Berkshire Capital Securities LLC

Investment Management Industry Review

2005

Berkshire Capital Securities LLC

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Half Full Or Half Empty?

The strong performance of equities in the U.S. in 2003 began to look like a brief respite from the protracted hangover left by the late '90's bubble, as the stock market resumed its struggles for most of 2004.

Although corporate earnings were strong for much of the year and balance sheets piled high with cash, investors displayed a great deal of skittishness.

Institutional sentiment suffered a continual decline during the year, dropping by nearly 25% between December 2003 and September 2004 (to 71 out of 100), as gauged by the Yale School of Management Stock Market Confidence Indexes. A number of high-profile mutual funds were also playing things very conservatively, including the $7 billion **Clipper Fund,** which had 28% of its assets in short-term holdings at midyear. Another high-profile value investor, Warren Buffet, had $35 billion in cash on **Berkshire Hathaway**'s books—nearly equivalent to the firm's stock holdings.

Investors elsewhere showed similar leanings, with major markets worldwide generally lackluster. **Merrill Lynch**'s summertime global fund manager survey found respondents overweight in cash, while Emerging Portfolio Fund Research reported "an astonishing" 13 straight weeks of inflows into global bond funds in the period through October 27. This included $1.3 billion in October alone, the highest monthly total of 2004 up to that point.

For the first half of the year, investors fretted over the possibility of U.S. interest rate hikes, with the Federal Reserve in June initiating the first of five quarter-point increases. The ongoing instability in Iraq and the huge run-up in oil prices provided additional reasons for caution. Beyond those factors, there was a gnawing sense that something wasn't quite right with the U.S. economy. After an initial bounce, job creation was less robust than anticipated given GDP growth that ranged between 3.3% and 4.5% in the first three quarters. Many observers chastened by the dot-com collapse also worried that the economy was too reliant on the fumes generated by an over-heated housing market.

Then there is the yawning U.S. current account gap, which at 5.4% of GDP is more than triple the level of the mid-1990s, and the expanding federal deficit ($400 billion in 2004). Two of the country's largest trading partners, Japan and China, continued to underwrite the twin deficits by recycling their trade-related greenbacks into purchases of Treasuries and other U.S. assets, though the drop in the dollar's value toward year-end had observers wondering if that policy had changed.

The deficits, combined with Americans' record-high levels of debt (as a proportion of income) and nearly negligible savings rate, helped to fuel additional concern that the country is living beyond its means and headed toward a possible day of reckoning. A *Financial Times* headline last August asked whether "America is now on the comfortable path to ruin."

The aging population is compounding those fears, as an already-stretched federal government considers the enormous obligations to retirees in the decades ahead, while citizens review their own limited provisions for the golden years. In 2004, the decibel level surrounding the retirement issue grew noticeably higher throughout the industrialized world—a discussion with enormous implications for asset managers.

Whereas four years ago the American public was entertained by books such as "Dow 36,000" that promised ceaseless prosperity, they now find themselves facing titles like "Running on Empty" and the "Coming Generational Storm" that warn of the fiscal crises ahead for Social Security and Medicare. That the issue has resonance among the public became evident during the presidential

Global Surge

GDP growth

	2003	2004*	2005*
U.S.	3.0%	4.3%	3.2%
Euro Zone	0.5	1.8	2.1
Japan	2.5	4.3	1.8
OECD	2.0	3.5	2.6
China	9.3	9.2	7.8
Global	3.9	4.9	4.2

**Projected (as of Nov. 2004)*
Source: World Bank

Strong Finish in '04

Index level (2002 & '04) and annual % gain/loss

	2002	2003	2004
DJIA	8,342 (-17%)	+25%	10,783 (+3.1%)
S&P 500	880 (-23)	+26	1,212 (+9.0)
Nasdaq	1,336 (-32)	+50	2,175 (+8.6)
FTSE 100	3,940 (-25)	+14	4,477 (+7.5)
DAX	2,893 (-44)	+37	4,256 (+7.3)
Nikkei 225	8,579 (-19)	+25	11,489 (+7.6)

campaign, as both candidates were forced to address this thorny issue by touting their own particular schemes for "saving" the Social Security system.

The crises facing some private pensions such as those in the troubled airline industry, as well as public pensions, underline the broader challenge. Pension consultant Wilshire Associates figures more than 80% of city and county pension plans are underfunded, with San Diego having made headlines for quietly accumulating a $1 billion-plus shortfall in its employee retirement plan.

In his post-election address, President Bush placed Social Security reform at the top of his domestic agenda, pledging to strengthen the system "for the next generation." The president wants to add private accounts to the 70-year-old system, and the early betting is on a proposal that will limit investment choices to low-cost index funds similar to those in the federal employees' Thrift Savings Plan. Observers speculate that President Bush will also press for additional incentives to spur retirement savings in existing private vehicles like IRAs.

As in the U.S. with Social Security, state pension reform in Europe remains the "Gordian Knot" of politics, and officials to date have been cautious in their proposals. Nevertheless, observers consider even minor reforms and debate as progress and harbingers of larger changes to come. In Italy, which currently spends 14% of GDP on its state pension scheme, the government last year increased the age of collection and the years of required contributions.

In the U.K., where a longstanding private pension system takes considerable pressure off the state, the Confederation of British Industry last year called for an increase in that nation's pension age requirement to 70, by 2020. In Germany, where a 401(k)-style plan was introduced in 2001 (with limited participation to date), a panel convened last year by Chancellor Gerhard Schroder also recommended increasing the age of collection and cutting benefits.

With flat-to-declining population throughout the Continent, Europe even more than the U.S. needs strong economic growth in the future to make good on its obligations. But for another year, the Euro area continued to disappoint, with GDP growth projected below 2% and domestic demand and investment generally weak. The U.K. remained a bright spot in Europe, with expected growth above 3%.

In a major report issued in late October, the European Union Commission acknowledges how far the Continent remains from the ambitious goal it set in 2000 to become the "most competitive and dynamic knowledge-based economy in the world." The commission cited over-regulation, under-investment in R&D and a lack of fiscal discipline as all conspiring to put a damper on growth. Longer term, many observers also worry that Europe's increasingly older population will stymie the innovation needed for solid economic growth.

Individual investors in Europe weren't showing much confidence in the near-term future, as they continued to steer clear of stocks, punching another hole in the Continent's equity culture. **Citigroup** figures Europeans put only 35 billion euros ($45 billion) in mutual funds in the 12 months through August 2004, a little less than one-tenth the level of 1999.

Amid the lukewarm performance of equities and the handwringing regarding longer-term challenges, there was much good news economically. In the U.S., GDP growth is expected to exceed 4% for the year, while the October employment report released right after November's elections showed a robust gain of 337,000 jobs, though much of that was due to hurricane-related hiring. The clear-cut victory of President Bush and the Republicans also appeared to bolster the spirits of investors, with the stock market enjoying a strong post-election rally.

Worldwide, GDP growth is expected to hit 5% in 2004—a level last achieved in the early 1970s. The East Asian economies excluding Japan are projected to generate 7% growth collectively, according to the World Bank, with China's economy set to grow more than 9%. Japan finally appeared to be awaking from its long slumber, with economic growth of 4.3% expected for the full year, though growth is projected to slow in 2005. In South

Dealmakers' Comeback

Worldwide M&A Activity

Number of Announced Deals	2003	2004
Worldwide	28,652	30,426
U.S.	7,702	8,313
Finance & Insurance Sector (Worldwide)	2,570	2,357
$1 Billion-plus Deals (Worldwide)	244	375
Value ($ billions)	**2003**	**2004**
Worldwide	$1,380	$1,949
U.S.	$570	$834
Finance & Insurance Sector (Worldwide)	$308	$359
$1 Billion-plus Deals (Worldwide)	$724	$1,264

Sources: Thomson Financial (Worldwide, U.S.); Dealogic (Finance & Insurance, $1b-plus)

Asia, India continued to progress with growth above 6%.

The IPO market, venture capital spending and M&A activity all picked up last year. In the U.S., VC fund-raising jumped 78% in the third quarter to $5.5 billion, and for the nine-month period was $11.3 billion, compared with $10.5 billion for all of 2003, according to Thomson Venture Economics. Spurred by the $1.7 billion offering of Google, the IPO market in the U.S. showed some spark last year after the rock-bottom performance of 2003, when the number of offerings dropped to the lowest level since the late 1970s. In 2004, 249 IPOs raised a total of $48 billion, with both numbers triple the levels of the previous year.

M&A activity also rose for the second year running, with the number and value of deals worldwide increasing 6.2% and 41%, respectively. In the U.S., the numbers increased 7.9% and 46%. The banking industry was a hotbed of activity. On the heels of the **Bank of America-FleetBoston** transaction in late 2003, **JPMorgan Chase** kicked off 2004 by acquiring **Bank One**, a $58 billion deal that was followed by a number of significant regional tie-ups.

In May, **Royal Bank of Scotland** (through its U.S. subsidiary, **Citizens Financial Group**) expanded its U.S. presence with a $10.5 billion bid for Cleveland's **Charter One**, while **SunTrust Banks** of Atlanta followed up a few days later by acquiring **National Commerce Financial** of Memphis for $7 billion. In June, **Wachovia** acquired Alabama-based **SouthTrust**, a $14.3 billion deal that created the largest bank in the Southeast and the fourth-largest in the U.S. as measured by assets.

Across the Atlantic, **Santander Central Hispano**'s $15 billion acquisition of **Abbey National** of the U.K. marked the largest-ever European cross border retail banking deal. The transaction furthers the Spanish bank's global ambitions, allowing it to move up a few notches in the banking rankings to No. 8 worldwide and balancing its dependence on Latin America.

In total, there were 133 asset management deals last year worth $10.7 billion in transaction value, compared with 135 valued at $9.3 billion in 2003. The 10 largest deals of 2004 accounted for $6.2 billion in value, compared with $5.5 billion in 2003.

Several firms were very active last year. **Mellon Financial** enhanced its growing wealth management arm by picking up three U.S. firms, along with a hedge fund of funds for its institutional business. **Affiliated Managers Group**, **AGF Management Ltd**. of Canada, **Bear Stearns**, **Federated Investors**, **First Republic** and **UBS** also made more than one acquisition. On the sell side, several insurers divested themselves of asset managers, an indication of the problems some insurers have had making sense of those businesses.

For the second year in a row, the wealth management sector dominated the number of asset management transactions, accounting for 48% of deals. Wealth management remains a highly attractive business, with Merrill Lynch/Capgemini projecting that individuals with $1 million or more in financial assets will enjoy a $12 trillion jump in their wealth in the five years through 2008, to $41 trillion. With hundreds of viable firms worldwide catering to such customers—and new ones being minted all the time—the sector provides an endless array of deal possibilities. UBS, which recorded $39 billion in net inflows in its global wealth management business in the first nine months of 2004, made six acquisitions, including the largest deal in the wealth sector ($302 million), for London's **Laing & Cruickshank**.

UBS and a handful of others aside, cross border activity in the asset management industry was limited last year. The transatlantic pipeline was virtually shut and Continental Europe was similarly idle. The U.K. took center stage, playing host to several wealth management transactions, including two by UBS. In addition, Affiliated Managers Group made its first overseas deal by taking a 60% stake

The asset management industry also played host to a number of significant transactions, including JPMorgan Chase's $1.3 billion acquisition of hedge fund **Highbridge Capital Management**—the second time in three years that a hedge fund deal has led the industry. At the same time, **Lehman Brothers** was also sniffing around the hedge fund universe, reportedly discussing a takeover of **GLG Partners**, a London-based firm in which Lehman owns a minority stake. The activity underlines the increasing interest in hedge funds among their longtime patrons, wealthy individuals, and the budding interest among institutions. Hedge funds now manage an estimated $900 billion in assets.

Earnings Acceleration

S&P 500 Earnings Per Share

2004	EPS	% Chg. vs. '03	Projections 2005	EPS	% Chg. vs. '04
1Q	$15.87	+26.3%	1Q	$17.15	+8.1%
2Q	16.74	+24.7	2Q	18.09	+8.1
3Q	16.61	+15.2	3Q	18.59	+11.9
4Q	17.44	+15.5	4Q	19.63	+12.6
2004*	66.75	+20.3	2005*	73.89	+10.7

**3Q, 4Q and full year 2004 are estimates; estimates & projections based on sell-side analyst consensus, as of Nov. 22, 2004.*
Source: Thomson Financial

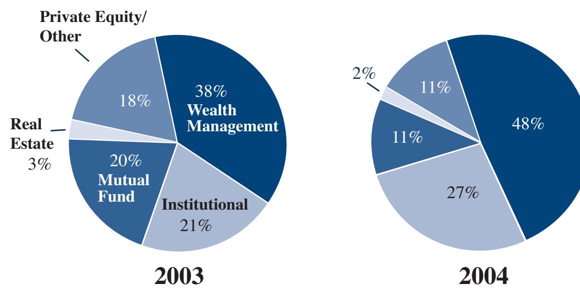
in **Genesis Asset Managers** of London. A British firm, **Friends Provident**, accounted for the largest cross border deal ($700 million), as it acquired the U.K. and European asset management business of Dutch financial services firm **Eureko**. Several U.S. firms turned to developed Asian markets for acquisitions that enhanced their institutional capabilities, including **Legg Mason**, **MassMutual Financial Group** and **Principal Financial Group**.

The **Wells Fargo-Strong Financial** transaction dominated activity in the mutual fund sector, which otherwise had its quietest year for deals since 1998, in large part a reflection of the market-timing scandals—and subsequent fines and regulations—impacting the industry. Although mutual fund flows remained strong throughout the year, three players dominated the action—**Capital Group Companies** (American funds), **Fidelity Investments** and **Vanguard Group**. In the first eight months of 2004, these three companies accounted for two-thirds of net inflows for equity and fixed income funds, while major fund companies that were caught in the scandals—such as **Putnam** and **AIM**—experienced large outflows.

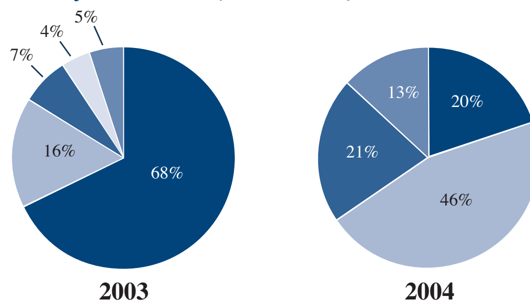
In the Strong deal, concluded right after the company settled its legal problems related to market timing allegations, Wells Fargo managed to pick up a large basket of assets ($34 billion), primarily in mutual funds. The handful of additional deals concluded followed along the lines of recent years, involving targeted efforts to add specific expertise or well-regarded funds, with **Dreyfus**' purchase of the assets of the **Thompson Plumb Balanced Fund** being one example. Other major firms that made mutual fund acquisitions included **Goldman Sachs** and **Federated Investors**.

WHO'S SELLING?

Number of Transactions by sector as % of total



Value of Transactions by sector as % of total



Source: Berkshire Capital Securities LLC

The institutional sector bounced back smartly after a relatively quiet 2003, accounting for many of the largest deals of 2004, with **BlackRock Inc.**, JPMorgan Chase, Mellon, and SunTrust among the buyers. There were a couple of noteworthy management buyouts in the sector, including a U.K. deal in which **Atlantic Value Partners** acquired **Delaware International Advisers**. Two private equity groups, **TA Associates** of Boston and **Orca Bay Partners** of Seattle, also committed capital to the institutional sector.

* * *

In the last *Investment Management Industry Review,* we suggested that the end-of-2003 Bank of America-FleetBoston deal portended more of the same in 2004, and sure enough the ink was barely dry on that purchase when JPMorgan Chase made its offer for Bank One. A succession of significant regional transactions followed, as noted in this Summary, before Santander Central Hispano woke up the European banking industry with its bid for Abbey National, in the third quarter.

Whether the SCH-Abbey deal will be the spark for additional cross border activity in Europe remains an open question, however. The increasing size and strength of American banks are clearly sources of concern and incentives for the large European banks to add some bulk. The limited growth opportunities in domestic markets is another. Europe's banks are also sitting on large and growing cash hoards and many are enjoying strong business results. **HSBC** saw its profits jump 53% in the first half while **BNP Paribas**' rose 40%, for example. Credit provisions are also coming down at the large European banks.

One significant European voice, Royal Bank of Scotland chief executive Fred Goodwin, has weighed in on the consolidation side, saying there is now a greater likelihood

WHO'S BUYING? *Number of Transactions*

	2000	2001	2002	2003	**2004**
Bank	41	45	49	32	**43**
Institutional	15	12	17	13	**19**
Wealth Manager	12	5	15	12	**18**
Financial	2	8	5	3	**8**
Mutual Fund	17	9	15	20	**7**
Securities Firm	15	13	11	11	**7**
MBO	1	8	8	9	**6**
Insurance Company	14	14	15	9	**4**
Trust Company	5	5	2	9	**3**
Real Estate Manager	0	4	1	2	**1**
Other	4	7	5	15	**17**
TOTAL	126	130	143	135	**133**

Source: Berkshire Capital Securities LLC

Investment Management Transactions

	2000	2001	2002	2003	2004
Majority Equity	121	118	119	116	119
Minority Equity	4	4	16	10	8
Management Buyout	1	8	8	9	6
Total	126	130	143	135	133
Value of All Transactions ($b)	36.4	15.6	10.3	9.3	10.7
AUM Changing Hands ($b)	1,405	830	548	375	720

Source: Berkshire Capital Securities LLC

of such deals taking place, particularly as Europeans look over their shoulder at Citigroup. At the same time, even competitive pressures and financial strength do not guarantee additional mega-deals. The single EU market and currency aside, Europeans remain highly sensitive to foreign ownership of their major domestic banks, while differing regulations present another stumbling block. Cross border synergies are tougher to achieve as well. Nevertheless, the interest remains for both banks and governments. In September, executives from **ABN Amro**, BNP Paribas and RBS were invited to brief EU finance ministers on the obstacles they face in pursuing cross border mergers.

In the U.S., the fortunes of publicly traded asset managers were mixed. Firms such as **T. Rowe Price** that were untainted by the mutual fund scandals experienced strong results and were beneficiaries of both the continued flow of new money into mutual funds and the transfer of money out of other firms. T. Rowe Price's net earnings for the quarter ended September 30 rose 38% from the year-earlier period and AUM increased by 26% to $212 billion; the stock rose 17% in the first 10 months of 2004.

Two prominent U.S. asset managers also announced IPOs in 2004: **Calamos Asset Management**, known for its fast-growing Calamos Growth Fund; and real estate firm **Cohen & Steers**, which raised around $100 million and commenced trading in September. In London, the IPO of **RAB Capital** represented the first public flotation of a hedge fund manager and was another indication of how that industry is coming of age. As asset managers consider future deals for hedge funds, RAB could help with valuations.

For several years we have focused in these annual reviews on the graying of the industrial world's population and the need for both governments and individuals to make provisions for that future. In 2004, this issue picked up steam, presumably because it can no longer be ignored.

Reform of current state-run systems so that they are sustainable over the long term is one imperative, and several governments have taken baby steps in that direction. But those policies, always tricky politically, must be supported by reforms designed to spur individual action.

On that front, the U.S. is far ahead of Continental Europe, but even here more can and should be done. As this debate continues, the asset management industry has a significant role to play in influencing policy—an opportunity and responsibility that in turn requires the industry to have a high level of trust and credibility with the public, the media, elected officials and regulators.

For the near term, here are some of the trends we see impacting the asset management industry:

• In general, there is overcapacity in all segments of the industry, a set of circumstances that argues in favor of continuing consolidation.

• The mutual fund scandals and subsequent financial penalties and regulatory burden have led some weary mutual fund players to question whether they should partner out this capability or quit the industry altogether.

• With the dollar growing weaker by the day, it seems, some bolder European firms will resume the search for alliances and investment management expertise in the U.S.

• Similarly, a few well-heeled U.S. mutual fund organizations will begin to seek international distribution alliances in Europe and Asia.

• China, for years a looming presence in the world economy, has emerged as a major force—and as an attractive market for a broad range of businesses, including money managers. Look for some of these institutions to partner with financial firms in Asia as one means of tapping this potentially rich market.

• With more than 7,000 funds, the hedge fund space is by definition overcrowded. This makes rationalization inevitable, perhaps hastened by a financial accident or other incident bringing undue attention and regulation to the industry.

• Finally, with the financial services industry accounting for a 20% weighting in the S&P 500 index—a position enjoyed by the energy sector a quarter-century ago and technology just a few years ago—one can't help but ask, "How much longer can this dominance last?" ■

H. Bruce McEver
Chairman

R. Bruce Cameron
President

Wealth Management

For the second year in a row, wealth management was the hottest sector of the asset management industry, accounting for 48% of deals (64) and 20% of value ($2.1 billion). Transaction value did decline from 2003 ($6.3 billion), however, as the sector lacked a blockbuster deal along the lines of **Lehman Brothers**' $2.6 billion acquisition of **Neuberger Berman** that year. Instead, transactions were small and strategic, with buyers seeking to extend their footprint into new geography, strengthen their hand in existing territory or add particular expertise.

Reflecting the robust demand in the sector, pricing on deals remained strong and players barely paused to catch a breath, with a consistent flow of deals running throughout the year. **Eaton Vance**, **Mellon Financial**, **UBS** and **Wilmington Trust** were among the familiar buyers, with UBS' $302 million purchase of **Laing & Cruickshank** in the U.K. the largest wealth management deal of the year.

Most observers expect the deal-making environment to remain strong in the years ahead. For one thing, the wealth management sector is ripe for ongoing consolidation, given the enormous number of small firms, many of which continue to struggle to compete for talent, technology, products and clients. For another, the sector remains highly attractive, with strong profit margins and growth prospects. A 2004 KPMG survey of private banks worldwide showed that one-third plan to make acquisitions in the next three years, with mid-size and larger firms particularly disposed toward deals. These firms also expect more than one-third of their growth to be driven by acquisitions.

Private banks surveyed identified the Asia-Pacific region as having the most growth potential, though restrictions limit foreign bankers in markets as diverse as Japan and India. Boston Consulting estimates that the region accounts for nearly a quarter of high net worth wealth worldwide, with assets up 22% in 2003 alone. While the Asian financial crisis of the late 1990s drove many wealthy people to strike up relationships with private bankers, **Barclays Bank** figures the vast majority of those assets remain with other institutions, leaving lots of untapped potential.

In 2003, the number of individuals worldwide with assets of $1 million-plus grew more than 7% to an estimated 7.7 million, according to a Merill Lynch/Capgemini report. The assets held by this group reached a mouth-watering total of $29 trillion. (Some 70,000 of those people fall into the ultra-high-net-worth circle, with $30 million or more in financial assets.) The study estimates these assets will rise to around $41 trillion by 2008, based on a 7% annual growth rate. The study also shows that individuals are seeking more advice and "best-of-breed" products, including alternative investments, underlining the increasing demands being made by private clients, as well as the impetus for transactions or alliances.

Mellon again showed its determination to build its already formidable scale in this market, as it made three transactions in three separate regions of the U.S., bringing to seven the number of wealth managers the Pittsburgh giant has acquired since 2000 *(see sidebar, p. 7)*. **First Republic Bank** also jumped into the fray, concluding three small deals to strengthen its operations in its backyard of California. In the largest deal, it acquired **Janus Capital**'s **Bay Isle Private Client Asset Management** division, which has $600 million in AUM and a client base in California and Hawaii. Bay Isle will be wrapped into First Republic's **Trainer Wortham & Co.** subsidiary. For Janus, the deal represents the divestiture of a non-core holding (the mutual fund giant did keep the institutional division of Bay Isle).

First Republic also took minority stakes in two San Francisco advisors that provide specific expertise: **Access Fund Management**, an alternative manager with $60 million in AUM; and **Cypress Wealth Advisors**, with strength in tax and estate planning. Prior to the deals, First Republic had nearly $11 billion in AUM in its wealth management business. "Cypress Wealth Advisors is a terrific complement to the First Republic team and will offer our clients a broader range of wealth management and asset allocation services," said Katherine August-deWilde, executive vice president and chief operating officer of First Republic.

Eaton Vance was in the wealth market for the second year running, this time on its home turf of Boston, where it acquired the local office of Scudder Private Investment Counsel, a unit of **Deutsche Bank**'s wealth management division. Prior to the transaction, which netted Eaton Vance $2.5 billion in AUM, the company had hired the former head of Scudder's Boston office, G. West Saltonstall. In 2003, the company acquired **Parametric Portfolio Associates** of Seattle.

Wealth Management Transactions

	2000	2001	2002	2003	2004
Number of Transactions	44	41	50	51	64
Combined Value ($b)	6.7	2.2	2.0	6.3	2.1
Total Seller AUM ($b)	186	53	63	189	94
Average Deal Size ($m)	153	53	39	124	33
Average Seller AUM ($b)	4.2	1.3	1.3	3.7	1.5

Source: Berkshire Capital Securities LLC

Another venerable name in the asset management industry, Wilmington Trust, reached an "affiliation" with **Grant, Tani, Barash & Altman, Inc.** of Beverly Hills. The deal provides Wilmington with comprehensive business management services it can offer its clients and strengthens its presence in the attractive Southern California market. "Our two companies' combined capabilities create a competitive distinction that will benefit current and potential clients of both firms," said Rodney Wood, executive vice president, Wilmington Trust Wealth Advisory Services.

BB&T Corp. of North Carolina added strength in some nearby markets by acquiring **de Garmo & Kelleher**, a 14-year-old Washington, D.C.-based firm with $630 million in AUM and customers in the District, Maryland and Virginia. Keith Karlawish, president of BB&T Asset Management, said the transaction "will immediately expand our ability to offer personalized investment management in the fast-growing metro Washington, D.C., area." BB&T has enjoyed substantial growth in its wealth business, with AUM up 50% between 2000 and 2003 to $10.8 billion.

Several smaller wealth managers and banks joined the buyers, highlighting the attractiveness of the growth-through-acquisitions strategy for firms of varying sizes. These included aggressive **Lydian Wealth Management** of Maryland, which made two acquisitions to gain additional know-how for its clients: Oregon's **Windermere Investment Associates**, which specializes in alternative investments; and Philadelphia's **Copper Beech Advisors**, with a niche in family governance and education. **Heartland Financial**, a Nasdaq-traded bank based in Dubuque, Iowa, acquired the wealth unit of **Colonial Trust Co.** of Phoenix. Heartland owns retail banks in many smaller communities in its five-state market, including Mesa, Arizona.

In line with its ambitions to create a national footprint

Mellon Continues To Cut Deals Nationwide

During the last three years, no U.S. firm has been more active buying up wealth managers than **Mellon Financial**. Between 2000 and 2004, the company acquired seven wealth management firms, including three last year. Recent acquisitions account for around 10% of the $76 billion in AUM run by Mellon's private wealth management group, with acquired firms generally managing around $700 million in assets.

"We don't target firm size," says David Lamere, vice chairman of Mellon and president of the private wealth management group. "Our criteria are much more around [a firm's] people, the communities, the reputation, and the connections and business philosophy. So if they had been twice as big that would have been fine with us and at some point there is such a thing as too small to make sense for either side." Geography is also a key, as Mellon seeks to establish a national footprint. Currently, the wealth management group has around 60 offices nationwide, including its headquarters in Boston.

Following acquisitions of firms in Atlanta, Cleveland and Glendale, California, between 2001 and 2003, last year Mellon headed for Las Vegas, Providence and Seattle. The activity began in April with the acquisition of Seattle's **Safeco Trust**, part of insurer Safeco. Safeco Trust enhanced Mellon's existing operation in that coveted region, adding $300 million in assets to the $500 million the firm already managed in Seattle. In July, Mellon acquired **Paragon Asset Management** (AUM: $600 million) of Las Vegas, a deal that provides entry to a new and growing area and a base for expansion in the Southwest. Two months later, Mellon bought **The Providence Group Investment Advisory Co.** (AUM: $750 million) of Rhode Island, which strengthens the company's presence in its New England backyard.

Lamere says Mellon can take from several months to more than a year engaging a targeted firm in conversation before it makes a bid. "One of the things we strongly believe in is that both sides really need to get to know and become comfortable with each other." Once a firm is acquired, local management may stay in command or be joined by Mellon employees, depending on circumstances. However, the Mellon name does replace an acquired firm's previous identity.

"We think one of the values we bring to these firms is the brand of Mellon, which is well-recognized and we think well-respected in the wealth management business," says Lamere. "So although we do retain the [local] identity during a transition period that can vary, the end goal is to create an overall Mellon brand."

Lamere says the changeover from a local identity to a national one is widely accepted by customers, with Mellon enjoying "excellent" post-acquisition retention rates. "Clients are with these firms because of the relationship and the trust they have with the principals," he says. "And if the principals through their due diligence think the combination with Mellon is going to be good for their clients, their clients tend to believe that and then our joint responsibility is to make sure it comes true."

Although Mellon has shown an interest in extending its limited presence in the Midwest, Lamere says the entire country remains on the company's deal radar screen. "We're interested in every area that has a concentration of wealthy individuals. It's obvious that we have less of a concentration in the Midwest than we do on the East Coast, so therefore it often is assumed that [the Midwest] is a focus. It certainly is a focus, but it's not the only focus."

for its wealth business in Canada, **AGF Management Ltd.** (AUM: $24 billion) purchased companies in Vancouver (**Cypress Capital**) and Ottawa (**P.J. Doherty & Associates**). AGF, primarily a mutual fund company, more than doubled its private client assets to $3.2 billion via the transactions. AGF also has wealth offices in Calgary, Montreal and Toronto and holds a 30% stake in **Smith & Williamson**, a U.K. wealth manager with some $11 billion in AUM.

The frenetic deal-making in Switzerland that dominated the European market in 2003 abated last year, though Swiss giant UBS cut four deals in Europe (six in total) as it continued to build its growing "onshore" private banking presence. (Switzerland itself reached agreement with the EU to impose a tax on savings accounts of EU citizens, with the revenue transferred to the appropriate countries, while maintaining the anonymity of account holders.) This included two deals in the U.K. the larger of which involved Laing & Cruickshank. A high-end wealth manager, Laing nearly doubled UBS' AUM in the U.K. to $18 billion, making it one of the largest private client firms in the market. Laing had been owned by **Credit Lyonnais**, whose new parent **Credit Agricole** decided to exit the U.K. wealth business. UBS also bought **Scott Goodman Harris**, a high net worth financial advisor formed in 1998 that focuses on life and pension products.

UBS cut six wealth management deals last year, including four in Europe, as the Swiss firm continued to build its "onshore" presence.

In addition, UBS acquired Germany's **Sauerborn Trust** and **American Express**' private banking operations in Luxembourg. A low-profile firm with an exclusive clientele of 100 families and family-owned companies, Sauerborn adds $8 billion in AUM to the $13 billion UBS managed in Germany prior to the deal. (In 2003, UBS acquired **Merrill Lynch**'s German private client business, with $1.3 billion in assets.) UBS described the Amex deal as "further strengthening its position as a wealth manager of choice in a key European financial center."

In other U.K.-based deals, British wealth manager **Singer & Friedlander** acquired the British and Jersey businesses of **Atlantic Wealth Management** (total AUM: $1.4 billion) from **Amvescap**, which has been concentrating on the U.S. market. Singer & Friedlander had more than $5 billion in AUM prior to the deal, primarily in its wealth business. Bermuda's **Bank of N.T. Butterfield & Son** added to its fledgling U.K. wealth business (AUM: $1.4 billion) by acquiring 85-year-old **Leopold Joseph Holdings** of London, for $95 million. Leopold counts such pop celebrities as Mick Jagger and Cat Stevens among its clients. "The acquisition of Leopold Joseph will enhance our presence in the U.K. and Guernsey and give us a strong platform for further growth in the private banking arena in these markets," said Alan Thompson, president and CEO of N.T. Butterfield. ■

Institutional Advisors

The institutional sector bounced back from a relatively quiet 2003 to record a broader range of activity in 2004, including a number of the year's larger asset management transactions, along with several cross border deals and management buyouts. In total, there were 36 transactions last year, valued at $4.9 billion. The heightened activity notwithstanding, the institutional sector remained characterized by a limited number of sellers alongside buyers who are generally seeking specific investment styles combined with strong performance. The problem for buyers: most strong performers are not interested in cashing out, since asset growth and margins in the sector remain attractive. Indeed, with many corporate pensions underfunded, observers anticipate strong inflows into the institutional sector in the years ahead.

Many of the sales last year were driven by restructurings on the part of parent companies. In the U.S., for example, insurers such as **Cigna** and **MetLife** were exiting the institutional business. In the year's largest institutional deal involving U.K.-based **Friends Provident**'s acquisition of **F&C**, Dutch parent **Eureko** had been pursuing a plan that would allow F&C to gain a public listing. A number of management buyouts also involved divestitures by parent companies. Buyers, meanwhile, were a diverse bunch, ranging from institutional managers to banks to private equity players.

Separately, institutions themselves continued to show greater interest in alternative investments, a factor driving some of the M&A activity in the hedge fund arena, as **JPMorgan Chase**, **Mellon Financial** and **Triarc Companies** all snapped up firms that either manage hedge funds directly or invest in funds of funds *(see Alternative Investments section for details)*. Traditionally, hedge funds have been the preserve of wealthy individuals, but institutions have been upping their investment of late, in part because traditional equity plays are no longer the sure bet they were in the 1990s. Researcher Greenwich Associates estimates pension funds will invest $250 billion in U.S. hedge funds in the coming years, providing a strong incentive for institutional managers to enhance their capabilities in this area.

The U.K. was the center for a number of important institutional transactions last year, including the deal for F&C, which Friends Provident merged with its 67%-owned retail fund manager, publicly listed **ISIS Asset Management**. The combined company will be the fourth-largest asset manager (AUM: $220 billion) in the U.K. and a top-10 manager of European pension assets, with F&C providing both an institutional base and a presence in continental Europe. Based on 2003 pro forma numbers, the enlarged group will derive 58% of its revenues from the U.K. and the rest from Continental Europe, primarily the Netherlands, where it will be the largest active manager of pension assets.

As part of the $700 million deal, Dutch financial services firm Eureko, F&C's former parent, will receive a 23% stake in the enlarged company and shares in Friends Provident, as well as cash. The enlarged group will adopt the F&C name, with Friends Provident assuming a 51% shareholding. Said Howard Carter, formerly head of ISIS and new chief executive of F&C: "This is a unique opportunity for us to achieve our stated objective of becoming a top five U.K. asset manager, extend our franchise into Continental Europe, create a more diversified business and provide a platform for meeting our clients' needs in terms of both product and investment management capability." In 2002, ISIS predecessor Friends Ivory & Sime acquired the asset management business of **Royal & Sun Alliance**, a deal that made the firm a top-10 U.K. asset manager. (Subsequently, FIS rebranded itself as ISIS.)

In a noteworthy management buyout in the U.K., newly formed **Atlantic Value Partners** acquired London-based **Delaware International Advisers** (DIAL) and certain affiliates from **Delaware Investments**, for $172 million in cash and additional obligations of around $27 million. Philadelphia-based Delaware Investments is the asset management wing of **Lincoln Financial Group**. Founded in 1990, DIAL has $19 billion in institutional assets and is one of the largest managers of international assets for U.S. institutions. Atlantic management will maintain the value investing style it pursued while running Delaware International and is also expected to retain a subadvisory role with Delaware Investments.

In another U.K. deal featuring a U.S. player, **Affiliated Managers Group** of Boston acquired London's **Genesis Asset Managers**, which specializes in emerging market investments *(see Cross Border section for more details)*. Within the U.S., AMG picked up the equity management business of Cigna's **TimesSquare Capital Management**, a growth-oriented small- and mid-cap institutional firm that has been recording 25% annual growth in AUM. In total, AMG added $12 billion in AUM from the two deals as the company saw its overall assets top the $100 billion mark, with half that total in institutional assets. Soon after the AMG deal, Cigna sold TimesSquare's institutional bond investment business to **Bear Stearns**. The acquisition adds $6 billion in AUM to the $9.3 billion in fixed income investments Bear Stearns already managed. In 2003, Cigna sold its retirement plan business to **Prudential Financial**.

MetLife also divested itself of an asset manager, selling **State Street Research & Management** to **BlackRock Inc**. for $375 million in cash and stock. Performance-based payments could add another 25% to the price over a five-year period. With the addition of SSRM's $52 billion in AUM, BlackRock will become one of the 20 largest asset managers in the world, with $366 billion in assets. From a product standpoint, State Street provides a mix of U.S. equity and real estate investment capabilities to balance BlackRock's heavy reliance on its fixed income business (two-thirds of AUM prior to the transaction). The deal also expands BlackRock's retail mutual fund business, which will reach a combined $26 billion in AUM, and provides for a cooperation agreement between BlackRock and MetLife around client products and services.

Although the divestitures by MetLife and Cigna are additional indicators of the difficulties some insurers have had making a go of the asset management business, **New York Life** was on the other side of the negotiating table last year in acquiring the high-yield asset management business of London-based **Pareto Partners**. The deal was done through New York Life affiliate **MacKay Shields**, which has $15 billion in high-yield assets (total AUM: $36 billion). Pareto adds $3 billion to that total, with products that tend to perform better than MacKay's in "more difficult markets," as the company put it.

At the same time, Mellon Financial acquired the lion's share of Pareto, consisting of its currency management business, with $35 billion in AUM. Mellon had owned a minority stake in the company since its formation in 1991. (**XL Capital** also owned a minority stake.) Ronald O'Hanley,

Institutional Advisor Transactions

	2000	2001	2002	2003	2004
Number of Transactions	50	44	56	27	36
Combined Value ($b)	17.0	7.3	3.6	1.4	4.9
Total Seller AUM ($b)	890	593	294	118	550
Average Deal Size ($m)	340	169	65	54	136
Average Seller AUM ($b)	17.8	13.8	5.2	4.4	15.3

Source: Berkshire Capital Securities LLC

vice chairman and president of Mellon's institutional business, said the company would leverage "Pareto's intellectual capital and global perspective to create additional innovative strategies for the benefit of our clients." Mellon also acquired $3 billion in fixed income assets from Pareto that complement its Standish Mellon Asset Management fixed income unit, which has AUM of $200 billion. The acquisition of Pareto was one of five asset management deals the Pittsburgh firm concluded last year.

SunTrust, which made news with its $7 billion deal for **National Commerce** bank in the first half, also acquired **Seix Investment Advisors**, a prominent institutional fixed income shop with $17 billion in AUM. For SunTrust, the transaction meets a "strategic priority" by broadening its institutional capabilities. The deal, done through SunTrust's Trusco Capital Management asset management arm, makes the Atlanta bank a top-30 U.S. institutional manager and one of the top five managers of endowment and foundation assets. New Jersey-based Seix will continue to operate under its name as a separate fixed income boutique.

Federated Investors acquired $29 billion in third-party distributed money market funds from **Alliance Capital Management**, in a deal that enhanced the Pittsburgh firm's status as one of the largest money market fund managers in the U.S. The deal gives Federated a total of $155 billion in these instruments. Alliance said the sale was in keeping with its strategy of focusing on equity and fixed income investments. Federated paid $25 million upfront, with additional payments based on revenue levels expected to add $103 million over five years.

There were several institutional deals of note in the U.S. involving either private equity or management buyouts. **TA Associates** of Boston led a $240 million recapitalization of neighboring **Numeric Investors** (AUM: $8 billion), in turn receiving a 50% stake in the quantitative manager of traditional and market neutral long/short portfolios. A private equity firm established in 1968, TA has for years invested in asset managers, including such firms as **AIM**, **Keystone Corp**. and **Clinton Group**. **Orca Bay Partners**, the Seattle-based private equity group that includes McCaw Cellular Communications co-founder John McCaw among its principals, backed the buyout of **1838 Investment Advisors** from **MBIA Inc.** 1838 is a tax-efficient investment firm that manages $3.6 billion for institutions and wealthy clients. In 2003, Orca Bay sold its interest in another tax-efficient asset manager, **Parametric Portfolio Associates**, to **Eaton Vance**.

American firms were active in Asia, which has seen the introduction in recent years of mandatory pension schemes in Hong Kong and Taiwan.

American firms were also active in Asia, which has seen the introduction in recent years of mandatory pension schemes in Hong Kong and Taiwan, as **Legg Mason** and **Principal Financial Group** made institutional acquisitions in Singapore and Hong Kong, respectively *(see Cross Border)*. In the U.S., Principal acquired a majority interest in **Columbus Circle Investors**, a Connecticut firm specializing in growth equities (AUM: $3 billion). Columbus will maintain its name and operational and investment autonomy. In 2003, Principal took a majority share in **MW Post Advisory Group**, an institutional firm specializing in high-yield and distressed securities. ■

Mutual Funds

In the face of the scandals that continue to reverberate in the U.S. mutual fund industry, money flows into equity funds remained positive in each of the first 10 months of 2004, in total jumping 19% over the same period in 2003, to $146 billion, according to the Investment Company Institute. But the sunny numbers hid a more subtle story about the damage suffered by many scandalized firms, as institutions and individuals alike became highly selective in where they placed their money.

Three industry giants that emerged with their reputations intact—**Capital Group Companies** (American funds), **Fidelity Investments** and **Vanguard Group**—accounted for 65% of net inflows for equity and fixed income funds in the U.S. in the first eight months of the year, according to Financial Research Corp. This compares with around 48% during the same period in 2003, just before the scandals became headline news. Meanwhile, major fund companies that were caught in the scandals such as Putnam, Janus and AIM saw their AUM decline last year by double-digit percentages, due to large outflows (a combined $41 billion during the first eight months of 2004).

The hangover from the scandals explains to a large degree the dearth of mutual fund deals last year, as the number of transactions sank to 15—the lowest level of activity since 1998, when there were eight transactions. The combined value of deals did rise above the diminished level of 2003, due to one marquee transaction involving **Wells Fargo** and **Strong Financial**. At the same time, the checklist of U.S. buyers last year was impressive, as Wells Fargo was joined by **Affiliated Managers Group**, **Federated Investors**, **Goldman Sachs** and **Massachusetts**

Mutual Life Insurance. Canada, which has played host to a number of major deals in recent years, took a breather in 2004 from its consolidation trend. Europe was similarly quiet, as was the transatlantic pipeline.

While the scandals may have stymied transactions in 2004, many observers believe they will drive deal activity in the years ahead, as the increasing cost and complexity of new regulations—and the resulting squeeze on profit margins—cause small and mid-size firms to seek suitors with deeper pockets and administrative infrastructures. In a *Barron*'s article last year, for example, the president of **Ariel Capital Management** (AUM: $6 billion) described how the regulations forced the firm to build an in-house legal department of four employees and spend several hundred thousand dollars to produce a compliance manual.

Deals that did get done in 2004 continued along the lines of recent years, with bigger firms seeking out generally superior funds (as opposed to companies) in a process that involves swapping distribution and marketing muscle for assets and investing expertise. The largest asset management industry deal of 2004 was a direct result of the scandals, however, as Wells Fargo took the opportunity to acquire the operations of Strong, which had been negatively impacted by improper trading charges and a $175 million settlement with the SEC and states. Although Wells Fargo declined to provide an acquisition price, reports place it at around $500 million, with performance agreements that could add as much as $200 million to that number—or around 1.5% to 2% of assets, depending on final price. By comparison, in the halcyon days of 1997, British insurer **Prudential PLC** made a $1 billion-plus bid that Strong rejected.

In recent years, Wells Fargo has been enhancing its asset management operations with a steady flow of acquisitions, as it seeks to increase the percentage of overall income it earns from such activities. But Strong represents a far more ambitious play, providing the California bank with an additional $34 billion in AUM, split 80/20 between mutual funds and institutional accounts. When the Strong deal closes in early 2005, Wells Fargo will have around $220 billion in AUM. "The acquisition blends the strengths of Wells Fargo's compliance and operations controls, investment capabilities and broad distribution with Strong's equity and fixed income management, no-loads funds and multiple distribution channels," said Mike Niedermeyer, head of Wells Fargo's investment management business. Wells Fargo plans to wrap the Strong products into its own fund family.

In a second, lower-profile deal, Wells Fargo picked up all three **Cooke & Bieler** mutual funds (AUM: $500 million). A 55-year-old firm based in Philadelphia, Cooke & Bieler will continue managing the value-oriented equity funds under a subadvisory agreement. In a statement that sums up neatly the rationale among sellers in these increasingly common transactions, Cooke & Bieler partner Kermit Eck said, "This relationship expands Cooke & Bieler's distribution capabilities and allows us to focus solely on investment management."

Another major fund group, **Dreyfus**, concluded a similar transaction with its purchase of the assets of the **Thompson Plumb Balanced Fund**. The fund, which was rebranded under the Dreyfus name, will continue to be subadvised by **Wisconsin Capital Management**. The deal was announced concurrently with the split-up of Madison, Wis.-based Thompson Plumb & Associates, whose owners differed on distribution strategy for their funds, which sported more than $2 billion in AUM. Dreyfus, part of **Mellon Financial**, has close to $170 billion in AUM. In November 2003, Dreyfus also entered into a strategic deal with **Bear Stearns** through which it wrapped $4.4 billion of Bear Stearns mutual and money market funds into Dreyfus funds. The deal, completed in 2004, included a subadvisory role for Bear Stearns.

Affiliated Managers Group concluded four asset management deals last year, including one of the largest in the mutual fund sector, with its purchase of $3 billion in mutual fund assets managed by **Fremont Investment Advisors**. The company acquired the assets through its Managers Funds, which acts as an advisor to a diverse group of subadvised funds. "The Fremont funds are an excellent strategic fit with the Managers Funds, adding complementary products and geographic reach, as well as opening additional distribution channels to the Managers Funds products," said Nate Dalton, executive vice president of AMG. Publicly traded AMG owns majority stakes in numerous mid-sized asset managers.

Federated Investors, which in 2003 acquired eight small mutual funds from **Riggs Investment Advisors**, dipped into the market twice last year for similar deals. The larger one involved its purchase of four mutual funds (AUM: $266 million) run by **Banknorth** Wealth Management

Mutual Fund Transactions

	2000	2001	2002	2003	2004
Number of Transactions	29	26	22	28	15
Combined Value ($b)	12.0	5.9	3.4	0.7	2.2
Total Seller AUM ($b)	323	154	132	21	43
Average Deal Size ($m)	415	228	155	24	150
Average Seller AUM ($b)	11.1	5.9	6.0	0.8	2.9

Source: Berkshire Capital Securities LLC

Group. The Banknorth deal included two equity and two bond funds, three of which were wrapped into existing Federated funds, while the fourth was rebranded under the Federated name. Since 2001, Federated has spent a total of $273 million on asset management acquisitions. Banknorth Wealth is part of financial services firm **Banknorth Group**, based in Portland, Maine. “Our decision to reorganize our fund assets fits with Banknorth’s commitment to provide our clients with open architecture and to offer them the best range of financial services products available,” explained Robert Esau, president of Banknorth Wealth.

In the second deal, Federated acquired the Golden Oak fund, a small-cap value vehicle run by **Citizens Bank** Wealth Management, part of Citizens Banking Corp. of Michigan. As in the Banknorth deal, Federated merged the fund into one of its own. At the same time, Goldman Sachs Trust acquired six Golden Oak funds, merging them into its family of funds. In total, the Golden Oak funds held $465 million in AUM. Meanwhile, **Highland Capital** acquired the bank loan asset management business of **Bank of America**’s **Columbia Management Advisors**. The deal includes floating rate mutual funds and collateralized loan obligations, with total AUM of $2.7 billion. Highland, an 11-year-old Dallas firm with $9 billion in AUM, specializes in credit and special situations investing, with a portfolio of funds in leveraged loans and high-yield bonds. ■

Cross Border

These may well be the best of times for European banks. Earnings are strong, coffers are bulging, credit provisions are coming down—and on top of all that the muscular euro provides a big currency edge for overseas acquisitions. **HSBC** saw its profits jump 53% in the first half of 2004 while **BNP**’s rose 40%, for example. Yet, with all those advantages, only a handful of European financial firms went searching for investment management opportunities outside their home markets last year. Although the number of cross border transactions worldwide rose slightly from 2003 to reach 30, that was still below the average of 38 deals per year recorded in the five years through 2003.

Instead, the cross border action in 2004 was in the retail banking industry, where a couple of European firms joined the regional banking deal spree in the U.S. The ever-acquisitive **Royal Bank of Scotland** extended its presence into the Midwest via a $10.5 billion acquisition of Cleveland’s **Charter One**, done through its U.S. subsidiary, **Citizens Financial Group**. RBS has made more than two dozen acquisitions in the U.S. since it acquired Citizens Financial in 1988. **BNP Paribas** also entered the heartland to acquire North Dakota’s **First Bankshares** for $1.2 billion. Within Europe, the $15 billion acquisition by Spain’s **Santander Central Hispano** of **Abbey National** of the U.K. was the largest-ever European cross-border retail banking deal.

Santander’s aggressive bid set observers to wondering whether this deal will spur greater cross border activity in Europe’s financial services industry. Within the asset management universe, however, cross border activity in Europe continues to be hobbled by the limited number of opportunities. Mindful of their badly timed spending spree across the Atlantic a few years ago, Europeans also remain hesitant to dip their toes in U.S. waters again, despite the currency advantage. American firms made a handful of small but interesting deals in Asia last year, but were largely absent from Europe.

Within Europe, the U.K.—the most sophisticated and open of European financial markets—was the center of cross border activity in 2004. With the Swiss offshore banking industry making tax concessions to the EU and facing additional pressure on disclosure from both Europe and the U.S., **UBS** continued to extend its “onshore” business with four acquisitions in Europe, including two in the U.K., of **Laing & Cruickshank** and **Scott Goodman Harris** *(see p. 8 for more details)*. In the U.S., the company acquired the wealth business of **Julius Baer**.

Another venerable Swiss private bank, **Bank Sarasin & Cie**, also set its sights on England, acquiring London’s **Chiswell Associates** for around $40 million. Chiswell management retained a 25% stake of the enlarged equity in Sarasin Investment Management. The deal, with Chiswell owner **Nedcor Ltd.** of South Africa, provides Bank Sarasin (AUM: $42 billion) with a charity and pension fund manager that had $3.1 billion in AUM. In 2003, Bank Sarasin, partly owned by **Rabobank** of the Netherlands, acquired **Expertise Asset Management**, a small

Cross Border Transactions

U.S. - Int’l	2000	2001	2002	2003	2004
Number of Deals	23	17	23	12	15
Value ($b)	13.8	5.9	1.7	1.1	3.4
Int’l - Int’l					
Number of Deals	21	18	20	16	15
Value ($b)	4.8	1.1	2.6	0.5	0.9
Total					
Number of Deals	44	35	43	28	30
Value ($b)	18.6	7.0	4.3	1.6	4.3

Source: Berkshire Capital Securities LLC

French institutional firm.

In a complex, British-based asset management transaction with a cross-border component, insurer **Friends Provident** acquired **F&C** and merged that firm with its existing investment management arm, publicly traded **ISIS Asset Management**. The combination creates the U.K.'s fourth-largest asset manager, with $220 billion in AUM, as well as a top-10 manager of European pension assets. As part of the $700 million deal, Dutch financial services firm **Eureko**, which owned F&C, will receive a minority stake in the enlarged company and shares in Friends Provident. The deal achieves Eureko's goal of gaining a public listing for F&C, which it acquired in 2000 as part of an effort to build a pan-European asset manager *(see p. 9 for more details)*.

Among U.S. firms, there were two deals of note in Europe. In the alternative investments area, **Goldman Sachs** acquired two private equity funds from **Societe Generale** for $270 million. The two SG Capital Europe funds invest in mid-size European companies. SG Capital management will continue to run the funds as general partner, with Goldman acting as limited partner. In addition, SocGen and Goldman agreed to jointly invest $220 million in a new fund run by SG Capital. "We believe the SG Capital Europe team is uniquely positioned to find attractive investments in European middle market companies," Goldman said in a statement. Goldman manages more than $11 billion in private equity.

In a second deal, **Affiliated Managers Group** purchased a 60% stake in London-based institutional manager **Genesis Asset Managers** (AUM: $7.3 billion), with management retaining the rest, in line with AMG's practice of leaving managers with a minority stake. Genesis, founded in 1989, runs several worldwide and country-specific emerging market funds and provides AMG with investing expertise in that area. AMG President and CEO Sean Healey called Genesis "a high-quality firm that further diversifies our broad product offerings to include emerging markets investments managed on behalf of a wide range of institutional investors." Separately, the London-based management team of **Delaware International Advisers** led a buyout of that institutional firm from **Delaware Investments** of Philadelphia *(see p. 9)*.

U.S. firms were particularly active in Asia last year, with three major asset managers concluding deals. With strong economic growth, high savings rates and an aging population in many countries, Asia is looming ever larger in the plans of many asset managers. The introduction in recent years of mandatory national pension schemes adds to the region's appeal. Cerulli Associates figures mutual fund assets in Asia outside Japan will average 14% annual growth in the five years through 2008, to reach nearly $700 billion.

Principal Financial Group continued to build its presence in Hong Kong's fast-growing, four-year-old Mandatory Provident Fund by purchasing **Dao Heng Fund Management**, which manages $300 million in assets for both institutional and retail clients. Principal, which already had 330,000 clients in the MPF scheme, gained another 70,000 through Dao Heng. (In 2003, Principal had entered into its second joint venture in India's mutual fund industry, while AUM in its international business jumped 70% that year to $7.5 billion.)

Another insurance company and asset manager, **MassMutual Financial Group**, expanded its investment management operations in Asia with the purchase of a majority stake in Taiwan's sixth-largest mutual fund firm, privately held **Fuh Hwa Investment Trust**. Assets managed by Fuh Hwa have more than doubled since 2000, to $4.1 billion. Late last year, the government kicked off its "big bang" of the island's fund industry, a far-reaching reform measure that follows the introduction of a mandatory national pension scheme. Cerulli Associates expects Taiwan to become the second-largest mutual fund market in the region, with AUM doubling to $210 billion by 2008. In Hong Kong, meanwhile, MassMutual introduced mutual funds in conjunction with its affiliate, **OppenheimerFunds**.

In the third U.S. transaction in the region, **Legg Mason** acquired **Rothschild Asset Management (Singapore)**, a deal that added $1 billion in assets, primarily in fixed income accounts, to its existing business in the republic.

Cross Border Transactions by Domicile and Type

BUYER / SELLER

2004	U.S.-Int'l	Int'l-U.S.	Int'l Int'l	Total
Wealth Management	0	0	12	12
Institutional	1	7	3	11
Mutual Fund	2	1	0	3
Other	0	4	0	4
Total	**3**	**12**	**15**	**30**
2003	**U.S.-Int'l**	**Int'l-U.S.**	**Int'l Int'l**	**Total**
Wealth Management	1	3	6	10
Institutional	1	1	5	7
Mutual Fund	3	0	3	6
Other	2	1	2	5
Total	**7**	**5**	**16**	28

Source: Berkshire Capital Securities LLC

"Building our presence in the Asian markets is of substantial strategic importance to the global vision we have in asset management," said Legg Mason Chairman and CEO Raymond "Chip" Mason. Separately, Singapore's powerful state investment agency, **Temasek Holdings**, said last year that it plans to enter the fund business, a move that sparked complaints from some foreign fund managers who fear they will be placed at a competitive disadvantage in pursuing clients. ■

The primary real estate advisory deal last year involved a company in the timber business. Timber, with approximately 15 managers, is a highly concentrated segment of the real estate advisory business that has traditionally been quiet on the deal front.

Alternative Investments

Real Estate

The real estate advisory sector recorded three deals in 2004, with the primary one being in a historically less active part of the sector, as **Regions Morgan Keegan Trust** picked up **Evergreen Timberland Investment Management** from **Wachovia**. With approximately 15 managers and about $16 billion in AUM, timber is a highly concentrated segment of the real estate investment management industry that has provided attractive risk-adjusted returns.

Evergreen ranked near the top of the timber pack, with more than $1 billion in AUM and 1 million acres under management. **Hancock Timber Resource Group**, with about 16% of the industry's assets, is the largest timber manager. For RMK, the asset management arm of Birmingham, Ala.-based **Regions Financial Corp.**, the deal furthers its strategy of serving institutional clients with a diverse set of products, including alternative investments. Although RMK already managed timber investments in its trust accounts, the Timberland business fills in the institutional expertise it lacked. Last year, Regions Financial also acquired **Union Planters Corp.** of Memphis, a $6 billion bank deal that turned Regions into a major banking force in the Southeast.

In a second deal, management at **Lend Lease Rosen Real Estate** (AUM: $3 billion) led a buyout and recast the firm as **Adelante Capital Management**. Founded more than a decade ago, the firm manages investments in REITS for a variety of institutions. **Lend Lease Corp.** of Australia began the process of divesting its U.S real estate business in 2003.

One other asset management deal of note last year had a significant real estate advisor component: **BlackRock Inc.**'s $375 million purchase of **State Street Research & Management** from **MetLife**. Although the deal primarily involved a portfolio of bond funds, it also included the **SSR Realty Advisors** business, with about $6 billion in AUM. (In total, SSRM had $52 billion in AUM.) SSR Realty manages both separate accounts and commingled funds, including its highly diversified Tower Fund *(see p. 9 for more on the SSRM deal)*. In 2000, Met Life sold its 48% interest in Nvest, another asset manager with a real estate advisory component, while in 2003, insurer **Cigna** sold off its retirement business, including a real estate advisory arm, to **Prudential Financial**.

In the financial markets, REITS suffered a sharp sell-off in April, as talk of interest rate hikes stirred fears about how these dividend plays would fare in such an environment. But the sector quickly recovered and appeared on its way to beating most market indices for the fifth year running. Separately, real estate asset manager **Cohen & Steers** became a publicly traded company in September, as it raised some $100 million in an IPO, with pricing falling on the low end of expectations. The company, which is the largest REIT manager in the U.S., manages more than $15 billion in assets, primarily through a variety of real estate mutual funds.

Real Estate Transactions

	2000	2001	2002	2003	2004
Number of Transactions	1	8	3	4	3
Combined Value ($m)	N/M	427	1,022	361	51
Total Seller AUM ($b)	2.0	19.3	22.8	21.4	3.8
Average Deal Size ($m)	N/M	53	341	90	17
Average Seller AUM ($b)	2.0	2.4	7.6	5.4	1.3

Source: Berkshire Capital Securities LLC

Hedge Funds / Private Equity

The hedge fund arena continued to generate a great deal of buzz in 2004, as the industry witnessed solid fund inflows in the opening months of the year and recorded one major transaction. In their quest for mainstream recognition, hedge funds were also aided by the disappointing performance of equities for most of the year, which underlined for many wealthy individuals and institutions the need for alternative strategies.

Overall, hedge fund assets have nearly doubled to around $900 billion since 1999, while the number of funds has doubled to 7,000. In 2003, U.S. institutions had close to $66 billion invested in hedge funds, but researcher Casey, Quirk & Associates projects the number will climb to $300 billion by 2008. The percentage of institutions now investing in hedge funds has also been climbing rapidly, doubling between 2000 and 2003 to 23%. Amid all this excitement, in 2004 the industry as a whole posted lower returns than in prior years and did witness a slowdown in inflows in the second quarter.

Despite the strategic interest in the sector, the universe of actual suitors for hedge funds remains limited for now primarily to investment banks and other financial services organizations, whose large trading operations and experience with risk management make the vehicles a more comfortable fit. The diversified banks, asset managers and private banks that count wealthy individuals and institutions among their clients have remained on the sidelines for the most part, but are considered likely buyers in the years ahead. Some banks have already begun to build their own hedge fund capabilities, with **Citigroup** being a prime example, through its **Tribeca Investments** subsidiary.

Meanwhile, buyers are seeking to minimize risks by paying less of the total purchase price at closings and stretching contingent payouts over a period that can last from three to ten years. For the most part, valuations are being assessed by distinguishing between the profitability of management fees and performance fees and applying a discounted multiple for the latter. The IPO last year of London-based **RAB Capital** (AUM: $1.2 billion)—the first public flotation of a hedge fund manager—is also viewed as an additional tool for creating a valuation benchmark.

In total, there were five hedge fund and fund of funds deals in 2004, worth $1.1 billion, topping the previous record set in 2002 of $1 billion. For the second time in three years, the largest asset management deal took place within the sector, as **JPMorgan Chase** agreed to pay as much as $1.4 billion for a majority stake in hedge fund manager **Highbridge Capital Management**. **Man Group**'s $833 million purchase of RMF Investment Group, a fund of funds company, was the largest asset management deal in 2002.

A multi-strategy hedge fund firm, Highbridge was founded in 1992 and has accumulated $7 billion in AUM. The New York-based company is viewed as a solid risk manager that has also managed to insulate its own operation from risk by avoiding the star system common at many hedge funds. The firm's only downside, in the eyes of some observers, relates to its success: with a relatively high level of assets, Highbridge may be hard-pressed to continue generating superior performance while building its AUM at historical rates.

JPMorgan Chase is itself no stranger to hedge funds. Prior to the deal, the firm managed around $3 billion in hedge funds in Europe and Asia and another $8 billion in fund of funds. The company said Highbridge will continue to be run as a separate entity. "We see this transaction as perhaps the vanguard of the institutionalization of the hedge fund industry," said Highbridge managing member and co-founder Glenn Dubin, who added: "Having one of the world's largest and most highly regarded financial institutions as a partner will undoubtedly strengthen our portfolio financing operations and access to intellectual capital across product and business lines."

Just after the Highbridge deal, **Lehman Brothers** was reported to be in discussions with **GLG Partners** of the U.K., one of the world's largest hedge fund managers, with AUM of $13 billion. Lehman already owns a minority stake in the firm. Additionally, fund of funds giant **Permal** said it was "investigating strategic options" for its business and had retained **Merrill Lynch** as part of that effort. Permal, owned by **Worms and Cie** of France, has $18 billion in AUM and observers believe it could fetch as much as $1.5 billion.

Affiliated Managers Group wrapped up a very active year in November by making its fourth acquisition, of hedge fund manager **AQR Capital Management** of Connecticut. A leading quantitative investment management firm and hedge fund manager, AQR has $12 billion in

Hedge Fund Transactions

	2000	2001	2002	2003	2004
Number of Transactions	**4**	**6**	**14**	**10**	**5**
Combined Value ($m)	**326**	**88**	**1,033**	**198**	**1,067**
Total Seller AUM ($b)	**3.1**	**14.5**	**16.6**	**4.2**	**19.8**
Average Deal Size ($m)	**81**	**15**	**74**	**20**	**213**
Average Seller AUM ($m)	**768**	**2,423**	**1,189**	**421**	**3,960**

Source: Berkshire Capital Securities LLC

AUM, more than half of which is in hedge funds, and has recorded 57% compound annual growth in assets since its founding in 1998. For AMG, the deal marked its first investment in a hedge fund. **Asset Alliance** took a stake in hedge funds manager **Spencer Capital Management**, in its first deal since the collapse in 2002 of Beacon Hill, the hedge fund in which Asset Alliance held a 50% interest. Spencer Capital specializes in deep-value investing through a range of investment tools. Asset Alliance is a holding company with $4.6 billion in AUM, including assets held by its affiliates.

There were several deals in the fund of funds area, with **Mellon Financial**'s acquisition of **Evaluation Associates Capital Markets** the largest. A 20-year-old firm based in Connecticut, EACM had $4.5 billion in AUM and follows a fund of funds and manager of managers strategy. In explaining the deal, Ronald O'Hanley, vice chairman and president of Mellon's institutional business, pointed to the rapid growth of the fund of funds arena and said, "EACM's institutional roots ensure the quality strategies, in-depth analysis and robust processes consultants and institutional clients expect." In 2002, Mellon acquired hedge fund manager HBV Capital, which had an institutional client base.

In an all-New York transaction, **Safra National Bank** acquired **Alpha Investment Management**, a fund of funds group with $1.4 billion in AUM. The deal was designed to enhance product offerings for Safra's wealth management clients and cement the relationship the two firms have had since 1999. In a smaller fund of funds transaction, newcomer **BayStar Asset Management** acquired an interest in **Ascendant Capital Partners**. An alternative investment management company started up last year, BayStar plans to make strategic investments in fund of funds with the goal of capturing $1 billion in AUM; Ascendant was its first major deal. Ascendant, which operates two fund of funds, is hoping to enhance its efficiency and access to capital through the affiliation with BayStar.

There were three private equity deals of note last year involving asset managers. **Goldman Sachs** acquired two European private equity funds from **Societe Generale** for $270 million *(see p. 13 for more details)*, while **Bear Stearns** acquired **BDC Financial**'s private equity specialty finance business, which provides customized investment management and advisory services to institutional and high net worth investors in the private equity arena. Bear Stearns praised BDC for the innovative products it has created, including a structured private equity fund of funds.

In a notable meeting of the private equity and hedge fund worlds, **Hamilton Lane** acquired a controlling stake in New York-based **Richcourt Group**, a subsidiary of **CITCO Group** (which retained a minority share). Richcourt, founded in 1992, has $1.5 billion in hedge fund of fund assets across a variety of investment strategies. Said Hartley Rogers, vice chairman of Hamilton Lane: "This transaction makes tremendous strategic sense for Hamilton Lane and Richcourt, as it reflects the accelerating convergence of the private equity and hedge fund businesses and will enable us to serve better the respective institutional and individual clients of both firms." Based in suburban Philadelphia, Hamilton Lane oversees $34 billion in private equity commitments from institutions, including $5 billion in AUM. ■

About Berkshire Capital Securities LLC

Berkshire Capital has been advising clients since 1983 in connection with merger, acquisition, divestiture and joint venture transactions involving investment management and securities firms and related financial services businesses. Headquartered in New York City, the firm has offices in London, Denver and Philadelphia.

The Berkshire Capital team consists of more than 40 professionals and support staff dedicated to our mandate, constituting the largest financial institutions group with an investment management and securities focus. As the first investment bank to target these sectors exclusively, Berkshire Capital developed an extensive proprietary transaction database, which provides a uniquely critical perspective from which to advise our clients on alternative transaction structure and valuation.

Since January 1997, Berkshire Capital has completed more transactions in the investment management and securities industries than any other investment banking firm. We have advised buyers and sellers, both foreign and domestic, on over 185 completed transactions. These transactions have involved the transfer of close to $300 billion of assets under management with an aggregate value in excess of $7 billion. We have also completed more than 150 independent valuation/strategic advisory assignments.

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