Brookvine Pty Limited

Selling by not Selling

Jack Gray

January 2009

specialists in alternative investments

Brookvine Pty Limited
ABN 53 098 072 390
Australian Financial Services Licence No. 246450

Introduction*

Successful selling to the institutional investment market requires almost Tao-like contradictory characteristics of patience *and* impatience, empathy *and* persistence, integrity *and* commerciality, discipline *and* opportunism. Their confluence describes the complex art of selling by not (explicitly) selling.

This paper synthesises experiences and reflections on selling from both sides, as a manager and somewhat earlier as a fund CIO.

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*Throughout, A, B, ..., Q, are actual managers, slightly disguised.

Jack Gray is also at the Paul Woolley Centre for Capital Market Dysfunctionality, University of Technology Sydney.

Impatient Patience

And it came to pass that for two reasons selling to institutional investors is slow.

First, managers are selling an *uncertain, intangible service* in a *compliance-driven*, *public* environment through *layers* of *agents*, where each italicised word is a cause of friction and delay. *Uncertainty* exposes buyers to the risk of underperformance. *Intangibility* of investment strategies means they can't be touched or tested unlike concrete products. *Layers* mean many eyes (CIO and staff, CEO, Board, Investment Committee, Consultants, ...) must see if not approve transactions. A *compliance-driven* culture causes delays on non-investment issues. A *public* environment entails added aversion to headline risk. *Agents* create misalignments and an emphasis on the shorter-term.

Second, more often than not initial filters have equalised all 'hard' explicit selection criteria such as investment process, performance, attribution, fees, and risk-management. Moreover, decisions are usually made well after direct contact with managers when memory of investment technicalities has faded. All that remains, Cheshire-cat-like, are *impressions*. Successful sellers create lasting impressions through crafting a *narrative* with interacting themes, anecdotes and analysis. They tell a rich story that via association reinforces both investment smarts and the softer attributes of integrity, trust and empathy. But far greater time is needed to recognise, and correctly value 'soft' implicit criteria such as trust.

> *"Successful sellers are patient and persistent. The former without the latter fails; the latter without the former irritates."*

Acceptance of long lead times is reflected in sellers' ability to be patient *and* persistent. Patience without persistence fails. The collective terror of persistence is necessary because CIOs are inundated by other managers. Those who don't squeak risk being overlooked. Persistence without patience irritates. As CIO I was faced with two managers *A* and *B* that were indistinguishable on all hard analytic criteria and were equally persistent. *A* irritated by being un-empathetic to the pressures I faced. *B* was empathetic and eventually won the mandate.

Empathy

Empathy means being in the prospect's shoes, heart and mind. Empathy allows a manager to connect, to engage, and hence to be front of mind. Effective sales people, like effective teachers find the *right* way to engage at the client's level of understanding. Global bond Manager *C* began at a high level and repeatedly remained at that level in spite of my evident and explicit failure to understand. *C* failed to engage and failed to win a mandate. Although I had minimal interest in specific stock holdings, equity Manager *D* spoke of them incessantly and ignored my interest in overall portfolio structures. *D's* excessively detailed reports exposed a lack of empathy to different client interests and levels of understanding. In pitching for a mandate Manager *E* was so enamoured with explaining clever process technicalities to the Trustee Board she missed a clear buying signal from the Chair, relentlessly elaborated on and almost lost the business that was hers for the asking.

Empathy is especially needed after losing or being fired because subsequent behaviour informs clients about the firm's integrity. Private equity Manager *F* showed great interest in my fund's needs, asked my advice on structuring his fund and fees, until he lost. I didn't hear from *F* again. Empathy in the face of loss can pay because sometimes the potential client has decided to appoint the manager next time. This was the case with Manager *G* who lost twice. Before I could tell him, *G* bluntly informed me it had never lost twice before, the inference being that our process was inadequate.

> *"Empathy for clients entails neither weakness nor lack of commerciality."*

Empathy entails neither weakness nor lack of commerciality. Firmness in fee and other negotiations is respected if based on ethical investment and business principles. Good clients expect their managers to be forceful and persistent and to disagree with them[*].

[*]Clients too should have empathy for their managers. I failed with Manager *H* who believed I had promised him a mandate. I hadn't, but I did mislead him by misusing the power I had over a start-up. Nonetheless, *H's* reaction was arrogant and inappropriate. Had *H* been more empathetic and aware of my vulnerability he might still have won through a delicate application of guilt.

Trust

Empathy inculcates trust, the cornerstone of all investing. Necessarily trust develops slowly through an understanding of the manager's culture, people and values; through meaningful relationships that allow clients to observe and assess the manager and its people especially during difficult times. Trust allows clients to overcome their healthy scepticism and make the leap of faith to commit. And the hurdles for that leap are high. Clients have to trust the manager's ability, trust the process is well developed and executed, trust the manager will share quality information, trust the fee structure is fair and won't be gamed, and trust the manager will stay for the longer-term.

"Trust allows clients to overcome their healthy scepticism and make the leap of faith to commit."

Trust can be enhanced or undermined by acts of commission. As growth fell from favour deep growth Manager *J* became increasingly value-based. Its attempts to cover up under the guise of 'Growth at A Reasonable Price' or GARP, more than the change itself, undermined trust and almost destroyed its business. Manager *K's* representative enhanced trust by not only not recommending his firm's second-rate credit strategy, but by recommending a competitors'.

Trust can also be enhanced or undermined by acts of omission. It is enhanced by not promoting inappropriate strategies; by having the courage and humility to await a better opportunity. 'Inappropriate' includes most so-called 'bespoke solutions'. Although clients *want* to believe their fund is special, aside from a small number of key factors such as maturity for DB funds, most differ only marginally from each other. Manager *L* insisted his hedge fund strategy had been tailored just for my fund, a lie exposed by checking with one of *L's* clients.

'Inappropriate' also includes second-rate strategies. Even if a manager believes his strategy to be first-rate, for three reasons clients might know better. First, they too work in imperfect organizations that generate imperfect products and services. Second, talking to other clients, consultants and managers generates indirect experiences of a manager's offering. (Manager *M* irritatingly continued to push a proposal when he knew from my talking to other clients that I believed *M* lacked sufficient skill to manage OTC derivatives.) Third, clients see many similar strategies *all* claiming to be first-rate, and have probably formed a reasonable view as to which do deserve that accolade. Occasionally informational asymmetry does favour clients. I expressed strong concern to existing equity Manager *N* about its risk management. *N's* response was denial and heavy schmoozing followed by a blatant attempt to curry influence by inserting a quant into the equity team. The tactic backfired

Trust

as I knew the quant's interests and abilities and I became further convinced that *N* knew not what they were doing with risk management, a definite firing offence.

Because honesty is inherent in trust, managers should adhere to the Nixon Principle: Tell the truth, nothing but the truth, and tell it quickly. Because complete and total disclosure serves only to obfuscate, some information must be omitted. Therein lies a challenge because trust is quickly undermined if information the client deems to be pertinent is omitted. Truth is also highly context and person dependent. A manager's report that "we are underweight asset-backed bonds because convexity is two standard deviations below trend and swaption vega is falling" may be true but it is meaningless if the client doesn't understand. It undermines trust if the manager *knows* the client doesn't understand.

Trust is reflected in a willingness and ability to explain technicalities to intelligent non-experts in non-patronising ways. Most managers fail. To the derision of clients they generate presentations and reports that are either technically or conceptually too demanding or redolent with bland blather and abjectly devoid of insight. Smart clients ignore both.

Trust evolves from deep and meaningful relationships that take time to build and that are invariably based on an *exchange of value* well beyond mere schmoozing. Bernie Madoff expertly showed how misguided trust can be when based on schmoozing and fake empathy.

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Exchanges of Value

The *primary* exchange of value between clients and managers will always be a 'swap' of explicit certain fees for implicit uncertain performance. Savvy clients expect more. With chosen managers they develop relationships based on *secondary* exchanges that 'swap' intangibles. For instance, knowledge transfer 'swapped' for the early funding of inchoate investment strategies. To a limited extent, secondary exchanges compensate for the asymmetry of pain inherent in asset-based fees, and for the free option inherent in performance-based fees.

Secondary exchanges elevate relationships from commodity transactions to deeper, more sustainable and mutually beneficial involvement. Private equity Manager *O* listened to my negative views on commitment fees, engaged in a substantive exchange of ideas and criticisms, modified the structure, and eventually won a large mandate. By continuing the relationship at the same engaging open level, with regular exchanges of proprietary knowledge, *O* ensured greater stickiness, greater willingness to invest in new strategies, and quicker decision-making.

Strong relationships induced by secondary exchanges help managers recognise and respond to changes in clients' organisational structures, people, needs and strategies. Many refuse to accept that what was appropriate in the past may not be now. Manager *P* managed a separate account of direct properties which now made little sense, although it had some 6 years earlier. *P* fought to retain it (welcome behaviour as we all like to be loved) but failed to accept that our fund, the property market, and the structure of property vehicles had changed to the detriment of his mandate. He also failed to interpret the significance of my talking to *P*'s recently retired portfolio manager who also saw the portfolio as suboptimal. A more relationship oriented manager might have suggested a re-structuring and retained some AUM. Instead, P lost the entire mandate.

Decision-makers find firing managers difficult because typically underperformance is neither consistent, nor *very* poor, nor explicable, so rarely is there an explicit, unambiguously clear reason for firing. Reasons are often 'soft' and complex, hence the oft-told simple clean answers as to 'why' fail to capture the entire truth. More often than not the underlying reason is a hard to explain but very real loss of confidence. The stronger the relationship the closer to the truth a manager will get.

Some relationships are best maintained at a transactional level, with managers as pure commodity providers. But it is *clients* not managers who determine the nature of the relationship. Contrariwise, *Q*, a first-rate deep value manager, spurns secondary exchanges. *Q's* view is that it provides alpha and only alpha, and clients shouldn't expect more, a strategy that has held up surprisingly

Exchanges of Value

well during value wipe-outs. However, managers like *Q* that don't see the need for deeper relationships should recognise the temporal nature of their pricing and other power. As Private Equity managers are now discovering power is inherently *cyclical* because it is driven by ever-changing fashion and capacity constraints.

> *"... rarely is there an explicit unambiguously clear reason for firing ... simple answers as to why fail to capture the entire truth."*

Conclusion

Once the hard analytic aspects of a manager's investments have been approved, decision-making properly shifts to softer aspects such as communication, empathy and trust, trust regarding culture, processes, integrity, structure and people. Once trust is entrenched throughout a client's organisation, future decision-making and sales will quicken. Trust takes time to establish because it evolves through secondary relationships based on mutual empathy and exchanges of significant value. Developing strong client relationships, from which managers too can learn, are well worth the wait.

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