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Lessons We Might Learn from the Financial Panic Part II: Implications for Investment Managers*

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* Part I ("The Implications for Institutional Managers") has been published separately.

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Lessons We Might Learn from the Financial Panic

Executive Summary

The financial panic has altered the investment landscape. As institutional investors grapple with seismic shifts in their strategies and needs, investment managers will also be undergoing profound change, including:

- More intense regulation and compliance
- Greater scrutiny of business practices and capital resources
- Potentially tighter strategic relationships with clients, but with corresponding pressure for lower fees
- Higher standards for risk management and disclosure
- Special requirements for credit research, given the diminished credibility of rating services
- Adjustments dictated by the cultural implications of increased hostility to financial services
- Potentially greater opportunities to provide solutions rather than merely products for clients

The following are some thoughts on the challenges as well as some reflections on the potential outcomes.

Background

I believe that the 2007–09 economic and financial tsunami will have a profound impact on investors and thus on investment managers. Many of these investors and managers are still in crisis mode but, in time, they will likely refocus on their long-term strategies. I have interviewed about 50 highly experienced professional investors to determine those strategic topics that are of greatest interest and concern. In all cases, I have promised my respondents total anonymity in their views. I have also listed below (in italics) my personal conclusions.

Of course, the investment reaction to the financial panic will be contingent in part on whether markets experience renewed setbacks or continue their rebound. If the markets deteriorate sharply, the financial revolution will probably be even greater, but if the rebound continues, memories of the pain will fade faster. My working assumption in this report – correct or not – is that the markets, having bounced off the lows, are more likely to be in wobbly stability than to deteriorate or advance dramatically from current levels. In any event, the 2007-09 financial panic has caused enormous pain, with huge implications. Thus, there is a critical need for institutional investors and investment management providers to try to learn the right lessons from a bitter experience.

1. Regulation and Compliance

Clearly, the impact of financial excesses is already being felt in a number of areas, including: calls for new regulation, tighter enforcement of existing rules, and more transparency for both the business and investment activities of investment providers. Just as importantly, we are still coming to grips with the implications of large-scale government ownership of financial institutions, for an indeterminate period. Like it or not, the cost and complexity of compliance will increase. These new requirements will probably apply to virtually all investment managers, large or small, operating in public or private markets.

The pressures and costs of regulation and compliance will likely raise the critical mass for being an investment management provider, especially a full service manager with a variety of styles and products.[†] For larger managers who are perceived as having the potential to create systemic risk, there will likely be special oversight, but virtually all will be subject to additional scrutiny, reporting, and compliance. Entities that continue to receive government capital assistance are likely to come under pressure for caps on compensation, especially for top paid managers.

[†] In this and other matters, I wish to acknowledge my judgment be perceived as prejudiced and self-serving because I am employed by a large multi-boutique investment management firm with very large financial resources.

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Smaller firms, which have not previously been subject to much, if any, regulation will experience a profound cultural change as well as substantial cost. Some of those firms are still likely to flourish, especially single-purpose entrepreneurial niche managers who can offer more compensation flexibility than larger competitors. My belief is that, all other things being equal, the consequences of the financial panic of 2007-09 will tend to favor larger providers (who already have much of the compliance infrastructure in place) and smaller niche investment providers (who may avoid the heaviest regulatory footprint), at the expense of mid-sized investment managers.

2. Capital Resources

The sharp decline in market valuations and the related fee revenue have been financially painful for many investment management firms, especially those dependent on performance fees tied to excess investment returns. Some entities, especially hedge funds, have liquidated as financial returns and carried interest have diminished. Other threats to the capital base include increased compliance and regulatory costs, the risks of “eating” trading errors, and even litigation from aggrieved clients. While this is hopefully a remote possibility for most firms, they must still protect themselves with expensive liability insurance. (A good example of the new pressure on bank capital is FAS 166 and 167,[‡] which will require banks to consolidate many securitized assets on their balance sheets. Banking regulators are also proposing to use such standards in setting risk-based capital levels.) In the past, little attention was paid to the financial resources of investment managers. Indeed, for smaller and/or private firms there has been no standard for equity capital, but this practice appears to be changing. Many RFPs now require a broader range of disclosure about business practices, including financial resources and prospects for business sustainability. These are positives for large organizations, including those who have access to the Federal Reserve or, in case of desperation, to governmental capital.

I suggest that smaller and/or private firms will now be subject to exponentially greater scrutiny, and will have to be able to assure clients that they are financially sound and able to withstand adversity. It remains to be seen how much this may tip the competitive balance in favor of large vs. small and public vs. private providers. Large managers who participate in TARP also will have an additional raft of new disclosure, in having to spell out the impact of their involvement in that government program. Of course, smaller TARP participants will have to make similar disclosures. Simply stated, I believe that the financial panic has created more distrust about investment providers and thus greater demand for more intrusive disclosures about capital resources.

3. Strategic Relationships

Even prior to the financial crisis, many institutional clients appeared to be concerned that they utilized more investment management relationships than they could effectively supervise and fully understand. In the wake of the crisis, the pressure has grown, especially for institutions with small and/or shrinking staffs, to reduce the number of separate relationships. This clearly is a particular negative for managers with unsatisfactory performance. Overall, clients are demanding more information about business practices, as part of the due diligence involved in consolidating relationships.

All other things being equal (and they often are not), I expect institutional clients to continue reducing the number of investment managers, even if this means asking many of those providers to execute a greater number of strategies, potentially across different asset classes. Investors will still require broad diversification among managers, but the extremely thin slicing of asset allocation targets and manager assignments is now typically seen as excessively complex and burdensome. If I am correct, this suggests further consolidation of investment managers, especially after markets stabilize and valuations of manager franchises returns to some normality. However, there will presumably always be a demand for managers who can produce sustainable and superior risk adjusted returns. So we may see a new model in which core “beta” investments – perhaps delivered at a lower fee – play a greater role than they do today, combined with “alpha” specialists who are expected to generate high excess returns at a premium fee.

[‡] Issued by the FASB on June 12, 2009.

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4. Risk Management

Given the financial losses due to risk taking, much of the discussion centers on risk management. While the goal of measuring and controlling risk seems overwhelmingly compelling, the execution is difficult. The discussion can sometimes be simplified with the basic admonition, “don’t make that mistake again.” Some fear that risk management systems will focus on the perception of risk rather than its reality. For those managers who stress test their portfolios, the financial panic of 2007-09 adds another stress test to their database. I believe investment managers need to address the “left tail problem” of the distribution of returns, even if (as the left tail implies) truly adverse events occur quite infrequently.

I think risk management processes will blossom along a number of related lines, with:

- *More detailed performance attribution and risk modeling*
- *Dissection of leveraged and unleveraged returns*
- *Creative use of still-more-elaborate stress tests*
- *Highlighting of derivatives and counterparty net and gross exposures*
- *Assessment of operational risks*

Assessments will clearly include liquidity risk, liability management, investment provider discontinuity, settlement issues, counterparty and collateral risks, and actual vs. market perception of risks for the investment provider, all of which may take on more importance relative to benchmark risk. I doubt that there will be vast changes in techniques of defining risk. Rather, I believe rather that there will be a strenuous effort to be more diligent in broadening and deepening the understanding of existing risks. Some institutional clients may demand more specific risk ratings, but I believe we should beware “the seduction of false precision.” Other clients may require extensive real time reporting, but I am skeptical about whether such voluminous information can be processed and used wisely by the client. While there will be continuing pressure for improved risk management techniques and greater transparency, to some degree this is like generals preparing for the last war. I suggest future investment cycles will produce new or different types of risk which will be difficult to anticipate or measure.

5. A New Rating Service Model

Perhaps it is a peculiar idiosyncrasy of fixed income managers, but I believe the investment world needs clear, accurate, and objective credit ratings. In the wake of the financial crisis, many have expressed the belief that the rating services provided just the opposite. Specifically, it is held that the ratings services failed to anticipate the complexity and nature of securitized risk, naively assumed that housing prices could not decline sharply on a national scale, and were conflicted by deriving fees from the issuers. There is the lurking suspicion that high credit ratings were liberally awarded to help issuers sell their securities, and preserve the fee-based revenue stream of the rating services. Further, many now believe that the rating services, having been slow in recognizing past risks, are now overreacting and tightening standards to create a procyclical ratings environment.

While there have been many complaints about the existing rating service structure and a few suggestions for different models, it is unclear (at least to me) what the new, improved version might be. While in theory one can see the advantage of having the user rather than the issuer pay for ratings, it is hard for me to imagine, in this web-based world, that the information would remain private very long. Investment bankers would undoubtedly share ratings with clients, etc., and the incentive for users to actually pay would be undermined very quickly. I can envision opportunities for credit research firms to provide specific private assessments for a fee, but I suspect the world also needs public rating services. Today’s environment opens up opportunities for managers to add value by providing clients independent credit research, but this can cut both ways. For larger managers with sufficient resources, and/or those who already specialize in credit research, this can be a plus. But it may be a hurdle for smaller managers in these lean times to achieve the “critical mass” of professionals required to do the job correctly. In my judgment, the issue of how to create a better, more objective credit rating system is important unfinished business.

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6. Alienation Toward the Financial Sector

Many financial institutions are experiencing heightened antipathy from an investing public that has been stung by dramatic pain and substantial losses. A number of perceived villains have drawn opprobrium: investment bankers, fraudulent advisors, weak regulations enforced by sleepy regulators, overpaid financial executives, asymmetric compensation schemes, questionable placement fees, and institutions that have required government (aka taxpayer) assistance. The financial sector is widely perceived as having become too large, too profitable, and too dominant in American business. Maybe public attention will be diverted to other issues, but at this juncture there is an extraordinary degree of alienation, anger, and hostility from the public toward financial institutions. Will this hostility extend to all investment managers?

To date, reputable investment managers who are perceived as having acted in their clients' interest appear to have been spared most of the opprobrium. Unfortunately, from a public perception standpoint, the profession overall has been tarnished by the actions of a relative few: those who have been found engaging in fraudulent or deceitful activity, have incurred risks beyond their stated practices, or have otherwise severely disappointed investors. Thus all managers will be subject to increased transparency requirements and higher standards. In my view, nothing could be more vital to the profession than assuring clients that investment professionals are operating as fiduciaries and in preserving the public trust.

7. Providing Solutions for Clients

Both investment managers and consultants are being criticized for failing to protect clients from one of the great financial debacles of all time. Investment managers often talk about meeting client needs, but this is perceived sometimes as a guise for creating new products. Investment consultants can be sophisticated asset allocators, but in some instances they merely extrapolated from past investment trends, which ultimately (if inadvertently) served to undermine the fundamental financial health of clients. Furthermore, managers and consultants can seem to be at war with each other. Is there a better way to serve clients?

At the risk of naïveté, I believe that institutional investors, especially those who are short-staffed, can use more investment wisdom and valuable financial advice — information that both good managers and consultants can impart. It would be extremely helpful if managers could broaden their role beyond attempting to beat benchmarks to provide more strategic insights. Similarly, consultants could gain by being receptive to more manager input, without compromising their objective gatekeeper role. While undoubtedly difficult to achieve, a side-by-side partnership of this nature would be an approach best-suited to conveying financial knowledge and better solutions to clients.

A Concluding Note

Many institutional investors are either still in crisis mode or just emerging, so it is probably premature to define the lessons we should learn, despite my belief such lessons exist.

However, there is one area where I despair that we will not learn the correct lessons, namely, adjusting our time horizons to be good investors so we do not overreact to either overpriced euphoria or to values created in panic. I hope I will be proven wrong, but the investment community is very short-term and reactive. We are confronted with ever-growing oceans of data, and feel compelled to respond to virtually all of it. Our herding instinct is incredibly powerful.

Thus, our biggest challenge may be to evolve an investing culture that guards against our worst instincts. The first step would be to narrow the gap between what we should learn and the inevitable mistaken conclusions, which typically arise from haste or emotion. Longer term, of course, the eternal hope is that we are not condemned to repeat history. To the extent we can learn the right lessons, an even bigger evolutionary step would be to find a way to avoid forgetting them too soon.

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Ted's distinguished career began at Standish, Ayer & Wood in 1962, and he was named Chairman in 1989. He became Chairman of Standish Mellon Asset Management in 2001 and Chairman Emeritus in 2004. He is a Director of the Conservation Law Foundation, Land Trust Alliance, A Better City, The Trustees of Reservations, and The Boston Company Asset Management. Ted is Chair of the Board of Trustees of the Beth Israel Deaconess Medical Center and a Trustee of Wheelock College. Ted is also Chairman of the Boston Committee on Foreign Relations, a member of the WGBH Board of Overseers, and Vice Chairman of the Massachusetts Taxpayers Foundation. He is a former Director of Citizens Financial Group, Harvard Management Company, and the Federal Reserve Bank of Boston. Ted has an M.B.A. from Harvard Business School and a B.A. from Yale University, holds the CFA® designation and has 47 years of investment experience.



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