The New Paradigm for Asset & Wealth Management

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Introduction

The current financial maelstrom has prompted all market participants to reexamine previously held investment "truths," and to fundamentally revamp their approach toward portfolio management in an investment environment that has become permanently altered. The "new paradigm" means an environment where global economic growth is slower, less leveraged, and less dependent on the American consumer. **Asset and wealth management firms that are best positioned to cater to investors' evolving financial needs will be coveted from an M&A perspective, and will undoubtedly be at the vanguard of the next wave of growth in the financial services sector.**

The Old Intellectual Paradigm

Last year was immensely significant not only due to extraordinary attrition within the financial services sector (a record 1,471 hedge funds and nearly 100 fund-of-funds liquidated during 2008 according to Hedge Fund Research), but more importantly because the theoretical foundations of modern portfolio management have been shaken to their core. Much of the advice often touted by financial advisors as investment "truths" now seem dubious in light of the fallout from the recent market meltdown: asset allocation failed to smooth performance, few hedge funds delivered absolute returns, and even relatively "safe" investments, such as municipal bonds, were not entirely insulated from turbulent market gyrations.

The traditionally dominant role of equities in portfolio asset allocation is also undergoing scrutiny. Between 1900 and 2008, US equities, on average, outperformed US bonds by 3.1% on a real return basis.[1] This historical equity premium propelled the dogmatic conviction by many that equities always outperform bonds over the long run. However, for anyone who started saving 40 years ago, which is the time when baby boomers joined the workforce, adhering to a *buy and hold* strategy with a portfolio that is overweight equities has sadly forced many to confront a more humble version of retirement or, in some cases, to postpone retirement entirely.

Short-Term versus Long-Term Trends

When analyzing this unprecedented span of history, it is critically important to distinguish temporary developments from those that will likely be long-lasting. The recent widespread flight to safety, and indiscriminant repudiation of all things risky, arose from a sudden surge in uncertainty and an immediate fear of the unknown. When the CBOE Volatility Index (the "fear gauge") reached unprecedented heights late last year, the market witnessed the biggest exodus

[1] Eroy dimson, Paul Marsh, Mike Staunton, and Jonathan Wilmont, *Credit Suisse Global Investment Returns Yearbook 2009*: Feb. 2009.

ever of money from professional management: American investors pulled a net $320 billion from mutual funds last year,[2] hedge fund assets fell a record 36% to $1.84 trillion ($512 billion of which was lost through withdrawals and fund closures)[3], and assets under fund-of-funds management dropped by 26% to $593 billion.[4] In December 2008, panicky investors briefly drove yields on one- and three-month Treasury bills into negative territory.

These events have already begun to unwind as risk aversion has gradually begun to abate. Since late 2008, investors' growing appetite for higher yield has begun to direct money back into the fund management industry: in the first four months of 2009, net flows into stock and bond mutual funds (not including ETFs or money-market funds) were approximately $50 billion, almost all of which occurred in April, according to the research and consulting firm, Strategic Insight. Global equities have recently climbed to their highest levels of the year, oil has risen above $70 a barrel, corporate spreads have begun to narrow, and government bond yields touched fresh six-month highs.

Notwithstanding these tenuous signs of sprouting "green shoots," investors realize that the recovery will not signify a return to business as usual, but rather the beginning of a new paradigm and investors' corresponding reactions will likely be long-lasting. **These longer-lasting trends will likely include: 1) an increased demand for truly comprehensive, high-level, wealth management client service, and 2) an ever more risk- and cost-conscious investment approach, demanding greater transparency, liquidity, and cost- and tax-efficiency.**

The New Paradigm:

• Wealth Management

For wealth managers, who may have previously competed on performance, brand, and/or pricing, client service is now more important than ever. In the current environment, shell-shocked investors require constant (sometimes non-stop) hand-holding. The situation requires wealth management business models to be less reliant on product pushing, and more focused on a client-centric approach. Such an approach may emphasize understanding clients' needs, offering unbiased and insightful advice, and collaborating with clients to formulate and execute unique value propositions. Ultimately, it will be a firm's ability to win clients' confidence that will differentiate winners from losers.

[2] Authers, John. "Is it back to the Fifties?" Financial Times 25 Mar 2009.
[3] www.Hedgefund.net 15 Jan 2009.
[4] Willoughby, Jack. "Five Questions for your Fund-of-Funds Manager" Barron's 16 Mar 2009.

Multi-family offices are uniquely positioned to attract high-net-worth clientele by offering a holistic approach to wealth management on an open-architecture platform, trust and estate and concierge services, and highly-personalized client service. In addition, multi-family offices are perceived to offer more exclusive, more entrepreneurial, less bureaucratic services than typical wealth managers.

- ## Defensive Strategies: Fixed Income & Hedged Equity

Although much of the recent asset inflows into fixed income and defensive strategies have been driven by a widespread fear of a financial apocalypse, investors (especially baby boomers) will likely permanently increase their asset allocation to fixed income as they adopt a more risk-conscious investment approach and abandon blind faith in equities. Managers with expertise in fixed income and defensive strategies have been, and will likely continue to be, direct beneficiaries of investors' heightened risk-conscious approach and prioritization of capital preservation. In 2008, when even top-ranked managers witnessed investors rushing for the exits, bond funds attracted net flows of $36.6 billion.[5] Of that total, Bill Gross' PIMCO garnered a net $23.6 billion, far more net new money than any other firm, according to Strategic Insight. In February 2009, Natixis Global Asset Management sought to attract volatility-conscious investors with the launch of two institutional hedged equity funds managed by Gateway Investment Advisors. Money market fund managers, whose managed assets have grown to comprise more than 40% of mutual fund assets, have similarly benefited from such trends -- although some managers, like Bank of America's Columbia Management Group, have incurred substantial losses as a result of providing capital support to ailing money market funds.

- ## Tax-Efficient Funds

As the Obama administration seeks to make good on its campaign promise to shift to a more progressive tax policy, investors will increasingly demand tax-efficient strategies. This trend affords equity-based ETFs, which rarely distribute capital gains, yet another advantage over stock mutual funds, which must distribute their capital gains and income each year. Municipal and tax-exempted fixed income strategies will similarly benefit. In February of this year, PIMCO sought to capitalize on investors' demand for tax-conscious investment strategies by launching the Unconstrained Tax Managed Bond Fund, which applies the firm's secular investment process across all fixed income markets, while investing 50% of the fund's assets in municipal bonds. The assets of Eaton Vance's Tax Advantaged Bond Strategy funds have increased 6.15% in the two months ending January 31, 2009, implying a stunning (but purely hypothetical) 43% one-year CAGR.

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[5] Sullivan, Tom. "Six Top-Notch Bond Funds." Barron's 6 Apr 2009.

- ## Passive Management

The increasingly embarrassing inability of actively-managed mutual funds to consistently generate alpha has driven disappointed investors to seek more cost-effective alternatives. This has contributed to the recent popularity and growth of exchange traded funds (ETFs) and passively-managed funds. According to S&P's Index Versus Active Fund Scorecard, which measures performance data, the majority of actively-managed mutual funds have failed to outperform their benchmarks, not only during the "sub-prime" and "dot com" bear markets, but also over longer market cycles between 1999 to 2003 and 2004 to 2008. In 2008, nearly three-quarters of active large-cap fund managers underperformed the S&P 500; 76% of mid-cap funds failed to beat the S&P MidCap 400; and less than 15% of small-cap funds succeeded in generating alpha. Similarly, a recent report by the consultant firm Wurts & Associates reveals that less than 27% of core and core plus fixed-income managers outperformed their benchmark in 2008.

This has led frustrated investors to shift assets into lower fee-based passive managers, signaling an increase of the competitive pressure on active managers to lower fees, generate alpha, or accomplish both. Thomson Reuters projects that total US equity mutual fund management fees will total approximately $26 billion in 2009, down from more than $40 billion in 2007. It is unclear whether actively-managed funds will ever achieve previous levels of market share considering that investors' lower appetite for risk and shifting preference from alpha to beta likely represents a permanent change, particularly for soon-to-be retirees.

Furthermore, downward pressures on fees may come not only by way of market forces, but also via the US Judiciary: a series of pending legal cases (including *Harris v. Jones*, which will be decided by the Supreme Court this autumn) may mark a turning point for US mutual fund fees by redefining the legal standard by which fund fees are judged. The current industry standard, known as the Gartenberg Standard, establishes that a fee could be deemed excessive only if it were so high that it could not be the result of arm's-length negotiations between the funds' Board and its adviser and bears no reasonable relationship to services rendered.

Vanguard and Northern Trust Global Investments, both among the top five largest passive domestic index bond managers, have witnessed assets increase by double-digit percentage points in 2008. These trends also partially explain why US ETFs experienced record inflows of $176 billion, while investors withdrew a net $320 billion out of US mutual funds.[6]

[6] Strategic Insight, SimFund Data as of 12/31/08.

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- ## Exchange-Traded Funds

The escalating popularity of ETFs, which allow investors to gain broad exposure to stocks, fixed income, and commodities by tracking the securities that comprise an exchange or index, emphasizes other important trends that have arisen from market dislocation. The recent egregious performance and stomach-churning volatility of actively-managed mutual funds have prodded investors to retool portfolios from active to passive funds (acting as the "push factor"), while the transparency, liquidity, tax-efficiency, and relative cost-effectiveness of ETF products (acting as "pull factors") have become ever more appealing in the current market environment to both retail investors and professional money managers. For instance, new bond ETFs have expense ratios of about 20 bps, while a typical bond fund has an average expense ratio of 109 bps.

The ETF industry has also benefited from the shift to a back-to-basics (do-it-yourself) mentality among retail and institutional investors who have been disappointed by actively managed funds; rather than try to cherry-pick successful managers in a tumultuous market, a growing number of portfolio managers (professional and self-directed investors) are using ETFs to gain exposure to areas where they expect active managers to underperform. Traders and wealth managers use ETFs for specialized exposure in sectors where they lack expertise. Some private banks, which tend to exclusively use their own products, are now adopting an open architecture platform, using third-party products and ETFs to cover a broad range of assets. Pension funds are using ETFs as part of core or satellite strategies, where previously they were used purely in a satellite approach, and hedge funds are increasingly using ETFs instead of futures and over-the-counter derivatives such as swaps. Moreover, fund-of-funds, hedge funds, and other active traders appreciate that ETFs are traded on an intraday basis (unlike mutual funds), which allows for easy access and more liquidity.

Since 1999, ETF assets have grown 15-fold to $593.3 billion in February of this year according to Barclays Global Investors; ETFs now account for 25% of all trading in US markets compared to 15%, a year ago according to Credit Suisse. ETFs nonetheless represent a far smaller market, currently accounting for only 4% to 5% of total mutual fund AUM. Asset and wealth managers are the biggest users of ETFs, comprising nearly three-quarters of all global institutional investors in the first nine months of 2008, according to Barclays Global Investors. Institutional users of US-listed ETFs are approaching 2,500, up from less than 250 in 1998. Precious metals, bond, and emerging market ETFs continue to be in very high demand, and comprise approximately 8%, 14%, and 13% of total ETF AUM, respectively, as of March 2009.[7]

[7] www.Indexuniverse.com 05 May 2009.

- ## M&A and Valuation

Like their clients who seek to lower risk through a balanced portfolio, mid-to-large sized asset and wealth management companies are increasingly seeking to diversify their investment capabilities through acquisitions. Natixis Global Asset Management, L.P.'s acquisition of Gateway Investment Advisers was one such transaction, adding hedged equity strategies to Natixis' investment capabilities. High-quality boutique businesses will continue to be in high demand from an M&A perspective and, despite the current slowdown in M&A activity, will continue to command strong multiples.

Regarding best-in-class firms, **deals are becoming increasingly contingent on future performance, with earn-outs comprising a major share of the total consideration. This flexible deal structure eliminates buyers' concerns about overpaying, and incentivizes sellers to maximize the value of their business. Importantly, this deal structure allows sellers the opportunity to capture a portion of the upside when asset prices appreciate and the market rebounds.** Federated Investors' acquisition of the Prudent Bear Fund, a short mutual fund, and the Prudent Global Income Fund, for $43 million at closing and up to $99.5 million in contingent payments is one example of such a deal structure: even if only half of the maximum earn-out is realized, the deal values the funds at 5.45% of AUM or an estimated 1.7x revenues. Moreover, Eaton Vance Corp.'s acquisition of M. D. Sass Investors Services' Tax Advantaged Bond Strategy funds is an even more striking example: closing payment was $30 million with seven contingent payments (paid between 2009 and 2016) based on future revenues. Even under extraordinarily conservative modeling assumptions, this deal was priced in excess of 3x revenues and 11x EBITDA. Lastly, Barclay's original deal with CVC Capital Partners to sell iShares at 10.1x 2008 EBITDA elicited such fervent interest that Barclays commenced an auction of the entire asset management arm. Blackrock may win the auction with a $13 billion bid.

As of May 22, there have been 40 transactions involving US asset managers, valued at $4.76 billion (including the CVC-Barclays $4.4 billion deal), according to Dealogic. In the same period last year, there were 53 deals, valued at $3.2 billion.

Park Sutton Advisors is a leading authority on the financial services industry, and specializes in providing high-touch, confidential advisory services on small- and middle-market transactions. These include mergers and acquisitions, valuations, divestitures, strategic alliances, joint ventures, fairness opinions, and planning for equity transitions and successions.

For Latin American families, Park Sutton Advisors offers exceptional wealth management services. Operating under the key principles of objectivity and transparency, Park Sutton Advisors is instrumental in helping families achieve harmony and success in asset growth and transfer across multiple generations.

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Steven leads and co-founded Park Sutton Advisors. He has focused on middle-market M&A and strategic advisory work in the financial services sector for the past 12 years working with asset and wealth managers, broker-dealers, and fund administrators globally.

Prior to co-founding Park Sutton, Steven worked with three investment banking boutiques where he focused on strategic and transactional work in the securities and investment advisory industry. He was a partner with Cambridge International Partners, which he joined from Millenium Associates where he led that firm's North American practice. Earlier, Steven worked at Putnam Lovell.

Steven holds a BA degree in Economics from Stanford University and an MBA in Finance from The Wharton School of the University of Pennsylvania. He is an alumnus of Stuyvesant High School. He is also a General Securities Principal.

Steven is a frequent speaker at industry conferences and seminars, and has been particularly active in the Speaker Retainer Program of the CFA Institute speaking on the topic of valuation of asset and wealth managers. He has served as an investment banking course instructor for Baruch College of the City University of New York. He is fluent in Spanish and prior to Wharton spent several years living in Mexico City.

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Jaime co-founded Park Sutton Advisors. Prior to Park Sutton, Jaime spent 8 years advising Latin American high-net-worth individuals representing over $500 million in assets. Most recently, he was a Private Banker with Deutsche Bank, actively involved in developing the Andean Region client base for the bank's New York office.

Prior to Deutsche, Jaime spent over three years with HSBC Private Bank, also focused on developing the Andean Region market and advising clients on their wealth management needs. At HSBC, with the bank's CEO for Latin America, Jaime co-managed the largest offshore relationship managed from New York. He was also awarded membership into the high-profile Group Private Bank's High Potential Development Programme ("HPDP"), a 3-year program accepting only 50 new members globally each year. Prior to HSBC, Jaime spent over four years with The Citigroup Private Bank also actively advising wealthy Latin American clients. From 1995 through 1999, Jaime was a corporate banker with Banco de Credito del Peru, the country's largest commercial bank, managing a significant portfolio of loans and performing credit analyses for some of Peru's largest private corporations.

Jaime is a dual Peruvian – Italian citizen and holds a BA in Business Administration from the University of Lima, Peru. He also holds an MBA in Finance, Marketing, and Strategic Management from The Wharton School of the University of Pennsylvania. He is Series 7, 63 and 66 certified. Jaime is passionate about 20th Century French decorative arts.