Bringing Great Investors to Light

AURORA BOREALIS

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A Time to Build Up, A Time to Break Down[1]

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About Northern Lights Ventures:

Northern Lights Ventures is a private equity firm providing capital and strategic resources to boutiques in the money management industry. Northern Lights identifies leading investment practitioners and funds the formation or growth of their investment businesses. In addition to capital, Northern Lights provides access to broad distribution, thought leadership in the institutional investor market, and strategic management resources. It partners with exceptional investment teams to build enduring businesses that put clients first.

The financial crisis of 2007-2009 has accelerated change in the asset management industry and brought into sharper relief several growing asset management challenges. Among these challenges are excessive compensation and poor performance, the separation of manufacturing and distribution, the new wave of boutique formation, the separation of alpha and beta and an apparent failure of financial engineering. While the asset management industry is always changing, a period of economic crisis often stimulates profound change and a struggle for survival of firms and business models. Some firms thrive and others fail. To use the English philosopher Herbert Spencer's characterization, it is the "survival of the fittest"[2]

THE THEORY OF PUNCTUATED EQUILIBRIA OF EVOLUTIONARY BIOLOGY

The asset management environment has changed dramatically in just the last two years. We believe it is likely to change further still. In the theory of punctuated equilibria of evolutionary biology, speciation is thought to occur because of dramatic environmental change. It is not that speciation isn't happening continuously but rather that dramatic environmental change closes off excessively narrow or fragile adaptations and opens the way for fundamentally new approaches to succeed. The same evolutionary argument can be made about industries and indeed entire economic systems.[3]

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[1] Lyric from the Byrds' song, Turn! Turn! Turn! from the album *Turn!, Turn!, Turn!* (1966).

[2] The phrase is often associated with Charles Darwin who did include it in the *Origin of Species* but Darwin himself attributed the phrase to Spencer.

[3] Bryan Jones and Frank Baumgartner (2005) "A Model of Choice for Public Policy" *Journal of Public Administration Research and Theory*. 15(3):325-351. Joel Moykr addresses a parallel argument regarding technological progress. Joel Mokyr (1990) "Punctuated Equilibria and Technological Progress" *The American Economic Review*, 80(2):350-354.

Industries often change only incrementally. Significant industrial change is usually impelled by a sizable swing in public sentiment, public opinion, or general economic or political conditions. So, industries often exhibit long periods of stability and perhaps niche refinement, infrequently punctuated by significant changes due to large-scale societal or economic change. When fundamental environmental change occurs, it can wipe out entire business models let alone narrow niches within those business forms.

It seems clear the changed environment for asset management is going to force both further speciation among existing asset management companies. Some firms and business models simply aren't going to survive. The separation of manufacturing and distribution should be accelerated and reinforced by this new environment – probably with interesting exceptions just as in nature. Speciation will take place in asset management partly through the divestment of manufacturing capability from large distribution firms (e.g., Bank of America sold Columbia Asset Management in September 2009). But perhaps more importantly, speciation will occur through the formation of entirely new investment boutiques.

About Northern Lights Ventures (cont'd):

What We Do:

IDENTIFY *exceptional investment management teams*
NLV's founders were instrumental in growth of the industry's most renowned investment manager research organizations.

BUILD *lasting partnerships through careful alignment of interests*
NLV team members have consummated over 50 private equity investments with a total transaction value over $400 million.

PROVIDE *access to broad distribution*
We have forged important relationships with leading distribution firms in the United States, Europe, and Australia

ENHANCE *our partners' businesses*
NLV deploys its intellectual capital, resources and relationships allowing our partners to focus on their primary mission—producing exceptional results.

THE CURRENT MARKET ENVIRONMENT FAVORS THE FORMATION OF INVESTMENT BOUTIQUES

Within an asset management firm, it is extremely difficult to nurture both a sales culture and an investment culture simultaneously. A sales culture thrives on revenue growth while an investment culture thrives on investment performance. While these can be complementary, walking that tight rope is a balancing act at which few asset management firms have excelled.

Over the last few decades, this balance has been especially challenging to maintain at large firms. At some point, large asset size ultimately affects investment performance negatively. A choice has to be made whether to grow as a sales-led culture and likely face diminishing investment success or remain an investment-focused, smaller but profitable boutique.

The environment of the 35 years prior to the recent recession was exceptionally favorable to asset management businesses. With a flood of assets coming from global pension funds since ERISA in 1974, declining interest rates since 1984, low inflation, and positive economic growth with very shallow and short recessions since 1975, almost every asset management business model succeeded.[4] Backed by almost continuously expanding profits, cultural stresses inside asset management firms could be papered over. In today's tougher economic environment, the competition for share of control, share of mind and share of wealth inside asset management firms is likely to blow some firms apart. This environment will likely accelerate the separation of distribution from manufacturing and put impetus behind a new wave of boutique formation.

[4] http://www.nber.org/cycles/cyclesmain.html According to the National Bureau of Economic Research, the four recessions between 1975 and 2007 lasted 6, 16, 8, and 8 months respectively as measured by the peak to trough decline. These declines were quite a bit shorter than the typical contractions from 1850 to 1950. The average post-WWII recession was 10 months long. The average recession from 1850-1945 lasted almost 21 months. If the NBER were to declare the current recession over now, it would have lasted for 25 months, more or less on a par with the longer-term historical data.

There are also generational stresses beginning to show among asset management firms. The group of entrepreneurs who formed and built many of the ERISA fueled boutiques of the 1980s and early 1990s, now face a more difficult overall environment (low pension growth, higher regulation, robust competition). Many of these boutiques have transformed into distribution-oriented behemoths over the past ten to fifteen years. Their total economic pie may in fact be shrinking as many firms come under fee pressure and regulatory scrutiny. It will be difficult for those past, and very successful, entrepreneurs to share a slow growing or even shrinking pie with emerging talent within their own shops. Some will find it impossible. At Northern Lights, we believe much of the younger investment talent will simply move out. And indeed we have seen a surge of managers interested in starting their own firms.

Building superior investment portfolios is a pure intellectual capital activity. It is natural that such intellectual capital is best grown and nurtured in an independent boutique with a focus on investment performance rather than a large distribution house with a focus on asset growth. As Walter Wriston, the former Chairman of Citigroup, pointed out: "Not only are massive historical transitions disruptive, even often painful, but they also upset long-held beliefs and require us to think anew – which in itself is a painful process." [5] The environmental changes of the last two years will undoubtedly spur innovation in asset management and the asset markets. It seems likely innovation will also be propelled by some form of global regulatory change whether that is simply the imposition of a Tobin tax as British Prime Minister Gordon Brown has proposed or more sweeping changes as being contemplated by the European Commission. There are almost certain to be unintended consequences.

We believe the changes of the last two years, and the likely changes ahead, will spur a wave of boutique formation. Wriston observed:

> "It is often easier to ignore changes and stick to what worked in the past than sail into uncharted waters. But the new reality is that old solutions will not yield answers to new problems."[5]

In our view, these new boutiques will be better able to harness the intellectual capital necessary to meet the challenges of the new market reality.

About Northern Lights Ventures (cont'd):

NLV Team Members:

- *Were central to building the world's largest investment consultancy at the Frank Russell Company ("Russell")*
- *Were instrumental in building the world's largest multi-manager investment firm at Russell*
- *Developed a proprietary investment manager research approach, which drove significant outperformance of Russell's funds.*
- *Have consummated private equity investments in more than 15 asset management firms.*

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[5] Wriston, Walter. (2007) *Bits, Bytes and Balance Sheets: The New Economic Rules of Engagement in a Wireless World.* Hoover Institution Press, Stanford, California.