WILEY FINANCE

INVESTMENT LEADERSHIP and PORTFOLIO MANAGEMENT

The Path to Successful Stewardship for Investment Firms

BRIAN SINGER
GREG FEDORINCHIK

Investment Leadership and Portfolio Management

Founded in 1807, John Wiley & Sons is the oldest independent publishing company in the United States. With offices in North America, Europe, Australia and Asia, Wiley is globally committed to developing and marketing print and electronic products and services for our customers' professional and personal knowledge and understanding.

The Wiley Finance series contains books written specifically for finance and investment professionals as well as sophisticated individual investors and their financial advisors. Book topics range from portfolio management to e-commerce, risk management, financial engineering, valuation and financial instrument analysis, as well as much more.

For a list of available titles, visit our Web site at www.WileyFinance.com.

Investment Leadership and Portfolio Management

The Path to Successful Stewardship for Investment Firms

BRIAN SINGER
GREG FEDORINCHIK
BARRY MANDINACH

WILEY
John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:

Singer, Brian, 1960–
Investment leadership and portfolio management : the path to successful stewardship for investment firms / Brian Singer, Greg Fedorinchik, Barry Mandinach.
p. cm. – (Wiley finance series)
Includes bibliographical references and index.
ISBN 978-0-470-43540-3 (cloth)
1. Portfolio management. 2. Investments. I. Fedorinchik, Greg, 1970- II. Mandinach, Barry, 1956- III. Title.
HG4529.5.S556 2009
332.6–dc22

2009020140

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Contents

Preface

In Murfreesboro, TN, childhood home of one of the co-authors, a weathered farmer walks out to get the morning newspaper in her usual morning back pain. Mary had forgotten to take her nightly painkiller to treat arthritis in her back and the impact of her weekly immune system inhibitor injection was beginning to wane. Regardless, she hobbles back into the old wood farmhouse and settles in to an easy chair, molded to her body after years of this morning ritual. She reads the local newspaper, building up the energy to mount the tractor for another day's labor.

Mary spots an article in the newspaper about a terrorist attack in Southeast Asia. She has never heard of the terrorist group, but she is certain that "some Muslim group" is behind the devastation. Mary hates Muslims and is sure that they hate her for her fundamentalist Christian beliefs. No bother, though, as they are on the other side of the world and Muslims are unlikely to have any influence on her narrow existence in this rural little corner of the world.

She couldn't be more wrong. What Mary doesn't realize is that both of the drugs she uses to control her daily pain would not have been possible without the generous financial support of those individuals whom she unjustly loathes. Conversely, the people who produce her pills may equally dislike Mary for her bigotry and hatred; yet they enable her to get up on most days to live a pain-free existence. Moreover, their investments created two successful drugs—interestingly developed by an Israeli company—that garnered generous returns supporting unprecedented infrastructure building around the world.

> *It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages . . . He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it . . . He intends only his own gain, and he is in this, as*

> *in many other cases, led by an* invisible hand *to promote an end which was no part of his intention.*
>
> —Adam Smith

These parties don't know and perhaps can't stand each other, yet they depend on, benefit from, and support each other on a daily basis. How can this happen?

ARE WE SETTING A GOOD EXAMPLE FOR OUR CHILDREN?

To understand how this happens every second of every day, consider a common misperception that was so eloquently portrayed in Tom Wolfe's *The Bonfire of the Vanities* (Random House, 2001). Sherman McCoy, a self-styled "Master of the Universe" bond trader on Wall Street, is asked by his daughter, Campbell, what he does for a living. The question is prompted by the fact that seven-year-old Campbell's friend's dad produces tangible things at his printing business and Campbell wants to tell her friend what her daddy does.

After several failed attempts to explain what he does, Sherman's wife Judy explains that, "Daddy doesn't build roads or hospitals, and that he doesn't help build them." Rather, Judy explains, "Just imagine that a bond is a slice of cake, and you didn't bake the cake, but every time you hand somebody a slice of the cake a tiny little bit comes off, like a little crumb, and you keep that. . . . Imagine little crumbs, but lots of little crumbs. If you pass around enough slices of cake, pretty soon you have enough crumbs to make a *gigantic* cake." (p. 239) Having equated the gains from bond trading to gathering millions of "golden crumbs," Judy has implied, in quite memorable manner, that Sherman doesn't produce anything tangible. Sherman is portrayed as a parasite on the efforts of others.

While Tom Wolfe provided a wonderful story (and a *New York Times* bestseller), he has shredded the contribution of investing. The critical role of an investor is to locate the best and cheapest cakes in the world and make them available to the individuals who want cakes the most. For providing this service, they get a very small piece of the cakes—the crumbs. Most likely, the consumer and baker don't know and will never know each other. In fact, the consumer may hate the baker and the baker may, likewise, despise the consumer, yet they merrily come to each other's service.

Mary, our rural farmer, benefits from the continuous efforts of investors around the world. Investors evaluate every investment opportunity, every request for money to build a business, research a drug, develop a new manufacturing process, and so on. When good opportunities are identified, they place capital in these opportunities. These same investors beseech entities that have capital to entrust it with them to make good decisions regarding which opportunities to support. Investors serve as stewards of society's wealth. That said, investors are not doing not-for-profit social work. Finding opportunities that may be profitable is incredibly difficult, and successful investors get and should get paid a lot of money. However, they should be successful to be paid handsomely, and it is difficult to distinguish success from randomly positive outcomes.

Another important consideration for investment managers is the fact that actually delivering successful performance outcomes to clients requires more than just improving the efficiency of the global allocation of capital, and generating value-added investment performance. It requires successful communication with clients that helps them overcome the natural human biases that often lead to poor investment outcomes. Succeeding in this endeavor is one of the greatest challenges in this business, and one that requires additional attention and great execution.

It is for these reasons that we have decided to write this book. After collectively accumulating nearly 70 years of experience, we feel a need to document the characteristics of firms that are and are likely to be successful stewards of client capital and the behaviors of these firms' leaders and their investment teams.

OVERVIEW OF THE BOOK

The book is a top-down analysis of successful strategies, structures, and actions that create an environment for generating strong investment performance and, most important, for delivering rewarding investor outcomes. Additionally, we discuss various aspects of the framework that we have found useful in this regard so that readers can examine real applications of the ideas. Each chapter can stand on its own and can be read in isolation; however, the chapters are best read in sequence.

The book begins with a discussion of the differences between investment firms and product firms. Both types of firms have their place in the industry, but they are motivated by different means and to different ends. The bulk of Chapter 1 focuses on the characteristics that are found in successful firms of both types, and includes discussion on the importance of culture, leadership, integrity, and the governance that must be in place to sustain investment success and superior investor outcomes.

Chapter 2 discusses "Building a Cathedral," with a focus on organizational mission, cultures, and values. It addresses some of the practical considerations required for living organizational values, setting mission and goals and measuring organizational success. We draw upon our own experiences and discuss what we have found to be successful and unsuccessful. The successful aspects of our experience will be delineated in detail for the useful application of senior managers in other investment firms.

Chapter 3 deals with some of the most important practical considerations in developing a meritocratic investment process that rewards individual contributions appropriately. We argue that far too much attention is paid to last year's performance results in determining the compensation of investment professionals. We outline and discuss our views on the two primary components of employee compensation, namely, performance and criticality. We lay out an approach that we have successfully employed for managing the compensation process and for encouraging individual development with a key focus on transparency.

Together, Chapters 4 and 5 discuss the importance of investment philosophy and process. The alignment of the two empowers individuals while setting clear boundaries to help govern the actions of investment professionals. These chapters explore a variety of issues related to fundamentally driven investment philosophies and processes. They also describe a number of the most important behavioral biases that serve to confound good investment decision making. Market behavior analysis can contribute significantly to successful execution of investment decision-making processes. In Chapter 5 we also cover theories of evolution and recently popularized notions of "black swan" tail events and their application to investing.

Chapter 6 demonstrates the importance of communication for superior investor outcomes, realizing that a successful investment process is equal parts investing and communication. Our experience has taught us that generating superior investment performance is extremely difficult but achievable for the highest quality firms. However, actually delivering superior investor outcomes raises additional challenges that most of the investment industry cannot achieve. Sound, consistent, and transparent communication with investors is the highest success strategy for achieving superior outcomes and helping investors avoid the pitfalls of performance chasing and other value-destroying behaviors.

Chapter 7 discusses incentive structures and fee models for asset management firms, challenging some of the pervasive models in the industry today. Some of the great wealth destruction of our time can be traced back to the basic culprit of flawed incentive structures. While the authors may disagree on the intent of various fee and incentive structures, we all agree that better alternatives exist than the status quo.

Chapter 8, the final chapter of the book, represents a distillation and summary of many of the most important concepts that we believe are presented here. If you have a limited time, and tend to prefer Cliff Notes over full texts, you may want to start with Chapter 8.

Interviews and surveys of numbers of individuals covering hundreds of different investment firms form the basis for much of the conclusions reached. Further, we have all had the opportunity to work for a number of both successful and ultimately unsuccessful ventures, spanning large firms and small firms, public firms and private firms, as well as our own entrepreneurial ventures.

Throughout the book, the importance of culture and integrity cannot be overstated. The greatest vulnerability to successful investment firms, teams, and processes is weakening or undermined culture and integrity. This is a point that will be raised again and again.

BRIAN SINGER

Acknowledgments

A number of individuals have contributed directly and indirectly to this work. The authors would like to give thanks to Alex McCarthy, April Powell, Edouard Senechal, and Brad Shade, all of whom provided editorial input as well as sweat labor at various stages in this process. Their hard work helped push this work to its completion.

We also need to provide special recognition to Joseph Maccone. Joe was a bit of a latecomer to the project, though we ended up pleading for his help to bring the book to fruition. In the end, he put in enough work on Chapter 6 to be considered a co-author.

We also need to thank our families for putting up with us through this past year. This is especially true of Linda, Margo, and Andy Singer, who put up with more than the usual number of rants from Brian. And of course Hilary, Tom, and Ted Fedorinchik—who will have been thankfully either too sleep deprived themselves or too young to remember this period of fatherhood in absentia.

We also would like to thank the hundreds of individuals who took part in conversations, interviews, and the other life experiences that shaped our views on a number of these topics.

CHAPTER 1

Characteristics of Successful Asset Management Firms

Generally speaking, employees and clients of asset management firms are looking for rewarding, long-term relationships with superior organizations. While newspapers and other media outlets provide frequent, often daily, scorecards of asset manager investment performance, determining superiority is difficult, requiring a long period of analysis. What does it mean to be superior? Identifying, understanding and implementing the characteristics of superior investment management firms is the key objective of this book.

Throughout this book we will relate a number of observations, some general and some very specific about various investment management firms. We will point to qualities of these firms that we, or those we interviewed, identified as positive or generally negative or disadvantageous. We are not however making recommendations for or against investing with these firms. The due diligence required to make such recommendations is beyond the scope of this book. We will simply use these firms as examples to identify and discuss the qualities that our research has identified as important for success.

Every investment firm performs two basic functions: the business function (marketing and client relations) and the investment function. We refer to firms that focus most energy on the business function generally as "product-driven" and those that focus most energy on the investment function generally as "investment-driven." These two functions often operate at cross purposes. Superior investment performance tends to attract assets from clients seeking attractive returns. This in turn may encourage product proliferation that feeds the business beast but undermines the sustainability of investment performance. A very small number of firms are built on a foundation that harmonizes the two functions. Vanguard is a product-driven firm with a low-cost business model. It delivers superior investment performance by distributing "passive" investment vehicles and avoiding the high fees of actively managed vehicles. We say "passive" in quotations, because the overwhelming majority of passive vehicles are benchmarked against active indexes. It might be more appropriate to call this activity "index fund" investing. Deciding which index fund to invest in is an active decision. However, once invested in an index fund, the fund itself employs a rule-based active strategy. The rules may include capitalization, credit rating or style tilt, among others. Unless the index comprises the entire capital market, it is active. Regardless, following market nomenclature, we use "passive" and "active" in the more pedestrian sense. Passive strategies are those with close adherence to any benchmark or index. Active strategies, by most definitions, are those that take positions different from such an index with the goal of producing an attractive risk/return profile relative to the index.

Superior investment performance through active management is, on average, not compensated. After fees, active management, in general, is negatively compensated. Further, the skill required to add value through active investing is very hard to identify. Finally, finding the skilled managers who do exist is a daunting task. Vanguard is a safer alternative for those without the knowledge, experience, or resources—the vast majority of investors—to identify investment skill. This is not to say that index funds come without risk. Understanding the basic risk characteristics of various asset classes and index funds, or relying on an experienced advisor, remains a prerequisite to investing in any investment vehicle, active or passive. Despite the fact that we characterize Vanguard as a product-driven firm, John (Jack) Bogle, Vanguard's founder, speaks to the importance of client outcomes by admonishing the industry to prioritize stewardship over salesmanship. He deserves credit for undertaking this important endeavor and executing with excellence.

Capital Group is an active, investment-driven firm whose business model revolves around the delivery of superior long-term client outcomes. As Charles Ellis points out in *Capital: The Story of Long Term Investment Excellence*, "Capital Group, especially the American Funds mutual fund subsidiary, puts sound investing well ahead of sales or marketing in every business decision."[1] Charley goes so far as to say that Capital is paternalistic in its relationship with clients and potential clients. If an investment product is very salable, but not in the best interest of potential investors, then Capital will not sell the product. Capital has earned a reputation of operating in the best interest of current and prospective clients.

Why do some investment-driven and product-driven firms provide successful long-term employee and client relationships while others do not? It is impossible to provide a recipe for success, but it is possible to identify certain characteristics of successful firms. We identify five critical aspects of asset management firms that we believe significantly influence superiority and success:

1. Strong culture
2. Limited size and complexity
3. Clear governance of the business and investment functions
4. First-rate (non-hierarchical) investment leadership
5. Integrity

We surveyed investors, spoke with industry leaders, and drew upon our collective experiences with multiple product- and investment-driven firms to assess the importance of each characteristic in determining superiority and success. Each is covered in detail below.

This chapter, and much of the book, argues that unifying culture among a team of individuals from diverse backgrounds and educations is indispensable to the long-term, sustainable success of asset management organizations. Due to its importance, we begin with a discussion of culture and follow with a major challenge to its survivability—the allure of size—and to critical contributors to its sustenance: strong governance, capable leadership, and integrity.

YOU CAN TAKE THE BOY OUT OF THE CULTURE, BUT YOU CAN'T TAKE THE CULTURE OUT OF THE BOY

The culture of a firm is defined by the total set of shared and socially transmitted attitudes, values, aspirations, behaviors and practices of its employees. Superior asset management firms, whether product-driven or investment-driven, exude strong and positive cultures.

Consider two very different firms, both with strong and long-standing cultures. Vanguard's culture is one that includes cost-consciousness and client outcomes. Its Internet home page states, "Investment costs count: Keep more of what you earn. The average mutual fund charges six times as much as Vanguard does." Vanguard's desire to deliver strong client outcomes is enshrined in its structure; mutual fund clients are owners of the firm.

Jack Bogle espouses the interests of Vanguard's clients through the delivery of a range of low-cost investment vehicles. Jack is noted for his frugality. When an individual joins Vanguard, there is no question of the firm's strong culture. Prospective employees know that if they are hired, they are unlikely to be jetting around the world in private jets or vacationing on yachts any time in the near future.

Some shrug off the importance of a strong and positive culture as having no place in the hardened, individualist world of investment professionals.

This sentiment is unwise. While culture involves much more than just legal behavior, the U.S. legal system does not support the bravado of these investment professionals. The U.S. Department of Justice says, "A corporation is directed by its management and *management is responsible for a corporate culture* in which criminal conduct is either discouraged or tacitly encouraged."[2] The guidelines for determining culpability direct judges to evaluate whether the culture encourages ethical conduct. The upper echelon of asset management firms should not be cavalier about the cultures that they promote.

> *Cowardice asks the question – is it safe? Expediency asks the question – is it politic? Vanity asks the question – is it popular? And there comes a time when one must take a position that is neither, safe, or politic, nor popular; but one must take it because it is right.*
>
> —Dr. Martin Luther King, Jr.

A strong culture does not arise from just the encouragement of legal behavior; it comprises positive values, attitudes, and performance. However, the backbone of a strong culture in any organization is its values. In 1963, Thomas J. Watson Jr., the former CEO of IBM, wrote of the firm's core values (beliefs) in the booklet *A Business and Its Beliefs:*

> *I believe the real difference between success and failure in a corporation can very often be traced to the question of how well the organization brings out the great energies and talents of its people. What does it do to help these people find common cause with each other? . . . And how can it sustain this common cause and send of direction through the many changes which take place from one generation to another? . . . [I think the answer lies] in the power of what we call* beliefs *and the appeal these beliefs have for its people. . . . I firmly believe that any organization, in order to survive and achieve success, must have a sound set of beliefs on which it premises all its policies and actions. Next, I believe that the most important single factor in corporate success is faithful adherence to those beliefs.*[3]

If values are so important, why do they seem to be the same, or at least very similar, for most firms? Moreover, firms of limited integrity often espouse positive values while ostensibly functioning free from their influence. This is no more clearly demonstrated than by reviewing the values of the now defunct firm, Enron Corporation. Enron collapsed after a long-term pattern of unethical and illegal behavior was uncovered. Figure 1.1 displays Enron's values.

Communication
We have an obligation to communicate. Here, we take the time to talk with one another…and to listen. We believe that information is meant to move and that information moves people.
Respect
We treat others as we would like to be treated ourselves. We do not tolerate abusive or disrespectful treatment.
Integrity
We work with customers and prospects openly, honestly and sincerely. When we say we will do something, we will do it; when we say we cannot or will not do something, then we will not do it.
Excellence
We are satisfied with nothing less that the very best in everything we do. We will continue to raise the bar for everyone. The great fun here will be for all of us to discover just how good we can really be.

FIGURE 1.1 Enron Corporation's Statement of Corporate Values
Source: www.enron.com (circa 1999)

Including the word "integrity" in Enron's values would be comical had its behaviors not destroyed the lives of so many employees and investors. The firm collapsed under the weight of executive fraud and conspiracy. Integrity is a value that Enron stated, but not one that it lived. While illegal behaviors are rare, values are more often stated than lived. We observe that many asset management firms create and display a set of values because it is a good marketing tool rather than any true set of guiding principles. One difference between firms with strong and positive cultures and other firms is the fact that their employees live the values that the firms display.

Case Study: Culture, a House Built on the Values Foundation

If a homebuilder starts from scratch, virtually any materials can be acquired and used. Eskimos in frigid environments use ice and snow. Native Americans used natural caves and cliffs or wood and animal skins. Similarly, the culture of a new firm can be determined at the outset and established by its initial and founding employees. Bill Hewlett and David Packard started Hewlett Packard with a clear set of values, the HP Way. The HP Way emerged from "deep convictions about the way business *should* be built. . . . [These convictions are] held *independent* of the current management fashions of the day."[4]

If a construction project is a renovation, then the builder is constrained by the existing structure, characteristics, and materials. Similarly, the materials for growing a firm, its people, must be consistent with what is already in place. Once a firm is established, the cumulative discussions and actions of every employee constitute a shared set of values and a culture that dictates recruitment, hiring, evaluation, and termination decisions.

A firm's values are not the firm's culture; they are a small aspect of the culture but arguably the most critical. Values comprise a small set of guiding principles of the organization. Capital Group, noted for its strong culture and superior mutual fund performance for example, has a culture that arises from its values. The Internet home page for Capital Group states that it offers "challenging opportunities in a highly collaborative, respectful, state-of-the-art environment."[5] Job candidates are told that Capital Group seeks individuals with specific characteristics common to all its employees: integrity, collaboration, respect, curiosity, accountability, detail-orientation, and humility.

And the Survey Says...

To test our hypothesis that firms with strong and positive cultures provide superior client outcomes, we segmented all firms into either the investment-driven or the product-driven category and queried investment professionals from around the world through surveys and interviews regarding superiority of the firms within their respective categories. Investment-driven firms are those with realized generally strong investment performance and a high potential for sustainable, superior investment performance. Product-driven firms have high client satisfaction based on offering features other than but not excluding investment performance. The non-investment features behind product-driven firms are low fees, client service, advice, diversification, and breadth.

We were not surprised to find that our queries confirmed the hypothesis. Superior firms, whether investment- or product-driven, generally possess strong and positive cultures that support their missions. In fact, of the firms covered in our research, culture was the most consistent and important differentiator of the quality of a firm. Of course some firms with strong cultures fail and others with weak cultures thrive for a period of time. However, it appears that a strong positive culture is a necessary, if not sufficient, characteristic of long-term superiority of asset management firms. The anecdotal evidence from our interviews suggests that these firms' leadership teams were able to develop shared values and culture while also maintaining and encouraging the individuality of the team's members.

Our findings are not unique and should not surprise readers familiar with extant literature. In *High Performing Investment Teams*, Jim Ware identifies key factors that help the best firms attract, retain, and motivate top talent. Among these factors are 1) leadership credibility and trust and 2) organizational culture and purpose. Further down the list is total compensation.[6] Jim observes that *values* motivate *behaviors* that in turn drive *results*. These values and behaviors are manifestations of culture.

Blake Grossman, CEO of Barclays Global Investors, observed in a presentation at the 2008 CFA Institute Annual Conference that innovation success factors at asset management firms include culture and evangelism. Readers are well advised to regard Blake's observations. He has built an organization that attracts and retains talent and continues to innovate products that target client needs. Barclays Global Investors has been a success story under Blake's leadership.

The American Funds subsidiary of Capital Group has a long history of strong investment performance and superior client service. Its culture has remained consistent since the beginning:

> *We are protective of the way we do business. For more than 75 years, we have remained single-minded in our desire to do right by our investors without compromising our desire to do right by our associates. We invest in our associates using the same thoughtful, deliberate approach we use to invest in companies.*[7]

The legacy and heritage of American Funds is clear, but perhaps investors should begin to be concerned. The Capital Group home page explicitly states that American Funds is "one of the three largest mutual fund families in the U.S."[8] Neither size nor growth is a foundational value of the American Funds unit that generated a long history of superior investment performance and client outcomes. Size is often an irresistible siren's song that draws many asset management firms away from their founding and successful cultures. Has this allure become too strong for American Funds?

The Capital Guardian and Capital International institutional subsidiaries of Capital Group define their missions as superior investment performance. Unlike the American Funds subsidiary, however, they curiously do not mention client results. Perhaps this is one reason why the success of Capital Guardian and Capital International have been limited and varied, especially relative to the mutual fund unit.

SIZE MATTERS, BUT NOT IN THE WAY MOST PEOPLE BELIEVE

While it is not difficult to identify the incentives that drive asset management firms to grow beyond their optimal size for superior performance, it is