Introduction:

I could have extended the title of this note to "Kicking Ass (et Managers) and other double entendres". In preview, alternative asset management[1] is a kick-ass industry, and, at the same time, every asset manager gets an occasional good kicking. That kicking can come from a number of places:

1. Broad-based market declines.
2. Natural "periods in the wilderness" when your portfolio is out of sync with whatever is working in the market.
3. Being wrong.

The kicking[2] is a "feature not a bug"[3] and is the tuition fee to work in an industry that is heavily skewed to the upside.

So much to like:

Who wouldn't like to own and operate a business that:

- Has high returns on capital employed.
- Requires negligible capital to grow.
- Has no bad debts.
- Has minimal operational, logistical, supply chain, manufacturing, or other messy 'real-world' challenges.
- In the case of private equity, enjoys the positive asymmetry of exposure to a basket of independently leveraged call options.

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[1] As distinct from traditional asset management and hedge funds which were historically attractive but have more recently been somewhat challenged.
[2] All track records, including the great ones, come with painful intermissions.
[3] To steal a software term.

- Employs professionals that are generally highly engaged and tend to stick around. The industry is attractive to intellectually curious people and is a highly "gamified" performance derby. The high challenge, high reward environment allows firms to build a "competitively advantaged human capital franchise"[4].
- At the industry level, earns an ad-valorem tax on cumulative collective wealth, the ultimate long term growth industry, as it broadly captures global productive capacity which continually marches forward. The structural leverage of earning a percentage fee on other people's accumulated wealth is enormous.
- For large parts of the industry, predominantly the alternative asset managers, the threat of technological/structural shifts is far less stark than in other industries.
- Operates in a broadly attractive pricing landscape, at least for the alternative asset managers, in the sense that there really is no benefit to cutting prices and institutional allocators have accepted that you need to pay for performance/access.
- Has private fund draw-down structures with embedded free optionality as return hurdles are only benchmarked against drawn capital, leaving the free optionality of allocating dry powder to act opportunistically.

<u>Peculiar characteristics:</u>

The broader asset management industry has some peculiar characteristics.

1. There are areas within asset management, such as low-turnover concentrated equity investing, where an amateur can copy an expert and get close to the same results. I know of no other skill-based profession where someone can so readily emulate an expert.
2. More books are written about successful investors/investing than most other professions (except perhaps business or sport). Why are there so few books written about the world's greatest tax consultants, surgeons, or scientists; professions that arguably require greater skill than that of investing? Perhaps it's the unique emulation potential, or more likely our general fascination with outsized wealth accumulation.
3. A solo operator or small team can enjoy extraordinary personal economics. Numerous solo individuals manage hundreds of millions. They earn millions per annum in base fees alone[5], a remuneration level that is normally associated with the CEO of a large complex organisation. Growth in AUM comes with virtually no additional costs, i.e., 100% incremental margins.
4. Despite earning a small fortune, most participants don't deliver real value[6] against an indexing alternative which is close to free. Here is a recent quote from The Financial Times:

> The harsh reality is that the investment industry as a whole makes a staggering amount of money — listed US asset managers had an average profit margin of almost 26 per cent in 2021, more than twice the S&P 500's average — and yet do a bad job on average. Despite the march of passive over the decades, there are still more mutual and hedge fund managers than ever before, many of which in practice do little more than extract rents from the financial system.

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4 ValueAct describing its investment in KKR.
5 Performance fees can add a life-changing kicker.
6 Gambling and weight loss companies arguably also fall into this category in that, over time, most gambling customers lose, and most weight loss customers don't lose!

5. The well-founded theory that most people can't beat markets doesn't stop numerous people trying. Call it the "trial versus theory gap", which seems especially wide in this industry.
6. It takes at least ten years for anyone to figure out whether your results are due to luck or skill, and even then, it's never 100% skill[7].

Those who run/own asset management firms understand how good the asset management industry is, yet in their portfolio construction they are routinely underweight the sector or have no exposure at all.

Why is this?

I can think of a few behavioural, mandate driven, and/or other non-economic reasons, but that's a note for another day.

Why work anywhere else?

In many things, the choice of game is the defining decision. Deciding where to work is no different.

In the media world Marshall McLuhan famously coined the phrase "the medium is the message" where the form of media communication impacts the message.

In choosing a career I suggest that "the median is the message". If you can go into an area where the median result is attractive, the odds are good that you will do ok[8].

Median compensation within the asset management industry is very attractive[9], and while it's hard to find reliable median data by industry, it is interesting to look at the market capitalisation per employee of some of the large alternative asset managers[10] set in the context of what are already some of the most profitable businesses ever created[11].

Market Capitalisation per Employee - $M			
Alphabet Inc.	8.3	Apollo Global Management, Inc.	15.0
Apple Inc.	17.1	Blackstone Inc.	18.2
Microsoft Corporation	9.0	The Carlyle Group Inc.	6.5
Visa Inc.	19.5	KKR & Co. Inc.	13.7
S&P 500 Median	1.5		

If you want to find many of the richest people in the world, look within the asset management industry.

[7] The old reminder not to confuse brains with a bull market springs to mind.

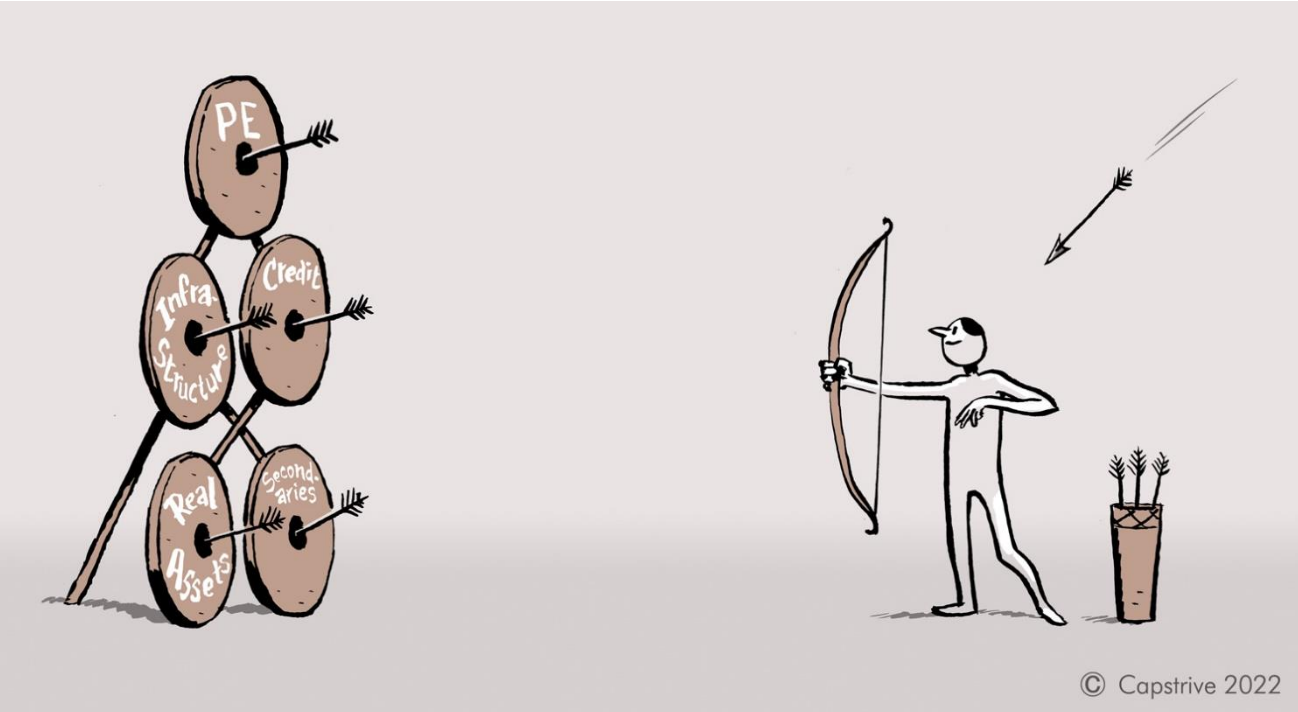
[8] This is less true with averages, the average may be attractive, but outliers skew the results. If you are going to work where outliers skew the averages, you want to make sure you get multiple shots on goal.

[9] If you work in asset management, you already know this!

[10] The focus here is on alternative investment management, but other asset management franchises, such as those run by Marriott or Hilton are also very attractive business models.

[11] Data as of 29 August 2022. Source Capital IQ.

What to look for when investing in alternative asset managers:



For investors who are happy to purchase shares in other asset managers, what should we be looking for? Unsurprisingly, given the simplicity and elegance of the asset management business model, three key metrics drive most of the analysis/value:

- AUM
- Fee rates
- Operating margins

At a broad industry level, there is a dichotomy between traditional and alternative asset managers across those three key metrics. At one end of the spectrum, large cap listed public equity active asset managers face AUM flow and fee/margin pressures and at the other end the diversified alternative managers are growing AUM while holding fees and margins firm.

The better businesses are those firms that:

- Have long duration capital. Many of the alternative asset managers have substantial amounts of 'perpetual'[12] capital. This provides utility like earnings visibility.
- Are scaled institutions that can offer a full suite of investment solutions to the larger capital allocators who are consolidating their LP relationships. The bigger firms get better access to financing and better terms. They face less competition in the larger deals[13], and they benefit from an asset management consultancy industry[14] where the incentives conspire towards recommending the largest players/most recognised brands. There is also a FOMO element with LP allocations, in that if they don't consistently allocate, they may be locked out of future opportunities.

[12] What the industry defines as 'perpetual' is not truly evergreen, but in practice should last at least a decade or more.
[13] Only a handful of firms can write a multi-billion-dollar cheque.
[14] The classic "friendly middleman" situation.

- Can invest across the capital structure thereby enabling them to provide a comprehensive financing solution in a single offering (which may later be syndicated for additional capital markets fees).
- Run multiple strategies over multiple vintages providing performance diversification such that earnings and future growth prospects are not reliant on any single strategy or vintage.
- Pursue investment strategies that are skill based and have a large 'access' component to them, i.e., if you want exposure to the asset class there is heavy lifting involved and it's not simply a case of purchasing a bond with an ISIN. With private assets there is no credible index alternative. Unlike public equities, it's expensive to build an origination platform at scale leaving the scaled managers in a strong position. Private assets have the added benefit[15] of lower 'reported' volatility giving investors some psychological comfort to stay the course.
- Treat investors and limited partners with respect and are super protective of their reputation and culture.
- Have transparent staff compensation systems that are not egregious[16]. A recent trend to allocate the substantial majority of performance fees to staff is a negative here and has stemmed from the fact that public markets have not been willing to put a fair value on volatile performance fees, so the alts management teams have said, "ok if the markets won't value them, we will keep them".
- Performance is at least better than average in enough strategies to enable follow on funds.

Once we find asset management firms with those features, we always need to then ask what's priced in, as overpaying is a classic unforced error.

Additionally, some big risks are lurking in the background.

The first is reputation. An asset management firm can destroy its franchise with bad behaviour.

The second is the degree to which financial assets suffer a material correction. The whole asset management industry has been a huge beneficiary of falling rates and accommodative monetary policy. Asset managers are leveraged to financial markets, and no matter how good they are, their valuations suffer disproportionately during market downturns (even when they have substantial dry powder to invest through the downturn). The current inflationary market environment has the potential to be very damaging to financial assets as the world deals with tighter monetary policy. This is a real and significant tail risk that should at least give one pause for thought on position sizing.

The third is founder/key leadership transition. Most of the alternative asset managers have been founded around strong personalities that are synonymous with the firm. Again, it seems like the larger firms may have an advantage here and some have already made the transition, but others have struggled.

Lastly, the compliance and political environment could get much more hostile towards an industry that has massively benefitted from the 'great financialisaton' over the last two decades.

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[15] I appreciate that this is arguably illogical, but it's nevertheless true.

[16] The best alignment is where leadership gets its compensation predominantly as a fellow shareholder. Berkshire Hathaway is the poster child of fairness in this regard.

Conclusion

Not all asset managers are created equal. While traditional managers are facing pressures on multiple fronts, the scaled diversified alternative asset management world is a structurally advantaged kick-ass industry. Welcome to "The Alt Age".

If you work in this industry, it's worth pausing to reflect whether you may have been rewarded for simply being lucky[17], and confusing that luck for brilliance. Lucky to work in an endlessly fascinating industry, with outsized economics, even if not deserved[18].

And remember, the next ass kicking is always just around the corner.

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[17] For example, how may investment portfolios were bailed out from money-printing immediately post COVID?

[18] Undeserved, unless you thoughtfully chose this game precisely because of this, in which case you at least might earn a pass for honesty!