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Building asset managers amid merger mania

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While growing "big" from a merger or acquisition carries some franchise value in terms of garnering assets, we believe small is much more likely to be the avenue to superior performance.

In the mergers and acquisitions of money management firms, clients may wonder whether the resulting upheaval brings them any benefits at all. The acquirer often justifies big cash outlays as cost-effective in providing economies of scale or a more complete business line. But the added bureaucracy alone may dampen the entrepreneurial drive of a talented money management firm. There is a better way to try to harness that entrepreneurial drive.

Incubating new managers focuses on nurturing entrepreneurial initiative, building on the experience of successful money managers and maintaining their motivation by positioning them to offer clients superior products. This is the thrust of a program the California Public Employees' Retirement System is implementing. CalPERS is entering partnerships to develop emerging money managers. CalPERS expects to capture higher value added in the portfolios these firms manage for the system, but it also expects to reap significant gains from its ownership stake in the investment management firms.

My firm is partnering with CalPERS in searching for these star firms of the future. We have taken our own template for incubating and growing four successful investment management firms and are now applying it to suit CalPERS' need. We like to refer to our business model as "the new form of venture capital," in which asset holders truly partner with business entrepreneurs by sharing ownership at the management firm level. In the last 13 years, Strategic has developed a broad and deep understanding of the process by which these ventures function well for all parties. An investment management firm typically enjoys its highest growth rate in the first five to 10 years. Not coincidentally perhaps, it typically produces its highest value added, or alpha, for its clients during this period. The profit growth and operational leverage experienced during this time can be tremendous.

After 10 years, strategic buyers that bring substantial permanent capital make great new partners for the firms and allow exit strategies for the original investors. For the industry, a new generation of fresh, agile and high-performance investment management firms is fostered.

In our program, we have realized an internal rate of return for our financial sponsors of 29% a year over