DECLARATIONS OF Independence

This is a golden age for independent managers, says Norton Reamer, CFA, and he's trying to keep it that way.

BY CHRISTINA GROTHEER

AFTER 40 YEARS IN THE INVESTMENT INDUSTRY, Norton Reamer, CFA, simply overflows with insights and wisdom. He began his career as an analyst but quickly moved up, eventually serving as president and CEO of Putnam Investments. In 1980, Reamer left Putnam to found United Asset Management (UAM), which collected 55 affiliated money management firms during its 20 years in business.

Today, at age 70, you might expect him to be living the cushy retired life: golf, fishing, sailing ... Are you kidding? Reamer is not a rest-on-his-laurels kind of guy.

After a mere two months of retirement in late 2000, he was back on the job. Then in 2003, he started up Asset Management Finance — a firm that builds on what worked at UAM, taking it to a new level in Reamer's personal quest to safeguard the autonomy of as many money management firms as possible.

"To me, it's a lifetime dream fulfilled," he says. "We've gone a whole other step here with something that can preserve the most precious thing they own, which is their independence."

What are the biggest challenges, on the business side, of running a money management firm today?

The biggest challenge is always producing outstanding performance. I mention that because, even though this is a business-oriented discussion, the form of the business often has a lot to do with how effective the organization is in serving its clients' needs. Specifically, I think the value of independence to clients has become more appreciated by most of them and, therefore, by most practitioners.

In the late 1990s, we had a lot of things happen in the industry to capitalize on the high values that were being put on investment management firms, which often caused these firms to be absorbed, if you will, into larger organizations. And I think that has proven to be not terribly productive for clients, often unpleasant for the managers who sold their businesses, and oddly enough, unrewarding for the large enterprises that bought those businesses.

I think we're having something of a reversal, where both clients and money managers are valuing the money manager's independence more than ever. Even those who may have acquired money management firms have found that the fit often isn't very good, the payoff hasn't been very good, and the businesses don't go very well together. In many cases, they are divesting those firms.

This is coming, I think, at a good time because, more than ever, clients are geared up to find niche managers, independent managers, and managers with exciting specialties. I don't know what the index of client investment in finding outstanding and sometimes obscure managers is, but I think such an index would show that there is more and more effort going into that quest at this point in time, which is a good thing given the fact that it seems to be the most congenial way to manage money.

On the flip side, where do you see the most opportunity in this business?

That's difficult. We're always inclined to look at what's been hot lately and to extrapolate that. Of course, the hottest area lately has been "hedge funds," alternative asset managers, and so on. Maybe instead, I'll take a slight turn from that.

Following on what I said earlier, with the advent of alternative asset managers and hedge funds, we're seeing a new independence movement. The first era of this that I lived through was in the late 1970s and early 1980s, when a lot of long-only managers were breaking away to start their own organizations.

They thought that they were going to have more freedom, be able to do a better job, get higher financial rewards, etc. That's obviously what's been happening again in the last four or five years with the advent of hedge funds.

Of course, as a result, we've seen this amazing tendency of investment management fees not to shrink, as you'd think they would over time, but to rise. In effect, performance fees are an increase. So this whole breakaway into more independent units — in this case, more highly compensated than ever — has been a major business development.

What are the forces of change that will most transform business conditions for investment managers in the coming years?

I think the business is inevitably becoming more competitive. There are more and more players out there, which makes it more difficult to achieve incremental returns. We had an exciting period when new things were being done by managers, but now, so many of the new things that managers are doing have already been done by somebody.

Now that the field has really opened up and large institutional investors have become more adventuresome in the kinds of managers that they're willing to hire, the force of change is, I think, an increasingly competitive environment for money managers.

In addition, I think we're probably about to face — this reflects some economic forecasting on my part, which is a field in which I have no particular claim to expertise — an environment of increasingly tightening money, higher interest rates, and possibly inflation. And this could make a more difficult environment for successful investing than the one we've had for many years.

How will these forces alter the business models of investment firms going forward?

In the late 1990s, the thrust of the investment management business was toward what I would call retailization. It was driven by the tremendous growth of 401k plans and tremendous interest in mutual funds by the public. What we saw then was the increasing importance of size, of mass market distribution — the ability to reach out effectively to the public and to smaller investors. That's not something that independent, medium-sized firms are very good at.

Today, we seem to be seeing the increasing professionalization of the client, which has made the medium-sized firm a more effective competitor than it was. In addition, we've also seen some detachment of professional money management from what I'll call professional distribution of money management — in my opinion, to the benefit of both. For a while, we all thought that the large financial conglomerates were going to absorb all the money managers, too.

In fact, the clients have shown some skepticism about that, and so have the large financial conglomerates. For example, one of the most striking recent transactions is the Legg Mason acquisition of Citibank's asset management group. Who would've thought it would've gone in that direction? Now Legg Mason has become a giant too, but a pure money management giant. And the fact is, there are many other divestitures going on.

I think we're in a golden age where investment managers can make their own way — where they don't have to be as dependent on mass marketing distributors as they became

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in the late 1990s. Structurally, I think it's something of a golden age for money management professionals.

What will the industry look like 10, 20, or 30 years from now?

That's a long way out. Five years out is the most I would attempt; I can't see beyond that. I'm really striking the same theme all over again. I see the industry as being more fragmented. I see deconsolidation going on. I'm sure we'll have other waves, but remember, it's the marketplace that is driving this.

When the marketplace was being driven by the retail public (401k plans, mutual fund, and other small investors) it tended to produce consolidation in the industry — to produce the large organizations that could reach that fragmented demand.

Today, when sophisticated clients are able to find special managers that they think are attractive, even though they may not be large, it fosters more fragmentation, more independence if you will, and that trend isn't over yet. But I certainly couldn't predict it would be a 10-year or a 20-year trend.

Some years ago, you cited consolidation, globalization, and "retailization" as the most important things affecting investment firms. What are today's buzz words?

I don't know when I gave that presentation, but if it was given any time from 1994 through 1998, it would've been an OK forecast. It was what was happening, or was about to happen in spades, for that period, which ran probably until the market peaked in 2000. Then we had this tremendous reaction in the marketplace, which shook out many investors, especially those who were smaller and less confident or well informed. Now we're in a reversal, which I think will last a number of years.

For me the new buzz words are independence, of course, and creativity, in the sense of the development of new investment approaches and the use of new asset classes. It's a more imaginative, open-minded approach to investments that is now being used.

Why do you believe the most perfect money manager is an independent one?

The people who thrive as money managers — as imaginative discoverers of new ideas and successful investments — tend to be jealous of their prerogatives and their freedom. It's a business that draws people who want freedom and opportunity, and that's why I tend to feel independence, from an entrepreneurial point of view, tends to go hand in hand with the best money management.

Do you agree that distribution channels for money manager products have narrowed, which makes it riskier than ever to be an independent money manager?

I'm going to take exception to that. I'm not sure what you meant when you said narrowed, but I think I disagree. A fascinating development that I've been observing over the last few years is the tendency to separate manufacturing from distribution. By that I mean, in the 1990s (we talked about this earlier), the big players were acquiring investment management firms because they wanted to produce and sell their own product.

Then lo and behold, what they found was that the client was skeptical of large broker X distributing funds that were run by large broker X. If anything, the separation of the two capabilities has taken a new lease on life in the last couple of years.

So I have to disagree. I think the current environment is more kind to people who are medium size and just money managers, as opposed to powerful combined money managers and distributors.

In the largest distributing organizations, there's a very real place for product that they don't produce. In fact, it probably is the dominant place now. Who knows how long it'll last? But over the next several years, I think we're going to see a better environment for people who are money managers only.

What can be done to encourage the existence of more independent firms?

I'm spending all my time working on this issue now. It's what I call achieving liquidity and generational transfer of ownership without having to give up independence. Many years ago I created a company, United Asset Management, and it's not the only one — there's Affiliated Managers Group and others — devoted to the fact that, ultimately, every firm would have to be sold someday.

In other words, entrepreneurial people went out, started these firms, made them valuable, made themselves potentially prosperous, but someday they had to cash in. As they got older, or got concerned about diversification in their personal net worth, they would do a transaction. I used to promote UAM as being the kindliest way to do these transactions with the least disruption to the firm.

Now, with the view that independence is the best thing and that anything that abridges that independence is not as good as avoiding abridging it, the question becomes: how do firms who have established themselves remain independent *perpetually*?

This company that I've been developing, Asset Management Finance, has been striving, I think with some success, to develop methods whereby owners of investment management firms can transfer ownership from one generation to another, have liquidity events to diversify their holdings, retire, take out older shareholders, lots of things like that, without giving up their independence. That is the Holy Grail for me.

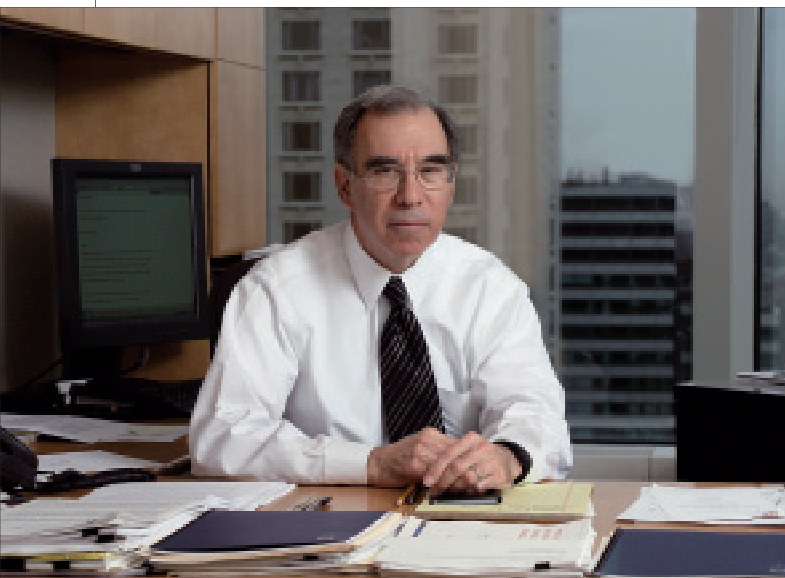
At a time like this, when independence has become more precious than ever, isn't it our job to figure out a way to preserve that independence rather than having it disappear in large financial institutions?

It's a relatively simple concept. We've got a whole lot of bells and whistles that we have put a patent application on, but it's using what I have called for 25 years "revenue sharing." We call our vehicle Revenue Share Interests (RSIs).

Banks don't like to lend money to investment management firms because they don't have a lot of hard assets or imbedded capital. We finance them through these RSIs, where you produce funding for these kinds of transactions, receiving in return a percentage of top-line revenues. By doing it that way, the risks for the firm and its principals are much lower, because if the revenues fall, then the amount that they pay for the financing will fall.

If firms want to determine their own expenses, don't want to deal with people who want to look at their books all the time — check what compensation they're paying or whether they're traveling first class or economy — then linking financing to revenues, as opposed to profits, is a very effective method. It works especially well in this industry, where the margins tend to be high. It's not so easily used in other industries, where the margins are much lower.

We pioneered this at UAM, but we were using it then in an ownership context, and now Asset Management Finance is using it as a specialty finance company, focused on this one industry.



Norton Reamer's lengthy career in the investment industry speaks for itself. He joined Putnam Investments in 1967, moving from portfolio manager to director of research, chief investment officer, president, and finally CEO until his departure in 1980 to found United Asset Management, where he served as chairman, president, and CEO for 20 years. In 2003, Reamer founded Asset Management Finance Corporation as an extension of the UAM concept.

Last year, he rejoined the board of the Boston Security Analysts Society, where he previously served a term in 1972. Reamer earned a BS in electrical engineering and an AB in economics in 1958 from Union College. He received his MBA from Harvard Business School in 1960 and earned the CFA designation in 1966.

I love your quote of Wayne Gretzky about skating to where the hockey puck will be, not where it is. How can investment firms implement this idea?

I'm not a great sports enthusiast, so I'm very proud of that quote. By it, I mean recognizing the changes that are occurring in the industry, and what clients are really prizing right now, as opposed to what the dominant client may have been thinking in the late 1990s. We're focused on preserving the kind of environment that truly entrepreneurial money managers need.

Are you concerned that the current global cash surplus could make AMF's services less essential to the industry?

No, because we don't seem to have the surpluses in the United States. The key issue with a company like ours (or for that matter, any very specialized company) is the conditions in its little micro-world, so to speak. We're doing something that, to many people, is unusual, and a little scary: providing equity-like financing to money managers without asking for ownership. Not many people understand the economics of this industry, and the few who know it are often very cautious about it.

Banks don't like to lend without personal recourse in this industry; they don't want to lend very much or for very long periods. So I guess I would say that even if there were an issue within this country, the niche is so specialized that I don't think these global surpluses would play much of a role in our situation.

Actually, [global cash surpluses] may have helped us, I would say. We recently raised [US$]100 million dollars of senior debt, and 80 percent of the money was from non-US institutions. They look at us as a way to be exposed to this industry, but with a buffer in between — someone who they think may know their way around the industry.

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