


Financial Services

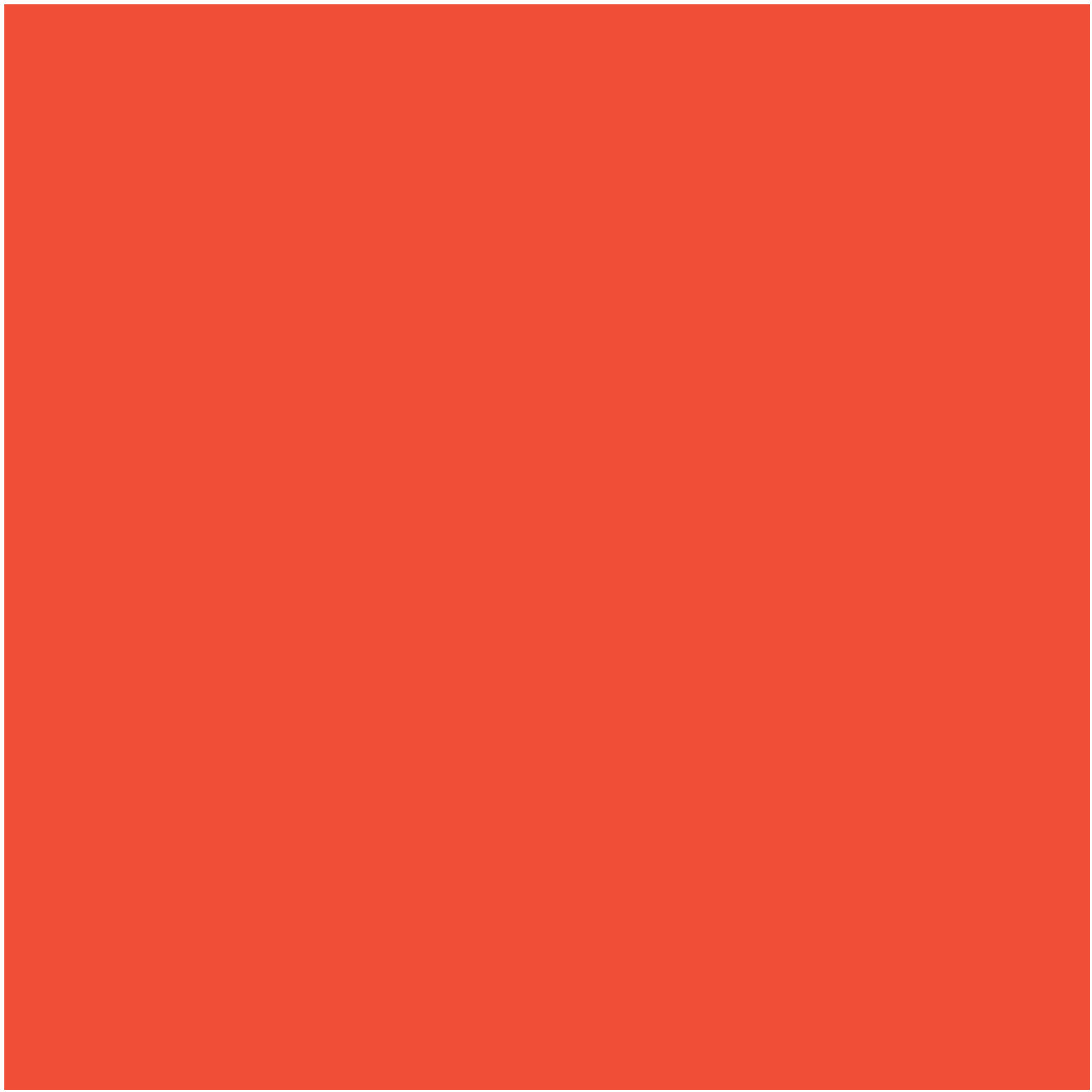
Talent and the alternative investment industry

Meeting the challenges as the sector matures*



*connectedthinking

PRICEWATERHOUSECOOPERS 



The business challenge

Talented individuals, by definition, are in short supply. They are the lifeblood of investment firms, driving performance returns, sales and operational efficiency. Their contribution has particular significance in alternative investment companies, which depend largely on the ingenuity, know-how and tenacity of their people. Hedge funds, private equity firms, real estate firms, investment banks and traditional fund management firms all vie for the best alternative investment exponents to satisfy the high expectations of their clients.

Alternative investment professionals are well aware of the contest for their services: they are remunerated handsomely, receive regular inquiries from executive search firms and can measure their value through their P&L. For a number of years, they have been leaving investment banks and traditional asset managers to launch or join alternative investment firms where the environment is seen as more entrepreneurial and where their personal contribution is directly recognised and rewarded. While this outflow has slowed recently, the trend still persists.

But the larger financial services institutions are fighting back, devising structures and strategies to attract and retain talent. At the same time, rapid growth in the allocation to alternative assets is forcing boutique firms to examine their organisational structures and seek to create a framework that encourages their best people to stay rather than defect to competitors.

The boutiques still have some way to go. While financial reward is paramount in the alternatives industry, there is evidence of deficiencies in how the issue is addressed. In the 2008 PricewaterhouseCoopers¹ report 'Transparency versus returns: the institutional investor view of alternative assets', fewer than one in ten alternative investment firms signal performance management as a critical human resources issue. It seems alternative investment firms view themselves differently from other employers. In volatile times, more than ever, they need to refine their thinking and structures to retain their principal asset: people.

This paper, the third in a series focusing on talent management within the financial services industry, is drawn from PricewaterhouseCoopers' global experience of the alternatives sector and proprietary research.

¹ PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Alternative talent at risk – the issues

- **Loss of talent to boutique and entrepreneurial environments:** Banks, insurers and institutional asset managers struggle to hold on to talented individuals. These individuals may already be managing alternative investments but seeking greater autonomy, or managing assets based on traditional benchmarks and seeking to test themselves using alternatives strategies. The loss of such individuals is damaging for the reputation of the firm and expensive in terms of hiring replacement talent.
- **Growing pains as boutiques go mainstream:** The most successful boutiques grow rapidly, creating great wealth for the founders. Yet expansion brings challenges, such as finding talented people to sustain the growth. One solution is via mergers, but buying whole businesses brings its own problems and, in practice, rarely occurs among alternatives firms.
- **War for talent spreads to the mid and back office:** Institutional investors seek evidence of control over systems and processes. Their greatest fear is investing in a fund vehicle that provides excellent risk-adjusted returns only for it to fail for operational reasons. Therefore, accounting, compliance, IT and process skills are in great demand and are increasingly hard to find and retain.
- **Lack of succession planning can harm the brand:** Some well-known boutique funds have thrived for 20-plus years and their founders may be considering retirement or a financial sale. But many firms are not ready for life without their prime movers and investors are starting to worry about how their assets will be managed beyond the short term.
- **Difficulty retaining people in hard times:** Volatility in financial markets has left some funds with no short-term prospect of clearing high-water marks and earning carry or incentive fees. Uncertainty in the market and wide volatility in returns means they can face a battle to keep their best people. The short-term nature of compensation – widely accepted by fund managers and investors – is now proving a double-edged sword.
- **Failure to reposition for a new environment:** Many firms are wondering if they have the right skills for the changed economic circumstances. Financial engineers may have been successful in the cheap credit era, but are their skills as useful now? A surfeit of outdated skills could lead to underperformance and the consequent loss of investor confidence in funds.

Alternative talent at risk – tackling the issues

Risk: Loss of talent to boutique and entrepreneurial environments

The outflow of talent to alternative investment firms was endemic in the early part of the decade and risked damaging the business model of banks and traditional asset managers. Some of this human capital is flowing back – often through acquisitions or strategic stakes – to the larger managers, which can offer greater support and stability than a boutique. The acquired talent requires nurturing. Those institutions that have successfully brought back talent are those that have re-engineered their human resources structures and processes, taking a fresh look at the critical issues. We have identified a number of good practice areas:

- **Satisfying the demands of the very best requires an understanding of what motivates them.** Independence, control, self-validation and reward. The evidence is that offering ever higher rewards will probably not suffice and risks creating an upwards spiral in compensation costs.
- **Firms need to be clearer about the employment proposition to their staff.** This should be in much the same way as they would present a product or service ‘proposition’ to clients.
- **Treating people differently can be a good thing.** We encourage employee differentiation, individual metrics and bespoke compensation.
- **Implement coherent HR policies.** Investment firms tend to carry out performance and value assessments but then fail to translate them into appropriate compensation programmes. Retention of talent requires both parts of the equation.
- **Create new platforms where appropriate.** Talented individuals often prefer to work semi-autonomously. Oversight and accountability must be balanced against the freedom desired by the management team of any new spin-off entity.

Risk: Growing pains as boutiques go mainstream

Alternative investment providers can grow extremely rapidly. But growth is not sustainable without hiring investment and distribution professionals of sufficient quality. Increased assets also behave the investment firm to cease operating as a collection of individuals and create a truly corporate structure. 'Transparency versus returns: the institutional investor view of alternative assets' found that performance management and training and development are considered the least important HR issues. Yet there is compelling evidence from those organisations that these issues are critical in retaining promising staff who can drive the business forward in years to come. Successful strategies include:

- **Team lift-outs and key individual hires.** These are usually more viable than full-scale acquisitions, even if it takes longer to build out the offering. M&A is notoriously difficult in financial services and even tougher in the alternatives industry given the potential for cultural disharmony and friction between creative individuals.
- **Talented individuals can be attracted and retained using innovative compensation structures.** This includes bonus deferral, performance fee/revenue sharing arrangements, and, increasingly, management fee sharing.
- **The lure of equity.** Equity offers long-term rewards and a say in how a firm is run. It can be offered at group level or in a subsidiary, franchise, fund or business unit. There is an increasing trend to create special classes of shares providing associated tax and accounting benefits, and a mechanism for realising value.
- **In terms of motivating and incentivising staff as a whole, more alternative investment firms need to develop a formal human resources function.** Few currently do so – the transition from start-up to a corporate mentality seemingly takes time.

Risk: War for talent in the middle and back office

The credentials of the back office are a key differentiator from the viewpoint of institutional investors. The pressure on alternative investment firms to raise their game is clear if they want to run institutional money – to date, investment in the middle and back offices has lagged. In ‘Transparency versus returns: the institutional investor view of alternative assets’, the majority of investment firms believed they were adept at managing many aspects of risk including the accounting and reporting of transactions, information technology (IT) security and dealing with conflicts of interest. Yet a far smaller proportion of investors agreed that this was the case. Alternative investment firms need to raise their game and consider the following measures:

- **Build out capability within these critical functions.**

Investors increasingly demand evidence that private equity, real estate and hedge fund firms employ chief operating officers, chief financial officers, compliance officers and risk executives. Firms with ambitions to gather institutional assets will need to comply.

- **Hire the best middle and back-office talent you can find.** Credentials are important, and the best individuals will also help to create structures that reduce risk firm-wide and optimise processes.
- **Create compensation models appropriate to the role.** Demand for middle and back office executives is high, with administrators and custodian banks competing aggressively alongside alternative investment firms for them. To attract and retain the best people, alternative investment firms should recognise the importance of the roles and reward them in similar ways to the front office. That could involve creating a bespoke bonus structure and long-term incentives so senior back office executives share in the success of the firm.

Risk: Lack of succession planning can harm the brand

Succession planning is effectively about managing risk: The risk that a founder retires or becomes ill, or dies; the risk that a key individual decides to leave the organisation to pursue their career elsewhere or independently. These events can affect an alternative investment firm's reputation profoundly. Clients and shareholders increasingly demand well-conceived succession plans:

- **The execution of scenario planning needs to include an HR aspect.** Many alternative investment firms stress-test portfolios and business performance against a range of economic and market-specific variables. They need to extend this to managing their talent.
- **Mitigating key-individual risk.** Long-term reward arrangements can be successful but can be circumvented if individuals wish to buy themselves out of a contract. Creating a team-based culture should help ensure that a replacement is at hand in the case of a sudden and unforeseen departure.
- **Long-serving founders should make time to consider succession issues and then discuss them with senior colleagues and external advisers.** It is important that succession plans are drawn up many years before a handover so that potential successors can be prepared for greater responsibility.
- **Founders must be encouraged to loosen the reins.** Many handovers involve the promotion of long-serving individuals. But talented individuals often need to be incentivised to remain patient and the founders may need to distribute equity to them years beforehand to keep them *in situ*.

Risk: Difficulty retaining people in hard times

The short-term performance targets and incentives employed by many firms contribute to a significant amount of discontentment in a poor investment environment. A single bad year could result in an exodus of individuals. Does this structure entirely make sense? It can certainly make sense to individuals in a great year, but it does not necessarily align managers with investors' long-term aspirations and it does not necessarily foster the long-term growth of a firm. We have identified a different set of approaches to help retain talent and grow the business over the long term:

- **Staff should be encouraged to invest in their firms.**
In 'Transparency versus returns: the institutional investor view of alternative assets', 50% of firms said they compelled employees to invest part of their annual bonus in funds. This proportion should probably be higher still.
- **Instigate, where appropriate, two- to three-year rolling incentive programmes.** These provide incentives for individuals to stay even in troubled years and also ensure managers are not over-compensated on the strength of a single good year. This can be hard to implement: but change is easier in difficult markets, especially in the absence of short-term bonuses.
- **Alternative investment firms might examine their whole *modus operandi* in the light of the market turmoil.** If their strategy revolves around chasing short-term returns, they are likely to lose a part of their franchise – clients and staff – if short-term results disappoint. Now may be the time to develop a longer-term business and investment strategy.

Risk: Failure to reposition for a new environment

A sustained period of cheap credit and high returns from equity markets created demand for a certain range of skills. In the private equity environment, financial engineers have been greatly sought after for their knowledge of the capital markets, banking contacts and ability to structure deals. In the hedge fund space, some firms have attempted to capture beta (or indexed returns) and have hired expertise – sometimes from the traditional asset management sector – that allows them to do this most efficiently. However, the changed debt and equity environment over the past 12 months should lead to a reappraisal:

- **Set new objectives for the business in the light of the changed economic circumstances.** These objectives could be based on revised return expectations, a shift in the client base or the performance of certain asset classes.
- **Rigorously reassess your talent.** Do the alpha producers of the past three years have the right skill sets for the next three? This can be difficult for firms to do – after all, these individuals may have created significant value. But last year's returns will not generate this year's performance fees.
- **Set compensation targets that reflect the changing circumstances and the kind of new talent acquired.** Performance and compensation structures may need to be adjusted to take into account new types of skills within the firm and the types of assets managed. One size does not fit all.

How can we help?

The whole alternative investment proposition is based on talented individuals. But talent can only express itself and enhance the business if it is nurtured within a strong framework. The financial services human resources team at PricewaterhouseCoopers can help alternative investment firms to identify talent management issues and prioritise them from a business-critical perspective.

We help companies align their people and business strategies more effectively, using a proprietary methodology. This focuses on recognising organisational requirements before building up a talent identification process.

The talent identification process dovetails with our performance management programme, which weighs performance against

potential and helps to create an optimised compensation path (See Differentiation of Employee Talent matrix on page 12).

Alternative investment talent specialists at PricewaterhouseCoopers can also help put in place effective succession planning to mitigate the risk of the loss of key individuals at management, front office, mid office or back office level.

Solutions for Attracting, Retaining and Incentivising

Differentiation of employee talent

Value	High value/Under performing Low levels of cash bonus Significant retention or long-term incentive awards High total compensation relative to peers but low in cash terms	High value/Strong performing High levels of cash bonus Significant retention or long-term incentive awards Significant total compensation compared to peers
	Low value/Under performing Low levels of cash bonus Zero retention or long-term incentive awards Low total compensation relative to peers but low in cash terms Exit from business?	Low value/Strong performing High levels of cash bonus Small zero retention or long-term incentive awards Moderate total compensation relative to peers but significant in cash terms
		Performance

Source: PricewaterhouseCoopers

If you would like to discuss any aspect of the issues raised in this paper, please speak to your usual contact at PricewaterhouseCoopers or one of the specialists listed below.

Contacts

Ron Collard

Partner – Global FS, Human Resource Services, Leader
PricewaterhouseCoopers (UK)
44 20 7213 4499
ron.p.collard@uk.pwc.com

Pars Purewal

Partner – UK Investment Management and Alternatives Leader
PricewaterhouseCoopers (UK)
44 20 7212 4738
pars.s.purewal@uk.pwc.com

Christopher Box

Director – FS Human Resource Services
PricewaterhouseCoopers (UK)
44 20 7804 4957
christopher.box@uk.pwc.com

Mark J. Casella

Partner – Alternative Investment Funds Practice Leader
PricewaterhouseCoopers (US)
1 646 471 2500
mark.j.casella@us.pwc.com

Robert Grome

Partner – Asia Pacific Investment Management
Industry Group Leader
PricewaterhouseCoopers (Hong Kong)
852 2289 1133
robert.grome@hk.pwc.com

Robert Mellor

Partner – UK FS Tax Markets Leader
PricewaterhouseCoopers (UK)
44 20 7804 1385
robert.mellor@uk.pwc.com

Graham Phillips

Partner – European Hedge Fund Practice Leader
PricewaterhouseCoopers (UK)
44 20 7213 1719
graham.p.phillips@uk.pwc.com

Marc Saluzzi

Partner – Global Investment Management and
Real Estate Industry Leader
PricewaterhouseCoopers (Luxembourg)
352 49 48 48 2511
marc.saluzzi@lu.pwc.com

William Taggart, Jr.

Partner – Investment Management and Real Estate
Practice Tax Leader
PricewaterhouseCoopers (US)
1 646 471 2780
william.taggart@us.pwc.com

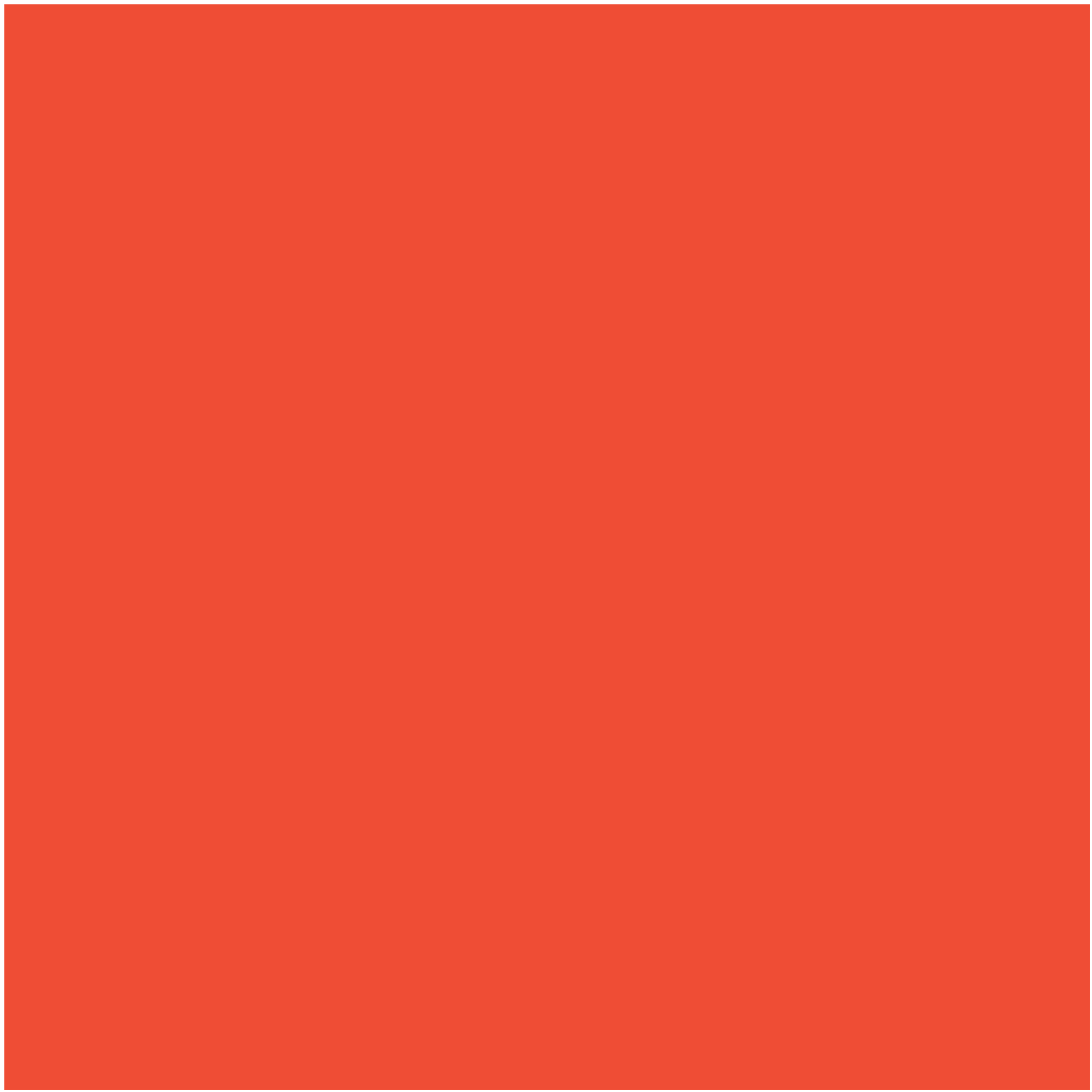
The member firms of the PricewaterhouseCoopers network provide industry-focused assurance, tax and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 146,000 people in 150 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

This paper is produced by experts in their particular field at PricewaterhouseCoopers, to review important issues affecting the financial services industry. It has been prepared for general guidance on matters of interest only, and is not intended to provide specific advice on any matter, nor is it intended to be comprehensive. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers firms do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

If specific advice is required, or if you wish to receive further information on any matters referred to in this paper, please speak with your usual contact at PricewaterhouseCoopers or those listed in this publication.

For more information on the PricewaterhouseCoopers Global Financial Services Human Capital programme, please contact Áine Bryn, Marketing Director, Global Financial Services, on 44 20 7212 8839 or at aine.bryn@uk.pwc.com

For additional copies, please contact Maya Bhatti at PricewaterhouseCoopers (UK) on 44 20 7213 2302 or at maya.bhatti@uk.pwc.com



pwc.com

© 2008 PricewaterhouseCoopers. All rights reserved. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Designed by studioec4 19355 (05/08)