Emerging Manager Monthly

The Trusted Source for Emerging Managers March 2020

Headwinds: 3 Ways Consultant Consolidation Creates Roadblocks for Emerging Managers

Headwind: *noun, a wind blowing from directly in front, opposing forward motion*

A new year represents different things to different people in the investment management business. For our firm, after 25 years in the third-party marketing industry, it means our phones are ringing with inquiries from money managers who are re-assessing their current sales, marketing and distribution efforts, looking for advice and opportunity.

While we view this annual ritual as a good thing, our conversations this year have a very different tenor than in years prior. For the first time, we have spent a disproportionate percentage of our time discussing the growing list of challenges and obstacles that now define the task of raising assets. To even the most casual observer of our industry, there is ongoing evidence of systemic, disruptive changes to the ways in which allocators invest, impacting how equity managers think about and position themselves to raise capital. Particularly for actively managed strategies, we now see several trends that seem to have permanently altered the landscape, rather than appear as temporary cyclical blips.

In our view, the most significant change with respect to the distribution landscape has been consolidation within the institutional consulting industry.

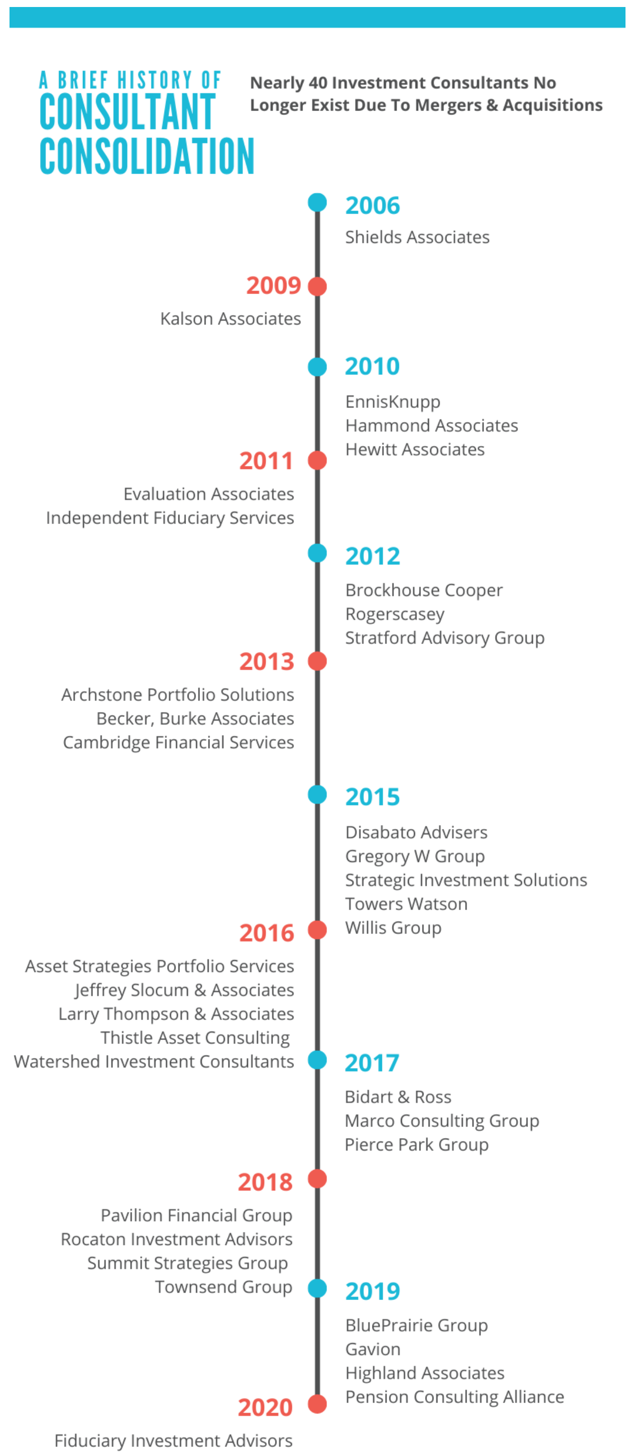
A quick review of our database revealed that more than 40 consulting firms and financial intermediaries have merged or been acquired over the past several years. While this trend has benefitted the consulting industry in many ways (offering expanded geographic reach, enhanced research capabilities and broadened asset class coverage), it has changed the fundamental underlying business model of the consulting industry.

And unfortunately, this consolidation has thrown up new roadblocks for investment managers (emerging firms especially) trying to grow their asset base:

Roadblock #1: Mergers Delay Manager Search Activity

Consultant industry consolidation has made it tougher than ever to make progress with these larger firms. After consultants' merge, the combined due diligence research teams focus on

1. reviewing existing lineups,
2. narrowing down the number of firms and strategies covered, and



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3. finding ways to best leverage their future time and effort.

Consequently, less time is allotted by these teams to evaluate newly formed or single strategy managers. Under these circumstances, holds are put on everything for several quarters until the proverbial dust settles.

However, it is important to recognize that some consultant firms do acknowledge the value boutique managers can offer. For example, we have recently seen wide-spread new initiatives to proactively seek out undiscovered emerging and diverse firms beyond dedicated emerging manager programs. Perhaps this initiative will offer more opportunities in the future. However, our direct experience, and that of our peers, is that many of these announcements have not yet begun to move the needle in terms of measurable asset growth for smaller firms.

Roadblock #2: Growing Bias Toward Multi-Strategy Firms.

In the aftermath of any merger, the first item of business is to eliminate redundancies and streamline operations. And because we are aware of the cost and labor-intensive nature of the manager due diligence process, it's not surprising that these larger consulting firms now prefer to allocate their time and resources towards those firms managing multiple strategies. After all, the logic behind a focus on asset managers with several strategies that could apply to a broad cross-section of a consultant's client portfolio is easy to understand.

Roadblock #3: More Competition for a Smaller Piece of a Shrinking Pie

Institutional investors continue to slash the percentage of assets invested with actively managed equity strategies, far below historical allocations, with massive inflows to less expensive passive strategies and ETFs. But why has this been the case?

For one, a large percentage of actively managed portfolios have lagged during the recent bull market making indexing a much easier (and less expensive) strategy to explain and justify. Lower performance and higher fees are never a popular combination. Also, there is a growing trend by large public funds to internally manage their portfolios to further reduce costs.

Finally, alternative strategies have gained acceptance as a viable source of alpha. As such, these alternative funds, including hedge funds, private equity, venture capital and real assets have offered much stronger competition for new allocations.

Making matters worse, one of country's largest public pension plans recently announced it was eliminating its multi-billion-dollar emerging manager-of-manager program. This move will undoubtedly drive several investment firms to either merge or unwind. The news has already proven to be deeply disruptive to the basic fabric of the emerging manager-of-manager industry.

What's Next?

In our opinion, the takeaways are clear.

First, the institutional sales cycle has lengthened, from 9-12 months to, in most cases, 2-3 years. For more established firms and those with financial strength or flexibility, weathering this new reality is possible, though undesirable. For emerging firms with lower AUM or a small roster of clients, this lengthened cycle may prove an existential threat.

Second, there are fewer searches than ever, with most of that activity devoted to replacement searches, rather than allocations of new money. (At Arrow, 13 of the past 15 new accounts awarded to our managers were replacements).

Investment managers and third-party marketers cannot ignore this changed landscape. While there may be some comfort in yearning for the "good old days," it is counterproductive and, in our view, a waste of valuable time and resources.

To grow or even survive, we need to adapt to the evolving market and adjust our expectations accordingly.

What is the Path Forward for Emerging Managers?

We believe it begins with finding experienced and dedicated sales professionals capable of telling the "right" story and having the insight to develop and execute a thoughtful, professional distribution process.

Emerging managers, and those of us who represent them, need to start playing three-dimensional chess; identifying where the new and expanding markets are located and finding ways to target them effectively.

We need to better account for the new realities which constrain our buyers and gatekeepers, always listening to both what's said and what's left unsaid to maximize our value-add and work to address their concerns.

Most important of all, we need to offer the necessary vehicles, competitive fee structures, act with a sense of urgency and be ready to transact on opportunities presented to effectively navigate through the industry's disruptions. If you're not ready, your competition will be!

Steve Rubenstein is the founder of Arrow Partners and possesses more than 25 years of experience and success in the institutional asset management business raising billions of dollars across wide range of traditional and alternative asset classes. Steve is a leading advocate of the third party marketing industry and served as President of The Third Party Marketers Association from 2004 to 2006.