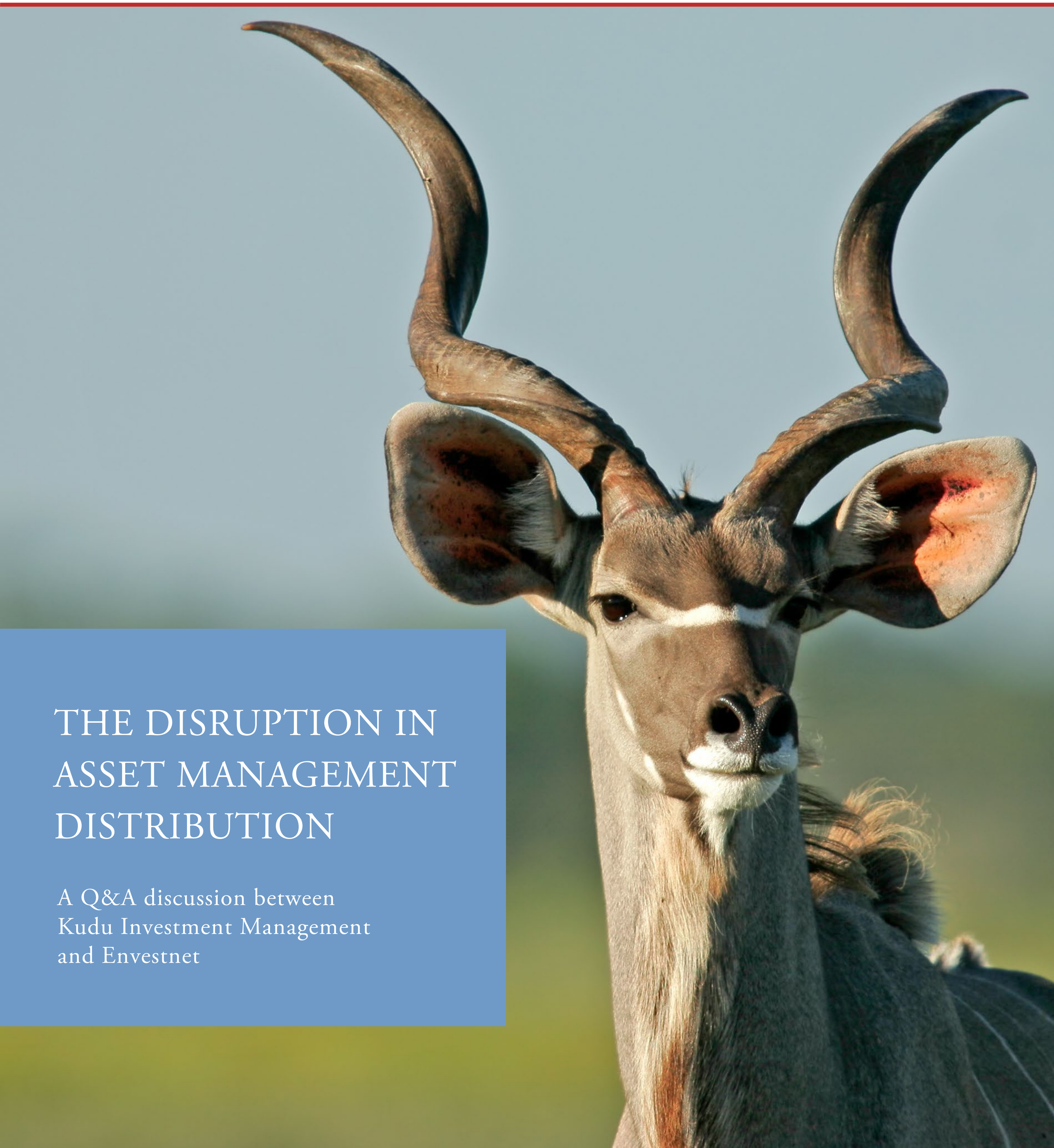
KUDU INVESTMENT MANAGEMENT



THE DISRUPTION IN ASSET MANAGEMENT DISTRIBUTION

A Q&A discussion between Kudu Investment Management and Envestnet

Lee Beck

Managing Partner
Kudu Investment Management

Mr. Beck is a Managing Partner at Kudu Investment Management where he and the team invest minority stakes designed to minimize disruption while providing strategic guidance for growth. In addition to Mr. Beck's role at Kudu, he guest lectures at universities in the United States and Europe.

Over the prior fifteen years, Mr. Beck led distribution and related execution teams at some of the world's most successful investment management firms, including BlackRock, JP Morgan and PIMCO where he also served on various executive, operating and global investment committees.

Before becoming an executive leader, Mr. Beck was an institutional and middle market account manager for Federated and PIMCO, covering Fortune 1000 companies, Governmental Entities and separate account relationships. He began his career as a university coach and assistant professor.

Mr. Beck earned an MA in Foreign Literature and Languages from the University at Albany and an MBA in Finance from Daniels College of Business at the University of Denver. His quest for knowledge drives his ongoing education.

Mr. Beck lives in Princeton, NJ and NYC with his three sons and serves with several charities that seek to protect at-risk youth and promote better inner-city education. His passions and hobbies include surfing remote regions of the world, writing, and working with his sons' academic and athletic programs.

James K. Patrick IV

Group President
Envestnet | PMC

Mr. Patrick, Group President, Envestnet | PMC, provides the leadership and strategic vision for the delivery and development of Envestnet's investment capabilities, including enterprise CIO solutions, investment research & due diligence, advisor consulting services and managed investment products. Jim also sits on the Executive Leadership Team of Envestnet Wealth Solutions, helping to guide the future growth of Envestnet's wealth management solutions, serving RIAs, broker dealers, banks and other financial institutions.

Prior to joining Envestnet, Mr. Patrick was the Co-Head of U.S. distribution for Allianz Global Investors and affiliated firms, including PIMCO, having joined Nicholas Applegate in 1997. Mr. Patrick is a founder and Board Member of Cavendish Global and the Institute for the Fiduciary Standard based in Washington, D.C. He also serves on the board of the Basset Medical Center in Cooperstown, NY, the Otsego County Conservation Association and the University of New Hampshire College of Liberal Arts board.

Mr. Patrick received a B.S. in Business Administration from the University of New Hampshire. He holds the FINRA Series 7, 24, 26 and 63 securities registrations and the Series 65 investment advisor registration.

Mr. Patrick is married with three children, and serves as a volunteer with the Sugarloaf Ski Resort ski patrol.

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INTRODUCTION

The asset management industry, like so many of its counterparts, is going through severe disruption. Key to this change is distribution, and particularly the evolution from a sales-led to a marketing-led philosophy.

Three catalysts are behind this shift; technology, client demands, and value pricing, with technology playing an outsized role. The biggest disruptor to our industry in the past 30 years has been technology, or more specifically Google, which has changed everything by providing transparency into traditionally protected business models, client behavior and pricing. The result is increased pressure on strategy, structure, margins and organic growth.

In this Q&A, Kudu Investment Management managing partner Lee Beck and Envestnet | PMC group president James K. Patrick IV offer their perspectives on trends that are changing how asset management distribution operates. With asset manager margins under pressure and competition increasing, evolving distribution through disruption is a critical task.

FundFire reported that one large asset manager employs some 40 data scientists and software engineers at their technology center. They started the center last year to improve how the firm targets institutional prospects and advisors. How do you think increasing use of technology and artificial intelligence will disrupt asset management distribution?

Patrick: Engagement with technology and analytics gets a lot of lip service, but not a lot of definitive execution by most firms. And I think many of the organizations we work with – the largest asset managers in the industry – are very slow to adopt a new way of doing business. It's like we're living a little "who-moved-my-cheese session" here. But the firms that are really successful are the ones that are fully integrating technology into how they interact with advisors.

Beck: Technology is impacting us in every aspect of our roles, but the real value is derived from user interpretation and an effective implementation process. Disruption will occur in different phases; we are in phase one, which includes data integration, interpretation and surface level execution. The biggest change is direction, evaluation and recommendations being provided from business intelligence leadership to sales leadership, reversing the traditional roles. The information is available, but most are marginally aligned to the insights.

Patrick: Also, it is more challenging than ever to fully integrate new technologies with the customer-relationship management systems most firms use to manage interactions with advisors because of the different ways advisors run their businesses. In some cases, there will be new proprietary technology that can complement what both the asset manager and advisor are doing, but in other cases, it will require understanding how your investment products and services foot back to the technology that the advisor and their end clients are already using today. Additionally, even when the right systems are in place, many people in sales and marketing are not ready to effectively use them. It's a new mindset and it requires investing in training.

The fact is that successful managers are consuming information more efficiently by fully integrating technology into how they execute their distribution strategies and track their effectiveness.

Beck: This all begins with education and a firm's true commitment to evolving. I believe learning and development platforms are the most important investments any asset manager can make over the next five years. How do you prepare, evolve and align your assets without an "infrastructure of education"? I think many firms still struggle evolving their primary assets, which are the people they employ. Look around and it is easy to see that most learning and development programs are underfunded and perceived as "nice to have" versus "must have". I believe firms like JP Morgan and AQR have differentiated themselves in this area.

I estimate there is only a ten percent utilization rate of the technology at distribution teams' fingertips today. The leadership and personnel firms maintain and hire will be different; they will trust the data and have metrics that align with strategy and structure, as I believe structure is your strategy in real form. I think leaders will need to change from providing direction to accepting direction from business intelligence. This will create intergenerational tension which requires leadership guidance, broad-based coaching and a reengineering of metrics, not to mention compensation schemes.

Investment in learning and development wraps the manufacturing side around the economic prioritization of the client base. That's something that I think has to happen whether you are a boutique manager or a multi-asset, trillion-dollar manager operating globally.

Is asset management distribution doing a good job meeting the needs of clients?

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Beck: I would say we witness mixed results. Distribution efforts have been built on what the asset manager needs or wants to sell, generally not derived from the client's problem. I would argue that asset managers must orient their distribution model to start with client concerns with a true understanding of the issues, if not the industry will continue to under-deliver for clients, which promotes digital interfaces and less human interaction. This can be accomplished through problem-solving "cascades" but the execution has proven to be difficult at firms who have attempted this transition. It is not a comfortable framework to implement and often runs contrary to the cultures and ethos the industry has built over decades.

Patrick: I think about distribution in terms of the different types of consumers. When I think about advisor-intermediated distribution, I think about it in terms of the types of products and services the end client would use, which depends on whether they would be considered mass affluent or affluent. And as I think about running a distribution organization, I'm very surprised at the number of managers and advisors who keep pushing the vernacular of the CFA – tracking error, beta, duration, convexity, etc.

There's a gap between the reality of delivering scaled advice to more clients and being able to engage in the minutiae of a discussion around the R-squared or tracking error of a strategy and translating it back to a client who needs, for example, inflation plus three percent to meet their investment goals. An advisor's end client thinks about budgeting, about cash flows, and about successfully realizing a financial plan with certainty. We believe that financial planning is the root of most engagements with end clients, and you must understand, as a distribution executive or representative, how your products and services might fit with a client's financial plan and use client engagement technology to show the results and benefits of that investment strategy.

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But, by and large, we are not seeing this happening. There's a compounding of the disconnect between how an advisor speaks to an end client and how they listen to asset managers, which is causing asset managers challenges and pushing advisors toward outsourcing investment decisions. But the firms that have succeeded realize there are only so many advisors who have a significant book of business, still have "control" of their clients and haven't started to see assets migrate meaningfully to the millennial children or grandchildren. Having another meeting with an advisor to present the same product story will not help the asset manager distribute products. I think we will see a lot of shaking out in the industry in terms of distribution and how they engage with their advisors. Firms that are winning have found ways to add value to an advisor's practice, such as programs for things like financial planning and dollar-based monthly cash flow models.

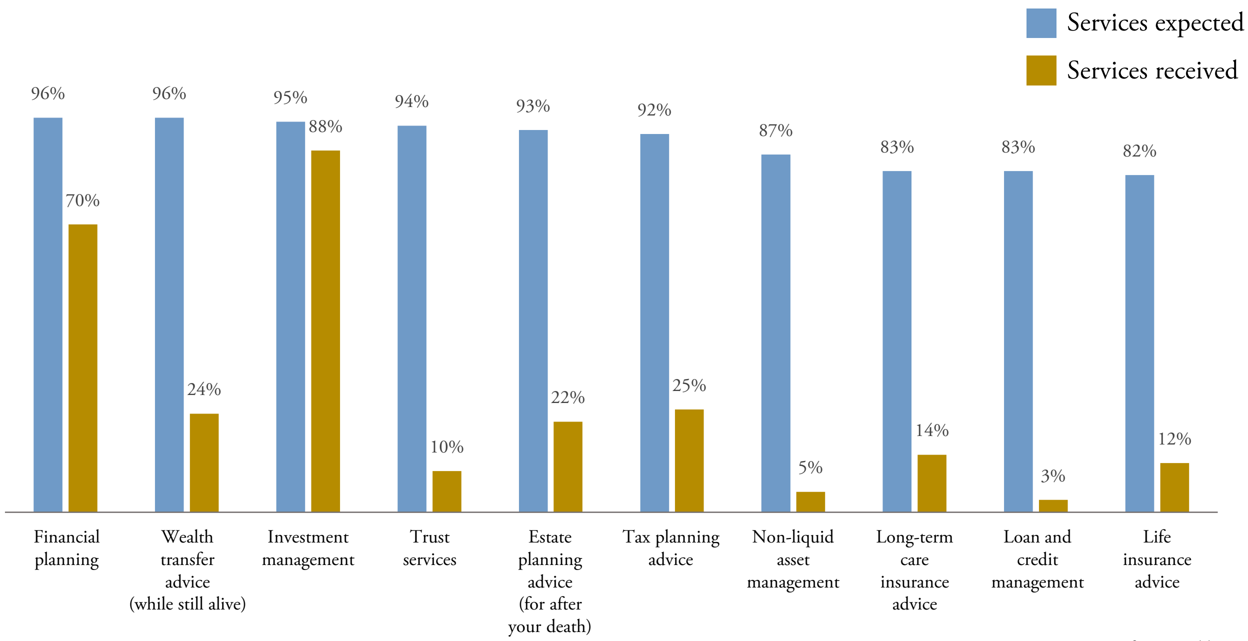
We've seen a material uptick in advisors' utilization of an asset manager's products when the asset manager has deployed technology that allows it to more effectively engage with advisors and helps its representatives scale their efforts. Couple that approach with analytics that prioritize prospects and product messages and you can see that some firms are really capitalizing much better on their human capital.

Beck: I believe asset managers can enhance their resource utilization significantly. Doing a better job at aligning and utilizing people will be critical for success. One clear catalyst for realignment is the volume and velocity of cash flow into research recommended platforms. The intermediaries currently have between 65 percent and 98 percent of all new cash flow investing into research recommended portfolios and that universe is a small one, maybe less than 300 names per platform or per research unit. The other 5,000 plus products outside of that research recommended list are all fighting for the remaining pieces of that puzzle.

And if an advisor or consultant selects options outside an institutional or intermediary research recommended list, they likely accept fiduciary liability at the individual level or at the firm level. Many aren't willing to do that unless there's real product differentiation of performance that they can't find on the research recommended list. It has to be a very unique opportunity for a client to take on that risk and if you're not selling a product in a way that's professional and you're not incorporating technology to leverage distribution, you're fighting for a small position against some tough competition.

There are only so many people you can get in front of first of all, so your product better be one, priced right, two, structured appropriately, and three, clear on how it answers a problem such as a certain risk profile, return profile, income profile, and so on. Then firms need it on the right platforms. I don't feel firms have the

THE GAP: SERVICES EXPECTED FROM ADVISORS VS. SERVICES RECEIVED



Source: Spectrum August 2018 Defining Wealth

appropriate level of resources aligned with this opportunity.

It sounds like there may be a misfit between product availability and client needs. Is greater product customization the answer to meet client needs?

Patrick: I read over the weekend that there are more than three million indices around the world. It's mindboggling and, at some point, there's too much work to differentiate one product or index from the other. We have 19,000 products, 1,300 SMA managers and 157 mutual fund and ETF strategies on the Envestnet platform, and we're probably only a third of the market. So I don't think lack of products is a concern. But we've done research on the gaps between the services clients want and what they actually get, which is interesting. I mean, 94 percent of people want trust services and 10 percent of advisors are providing them; 96 percent want wealth transfer advice, but only 24 percent receive it.

Should advisors be spending their time deciding between a two-times or a three-times short index ETF for their clients or should they be trying to meet some of these gaps? I'm not sure more products, or customized products, are the answer for advisors looking to differentiate their capabilities and reassure clients that he or she is earning their fee.

Beck: The last thing the industry needs is more product, but there is client demand for return profiles balanced with liquidity levels and risk. Customizing capabilities is appealing for clients but creating the scale required to do so within the intermediary segment is difficult. That's why you see most multi asset product sales happening at institutional clients and not through intermediaries. I think the customization needs to be happening at the client level. We have more than enough products to match their concerns if assembled correctly.

Patrick: We are starting to see end clients question the value proposition of the advisor engagement overall and demand cutting-edge digital tools, like budgeting apps, that are linked to their investments and the ability to do lending off of their holdings. As an advisor, picking a really cool 60/30/10 portfolio and allocating it has become table stakes, where before it might have been a differentiating feature.

Remember that a prospective client can go online and get all kinds of in-depth information on the value proposition of advice. We're starting to see more requests for our consulting services around how an advisory firm can differentiate itself in terms of tax awareness, impact investing, overlay strategies and so on.

How can asset managers enhance distribution given the challenges we've discussed? What might give managers the greatest return over the next five to ten years?

Patrick: It will be key to think differently about who the leaders are at your firm and how they execute firm strategy. There are a lot of sales representatives who can have a phone call or get a meeting, but only a few can take all of the factors we've been talking about, especially how to capitalize on technology and client relationships, to truly drive execution and distribution.

You'll also need to think differently about using distribution P&L and milking your cash cows – not abandoning them – but establishing a base level of support for your product line. If managers right-size their organizations, think differently about how they engage with the end client and the consultant or advisor, and completely retool how they work, they can either change product focus or seed new products today that might allow them to think about engaging differently going forward. What you've competed on in the past is not going to be a differentiator in the future.

Beck: Start with your strategy and clearly define who you are. Most haven't even accomplished this stage. It's hard to go through professional or personal success if you don't have a clear understanding of who you are and who you are not.

Secondly, prioritize the structure which will allow you to execute on your differentiation. I think asset managers will need to shift from a sales-led to a marketing-led distribution model. One way to assist that shift is to incorporate a "pod" focus where everyone works out of a central structure to enhance education and mentor people in a common environment facilitated through technology connectivity.

Thirdly, prioritize the product line and the clients. Regarding the latter, define who the clients are you're going to allocate capital and resources to and who aren't. The asset management business has always said "we have strategic partnerships and we think carefully about who we want to serve." But that's generally not the case; our industry has had a shotgun approach to distribution which has been reinforced by paying sales teams to sell everything everywhere and waiting to see what might stick.

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I would argue whether it is in the institutional or intermediary space, the top 15 clients are probably greater than 70 percent of a firm's revenue. Often, I don't see managers reflecting that in their day to day efforts.

Lastly, invest in a learning and development team, platform, and ongoing education framework. Having your "assets" stepping away from the distribution process for 20 percent of their time to relearn and evolve communications regarding the firm, its capabilities, positioning, market intelligence, etc., has an immeasurable value.

Patrick: Asset managers also need to focus on how they differentiate and brand their capabilities, what product suite they are going to put resources behind, how they engage with clients, and the execution of distribution.

Do these views apply to all asset managers or just to large firms with significant distribution capabilities and deep pockets?

Patrick: One way of thinking about this is to use a barbell analogy of large, mid-sized and giant firms. I think there are going to be pockets of engagement that are really important for an asset manager to differentiate itself regardless of firm size, and if you compare a mega-sized manager with a smaller boutique, you can find examples where both firms have done a great job at differentiation and branding. But, in many cases, it will be easier for smaller firms than mid-sized firms to brand and differentiate themselves.

Beck: The opinions Jim and I have raised are applicable at small or large firms.

Patrick: I believe that the big managers will get bigger with greater scale, and the boutiques will still be small, but it will be hard to rationalize yourself as a mid-sized firm. I think it's going to be really interesting to understand how a mid-sized manager defines itself. Are you a Ford or are you a Ferrari? Ferraris are very distinct and are custom style managers, versus Fords which are like everyday brand style managers. How Ferraris and Fords brand and differentiate themselves and their distribution capabilities will depend on which make they decide they are.

Beck: Speaking of boutiques, even Jack Bogle said in Barron's that there will always be a place and always be demand for boutique managers that excel. Many boutiques question if they should stay independent or accept an investment by a bigger manager to leverage their distribution and infrastructure. I believe managers have greater opportunity for success long-term by managing this organically. I believe if a firm has the manufacturing differentiation, with thoughtful leadership and decision making, the ability to succeed in today's environment is very strong, even when it is David versus Goliath.

Patrick: I absolutely think they can be competitive and, to me, that is what is great about America. In America, we are tremendously entrepreneurial in a capitalistic structure, and we have the opportunity for great ideas with great execution and great engagement to continue to succeed.

There are many examples, especially in asset management, where small firms have differentiated what they do and how they do it for an end client, a consultant, or intermediaries to end clients. I absolutely think small firms will be able to differentiate themselves. But I think it's important they have a strategy and a following and can differentiate themselves and their products. A key question for them is whether it is still profitable to run their business like they did before they got to scale. I also think they need to understand their niche, stay inside it, and not try to compete with mega-managers by getting outside their niche and into arenas where the big firms dominate.

Kudu Investment Management

provides specialized capital solutions to asset managers and registered investment advisers, including generational ownership transfers, management buyouts, acquisition and growth finance, as well as liquidity for legacy partners.

In addition to capital, Kudu provides value-added consulting on strategy, marketing, and distribution designed to help managers and advisors accelerate growth in revenue and assets under management.

Kudu's principals have structured over 20 transactions for a total of nearly $1 billion and have advised on merger and acquisition deals over their careers. The firm is backed by a $250 million capital commitment from leading institutional investors including White Mountains Insurance Group, Ltd.

For more information on Kudu, please visit www.kuduinvestment.com

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