Changes in Asset Management

"There's something really big happening."
--Ed Garden, CIO and Founding Partner, Trian Partners

Cleary Gottlieb's Ethan Klingsberg asked the Chief Investment Officer and a Founding Partner of Trian Fund Management, L.P., Ed Garden, and the chairman and CEO of The Bank of New York Mellon, Gerald Hassell, for their views on the future of the asset management industry and what the consequences will be for boards of directors of publicly traded companies.

It turns out the asset management business is changing rapidly and public company directors should be alert to these changes.

Ethan Klingsberg: The Bank of New York Mellon is not just an issuer dealing with your own shareholders but also a business where you host passive-strategy vehicles, such as index funds and ETFs, as well as actively managed funds. There has been this huge increase in investment in passive strategies matched by a correspondingly significant decrease in flows into actively managed funds. This trend is putting pressure on actively managed funds to distinguish themselves in the public's eye and to improve their returns—goals that arguably can be accomplished by being more outspoken in their communications with the companies in which they invest. Meanwhile, if you look at the boards of publicly traded issuers, especially at S&P 500 companies, there are hundreds of new directors taking seats and these new directors tend to be CEO-types, less deferential to management and more receptive to good ideas from shareholders. Compounding this set of circumstances is the increased concentration of the shareholder profile for public companies arising from the shifts in the asset management industry. For example, at this point, Bank of New York Mellon's top ten shareholders hold about forty percent of the voting power and that concentration is increasing. You can easily foresee a near-term future where the actively managed funds consolidate, the leading passive-strategy vehicles grow further, and most publicly traded companies suddenly have at least 55% to 60% of their float held by their top ten shareholders. You combine this landscape with the more receptive boards and it makes for a fertile situation where there a convergence between what Trian has been doing, as a highly engaged shareowner, in its efforts to influence the way companies conduct business and what institutional shareholders of all stripes are able to go out and do. Do you think there will start to be consolidation among the actively managed funds or pressure on the actively managed funds to be more active, more like Trian for instance?

Gerald Hassell: I think we are going through truly secular changes in the asset management industry and particularly the actively managed aspects of it. The dramatic change in flows from active funds to passive funds, whether they're ETFs or index, is extraordinary, truly extraordinary. Much of the conversation now with investors when choosing which funds to go into is what's your expense ratio. Not what your return is. Not what is your risk-adjusted return, which is the right question. So, the active managers, since they're having a very hard time meeting benchmarks or the median for index funds, don't have a good answer. The first thing they have to do, besides trying to out-perform, which is always hard, is they've got to look at their structural costs. Actually, that's where our firm is benefiting because we're one of the biggest providers of infrastructure—mid-office services, back office, clearing, custody, settlement, *et cetera*—and we have enormous scale, whereas investment managers shouldn't be doing those things themselves, they should leverage our capabilities. So we're actually on one side of the house benefiting from that trend, and on the other side of the house we do have a number of traditional high-conviction active managers. They're challenged. We also benefit from the fact that one of our boutiques is a very large index fund. We do have some balance in our own portfolio. That's the good news. But the active managers are under enormous pressure. When it comes to voting, I think the index funds are still figuring out how to not just vote for governance reasons, but how to vote based on the performance of the company. They are very challenged to figure that out. So I do think that *active* active managers will still get a lot of flows where they can differentiate from either the style or the performance. Middle-of-the-road active managers are going to be extraordinarily challenged and index funds and ETFs will continue to grow.

Ed Garden: This is a little bit of a tangent. But I think there is something really big happening. And here's my observation—for the last hundred years or so, the way the public equity markets worked, what became conventional thinking, is that if you, as an owner, didn't like what was happening, you had one option: sell your shares. Now think about that dynamic versus private equity. The other end of this spectrum is private equity, where the ownership of the company *is* the board. Managements report to a board, and the board are the owners. And by the way, they have a lot of skin in the game and they are very well-informed. I would also submit to you that over the last forty years there has been a transfer of wealth from public shareowners to private equity limited partners. For some reason, that dynamic of having the ownership in the boardroom has created really good results. But the erroneous theory that emerged from the success of private equity is that you can't fix a company by staying public. You need to take it private, fix it out of the public spotlight. Now we are witnessing a consolidation in the public shareowner base. You just mentioned that at The Bank of New York Mellon our top ten shareowners own forty or fifty percent. Those shareowners are very sophisticated. They know the industries. They understand the nuances and subtleties of the businesses. And all of that—that convergence of factors—has created, and I think we're at the forefront of this, an ownership mentality in the boardrooms of *public* companies. The owners of public companies no longer think, 'If I don't like what's happening, I need to sell.' They now think, 'Along with others, I own this company and I have a responsibility and a right to make sure this business prospers. And I want to see that happen.' That's why we believe institutional shareholders are receptive to learning about Trian's operating and strategic initiatives to enhance long-term shareholder value.

Ethan Klingsberg: Is there an argument, though, that when you're able to have your top ten shareholders in one room and they own the majority of the company and you have these boards who reflect this sense of ownership such that they're not deferential to management necessarily, you don't really need a Trian at that point?

Ed Garden: The issue is, Ethan, that, while a lot of these groups no longer feel that they're only option is to sell, they still don't necessarily have the skill set, the locked up capital, the temperament to go into board rooms and for the next five, six, seven, ten years to get sales up and expenses down.

Ethan Klingsberg: As the shareholder base changes and the passive strategies become stronger, how does that impact support for what Trian is doing? As Gerald was pointing out, some of these passive strategy investors have trouble figuring out what they're really after. Are they after governance? Are they after performance? How does that impact the ability of Trian to get support from the shareholder base?

Ed Garden: The index funds, the passive strategies have put in a lot of time and energy into making sure that they're contributing to strong corporate governance. And not just on the traditional governance measures like board refreshment, but really having a point of view on things like operational issues. It's hard because, for example, the index fund complexes may hold in excess of 1,000 different stocks and it's hard to have industry expertise on every public company. Do you agree with that, Gerald?

Gerald Hassell: Yes, I would agree. I would also add that I think the index funds, particularly given their structure and their inability to truly analyze companies, like the fact that someone as engaged as Trian is there, and can have positive influence on companies where they [the index funds] don't have the time or the energy or the ability to do so. So I actually think in many cases the index funds like to see this kind of engagement.

Ethan Klingsberg: Thanks to both of you for helping us to understand what's going on with the big picture of the shareholder and board landscapes. From the macro-perspective, as Ed said, there's something really big happening right now.

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