Casey Quirk

December 2008

The New Gatekeepers:

Winning Business Models for Investments Outsourcing

- **Investments outsourcing providers will become increasingly important intermediaries that will further reshape the relationships between asset managers and institutional investors.**

- **Assets from U.S. institutional investors delegating 100% of their portfolios to investments outsourcing more than doubled in the past four years,** from $97 billion to $195 billion, representing 6% of assets and 15% of investors. **Including partial outsourcing arrangements, the market is substantially larger.**

- **We estimate the investments outsourcing market will grow to $510 billion by 2012,** representing 13% of assets and 25% of investors—creating a broad pool for both traditional and alternative asset managers to tap.

- **The current financial crisis will accelerate investments outsourcing by emphasizing a number of the market's primary growth catalysts,** which include the lack of required professional resources among institutional investors and a rising desire for non-correlated assets such as alternative investments.

- **Non-profit institutions have fueled most of the market's recent growth.** Endowments and foundations seeking better investment propositions have increasingly outsourced.

- **Innovative investment consultants and dedicated outsourcing platforms are changing the competitive landscape substantially,** taking market share from managers-of-managers, historically the dominant outsourcing providers.

- **Successful investments outsourcing businesses will share seven key attributes,** which include sustainable and competitive performance, deep competence in alternatives, and the ability to work with clients in a customized, highly interactive manner.

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Casey Quirk

Casey, Quirk & Associates provides management consulting services exclusively to investment management firms. The firm specializes in developing business strategy, enhancing investment practices, and crafting distribution plans. The firm draws on more than 40 years of experience in delivering value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to influence change within organizations.

1. Introduction

Investments outsourcing is a trend in the global investment management industry that Casey Quirk has been tracking for a number of years. Our October 2007 whitepaper, *The Brave New World: Winning Product Strategies for a Changing Global Market*, co-authored with Merrill Lynch's Financial Institutions Group, highlighted outsourcing as one of the four strategies from which investment managers will realize significant growth in the coming years.

This research study focuses on one particular portion of the investments outsourcing market—the U.S. institutional market. But the opportunity for successful investments outsourcing models extends well beyond this market segment. Driven by a number of key catalysts, successful investments outsourcing businesses will look strikingly different from the models that have been dominant historically.

2. Investments Outsourcing: Definition, Our Research, and Global Context

Defining Investments Outsourcing

Investments outsourcing takes on many shapes and is often defined differently by various market participants. For the purposes of our research, we currently define investments outsourcing simply as:

"When an investor delegates 100% of its assets and some level of investment discretion to a third party for a portfolio-based fee."

Many institutional investors, however, allocate less than 100%, but significant portions, of their portfolios in broad mandates to investments outsourcing firms. Examples of such assignments include oversight of the alternative investments portion of the portfolio, or an unconstrained mandate with fairly broad investment freedom to achieve a return objective.

Another way to further define and understand investments outsourcing, at least in the context of the institutional market segment, involves comparing it to a traditional investment consultant-investor relationship. Investments outsourcing is distinctly different in a number of ways, including greater levels of discretion, asset- and performance-based compensation arrangements, and a wider use of proprietary vehicles, including many focused on alternative investments.

Exhibit 1

Traditional Investment Consulting vs. Investments Outsourcing

Traditional Investment Consulting	Investments Outsourcing
• Advice-only	• Significant, if not total, discretion on key investment decisions
• Make asset allocation and manager selection recommendations	• Often require approval on big decisions
• No proprietary investment products/vehicles	• Often maintain proprietary, pooled investment vehicles
• No investment records	• Tangible investment records exist
• Retainer and project fees	• Asset-based and performance fees

Source: Casey Quirk

Our Research

Casey Quirk has worked recently with a number of investment managers that reported greater client interest in handing over entire investment portfolios with greater levels of discretion. Our consultants also spoke with a growing number of institutional investors seeking firms that could handle such discretionary assignments. Consequently, we decided to define and measure this trend with a proprietary survey of investments outsourcing firms.

We focused our initial research on the U.S. institutional market, from which most of the anecdotal evidence was emanating. Our survey sought to measure investments outsourcing trends among:

- Corporate defined benefit plans
- Public defined benefit plans
- Taft-Hartley defined benefit plans
- Endowments
- Foundations
- Other non-profit institutional investors

During 2008, we surveyed more than 20 investments outsourcing providers regarding their U.S. institutional investments outsourcing business. Our research aimed to size the market, understand the services and client arrangements offered, and better understand the various types of business models.

Investments Outsourcing: Global Market Context

While our research focused on the U.S. institutional market, we think it is important to recognize that investments outsourcing is a broad industry trend appearing in most investor circles, albeit in different forms. Consequently, we believe the business opportunities for these services are substantial and growing in multiple market segments, including:

- **The U.S. institutional market**, the primary focus of our research, which has seen rapid growth, especially as larger institutions outsource all or part of their portfolios.
- **Insurance general accounts**, which represent a large and growing market. Although dominated by small and mid-sized insurance companies served by firms with strong fixed income capabilities, larger insurance companies increasingly have been outsourcing as interest in equities and alternative assets has risen. This market held approximately $800 billion in assets as of year-end 2006, and is expected to grow at an 18% CAGR through 2011.
- **The high-net-worth market** has been the primary client base for many of the fastest growing investments outsourcing platforms. In many cases, these clients are outsourcing a significant portion, often a majority, of their financial assets. Good investment records and access to high-quality alternative investments have been big motivators. The global high-net-worth market is massive: an estimated $40 trillion as of year-end 2007.
- **The Dutch pension market** has embraced investments outsourcing, making it the norm for much of the market. More stringent Dutch pension accounting and funding regulations, collectively known as FTK, have led many defined benefit plans to rely on so-called fiduciary managers to handle a scheme's entire investment strategy. Fiduciary managers oversee at least one-third of the Netherlands' $930 billion pension fund marketplace, according to Bureau Bosch.
- The world's largest **defined contribution markets** are either dominated by or experiencing substantial growth for investments outsourcing (effectively "set it and forget it") products:
  - Diversified manager-of-managers products, with target risk profiles delivered by platform providers and superannuation plans, are where the majority of assets reside in the **Australian superannuation system,** which comprised $760 billion as of June 2008.
  - The U.S. Pension Protection Act has helped make target date retirement funds the default option of choice in the **U.S. defined contribution market**; such products represent at least one-third of designated qualified default investment options (QDIAs), accounting for $228 billion in assets as of March 2008. Although dominated by proprietary products managed by the large plan recordkeepers, we expect competition and open architecture to creep into this market.

- **The global retail manager-of-managers** market has seen growth around the world. In the last decade, a wider swath of the world's mutual funds have hired multiple subadvisors, either in a bid to diversify risk or as a part of building more sophisticated asset allocation products. The global retail manager-of-managers market held approximately $440 billion as of year-end 2006, according to Cerulli Associates.

Successful investments outsourcing firms have the opportunity to consider targeting not only U.S. institutional investors, but also clients within these additional—and potentially faster-growing—market segments.

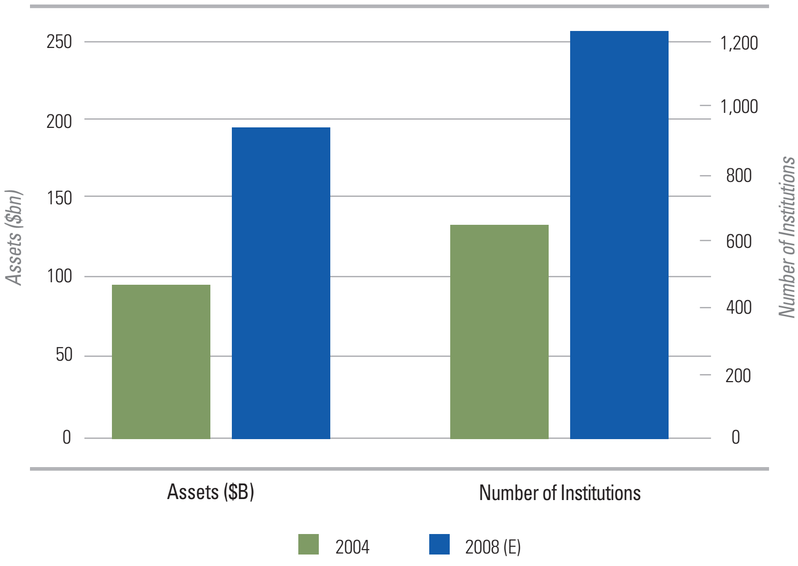
3. The U.S. Institutional Market Opportunity

Current Market Size and Historical Growth

As of year-end 2008, we estimate that investments outsourcing relationships will represent, at a minimum, 1,250 U.S. institutional investors delegating $200 billion in assets. Excluding public pension plans, investments outsourcing relationships represented approximately 6% of the assets and 15% of institutions in the total market. The investments outsourcing market more than doubled in size in the four years following 2004, when approximately 600 institutional investors outsourced less than $100 billion.

Exhibit 2

U.S. Institutional Investments Outsourcing Market
2004 vs. 2008 (E)

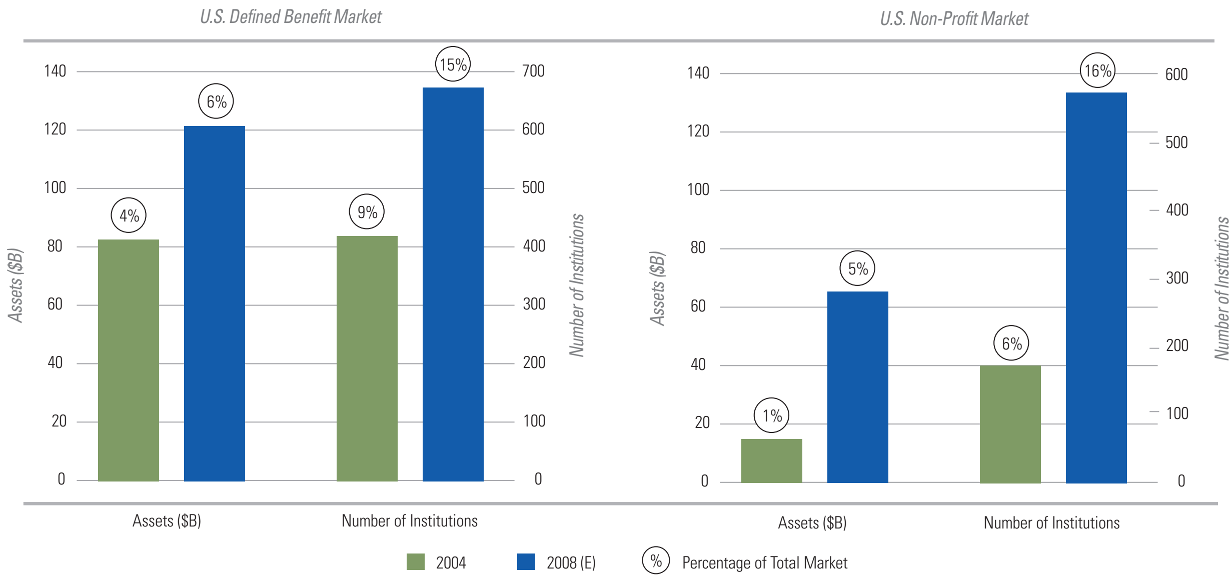


Source: Casey Quirk Investments Outsourcing Survey 2008

The non-profit market represented the primary source of recent growth for investments outsourcing. Smaller endowments and foundations, in particular, have embraced the investments outsourcing model. From year-end 2004 to year-end 2008, investments outsourcing among non-profit investors grew at a 43% CAGR from $15 billion to $63 billion, and the number of investors grew from approximately 190 to nearly 580. Pension funds, although accounting for a larger share of the assets and number of investors, saw investments outsourcing assets expand at a 10% CAGR, and investors grow at 13% compounded annually, during the same time period. Corporate and Taft-Hartley defined benefit plans represent the substantial majority of the total defined benefit outsourcing market. Public plans comprised only $7 billion in outsourced assets as of year-end 2008.

Exhibit 3

U.S. Institutional Investments Outsourcing Market
2004 vs. 2008 (E)

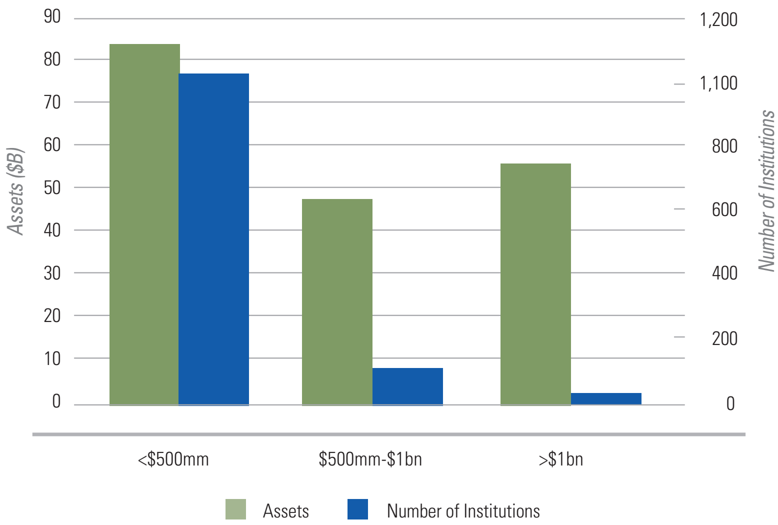


Defined benefit includes: corporate and Taft-Hartley defined benefit assets
Non-profit includes: endowments, foundations, hospitals, and other non-defined contribution institutional pools of capital
Source: Casey Quirk Investments Outsourcing Survey 2008, S&P Money Market Directory

Smaller investors historically have been by far the most likely to outsource their portfolios. About 15% of the collective assets from institutions with less than $500 million in total assets under management, excluding public pension plans are outsourced. Corporate defined benefit plans in that segment outsourced 23% of their assets, compared to a similar metric of 9% among non-profit institutions.

Exhibit 4

U.S. Institutional Investments Outsourcing Market
By Size of Institution
December 31, 2008 (E)

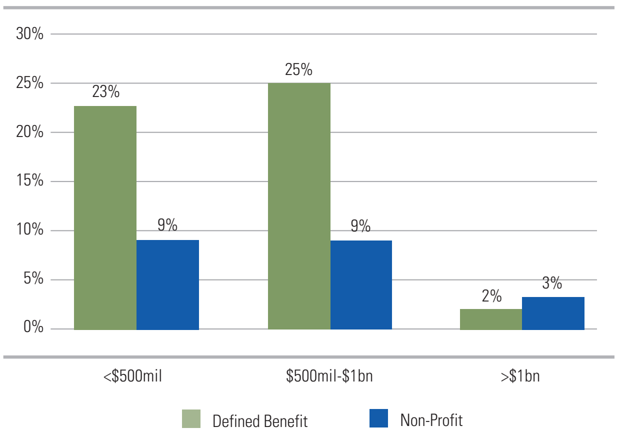


Source: Casey Quirk Investments Outsourcing Survey 2008

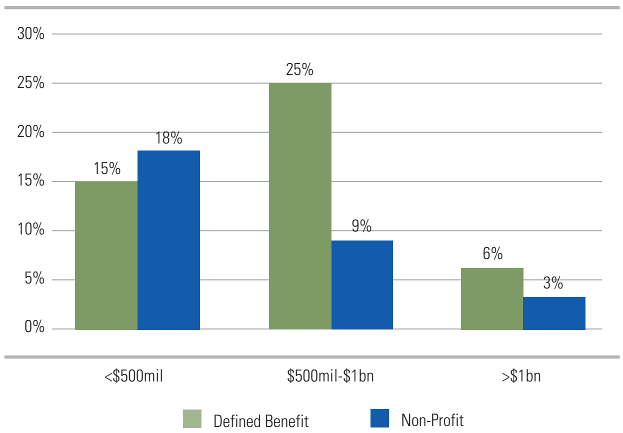
Exhibit 5

Percentage of U.S. Institutions Outsourcing
December 31, 2008 (E)

Assets Under Management



Number of Institutions



Excludes public defined benefit plans

Source: Casey Quirk Investments Outsourcing Survey 2008 , S&P Money Market Directory

Despite the prominence of smaller investors in the investments outsourcing market, larger investors are increasingly outsourcing as well. Big institutional investors are still a small portion of the overall investments outsourcing market, but the current financial crisis will convince many to join the trend. As of October 2008, a typical U.S. pension plan only could meet about 80% of its projected benefit obligations. The situation actually appears worse after considering that the discount rate for most pension plans has risen artificially, thanks to soaring yields on debt issued by financial firms. Shoring up these deficits will require access to a wider set of products and skills than many plan sponsors currently can access, even in concert with their investment consultants.

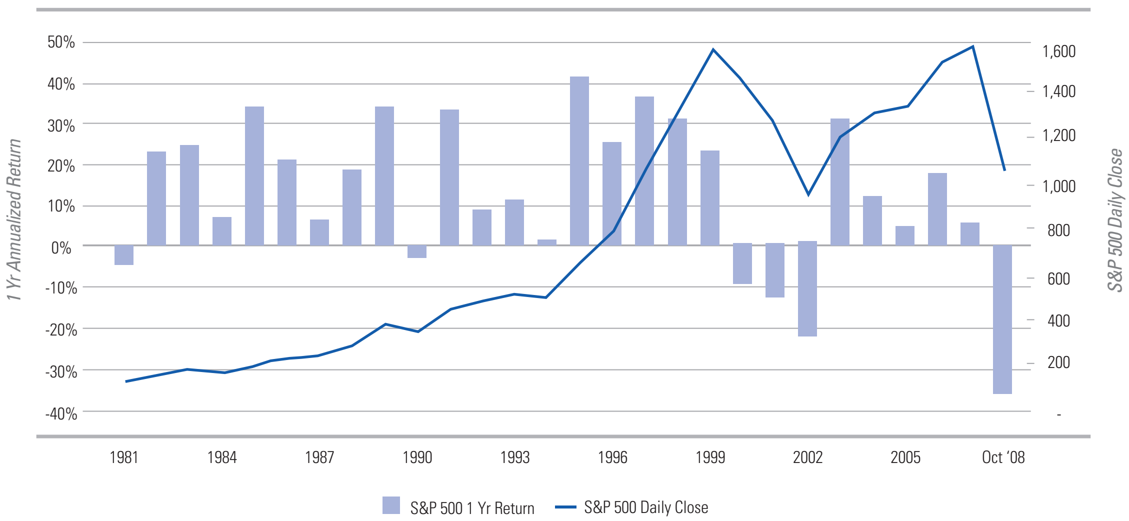
Investments Outsourcing Demand Drivers

We believe six critical catalysts are driving the growth of investments outsourcing in the U.S. institutional market:

1. **Difficult capital market environment.** The 1980s and 1990s brought strong stock and bond markets, allowing investors to regularly exceed their objectives on a consistent basis simply by investing in publicly-traded equities and bonds. During this decade, however, the capital market environment has brought volatility and lower returns —especially during the recent financial crisis—and successful investing has become a much more elusive pursuit.

Exhibit 6

S&P 500 Performance:
Annual Returns & Daily Close
January 1, 1981 to October 31, 2008



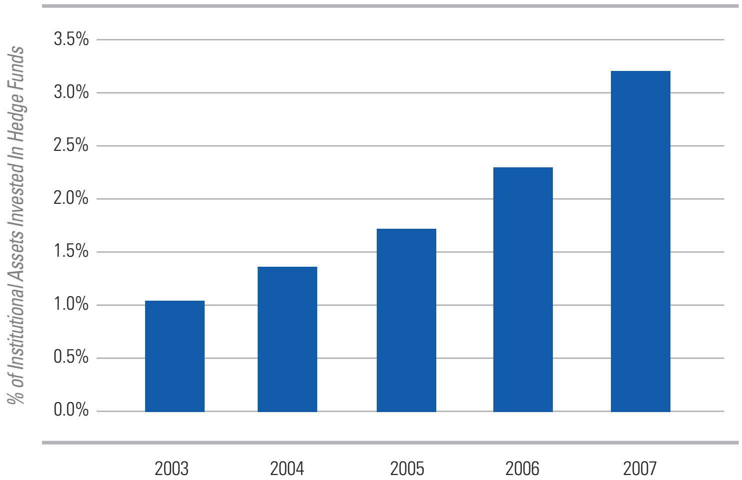
Source: S&P

2. **Limited resources among institutional investors.** Many investors have seen the size of the professional resources dedicated to their portfolios either shrink or stay static. As companies freeze defined benefit plans, they have directed greater attention toward defined contribution schemes and other aspects of corporate finance. Despite growing mightily on the back of expanding wealth, endowments and foundations are often still relatively small with few resources dedicated to the portfolio on a full-time basis. At a time when complexity has increased, investments outsourcing platforms offer a "staff down the hall" approach. Plummeting equity markets only emphasize this, as widening pension deficits—and the complex solutions required to fix them—threaten to overwhelm the thin investment staffs of many institutional investors.

3. **Demand for alternatives.** Institutional investors across the board increasingly have sought to diversify their portfolios into alternative investments, but quickly discovered that they (and often the traditional investment consultants they employed) did not have the experience or the business models to deliver competence and access in alternatives. The broad endowment community, in particular, has sought ways to replicate the "Yale model" of investing, historically characterized by substantial allocations to alternative and esoteric investments. As these investors pursued a radical makeover of their portfolios and built a substantial allocation to alternatives, emerging investments outsourcing platforms, built on the back of strong alternatives experience and an array of existing commingled products, found significant traction.

Exhibit 7

U.S. Institutional Market Investment in Hedge Funds
Assets Invested as a Percentage of Total Portfolio
2003 to 2007



Source: Casey Quirk

4. **Pension plans' increased focus on liability-driven investment.** Accounting rules (FAS157) and the Pension Protection Act (PPA) have changed the environment for corporate defined benefit plans. Matching liabilities and appropriate funding have become critical. In addition, as companies freeze more defined benefit plans, liability profiles are changing as plans move toward a long wind-down phase. As a result, liability-driven investing (LDI) has become a key investing framework for many corporate schemes, and investments outsourcing platforms with LDI competency and experience have become attractive options.

5. **The traditional investment consulting model and some of its critical disadvantages.** Many investors, and specifically investment committees, have concluded that the traditional investment consulting approach, which often entails the investment committee spending substantial time vetting tactical investment decisions, is not likely in the future to be a good use of the investment committees' time or competence. In addition, they have recognized that this lengthy process can miss tactical opportunities to better position their portfolios. Properly structured investments outsourcing relationships can address some of these disadvantages.

6. **Cost.** Although a less important singular motivator today than it once was, smaller institutional investors must consider the most cost-effective way to implement their portfolios. Pooling institutional assets creates economies of scale for smaller institutions, granting them greater access to managers and strategies.

Return Objectives and Asset Allocation

Non-profit institutions' greater use of investments outsourcing appears to center on their higher return objectives. On average, investments outsourcing providers report that foundations and endowments target returns of 100 bps more than their pension fund peers.

Exhibit 8

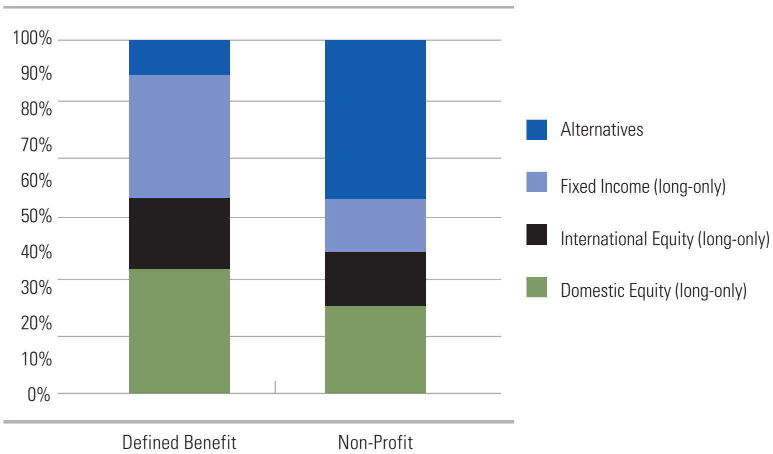
Long-Term Total Portfolio Return Expectations
December 31, 2007

Source: Casey Quirk Investments Outsourcing Survey 2008

A related, but perhaps not surprising, difference among institutional investors involves asset allocation. Non-profits using investments outsourcing have sharply higher allocations to alternatives than do pension funds. Non-profits, on average, allocate 45% of assets to alternatives. In contrast, pension funds—while having increased their exposure in recent years—have committed only 10% to such investments. Historically, non-profits typically have maintained higher allocations to alternatives and more illiquid strategies because they have a perceived longer investment horizon, while pension plans have clear liabilities with a fixed duration.

Exhibit 9

Average Asset Allocation of Outsourced Institutions
December 31, 2007



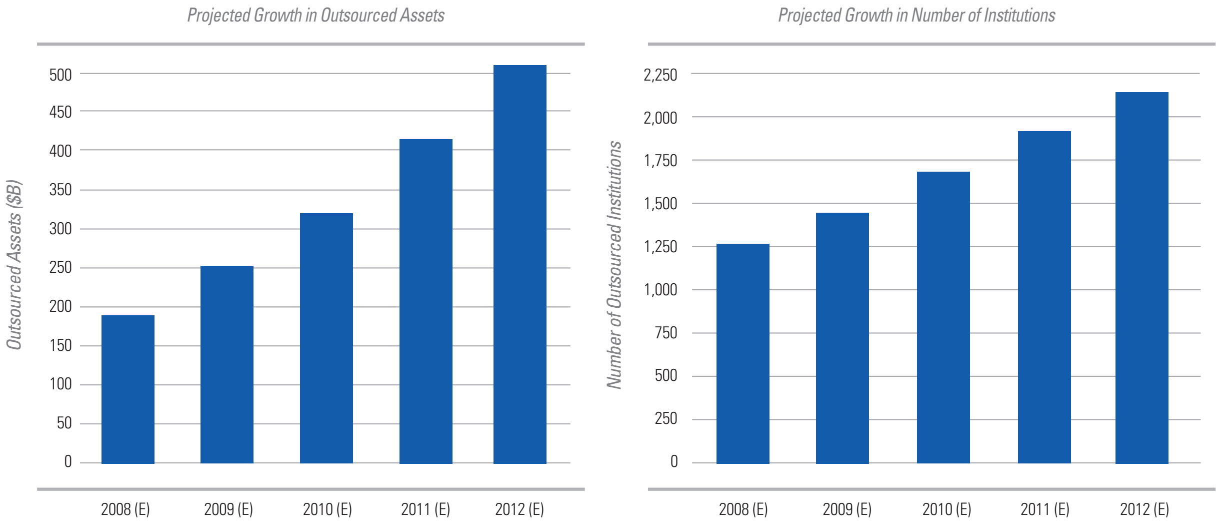
Source: Casey Quirk Investments Outsourcing Survey 2008

Future Market Growth

The current market environment has accelerated many of the trends driving institutions to fully outsource their portfolios. Poor returns have led investors to re-evaluate their current investment frameworks and relationships. As a result, we believe investments outsourcing will grow substantially over the next five years in the U.S. institutional market. Overall, we expect total assets to grow from approximately $195 billion at year-end 2008 to $510 billion by year-end 2012. During the same period, we expect the number of investors adopting investments outsourcing structures to grow from around 1,200 to more than 2,000.

Exhibit 10

U.S. Institutional Investments Outsourcing Market
2008-2012

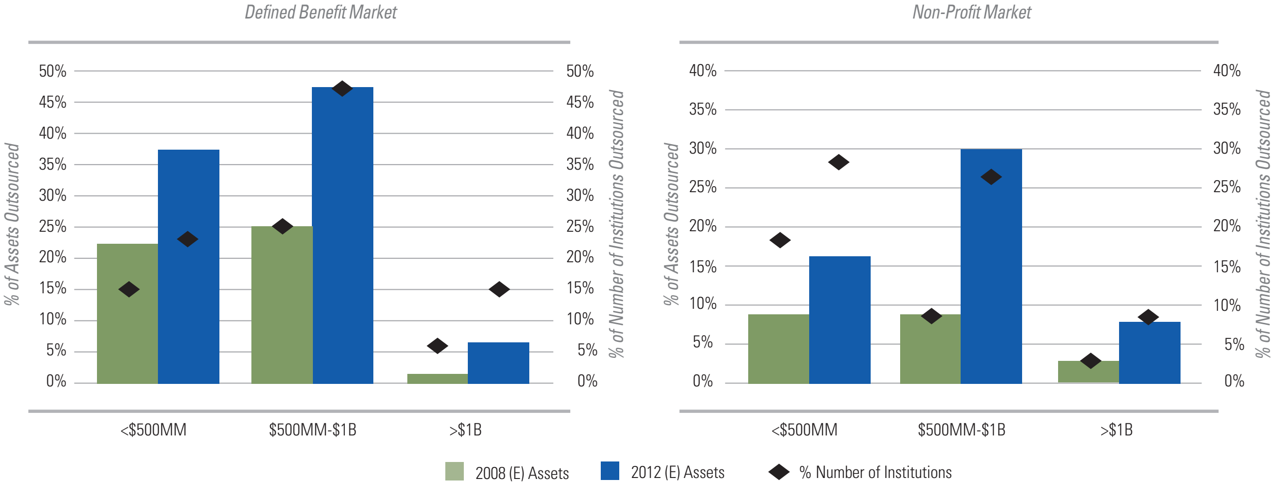


Excludes public defined benefit plans
Source: Casey Quirk

While we expect outsourcing across all market segments to experience growth, the market comprising institutional investors between $250 million and $750 million in size will see the strongest adoption rates. Small to mid-sized investment programs will continue to get squeezed in this market environment, as they struggle to find and retain talent. They also lack the scale of larger institutions, which impedes their access to the most attractive investment strategies and pricing power. We expect the $500 million to $1 billion segment of the investments outsourcing market to grow at a CAGR of 32% during the next four years. We estimate that penetration rates in the $1 billion-plus market to reach 6% of assets by 2012.

Exhibit 11

Percentage of U.S. Institutions Outsourcing Investments
2008 vs. 2012 (E)



Excludes public defined benefit plans
Source: Casey Quirk Investments Outsourcing Survey 2008

The steady expected growth of investments outsourcing among U.S. institutional investors will impact the asset-gathering strategies of traditional and alternative fund managers. Such firms will demand more information from the subadvisors they select, making institutional sales more technical and requiring client-facing officers to wield more investment knowledge and expertise. Investments outsourcing providers, and other professional buyers, are no longer secondary servicing targets, but critical primary targets, further reshaping the relationships between asset managers and their institutional clients.

4. U.S. Institutional Market Competitors

Competitor Types

Today, four types of investments outsourcing providers service the U.S. institutional market:

1. **Managers-of-Managers:** Typically longstanding investments outsourcing firms that have scale businesses and well-developed manager-of-managers and fund-of-funds brands, as well as investments and distribution infrastructure. In most cases, these firms hail from an investment consulting background, but have made multimanager products their primary business and usually have de-emphasized or abandoned the investment consulting business altogether.

2. **Investment Consultants:** Firms whose primary business, historically, has been investment consulting, and often these businesses continue to retain investment consulting as a primary business line and brand. Most, however, have evolved to offer some type of investments outsourcing capabilities. In some cases, they have developed proprietary commingled product offerings, but more often they implement their strategies through separate accounts.

3. **Dedicated Outsourcing Platforms:** The firms that have received the most attention in recent years, dedicated outsourcing platforms often are founded by high-profile institutional investment professionals, usually former endowment CIOs. These firms are unique in that their sole business is investments outsourcing. Also, they are often characterized by their distinct experience in the alternatives area, with a number of these firms running proprietary funds-of-hedge-funds and private equity vehicles.

4. **Traditional Managers:** Firms that employ the conventional direct investing model for investment management. The traditional investment management firms that compete in the investments outsourcing business usually have broad investment platforms and are scale players with well-recognized brands. They can be differentiated by an open or closed architecture investment structure. Providers that deliver an open architecture solution sometimes will partner with an independent advisor to source third-party, external managers. Firms that use only proprietary products can charge significantly lower fees, but institutions may feel limited by the lack of access to non-proprietary investments.

Exhibit 12

Primary Investments Outsourcing Competitors Types

Managers-of-Managers	Investment Consultants	Dedicated Outsourcing Platforms	Traditional Managers
• At scale, packaged product providers • Recognized tenure in outsourcing market • Pooled vehicles provide small institutions access to managers at lower fees	• Historically, delivered expertise via consulting model • Recent entrants to investments business to sustain/grow firms • Leverage long history of consulting relationships	• Founders: Ex-CIOs of well-known institutions (often endowments) • Focused solely on investments outsourcing • Alternatives expertise and access has been critical growth catalyst	• Select large, traditional asset managers with wide product breath • Typically, employ some proprietary product (versus external managers) • Most have yet to make business strategic focus

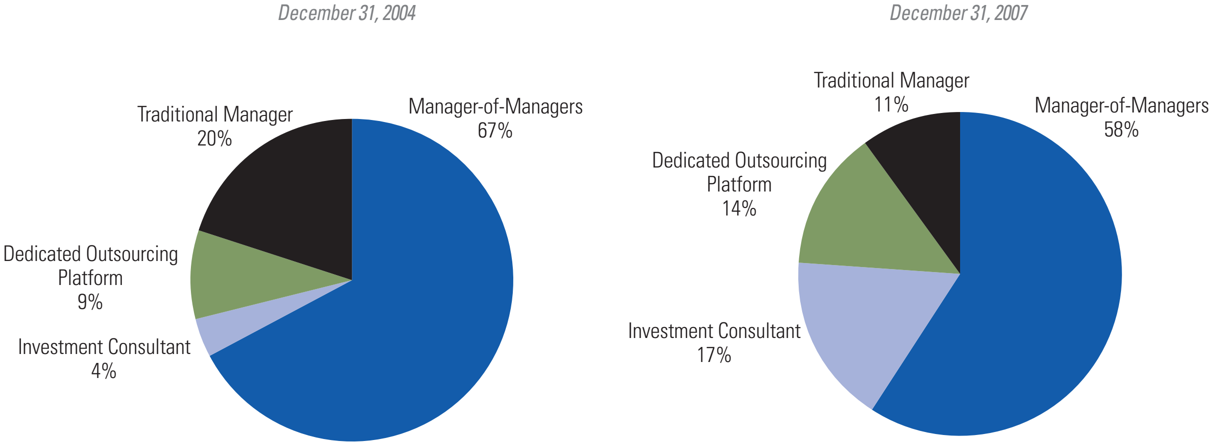
Source: Casey Quirk

Market Share and Growth

Managers-of-managers still own a substantial portion of the U.S. institutional investments outsourcing market, but they have been ceding increasing amounts of market share to dedicated outsourcing platforms and traditional investment consultants.

Exhibit 13

U.S. Institutional Investments Outsourcing Market
Assets Under Management by Competitor Type



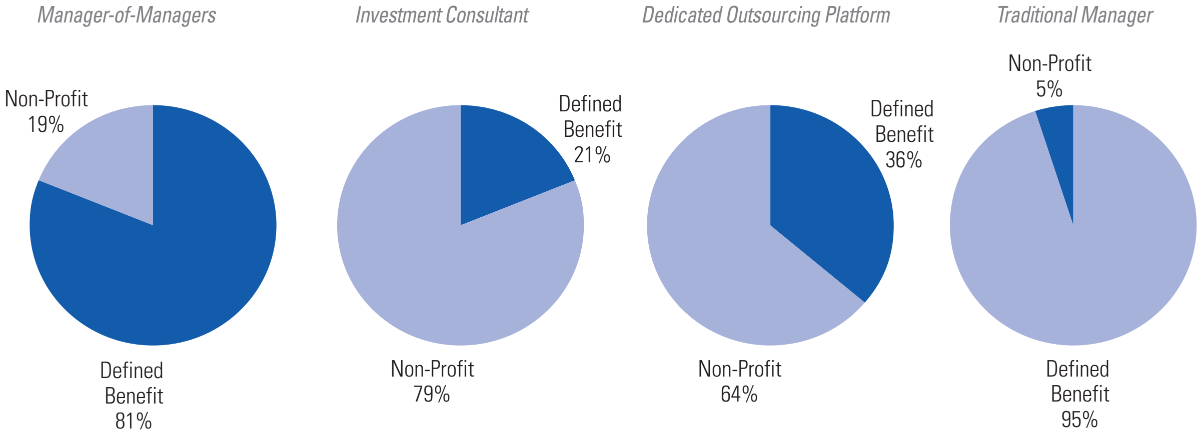
Source: Casey Quirk Investments Outsourcing Survey 2008

Fueled by strong alternative investments capabilities and a more holistic approach to asset allocation, dedicated outsourcing platforms and traditional investment consultants have increased assets under management, as well as client lists, dramatically. Such rapid growth, however, is forcing many to consider implementing organizational changes to support businesses of greater scale.

As discussed earlier, the non-profit institutions has fueled much of the recent growth in the U.S. institutional investments outsourcing market. Dedicated outsourcing platforms, many of which were founded by former endowment investment officers and investment consultants, have benefited from such trends.

Exhibit 14

U.S. Institutional Investments Outsourcing Market
Non-Profit vs. Defined Benefit Client Assets by Competitor Type

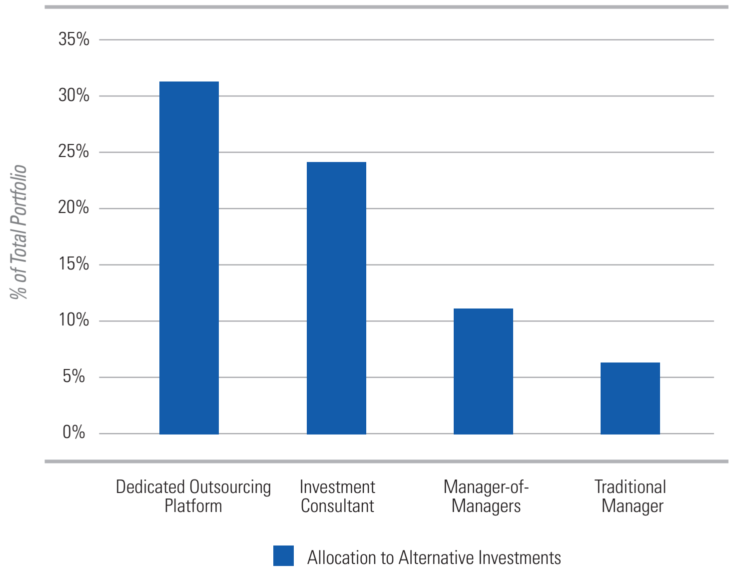


Source: Casey Quirk Investments Outsourcing Survey 2008

Often more risk-tolerant than liability-saddled pension schemes, endowments and foundations have maintained a stronger appetite for alternatives, playing to the strengths of new outsourcing providers, such as dedicated outsourcing platforms and investment consultants.

Exhibit 15

U.S. Institutional Investments Outsourcing Market
Median Alternative Investments Allocation by Competitor Type
December 31, 2007



Source: Casey Quirk Investments Outsourcing Survey 2008

Discretion, Service Offerings, and Vehicles

The degree of discretion the investments outsourcing firm provides often depends on the needs and preferences of the investor. In some cases, the investor prefers a very hands-on approach, which may include involvement in most areas of the investments decision-making process. At the other end of the spectrum are investors who prefer to delegate most tasks. Often, these investors will approve the highest-level portfolio policies (e.g., strategic asset allocation targets) and leave much of the remaining investment decisions (e.g., tactical/opportunistic allocations and manager selection) to the outsourcing vendor. Often, however, investors fall somewhere in the middle of this continuum, getting involved in some, but not all, of the key investment decisions. Many investments outsourcing providers describe a client's arrival at the appropriate level of discretion as a "journey" that involves a fair amount of upfront discussion.

Exhibit 16

Investments Outsourcing Discretion Continuum

Minimal Discretion

- Outsourcing provider makes formal recommendations to investment committee
  - Asset allocation
  - Risk budget
  - Manager selection
- Investment committee approves all investment decisions

Partial Discretion

- Investment committee sets asset allocation, risk budget, and investment policy ranges
- Investments outsourcing provider implements portfolio decisions
  - Chooses managers
  - Investment instruments
  - Flexibility to make tactical investment decisions within policy ranges

Full Discretion

- Investments outsourcing provider responsible for making all investment policy decisions...
- ...as well as implementing those decisions

Source: Casey Quirk

Discussions about the level of required reporting and client interaction are related to decisions about discretion. Virtually all of the investments outsourcing vendors with whom we spoke provided monthly reporting to their clients. In addition, most firms also provided quarterly briefings for their clients. Surveyed outsourcing vendors included several services as part of their ongoing fees. The most often mentioned included:

- Asset and liability study
- Spending policy study
- Quarterly meeting participation
- Monthly reporting

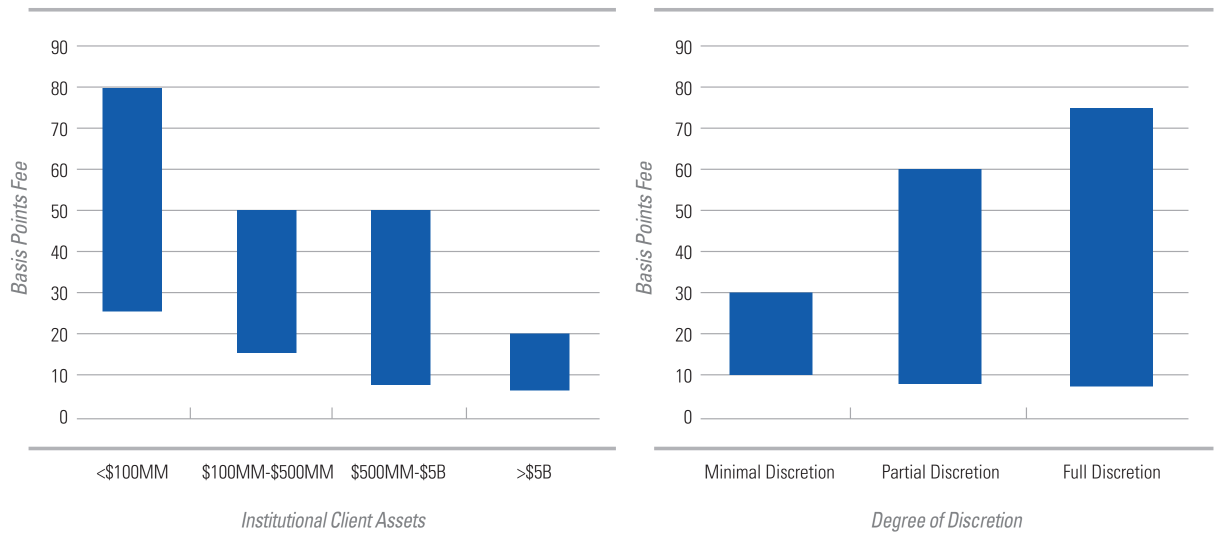
Packaging is a differentiator among outsourcing vendor types. Managers-of-managers remain most likely to use commingled vehicles. Sizeable commingled funds and collective trusts have allowed these scaled businesses to deliver their products for lower fees. Investment consultants more often deliver their services almost exclusively via separate account vehicles. Dedicated outsourcing platforms often use a combination of the two, maintaining commingled vehicles for their alternative products and employing separate accounts for the more traditional parts of the portfolio. The latter two competitors often position their services as customized solutions, making the separate account vehicle important. At the same time, commingled alternative vehicles have afforded smaller firms the ability to develop scale products, and, therefore, often secure better access to high-quality alternative investments.

Fees

Investments outsourcing fees in the U.S. institutional investor market typically range between 20 and 50 bps of assets under management. A number of different variables affect fees. As in other segments of the investment management industry, breakpoints apply to larger mandates. Assignments that involve greater degrees of discretion typically command higher fees.

Exhibit 17

U.S. Institutional Investments Outsourcing Market
Investment Outsourcing Fee Ranges
December 31, 2007



Source: Casey Quirk Investments Outsourcing Survey 2008

Although most surveyed investments outsourcing firms charge only flat management fees based on assets under management, certain firms also use performance incentives. The most common type of performance fee emerging involves a minimum-return hurdle and maximum-return cap. The outsourcing vendor is paid a percentage of returns once clearing the hurdle, but not compensated for any returns that exceed the specified cap. This system seeks to mollify client concerns about the investments outsourcing firm assuming inordinate levels of risk.

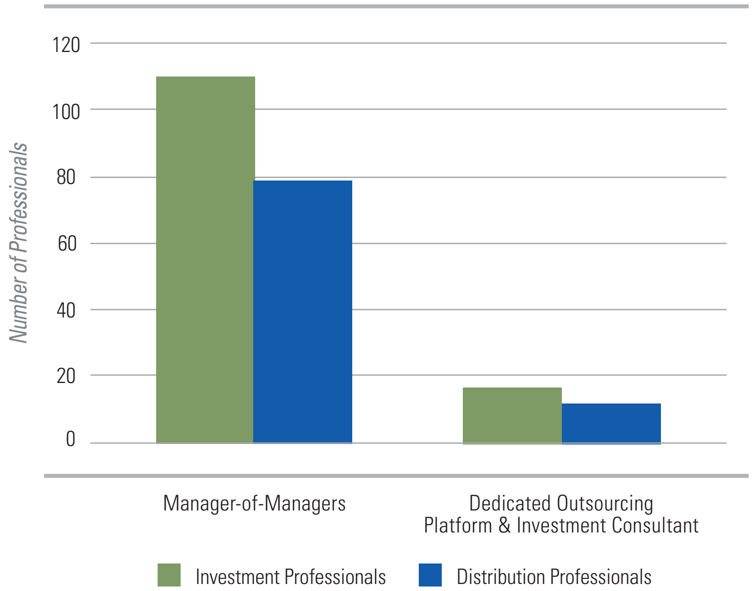
Organizational Structure

The organizational structures of investments outsourcing vendors in the U.S. institutional market vary significantly due to the differing sizes and ages of the businesses. In general, managers-of-managers retain substantial investments and distribution organizations. The number of investment professionals can reach into the hundreds, as can the number of distribution professionals. The median number of investment professionals for managers-of-managers in our survey was 110. In many cases, however, these larger investment staffs are supporting businesses that stretch well beyond the U.S. institutional market, such as global partnerships, retail businesses, and investment consulting. Their sizeable sales teams have been active in the market for decades. The median size of marketing, sales, and client service professional staffs among surveyed managers-of-managers was 79.

Investment consultants and dedicated outsourcing platforms, on the other hand, tend to have very focused investment staffs. The median number of investment professionals for such organizations in our survey ranged between 15 and 18. For many, the focus of the investment professional team, on balance, is the alternatives area. Because many of these firms are still small and growing, the marketing, sales, and client service staff is fairly thin. However, some investment consultants do not have a dedicated sales and marketing team; they simply leverage the institutional relationships of their field consultants. Among our surveyed firms, the median number of marketing, sales, and distribution professionals was 15 for dedicated outsourcing platforms and 6 for investment consultants.

Exhibit 18

U.S. Institutional Investments Outsourcing Market
Median Number of Professionals by Job Function



Source: Casey Quirk Investments Outsourcing Survey 2008

Strong client service and relationship management, at the core, is an essential part of the investments outsourcing business. The majority of providers surveyed mentioned that they were looking to add senior client service professionals to their organizations. Firms that have grown rapidly over the last three years are most challenged to maintain the appropriate client-to-service-professional ratios. Such ratios varied significantly, ranging from 15:1 to 3:1.

5. Building a Winning Investments Outsourcing Business Model

Future Winners Will be Characterized by Seven Key Attributes

We already have observed modest changes to the competitive landscape for investments outsourcing, catalyzed by new players entering the market. But it appears that more dramatic shifts will come during the next five years. Our research reveals that winners in this market will be characterized by at least seven key attributes:

Exhibit 19

Checklist: Future Critical Success Factors

Investments Outsourcing - U.S. Institutional Market

√ Investments competence/performance
√ Breadth of investment capabilities
√ Alternatives competence and access
√ Sophisticated risk management
√ Consultative delivery skills
√ Distribution strength and scale
√ Ability to customize portfolios

Source: Casey Quirk

1. **Demonstrated investment competence and performance:** Historically, investments outsourcing platforms have been sold largely on their manager research resources and experience. Performance was an afterthought in the nearly continuously rising markets of the 1980s and 1990s. Recent volatile (and often deteriorating) market conditions have separated investment performance winners and losers more clearly. Going forward, successful investments outsourcing platforms will have a clear investments philosophy and a proven record of performance in difficult conditions.

2. **Breadth of investment capabilities:** Successful investments outsourcing platforms will have skills that cover the entire universe of potential investments around the world, not just the publicly traded equity and bond markets. Successful investments outsourcing platforms will have the ability and inclination to take advantage of tactical investing opportunities uncovered by their extensive research and consistent with their well-defined investment philosophy.

3. **Alternatives competence and access:** Due to the prospective challenge to investment returns going forward, alternative investments competence—and, in particular, access—will be distinguishing features of tomorrow's leading investments outsourcing platforms. Hedge funds, private equity, real property, infrastructure, timber, and commodities are some examples of the types of investments that investors will expect their investments outsourcing platforms to provide. Platforms with experienced professionals and a track record in the alternatives area will have a distinct advantage.

4. **Sophisticated risk management:** Leading investments outsourcing firms will have the ability to define each client's critical risks, measure those risks on an ongoing basis, and possess clear plans to address them. Both top-down and bottom-up risk systems and processes will be critical features for clients. Investments outsourcing leaders will be differentiated by firms that best implement and execute on a centralized versus a decentralized approach to risk management. Being able to assess manager-specific risk, as well as underlying security risk, across a wide range of asset classes and investment instruments, in real time, will be mission-critical. In addition, outsourcing providers that have a dedicated and independent risk capability, actively engaged in the portfolio's investment decisions, also will stand out.

5. **Consultative delivery skills:** Investments outsourcing delivery, in many ways, takes a hybrid investment manager/investment consultant form. While investors are outsourcing, they still require regular interaction and information about their portfolios. In many cases, the handholding and participation in the investing experience can be quite intensive. As a result, delivery of investments outsourcing services is not a simple "product-and-sales-plus-reporting" model. Rather, delivery requires sophisticated investment knowledge. The professionals responsible for delivery within successful investments outsourcing platforms going forward often will come from investment management, institutional investing, and investment consulting backgrounds.

6. **Distribution strength and scale:** The competitors in today's institutional investments outsourcing market have distribution capabilities that run the gamut—everything from large, sophisticated marketing and sales organizations, to those with no professionals dedicated to distribution. Some organizations will choose to remain small boutiques. However, for those with aspirations of become leading investments outsourcing platforms, distribution scale and strength will be essential. For many, this will mean the addition of sales and marketing professionals and a growth strategy that maintains the appropriate "high-touch" client service model that investors will demand.

7. **Flexibility to customize portfolios:** Institutional investors increasingly will seek platforms that have the ability to customize solutions for their unique demands. This will include the ability to manage toward certain types of investments, and away from others. Investments outsourcing platforms that are able to use a range of vehicles, including commingled and separate accounts, will be better positioned to customize. Additionally, successful firms will have the ability to work with clients on a modular basis. This includes not only overseeing total portfolios, but also specific portions of the portfolios (such as alternative or illiquid assets).

The Incumbents: Managers-of-managers still own a significant portion of the market, but face fierce competition

Managers-of-managers will continue to own a significant portion of the U.S. institutional investments outsourcing market going forward, thanks to a number of important competitive advantages:

- **Scale businesses afford lower-cost delivery.** Managers-of-managers, individually and as a group, hold substantial client assets in their portfolios. As a result, they are in a position to negotiate better fees with underlying managers, deliver their own model at lower fees, and still maintain healthy margins.
- **Substantial investment management and fund selection resources.** As a result of their scale businesses, managers-of-managers have the ability to develop substantial investment resources. Although no guarantee for good investment performance, the managers-of-managers certainly can claim an ability to conduct broader and deeper research.
- **Longest investment performance records.** Leading managers-of-managers have been in business for well over 20 years and can point to their long product investment records as tangible proof statements of their experience.
- **Prominent brand and market recognition.** Aside from some of the traditional managers, the managers-of-managers easily have the most recognized brands in the institutional buyer and intermediary markets.
- **Distribution scale and scope.** Leading managers-of-managers have dedicated significantly more resources to marketing and sales. These resources translate into a distinct competitive advantage when it comes to calling on prospects.

At the same time, these businesses also face very serious challenges going forward:

- **Undistinguished recent investment results.** At least recently, most of the managers-of-managers group have by and large, not demonstrated consistent outperformance across many of their portfolios and funds. At least for some periods, the lack of meaningful alternative allocations has certainly played a role in the relative underperformance.

- **Lagging alternatives investment competence.** Many of the outsourcing platforms gaining market share have made alternatives capabilities and access a key differentiator. But with only a few notable exceptions, the managers-of-managers have generally struggled to demonstrate an ability to develop and maintain alternative investment capabilities that the market views as credible.

- **Less willingness to customize.** Managers-of-managers generally have delivered their products in commingled vehicles to many, if not all, of their investment outsourcing clients. A number of the managers-of-managers are either considering or have recently introduced efforts to deliver their services in a more customized manner, including the use of separate accounts.

- **Brand lacks "innovation."** As many of the dedicated outsourcing platforms and consultants have come to market more aggressively with alternatives and customization as their mantra, the managers-of-managers have found themselves relegated to a market position that resonates as less innovative to many institutional investors.

Managers-of-managers businesses must take a serious look at their investment models to ensure they are competitive going forward. A more thoughtful approach to supporting a wider bench of alternative investment strategies, and blending them carefully with long-only managers, will be a required ingredient of success. Introducing performance fees and adding technically competent relationshiop professionals, as well as considering acquisitions, may be strategies that these firms pursue to strengthen their product set and competitive position.

The Challengers: dedicated outsourcing platforms and select investment consultants will continue leveraging their alternative investments expertise and customization capabilities to strengthen their competitive advantage

Dedicated outsourcing platforms and investment consultants bring a number of key attributes that will continue to shake up the competitive landscape:

- **Reputation as experienced investors.** Whether via an experienced institutional CIO or through their experience in investment consulting, these firms typically come to market with substantial experience. This can significantly mitigate the fact that their businesses and products are often relatively young.

- **Better relative performance.** For select firms, strong relative investment performance in recent years has been an important feature for those clients seeking to outsource. It will be a critical year for these firms to demonstrate their ability to deliver stronger relative outperformance in 2009.

- **Strong alternatives expertise and access.** For most of these businesses, strong alternative investments singularly have been the most critical differentiator. Many investors have sought out new investment propositions that employ alternative investing techniques as the backbone of their philosophy.

- **More support for customized packaging and delivery.** Both the dedicated investment platforms and investment consultants often position senior investment professionals as those who provide portfolio oversight/management and client delivery. In addition, these firms feature customized portfolios that employ a combination of separate accounts and commingled vehicles.

However, these firms also face some important, but different, challenges to their continued growth:

- **Immature distribution models** that often rely on existing relationships, but have not considered a strategic asset-gathering approach required to grow.

- **Serious capacity constraints**—key senior professionals are difficult, if not impossible, to replicate for clients.

- Related, the dependence on a single, high-profile professional carries **key-person risk.**

Leading dedicated outsourcing platforms and investment consultants must continue to aggressively build their distribution and delivery infrastructure. Adding scale to their marketing and sales organizations and developing leveragable delivery models will be essential factors in growing their businesses.

The Question Marks: Traditional investment managers will either bow out or compete aggressively via substantial organic change or acquisition

Only select traditional investment managers compete today in the U.S. institutional investments outsourcing business. For most, trusted and broad institutional relationships have provided a platform to develop these businesses. This will continue to be a critical differentiator. Some of these firms, however, will choose to exit the investments outsourcing business because they do not view it as core to their offering—in fact, it may conflict with their value proposition of proprietary investment management—and (more importantly) it does not contribute demonstrably to the bottom line.

Other traditional asset managers, particularly those with strong distribution but weak manufacturing skills, will redefine themselves as assemblers, offering more non-proprietary investments and integrating them into their broader client interfacing efforts. These firms may continue their current operations and rely on organic growth. However, more aggressive traditional managers will seek to improve their competitive position by acquiring firms that have external manager-oriented investment capabilities and products, as well as established investment outsourcing relationships.

6. Conclusion

Firms wishing to compete in the investments outsourcing business should ask themselves several key strategic questions:

- Should we compete in the investments outsourcing business? What are our competitive advantages and disadvantages? Does it fit our strategic plans?
- In which specific market segments should we compete?
- What should our product and delivery offerings look like? How will we position them competitively?
- What is the optimal organizational structure going forward? Investments? Distribution?
- How will we grow our capabilities? Organically? Partnerships? Acquisitions?

Investments outsourcing remains in a nascent stage in the U.S. institutional market, but the financial crisis will accelerate demand for such services. As tumbling equity values place institutional investors under mounting pressure, a greater number will seek partners that have access to products and services unavailable to all but the largest institutional investors.

Similar to other types of professional buyers and assemblers, investments outsourcing vendors will keep gaining market share and play a more pivotal role in not only the U.S. institutional marketplace, but also the global fund management industry. They represent a substantial growth opportunity for investment managers—both for assembly-oriented firms that want to become more competitive outsourcing providers, and the institutional firms seeking to service them.

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The New Gatekeepers:

Winning Business Models for Investments Outsourcing

Casey Quirk

Casey, Quirk & Associates provides management consulting services exclusively to investment management firms. The firm specializes in developing business strategy, enhancing investment practices, and crafting distribution plans. The firm draws on more than 40 years of experience in delivering value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to influence change within organizations. Casey Quirk publishes a series of thought-leadership papers on topics of interest generated by ongoing industry research. To discuss this white paper, please contact:

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