FOSTERING INDEPENDENCE IN THE INVESTMENT MANAGEMENT INDUSTRY

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For nearly 25 years I have been involved with ownership issues affecting money management firms. Throughout that period, I have been part of an industry search for successful ownership transfers, timely liquidity events for principals, and constructive recapitalizations without impairing the independence, creative satisfaction or performance for clients of the firm.

Over time, ways of thinking about investment management as a business, as a profession and as the means of meeting the vital performance needs of institutions and individuals have been evolving. The one clear trend which I believe has emerged is that the best qualified people operating in the most independent, free and satisfying way produce the best outcomes for clients.

What we must strive to achieve in this industry is to promote these gratifying environments so as to produce the best investment results and with them the greatest rewards and happiness for clients and professionals alike.

Unfortunately, up until now it has been difficult to achieve ownership solutions which can meet the multiple needs of investment managers and their clients. For example, the highest prices in the sale of money management firms have typically been paid by strategic buyers such as large financial institutions attempting to diversify into or augment their money management business. On the other hand, these kinds of strategic acquisitions often have the poorest record in terms of future performance for clients and satisfaction for employees of the money manager, including difficulty in retaining key personnel long term.

Money management is a very idiosyncratic, personal (almost art form) kind of business. Submerging smaller groups or firms into larger ones, which have a perceived need for uniformity, efficiency and consistency, leads to alienation of the individual achievers who make a money management firm truly special. Even such seeming trivialities as common identity, employee benefits, procedures, etc. can be unnerving for highly individualistic performers.

Now let’s talk about some history:

The first industry wide independence movement in the investment management business began in the late 1970's and early 1980's. This movement has been associated with the passage of ERISA in 1974-75. I'm not sure that ERISA was a factor but the dramatic growth of pension funds certainly was. This growth of sophisticated, organized large clients led to an environment where successful money managers could be identified by skilled groups of analysts and consultants employed by these clients. These money managers knew the economics of the business were changing and they chose to risk going out on their own. The success of these firms was creating the first "ownership crisis" in the industry.

People were building valuable small businesses in an arena where few had existed before. Eventually they would need a way to "cash out" although few were thinking about that yet.

Incidentally, it was also a period where investment management fees were rising as they are today. We were all astonished that it was possible. That's when I realized that money management was like "brain surgery". Forgive me for telling this old story of mine, but:

- Like brain surgery, the service is very important and very little understood
- If you needed a brain operation:
- Five brain surgeons quote you prices of $45,000, $48,000, $39,000, $41,000 and $12,000
- I guarantee you wouldn't hire the cheapest one
- The price is part of the service when the service is crucial but not well understood

But the success of these independent money managers was creating major ownership issues that needed to be solved. Up until that point, the only way for owners to achieve liquidity was to sell the firm to a large financial institution such as a bank or an insurance company. However, there was "no life after the deal". The stifling environment of many of these large institutions made this outcome very unpalatable indeed.

In 1980, along came the first investment management holding company, United Asset Management. It offered a much better but still only partial solution to the problem. Holding companies like UAM or Affiliated Managers Group , clearly provided liquidity to the principal owners. They also clearly offered an improved working environment after the transaction by not impairing the identity of the selling firm and, importantly, preserving a major part of the firm's autonomy. What the holding companies have not been able to do is provide the true independence of the firm and, clearly, generational transfer of ownership is largely impossible.

The concept of revenue sharing is a crucial element in the holding company model. The operation of revenue sharing is roughly as follows:

- "Revenue sharing" means receiving a return for an investment in a money manager in the form of a percentage of the manager's top-line revenues rather than as a portion of profits
- The high margins of investment management firms make revenue sharing possible
- Revenue sharing makes it easier to keep outside "owners" out of the inner workings of the business
- It permits firm executives to control:
  a. Compensation
  b. Hiring
  c. Expenses
  d. "Life style"

The continuing quest for identity, independence and greater rewards has now led to the hedge fund phenomenon. I believe it's part of a bigger, more universal drive of highly skilled professionals.

- I see parallels between the hedge fund movement of the last few years and the first wave of money managers becoming independent in the late 1970s and early 1980s.

- The vehicles and instruments are different but the motivation and perceived benefits are the same. Greater independence, higher levels of control and much larger financial rewards for money managers. Improved performance for clients.

- I believe the hedge fund movement will eventually "regress to the mean". By that I am saying that hedge fund managers will become more conventional and their performance will become more "average" while long-only managers will begin hedge funds and other more exotic portfolio strategies.

- The hedge fund phenomenon will end "not with a bang but with a whimper" and be subsumed into the independent manager population as a whole.

But the problems are still the same. How to adapt to the maturation of the firm without destroying what makes it unique and special.

The industry has been crying out for "a better way" to preserve identity and independence while still meeting the liquidity needs and generational ownership transfers which must naturally occur over time.

About three years ago, I was approached by a group of structured finance people based in New York who had some new ideas about revenue sharing as a way of meeting these needs.

Eventually these new ideas became the basis for a new company that was formed a little over a year ago, called Asset Management Finance, and I became its CEO.

The concept is remarkably simple, given what has gone before. Simple, but its' elements are the subject of a pending patent application which was filed in early 2004.

These new elements are the following:

1. Detach revenue sharing from ownership and establish revenue sharing solely as a financing vehicle, one which provides capital in return for a share of top-line revenues but does not involve any ownership transfer or creditor relationship. The share of revenues is a fixed percentage.

2. Up until now, revenue sharing has always been "in perpetuity" as befits an owner/subsidiary relationship. But why couldn't revenue sharing be for a term, for example a 10-year term? In the event, Asset Management Finance offers revenue sharing arrangements of from 7 to 20 years. There are no balloon payments at the end. The regular payments just stop.

3. These structured finance people had designed very specific models to describe an investment management firm. The use of these models to supplement more qualitative assessments of the firm offer, I believe, a more precise and improved deal underwriting method. This should produce more accurate valuations of firms.

4. This team also felt they could help create a more truly diversified portfolio of these "Revenue Share Interests" (RSI's) by using their quantitative techniques to more precisely define the role of each holding in the entire portfolio.

5. Finally, they believed it was possible to create a much more efficient capital structure by eventually securitizing baskets of these RSI's and, thereby, permitting higher returns to shareholders while still offering attractive terms to investment management firms.

With these new elements, revenue sharing becomes extraordinarily useful and extraordinarily flexible, all the while maintaining complete independence for the firm and a total absence of fixed principal debt or any equity transfer. Incidentally, transactions of this kind do not require client consents because there is no change of control of any kind.

Ironically, these transactions are something that firms might <u>want</u> to discuss with clients because they show that the firm is evolving without impairing its autonomy and while preserving its management continuity.

Specifically, the kinds of transactions that these RSI's can support include the following:

- Liquidity events for the principals of the firm
- Transfers of equity from generation to generation
- A spin-off of the firm from a parent company
- An important growth initiative or a key acquisition
- Situations where the firm needs to commit capital in order to co-invest with clients

The time period is flexible and, as I said earlier, can be as short as 7 years or as long as 20 years.

The amount of capital advanced depends on a number of variables, including:

- The length of the revenue share period
- The percentage of gross revenue purchased (typically 5% - 25%)
- Historical and anticipated asset growth and volatility of the firm
- Asset mix and fee stability of the firm
- Qualitative factors such as management depth and infrastructure

Advantages of RSI's include:

- Risk sharing – we are truly partners in the successes and disappointments of the business
- Terminating revenue participation – full upside of the business reverts to the owners after the RSI period expires

- Owners never give up control – AMF owns no equity in the firm
- The RSI is not a recourse obligation of the principals
- We are a truly silent financial partner – management has autonomy, less restrictive covenants
- Owners enjoy the benefit of margin expansion during the RSI period
- Structural flexibility to meet the manager's objectives – possible follow-on or serial transactions

AMF allows the principals to preserve the full range of future strategic options, including selling the firm if and when they wish to do so.

We think moving in this evolving ownership direction has profound implications for the industry:

To begin with, it can be a "perpetual motion machine". The endgame does not have to be a conventional sale of the firm. The process of creating expiring RSI's can continue indefinitely as long as there are margins to support it. We prefer to keep our percentage of revenues to one-half, or less, of the firm's natural margins. This is in order to assure that the firm's management has strong incentives to perform and grow and the resources to withstand margin shrinkage if it occurs.

RSI's are extraordinarily flexible. They can be used on a "project-by-project" basis to liquefy owners partially or completely, one by one, or in groups; gradually year by year, if desired. And with the liquidity for some can come transfer of equity to others.

Since RSI's expire, they can, in effect, be recycled.

We also believe that this is a good time in the development of the investment management industry to sponsor mechanisms which preserve independence and autonomy:

1. The experience of consolidating acquisitions in the 1990's was extraordinarily poor for buyers, sellers and clients. There is a natural backlash in progress which we believe will lead to an accelerated pace of spin-offs/divestitures of money managers by large corporate owners.

2. Clients are thirsting for unique, highly skilled and completely autonomous firms as a better way to achieve their performance goals. Never has so much sophisticated money worked so hard or been willing to pay so much to find new and exciting firms with whom to entrust their accounts.

3. Distribution is often a problem for medium-sized, independent firms. But today:

   a) Large, sophisticated and experienced clients are wiling and able to search out smaller "unique" firms.

   b) Large, powerful distributors are willing to separate their distribution function from the investment management function - for the betterment of both. The performance is better and, as a result, the sales of the product are better.

Now let's discuss some of the special features of RSI's:

1. They are not appropriate for start-up firms. The models require at least five years of history. In addition, a start-up firm has no profits to capitalize.

2. Generally firms will need at least $500 million to $1 billion of assets under management in order to have adequate margins.

3. RSI's can be used with private equity firm investments in money managers. When the private equity firm invests, AMF can provide a form of mezzanine financing - much more flexible and sophisticated than bank debt. When the private equity firm wants to cash in (5 to 7 years later?), RSI's can be used by the management to take them out and restore full management control.

4. RSI's can be useful to take out original start-up investors (backers) when the firm becomes more mature or to take out retired partners when they are no longer active.

5. RSI's have some attractive tax features. In most cases, if the original payment made by Asset Management Finance is removed by one or more of the principals, they will receive capital gains treatment. Also, in most cases, 85 to 95% of the subsequent revenue share payments made to Asset Management Finance will pass before the tax line.

We believe that the natural market for this product is some 1000+ independent investment management firms in the United States with $500 million to $40 billion under management. In addition, there are an immeasurable number of subsidiaries, affiliates and divisions of large financial institutions which are candidates for divestiture.

The majority of these firms emphasize institutional investment management, but high net worth managers and mutual funds may also present significant opportunities.

In addition, there are scores of non-U.S. firms: in Canada, the UK, Continental Europe, Australia, perhaps even other far eastern countries. However, we feel there is enough to do to reach out directly to the U.S. market and are relying on investment bankers and word-of-mouth to expose us to foreign markets.

Studies seem to indicate between 100 and 130 transactions a year in the investment management business over the last 3 to 5 years. Our original goal was to do eight transactions a year. However, one could easily believe, given the non-invasive nature of an AMF transaction, that RSI's could double the number of annual transactions in the industry. That could leave us pretty busy. But our goal is to "be there" for all qualified firms who want this service. We believe, given the size of our equity partners and the receptivity of the senior debt market, not to mention the opportunities for securitization once our portfolio becomes large and diversified enough, that we will have the resources to meet the need.

Another feature which may enhance the use of RSI's is their ability to be executed in small units once the original research and due diligence has been completed on a firm. Liquidity events and equity transfers can be undertaken for a single partner of a firm and executed on a serial basis.

Our hope is that we have created an instrument that will revolutionize the ownership structure and pattern of the industry; changing it from a consolidating industry into one where permanent independence with evolving and renewing leadership is not only possible but prevalent. Where creativity, client focus and high levels of satisfaction for clients and professionals alike is the rule rather than the temporary exception.