue despite the 2008 debacle, and foresee a multi-trillion-dollar hedge fund industry, dominated by a few large players. A Casey, Quirk & Associates/Bank of New York study projects that retirement plans will account for the majority of asset flows into hedge funds by 2010, and will represent more than 40 percent of total hedge fund assets by 2010.[6] "We are seeing signs of hedge funds evolving from entrepreneurial alpha hunters to institutional product developers." For investors, it is critical to discern the difference. "The hedge fund industry is at its core a talent pool, and talent is not scalable and cannot be cloned," says Robert Discolor, head of hedge fund strategies at AIG Global Investment Group.[7]

Alternative investments flooding the market also contributed to an evolution in asset allocation. People were willing to pay, and pay dearly, for alpha—but not for beta. Sophisticated investors separated management of the different return elements of a portfolio—alpha and beta. Indeed, the separation of alpha and beta may prove to be the defining trend for institutional investors, much as style boxes were a defining trend of the 1980s but now are cited as obsolete by some. Other experts expect large asset flows to return to traditional long growth and value equity, both large and small

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cap. Russell Investment Group polled 206 asset managers for its ''Investment Manager Outlook'' for 2009, and they were ''astoundingly bullish'' on four asset classes: corporate bonds, U.S. small-cap value equity, mid-cap value equity, and high-yield fixed income.[8]

Core-and-explorer investment programs using passive management coupled with skill-based management also have become popular. ETFs, appealing to investors for their flexibility, liquidity, and inexpensive sources of beta, are stealing market share from index funds, mutual funds, and traditional long-only managers. Constraints are being lifted on the quantitative side as well as on the traditional active management side. While some plans stay married to traditional programs, more are becoming better educated and more opportunistic to achieve their goals. Global products, as a result, are in greater demand. These trends will persist, particularly as academia continues to contribute, both on the practitioner level and at the college level, graduating the next generations of gatekeepers, portfolio managers, and fund sponsors.

Corporate plan sponsor concerns about matching their assets and liabilities, exacerbated by 2008, have also sparked renewed interest in liability-driven investments (LDIs). With low interest rates, however, these investments seem less attractive than they were in the 1980s, when interest rates were in the teens. An increased focus on risk management, particularly in light of the choppy markets of 2007–2008, is also contributing to fund sponsor interest in LDIs. The demand of a fiduciary role in meeting liabilities, and pressure arising from limited resources, too many constrained opportunities, and rising costs, however, are likely to lead more and more plans into LDIs in the future.

The mounting population of retired and semiretired Baby Boomers in the United States is driving an increasing need for high-income, low-risk investments. IRA rollovers, inheritances, trusts, and foundations will multiply, with current demand for ''growth at controlled risk'' supplanted by increased appetite for high income at minimal risk. In the high-net-worth market, generational wealth transfer and wealthy entrepreneurs have encouraged the growth of family offices and financial advisors. Financial advisors are growing in both prominence and power as the demand for investment guidance explodes. With an increasing number of retirees, expanded life expectancy, and growing rollover assets, investment solutions will be forced to evolve yet again. Tax considerations will be key. New technologies are being developed to deliver tax-sensitive solutions without relying on manager attention. New legislation to ensure effective monitoring and fee disclosure regulations are also being proposed, and will shape the future business opportunities.

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GLOBALIZATION—BROADER OPPORTUNITY SET AND EXPANDING COMPETITION

Globalization is a growing force—in both the opportunity set for asset growth and the competitive pool for institutional investment managers.

The drive for growth of assets and strong competitive positioning lured many U.S. managers to expand their sales efforts outside the United States in the early 1980s, but U.S. managers found it difficult going at first. Is it best to set up shops in Europe, Australia, or Asia, or to partner with global distribution partners? As consultants started to position themselves as ‘‘consultants without borders,’’ sharing databases and manager research, opportunities for U.S. managers to build their presence in non-U.S. markets grew. Global consultants became influential in introducing managers in different regions of the world, both to the benefit and detriment of U.S. managers.

The easing of restrictions on allocations to domestic and nondomestic investments by countries such as Canada and Australia created additional opportunities and attracted the attention of U.S.-based asset management firms seeking to grow their businesses. The strong growth of Australian institutional assets in particular became a siren song of opportunity for many investment firms.

Sovereign wealth funds (SWFs) are another whole new wave of institutional investor. The rise in the prices of major commodities led to a rise in the wealth of exporting countries, with oil-producing countries representing nearly two-thirds of SWF assets. Although SWFs do not publicly disclose their investments, there is movement toward increased transparency, particularly as concerns arise from SWFs making major investments in troubled U.S. financial institutions or U.K. shipping companies. The question that surfaced was: ‘‘Will governments use [SWFs] simply as financial tools or will SWFs emerge as an implement of political muscle?’’[9] Better regulations and definition of international standards for cross-border investments are being sought as SWF assets continue to increase.

Simultaneously, managers from outside the United States began targeting the lucrative U.S. institutional market. From Nomura Capital Management's and Phillips & Drew's successful entries in the early 1980s, to firms currently vying for market share, including Paribas, F&C Asset Management, Robeco, Degroof, and Pictet, the investment management community is truly global.

Globalization for investment firms translates into a greater need for strategic and organized marketing. An investment firm's messages need to be consistent in every market. Different markets, however, have slightly distinct needs in materials and presentations. The United States, Australasia, Europe, and the Middle East all have their own preferences. Systems help delivery and production, but personalization is still helpful to standing out

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in a particular market. Increasingly, global marketing teams are challenged to achieve one cohesive global message.

The impact of globalization is not limited to investment management asset gathering. The decline of U.S. economic leadership and the trend toward less constrained asset allocation are leading U.S. institutional investors to think more globally. Global equity mandates, long the norm in non-U.S. markets, but quietly ignored in the U.S. market, have gained considerable momentum. Fixed income has been a global proposition for decades, and globalization is finally influencing equities—in both passive and active mandates, and in both traditional and alternative investments. Darien, Connecticut–based money management consultant Casey, Quirk & Associates' latest institutional product review shows global equity strategies garnered $15 billion in net inflows during 2007, a sharp contrast to the $176 billion in net outflows for U.S. equity products. Emerging markets equity and international equity had negative total net flows during the same period of $8.7 and $17.6 billion, respectively.

As with equities, U.S. investors looked abroad for fixed-income opportunities. Casey, Quirk & Associates' product review shows that in 2007, global and international bonds enjoyed net inflows of $14 billion, and emerging market debt took in $7 billion. For 2008, Casey, Quirk & Associates reports net inflows for international bonds were $8 billion and net inflows for emerging markets debt were $ 10 billion.[10] Global bonds ended the year with net outflows of $23 billion. (*Sources: Casey Quirk Institutional Product Reviews 2007 and 2008*).

Nearly three-quarters of U.S. consultants will focus on core and core-plus fixed income searches in 2009, a dramatic fivefold increase over 2008. Consultants expect institutional investors to consider replacing underperforming core-plus managers. They also increasingly expect clients to consider a wider number of large core and core-plus fixed income managers, given the view that investment opportunities still exist in the fixed income markets, particularly for firms with strong credit analysis skills. A number of consultants report that they expect more investors to adopt a core-satellite approach for fixed income portolios, wrapping a large, potentially passive, core with specialized mandates in specific disciplines, including credit, duration, inflation, mortgages, distressed securities, and international fixed income. (*Casey, Quirk 2009 Consultant Search Forecast Annual Survey February 2009*).

Just as countries like Canada and Australia eased their pension plan restrictions to enhance their diversification and return benefits, so are U.S. institutional investors moving beyond their borders to the investment opportunities offering the greatest risk/reward potential. Numerous opportunities will be open to investment firms able to expand their offerings to global mandates.

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SPECIALIZATION IN PROFESSIONALS' ROLES—CREATING BARRIERS TO ENTRY AND A STRONGER FOUNDATION FOR GROWTH

In the 1970s and 1980s, most of the investment companies were run by investment professionals who were also responsible for client service, presentations, finals, and in many cases, request-for-proposal (RFP) responses. Today, business leadership, client service, compliance, sales management, consultant relations, marketing expertise, operations, and administration all have developed into professions in their own right. Firms, even startups, without strong business leadership and infrastructure, and lacking expertise in any of the above areas, are at a competitive disadvantage.

Investment Management Business Leadership

One of the most challenging roles is that of business leadership. A leader who brings the right combination of vision and voice, effective alignment of resources, anagement and motivation of the firm's professionals, and strategic thinking is essential to grow an investment firm. As many founders and leaders of investment firms retire, companies are finding themselves in perilous positions. This is even more the case given the turbulent markets of 2008-09. Leadership can much more easily make or break a firm.

A client shared with us that a mark of a quality business is one where the debt ratio is neither zero nor too high. If it is zero, then management does not understand how to allocate capital to grow. Another shared that the bull markets hid management weakness. The bear markets reveal management issues. How do firms replace the original founders with leaders who have strong understanding of what is required to grow an investment management business in today's competitive environment and volatile markets? How do firms avoid business leadership that focuses more on quarterly earnings, cost controls, and compensation packages than on strategic alignment of products, effective distribution, and attraction and retention of investment talent? How do they control costs without sacrificing quality of investment results and communications?

Part Six of this book (beginning with Chapter 23) specifically addresses leadership challenges.

Client Service

When client service is strong and strategic, it can make the difference between a company's growth and stagnation. Understanding and addressing clients' changing needs, achieving investment objectives, and serving as an

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educational resource to fulfill needs beyond just performance, earn an investment company a reputation and role as leader in the industry. Firms that rank high in client service have teams of experts with long, successful experience in fulfilling communication and educational needs, and serving as invaluable resources to their clients. Supporting them are product specialists, client-service administrators, systems, and marketing, who address client needs as well as develop growth initiatives.

As firms grow larger, many distinguish the client-service role from sales, although this is still an area of debate among leading institutions. A firm's success in client service is frequently measured by surveys conducted by firms such as Greenwich Associates or Eager, Davis & Holmes, LLC. Best practices include proactive education and communications, strong reporting and customization, innovative solutions responding to client-specific needs, and clear awareness of and responsiveness to client concerns and issues.

Compliance

Formerly a part-time role of an administrator, compliance is now a required professional role at every registered investment advisor. Mutual fund and market-timing scandals gave rise to increased regulation and new accounting standards. As laws and regulations multiplied, intense scrutiny of performance, marketing, and client-service materials became a given. The SEC dictated the role of *chief compliance officer*. The infamous Ponzi scheme inflicted by Bernard Madoff revealed that even existing regulations were insufficient.

Hedge fund managers expect further regulations under the Obama administration. An extensive discussion of regulation can be found in Chapter 3 of this book, "The Solidarity Challenge."

Compliance officers who keep investment firms compliant with rapidly changing regulations and avoid negative headlines play an increasingly important role in the success of an investment management firm. Compliance professionals clearly either contribute to or impede the success of an investment management firm. The best compliance officers have become knowledgeable on the broader aspects of the industry, serving as strategic advisors on how a firm can best grow and serve the investment community at large. In the 2000s, for the first time, many compliance officers have become partners in investment management firms.

Sales Management and Consultant Specialists

Again, originally just part of many roles of the founding partners of investment companies, these have evolved into distinct professional roles in high

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demand. When DB assets were experiencing double-digit growth and firms relied on the Money Market Directory, strategic sales planning was not that necessary. Managers targeted the low-hanging fruit for direct calls, focused on a select group of consultants, and/or zeroed in with "hit list" marketing, soliciting clients of competitors who were in trouble.

Those days are over. There is no low-hanging fruit in the DB market. Managers have to take market share from other DB providers. They have to consider other institutional markets and how they will connect with those buyers. A strategic sales plan with talent and resources clearly aligned to the markets where the firm and its products will have the greatest success is essential. Today's most successful growth firms have skilled strategic management professionals leading sales forces focused on specific target markets, multiple sales teams, or specialized distribution forces, leveraging a firm's infrastructure.

Consultant firms have been a powerful force in the institutional investment industry throughout its history. Many firms have evolved from just a few consultants with focused services to large entities with sizeable staffs located across the United States or worldwide offering a broad spectrum of services. And the number of consultant firms that can impact an investment firm's growth efforts has multiplied significantly. Tiering of consultants to manage coverage is now the norm.

Surveys show that the emergence of consultant specialists has been especially well received by the consultant firms, who appreciate having one knowledgeable point of contact. The role of consultant specialist does not replace the sales professionals' relationships with consulting firms. It brings consistency in contact, clarity in messaging, and proactive communications in building relationships with the consulting firms, whether global or regional.

The consultant specialist is also typically responsible for defining the strategic plan of action for consultants. With shrinking resources, a strategic plan becomes even more critical for a manager. Which consultants are key to the firm's business? What databases are essential to the key consultants you want to cover? Which firms are not appropriate for your strategies? What level of activity and communications is appropriate for each consultant firm? What are the individual firms' preferences? Which RFPs will the firm respond to? Who are the best people to build the relationship with each consultant firm?

Marketing and Communications

In the 1970s and 1980s, portfolio managers frequently wrote their own marketing materials and presentations, completed consultant RFPs, and decided marketing strategy. Today, with multiple target markets, broad

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investment capabilities, and a high level of activity, the need for cohesive marketing plans, messages, and support has led to the development of strong, well-resourced, and well-structured marketing and communications departments. Ron Gold of Gold Consulting, Inc. elaborates in Chapter 17 of this book, "The Marketing Challenge." When marketing works well with business leadership, client service, sales, and investments, investment firms increase market share and earn strong reputations in the industry. Whether a global firm that needs to integrate multiple visions or a U.S. boutique, marketing becomes the ear and voice to the market, and critical to growth.

Product development, previously under the purview of portfolio managers, is paramount to fulfilling client needs and the long-term success of an investment management enterprise. Marketing serves an important role in identifying client needs that can be addressed by internal investment talent, and helping the firm develop investment solutions that will resonate in the market. Marketing is then responsible for resource management, budget, market research, database population, targeted marketing plan, materials, and new product launches. A successful product is one that aligns market demand with manager talent and ability to add value consistently and reliably.

Firms cannot afford to be complacent about their communications with clients, consultants, intermediaries, or prospects. Quality, clarity, and consistency of messages are key. Materials can be neither a shabby hodgepodge evoking past decades, nor so slick that they cost more than most clients' annual reports. Neither are desirable. Consistency of communications among a firm's professionals on key messages, asset management approach, and a firm's priorities is essential to success. Key messages must be aligned with a firm's strengths, and incorporated into all communications from introductory materials to websites to databases to final presentations to client-service materials. Seasoned marketing and communications professionals, distinct from portfolio management and sales, are assuming these responsibilities at most investment firms.

PAICR (the Professional Association for Investment Communications Resources) was founded in 1997 to provide an educational and idea-sharing forum for professionals in these roles. PAICR (www.paicr.com) is a nonprofit membership organization that empowers investment marketing and communications professionals through cutting-edge opportunities for professional development, continuing education, and networking at association events throughout the United States and Canada.

Operations and Administration Infrastructure

These are the foundation for a firm's ability to account for its clients' portfolios, effectively assimilate new accounts and assets, deliver timely

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communications, and achieve institutional quality across all areas to compete. Information must be well-managed with the objective of offering sophisticated clients high functionality and useful analytics. Many firms have failed to pay attention to the importance of infrastructure in achieving these objectives, and clients instantly recognize firms with growth problems. Reports are slower, inaccuracies begin to appear, trading is not competitive, and portfolio managers and client-service professionals are without tools that competitors have. In Chapter 28 of this book, ‘‘The Data Management Challenge,’’ Don DeLoach of Aleri provides some excellent recommendations for thinking about the ‘‘life’s blood’’ of your firm.

The infrastructures of firms offering alternatives are under especially high scrutiny. Will they be able to handle growth? Historically, a majority of the hedge fund firms that have closed have gone out of business due to operational failures, not due to performance problems.

Infrastructure also includes human resources. The need for professional development and ongoing training has become key as investment vehicles have proliferated and the ability to represent multiple solutions has become essential. McKinsey’s 2008 survey of more than 90 firms says, ‘‘Higher performing asset managers who employ best practices in sales and client service are, on average, 20 percent more profitable than their peers.’’ Best practices include ongoing training to ensure their firms and products are well represented in the market.

The evolution of investment firms as true businesses has led to this specialization of roles. These demands in turn produce higher barriers to entry. The opportunities still attract entrepreneurs, but the days of hanging up a sign with high numbers and having buyers flock to your door are over. It is the *business* of investment management that makes the difference between earning a living and achieving true success.

ADVANCES IN TECHNOLOGIES AND SYSTEMS—PENNY-WISE OR POUND-FOOLISH?

Automation of the investment industry has truly revolutionized how people work. Emergence of new or advanced technologies has changed the way investment firms invest, support client service, sales, and marketing initiatives, and communicate internally, as well as the way that managers are measured and monitored.

Communication technology has changed how managers gather and disseminate information, facilitating timely and global exchange of information. Portfolio management systems permit instant analysis of the impact of a single holding on a portfolio’s risk characteristics or of the addition of a

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different asset class. A portfolio manager in Tokyo can see in real time what his or her counterpart is doing in London. News alerts and customized information flow are standards for analysts and portfolio managers.

In the 1970s, index cards were a marketer's CRM system. Today, relational databases are critical to the sales and client-service process. The Money Market Directory in hard paper form was the green gospel for prospect information, and detailed information on a manager's competitors was hard to come by. Today, dozens of databases and the Internet provide a plethora of information on prospects, consultants, and competitors. eVestment Alliance, PSN/Mobius, Nelson Information, Zephyr, Altura Capital, and Morningstar are just a few of the sources used by consultants, investors, and investment firms alike. To populate the databases with current data at quarter-end, or after an important event, has become a major initiative and resource demand for managers.

Global communications have become seamless with the evolution from overnight mail to fax machines to e-mail, PDAs, webinars, and videoconferencing. Managers leveraging technology have an enormous advantage, while those unwilling to invest or those who lack the vision to employ progressive technologies are at a stark disadvantage.

Performance measurement and attribution analysis have evolved simultaneously. It is no longer just about absolute and relative performance. Enhanced attribution tools present challenges to active managers. Clients are easily able to discern value-added management over time, and weed out traditional active managers just managing beta. Strong managers benefit from having tools to demonstrate their value added. The challenge is which measures are truly meaningful.

The majority of firms today use a blend of quantitative and qualitative disciplines to discover high-probability-of-success investment candidates for their portfolios. Institutional investors have followed suit, embracing similar tools to assist in their searches for high-probability-of-success managers. Today's consultants and clients can assess managers' performance against a variety of quantitative screens and metrics such as information ratio, alpha, beta, Sharpe ratio, R^2, and more. Formerly a labor-intensive process, screening managers against specific criteria can now be executed in minutes. Once you define your quantitative criteria, you simply select your database, enter your search criteria, and a list of qualified managers is at your fingertips.

Then what happens? Some clients take their lists and visit managers' websites to qualify candidates. Managers need to take these new tools seriously. Websites that are more than "brochureware" can be an effective way to leverage resources and generate new business leads. Yes, surveys commonly show that 50 percent or less of plan sponsors and

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consultants visit websites, but those that do, do so with purpose. More often now, knowledgeable investors are scouring databases, vetting manager candidates through websites, and contacting them directly, with no consultant involvement. Technology, on every level of our industry, is here to stay.

PROLIFERATION OF CONSULTANTS AND THEIR CHANGING ROLES—GATEKEEPER, COMPETITOR . . . FRIEND OR FOE?

As Ron Gold notes in Chapter 17, ‘‘The Marketing Challenge,’’ ‘‘[T]he U.S. consulting industry started in the late 1960s, when three firms—A. G. Becker, Callan Associates, and Frank Russell—began providing performance measurement services to institutional investors. . . .’’

The traditional consultant’s business model is labor intensive and difficult to leverage. Many consultants, seeking ways to enhance the profitability of their business models, are abandoning their own proprietary databases, which are expensive to maintain, and subscribing to independent industry databases such as eVestment Alliance, PSN/Mobius, and Nelson Information.

Another profitability solution for consultants is expansion into the investment management domain, which also permits them to attract and keep their most valuable resource—their people. A number of the larger, more recognized consultants developed manager-of-managers and funds-of-funds programs and limited partnerships. These became successful business models for the consultants, and simultaneously fulfilled the needs of midsized and smaller institutional investors in particular. In a beautiful case of irony, some of these consultant firms now have consultant specialists of their own, and call on other consultants to introduce their manager-of-managers, funds-of-funds, and transition management programs.

Outsourcing, of either a portion of or the entire investment program, and sharing of fiduciary responsibility has become one of the major recent market developments. With so many investors grappling with the same issues—need for more consistent returns, less risk, more education—many consultants have risen to the occasion, some better than others. Most consultants are offering or developing outsourcing services. Moreover, as the staff of Fi360 observes in chapter 15 of this book, ‘‘ The Client Challenges,’’ the education of trustees is always a need.

At the same time, regional consultants, family offices, specialists by markets, and specialist consultants in alternatives, have gained and continue to garner market share via expert knowledge in territories neglected by the

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major consulting firms. In addition, many managers have started leaping into the consultants' territory, becoming more consultative in building deeper relationships with their clients, and providing them educational tools and resources. Managers with the capabilities to do so are moving into the asset-liability business.

What is the outcome? A stew of possibilities, as consultants and managers compete, as the number and type of gatekeepers proliferate, and the number of consulting and investment firms and strategies multiply like rabbits.

With consultant power continuing to ascend, and the number of consultants proliferating, how does a manager address the consultant's needs for research and insights, and achieve the manager's goal of a strong, mutually productive relationship? The answer is simple and twofold: First, those who view consultants as allies or conduits to success, and support the consultants' initiatives for education, manager research, and contact, will have greater success. That assumes one thing: that the manager is competitive—in clarity of approach, disciplines, and consistency in fulfilling investment objectives. Second is that the manager targets those consultants with the desired target client market(s). Resources need to be focused in a strategic way.

DISTRIBUTION OPPORTUNITIES

Two roads diverged in a wood, and I—
I took the one less traveled by,
And that has made all the difference.
—Robert Frost

In the early years, most managers focused their business by client type (institutional or private client), asset management style (balanced, equity, or fixed income), and perhaps geography. They concentrated on direct calls, using the Money Market Directory, and targeted a few consultants emerging as influential gatekeepers. Today, managers can leverage a variety of distribution channels, including consultants, brokers, centers of influence such as accountants or lawyers, financial advisors, subadvisory platforms, manager-of-managers and funds-of-funds platforms, and databases, and of course, there is still the good-old-fashioned approach of direct calls.

But first, a manager must determine its best target markets. Target markets have become much more specialized. The institutional market, while to some degree still generalized, has specific needs for the various segments: large public funds, small to midsized public funds, large endowments, large foundations, small to midsized endowments and foundations,

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Taft-Hartley funds, corporate defined benefit, corporate defined contribution, public deferred compensation, insurance and reinsurance, hospitals, operating cash, and variations. The markets need distinct solutions and levels of service.

Managers need to establish their business focus, as well as their client-service promise for each type of client. What resources and systems will be needed to reach the target market(s) and to support that client-service promise? Market leaders serve virtually every client base, leverage multiple distribution channels, and offer a broad spectrum of investment capabilities and services around the world.

The consultant and intermediary industry has segmented as well—with plan-type specialists, global consultants, regional firms, brokerage firms, financial advisors, and others. Individuals' assets are now segmented into high-net-worth, family offices, bank clients, financial advisors, registered investment advisors (RIAs), separately managed accounts (SMAs), and brokerage firms. Subadvisory markets, manager-of-managers, and funds-of-funds all offer viable ways to grow assets under management.

With such a spectrum of distribution opportunities, the need and demand for strategic marketing explode on multiple fronts. On which markets and countries does a manager focus? Which products will be successful in which markets? How should a manager organize its resources? Will the firm participate in distribution channels that require fee discounts? If aligning with external distribution entities, who will provide the distribution needed and what requirements will that entail? Will ownership or equity be required to achieve strong distribution? Even a few years ago, it would have been unheard of for a startup alternative shop to have its first distribution partner in Japan. Today, it can well be the most advisable strategy to garner assets quickly.

Each market and distribution partner may require different levels of communication and service. When a manager makes a commitment to a distribution channel or partner, knowledge of the requirements along with a defined plan, people, resources, and systems in place are required to succeed.

SUMMARY

With rapid change on so many fronts, and unfolding risks and opportunities with virtually every change, tomorrow's investment leaders need to aspire to all of the following attributes:

- Flexibility and foresight to adapt to and serve shifting asset pools
- Innovative investment solutions and strong product development to meet changing investor needs

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- Ability and resources to capitalize on global investment and distribution opportunities
- Strong, well-managed business on every level—business leadership, investments, branding and messaging, marketing, client service and sales, professional development, legal/compliance, and operations/administration
- Commitment to invest in new tools, systems, and technologies to enhance alpha generation and risk management, to achieve business efficiencies, and to lower costs
- Collaborative, proactive relationships with clients and targeted consultants and intermediaries
- Well-planned, focused, and well-managed client-service, sales, marketing, and communications efforts

For investment firms with competitive investment offerings, we believe that strategic client service, sales, and marketing will be pivotal for growth. As performance and investment management become more like commodities, strong client service and astute marketing will distinguish one firm from another. Appropriate target markets and distribution, competitive positioning, clarity and power of messages, effectiveness of communications both internal and external, experience and training of client-facing professionals—all will become the currency of the successful investment firm.

The growth leaders in our industry have a clear vision for their future courses, and are implementing their strategic plans with energy and enthusiasm. These leaders will direct their resources and talent appropriately and lead their firms, clients, and prospects through successful evolution.

As Darwin said, and we are here to echo, ‘‘Success will belong to the one most responsive to change.’’

NOTES

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