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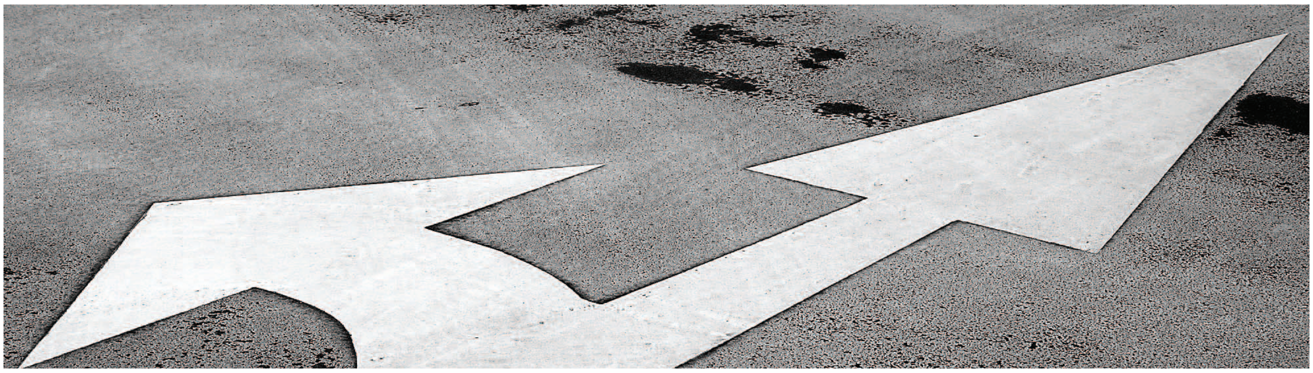

Institutional Investor Coverage: Managing Clients Across Multiple Products

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Institutional investor coverage: Managing clients across multiple products

Hedge funds are among the most complex investor clients that banks and broker-dealers serve. Within the equity asset class alone, hedge funds trade globally in cash as well as derivatives, use high-touch and electronic means, and rely on prime brokers to lend cash and securities. This breadth of activity translates into substantial revenue for the firms able to harness it, as hedge funds pay their trading counterparts almost 25 times more per dollar of assets under management than traditional managers. Competitive factors are driving traditional active asset managers to behave as hedge funds do, so institutional sales and trading managers need to develop a coverage strategy to deal with their increasing resource demands and product activity.

While trading in multiple products with broker-dealers, investors also consume their research, capital, and balance sheet, rent their execution infrastructure, and access their corporate relationships. These unique or scarce resources comprise a value proposition for each firm and, even more than the products themselves, are what binds a client to its broker. Clients pay for these resources with their discretionary trading commissions and financing accruals.

Client behavior and payments can be influenced through considered allocation of resources. Managing existing revenues alone is inadequate. Finding the opportunities to increase revenues and having the courage to invest in them are critical to growth, even when it means taking resources away from less-productive clients. Segmentation and prioritization of the entire client base allows a firm to define its value proposition and make investments in the most profitable clients as well as in those with the highest probability of increasing their payments to the firm.

Broker-dealers need an efficient organization and scalable methods to coordinate different parts of the firm, and they need to measure the profitability of each client across all products. An effective sales and trading effort coordinates the delivery of resources with a unified goal of maximizing firm-wide rather than individual product revenue.

Because of their comprehensive product and resource utilization, hedge funds are an excellent client model for developing sales strategy. Creating methods to handle such complexity enables banks and broker-dealers to cover any client, from single strategy to multi-strategy, no matter how many products it trades or resources it consumes.

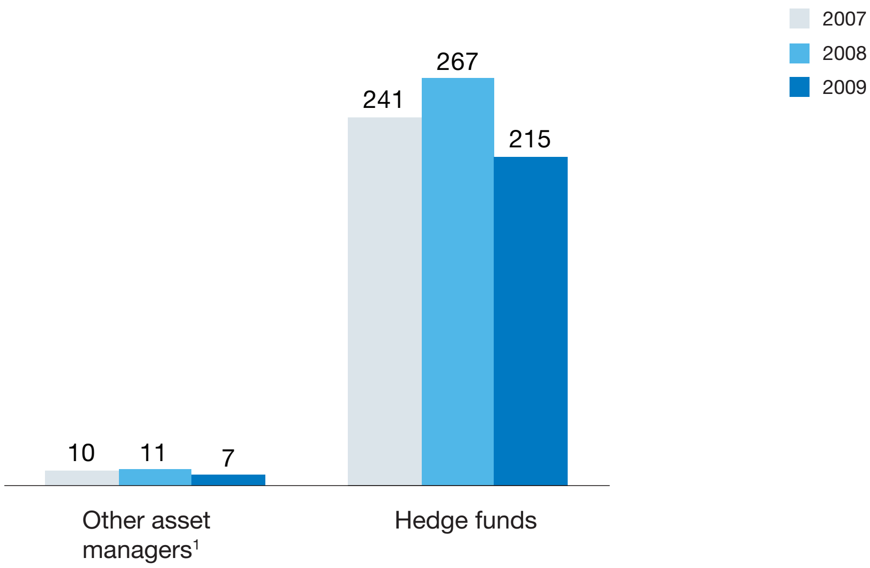
The sales management practices described in this article are broken down into the following eight steps:

1. *Developing a value proposition* (understanding what clients want and will receive in terms of resources)
2. *Protecting current revenues* (segmenting clients based on revenues)
3. *Finding new revenue opportunities* (building client plans; marketing)
4. *Investing for growth* (prioritizing clients according to their potential for incremental revenue)
5. *Measuring client profitability* (reflecting costs in the segmentation)
6. *Tuning for behaviors* (accounting for individual preferences and drivers of satisfaction)
7. *Selling as a team* (coordinating sales professionals across products and client buying centers)
8. *Managing the process* (reviewing clients, aligning resources, and creating incentives)

Understanding the Opportunity

Exhibit 1 shows revenue earned from 2007-2009 by broker-dealers from hedge funds as compared with all other asset managers, expressed as a percentage of assets under management. Despite managing fewer assets, hedge funds generated more than 24 times the revenue per asset than sovereign wealth funds, pension funds, or mutual funds. A single hedge fund may generate as much revenue for banks and broker-dealers as a mutual fund that is 96 times larger.

Exhibit 1
Capital markets revenue per assets under management



1 Includes sovereign wealth, pension, and mutual funds
Source: McKinsey, High Line Advisors

This surprising result directly relates to the number of different ways a hedge fund interacts with its brokers. Unlike traditional asset managers, hedge funds trade more frequently, use more products, and deploy leverage. We believe that institutional investors will increasingly adopt the investment techniques of hedge funds, creating the potential for additional revenues.

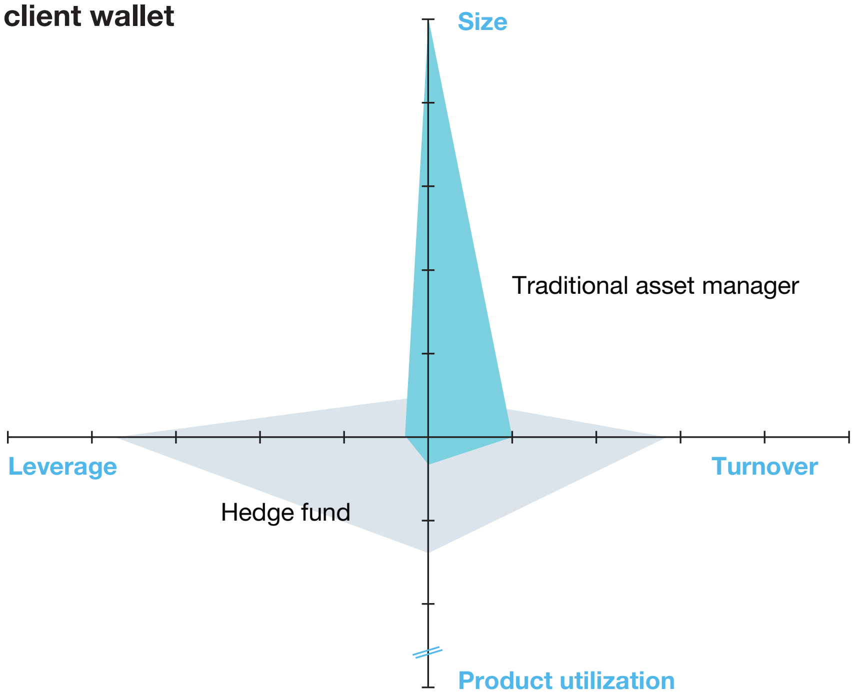
Sizing the Client's Wallet

A client's wallet is a metaphor for the amount of money paid by the client to its vendors. The size of an institutional investor's wallet is the total of all fees, spreads, and commissions that the investor pays to its broker-dealers in the process of managing its investments. Increasingly, investors are using more products, trading more actively, and offering more absolute return strategies that involve hedging. As additional client activity adds to revenue, successful brokers that can offer the convenience of "one-stop shopping" can increase share of the client's wallet.

Exhibit 2 illustrates the revenue productivity of hedge funds relative to other asset managers as a function of four characteristics:

- *Assets Under Management.* Larger clients do bigger trades but may also demand more services and resources.
- *Turnover.* Clients that trade actively generate more commissions. The average holding period for investments in mutual funds is six months, which equates to turnover twice per year. Hedge funds trade more frequently, with some statistical arbitrage and market-making strategies resulting in daily or even more frequent portfolio turnover.
- *Product Utilization.* Clients that use derivatives (futures, options, and swaps.) in addition to cash instruments generate commissions and/or pay additional spreads on the components of the instrument, such as volatility or financing.
- *Leverage.* Clients that borrow money to finance their purchases and/or borrow securities to sell short pay spreads on the resulting balances.

Exhibit 2
Investor client wallet



Source: McKinsey, High Line Advisors

Despite fewer assets under management, hedge funds make up for size in other ways that are profitable to banks and broker-dealers. For example, a larger, long-only asset manager that turns over its portfolio infrequently can have a smaller wallet than a hedge fund that trades actively, deploys derivatives, and uses leverage. In terms of client potential, size does matter; however, it's the size of the overall wallet, not simply the amount of assets under management.

Competition among brokers as well as potential for revenue growth is reflected in wallet share. A small percentage of a large client's wallet may produce the same revenues as a large percentage of a smaller client's wallet; however, the latter does not hold the same potential for growth. A planning process that uncovers each client's total product activity and ability to pay will help sales managers make better coverage decisions.

Collecting Payment for Resources

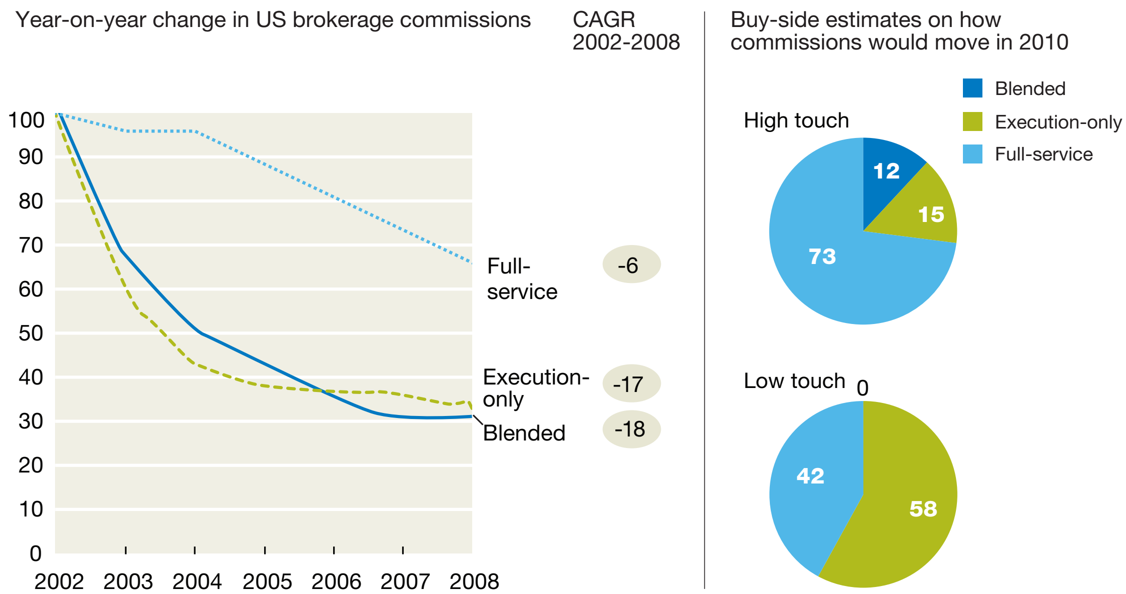
What leads clients to select a particular broker? The answer lies in commission trends: despite ever-decreasing costs of pure execution, the proportion of higher, full-service commissions has remained stable. Investors use discretionary commissions to pay for resources as well as execution. They rely on firms with the most valuable investment ideas and opportunities as well as unique intellectual and financial assets.

Exhibit 3 shows the overall decline in cash execution commissions over time, with the 6% decline in full-service or "high-touch" commissions outperforming the 17% decline in execution-only or "low-touch" commissions. The associated pie charts depict the buy-side expectation for its commission payments for 2010, with high-touch commissions holding current levels or even increasing while low-touch commissions continue to fall:

Exhibit 3

Low-touch commissions have decreased dramatically while high-touch commissions have been fairly resilient

Percent



Source: Bernstein Analysis, Tabb Group Report "Institutional Equity Brokerage 2010 (Feb 2010)"

This trend is reflected not only in historical data and client expectations, but also in surveys conducted by Greenwich Associates[1] and the FSA.[2] These studies confirm that institutional investors rely on full-service commissions as payment for resources in addition to pure execution and permitted soft-dollar expenses.

1 See U.S. Equity Trading Business Falling Short of Expectations in 2010, Greenwich Associates, June 2010

2 See Consultation Paper 176 on bundled brokerage commissions and soft dollar arrangements, Financial Services Authority, April 2003, and Use of Dealing Commission – Results of Thematic Review, Financial Services Authority, January 2008

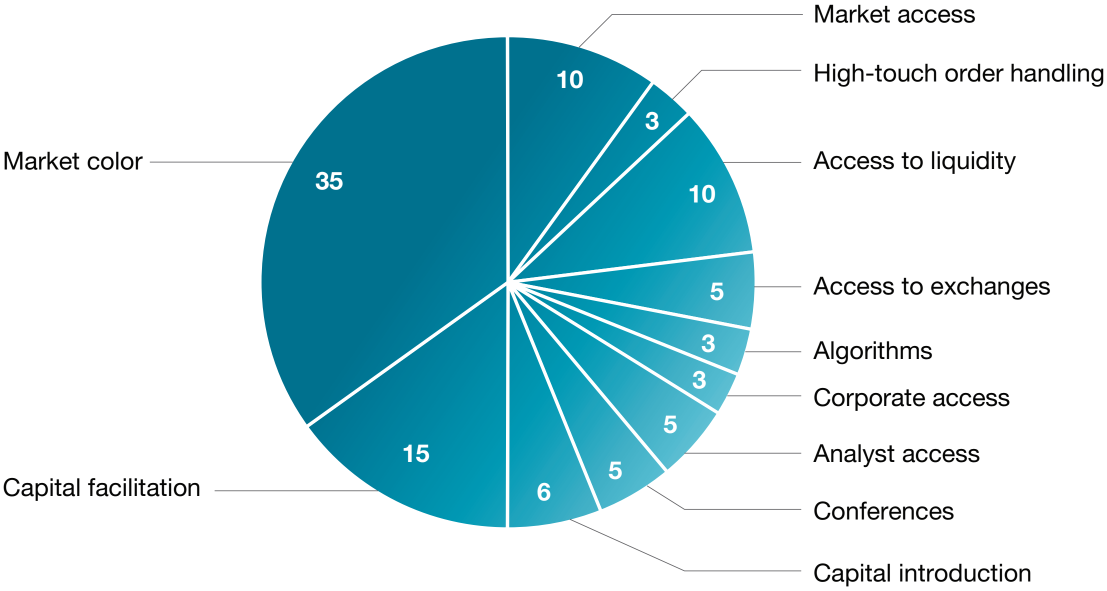
To differentiate itself from the competition, a firm must first identify the resources that clients want. Resources and the value ascribed to them will differ across the client base. A client's investment strategy may call for access to the firm's corporate clients for a fundamental investor or the fastest link to an exchange for a high-frequency trader. Regardless of strategy, there are a number of resources apart from pure execution that investors expect in exchange for their commission flow.

Exhibit 4 shows one example of how a multi-billion-dollar hedge fund with a macro investment strategy attributes its commission expenses. In the example, 19% of commissions are allocated to information resources or services, with 15% allocated to what could be considered scarce resources, including capital, foreign market access or stock loan supply, and captive liquidity.

Exhibit 4

Client attribution of execution commissions

Percent



Source: McKinsey, High Line Advisors

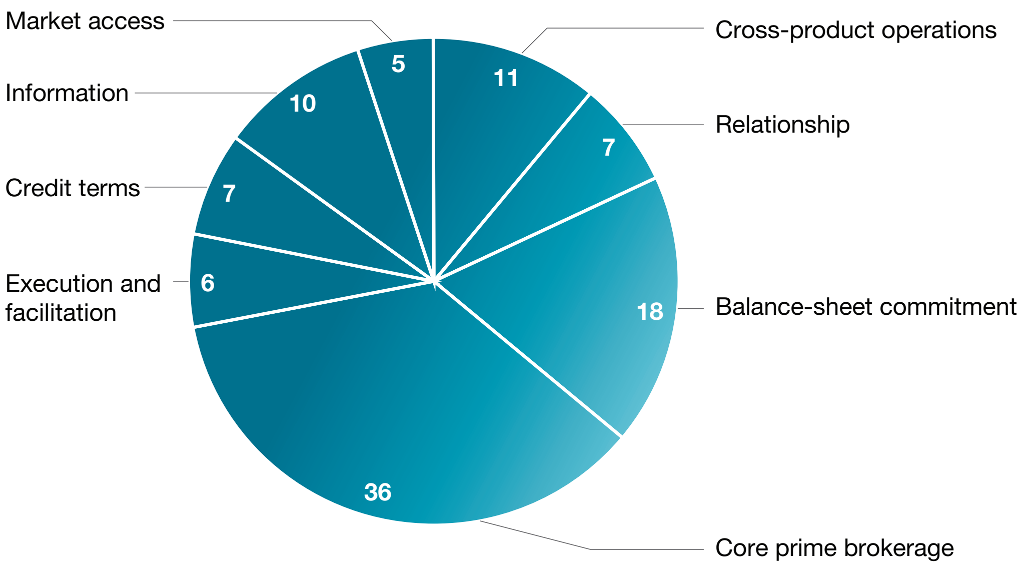
In addition to discretionary commissions, hedge funds also pay for resources with their financing accruals and clearing fees. These revenues are captured through a prime brokerage or clearing relationship and can be considerable, in some cases exceeding revenues from execution commissions. As hedge funds become aware of this fact, they are pressing their prime brokers to provide access to resources previously considered outside of the prime broker's purview.

Exhibit 5 details the resources by which one multi-strategy hedge fund evaluates its prime brokers, with less than half of the fees directly attributed to traditional prime brokerage products. This weighting suggests many opportunities for a broker to differentiate itself, starting by taking additional risk (as reflected in balance sheet, capital, or credit terms) and/or providing unique, quality information.

Exhibit 5

Client attribution of prime brokerage fees

Percent



Source: McKinsey, High Line Advisors

Risk appetite and access to information should be considered scarce resources and allocated to extract the most revenue from the clients that value them. Clients also expect their brokers to simplify trading in multiple products (requiring the broker to coordinate across organizational silos), and to give them access to senior management, which is by any definition a scarce resource.

From an understanding of the resources that clients value, firms can define a value proposition that sets them apart from the competition.

Developing a Value Proposition

The value proposition of a broker-dealer to an institutional investor is a bundle of resources that the investor relies on to meet its investment goals. In order to compete effectively, the broker-dealer's resources must be differentiated in some way, either because they are unique or superior.

For the broker, additional revenues may come from market expansion, but growth is more reliably obtained by taking client wallet share from competitors. To capture business from a competitor, the key question is: "why would the client trade with our firm instead of its current broker?" The answer differs by client and necessitates the creation of individual client account plans. As a starting point, the firm should have a broad sense how it can be uniquely valuable to its clients.

Resources are different from products or capabilities, many of which are similar from firm to firm. It is important for product-centric sales organizations to recognize that the products themselves do not necessarily comprise a value proposition to the client.

Value from a client's perspective is established by addressing a need or solving a problem. In order to compete, the broker-dealer needs to address client needs or solve its problems in a way that other broker-dealers cannot match. In a mature market, the ability to differentiate resources is the best way to take market share from one's competitors. Any bank or broker-dealer offering undifferentiated products alone will find itself competing solely on the basis of price, not only for execution but also for legal or credit terms, bringing additional risk with lower revenues. Price-cutting and risk-taking should be balanced commercially rather than included as part of a value proposition.

Increasingly, institutional investors are comparing their brokers by the total of all payments (their respective wallets) rather than by specific products. This trend is most apparent in equities businesses, where hedge funds aggregate payments to their brokers across cash, derivatives, prime brokerage, and other product areas to justify their resource demands. A successful sales strategy depends on delivering resources from anywhere they are needed and collecting payment in any potentially unrelated product area.

A firm's value proposition may shift over time and must be continuously reviewed in light of results. Assumptions regarding client needs should be refreshed through feedback studies and the account planning process.

Identifying Scarce Resources

The main differentiator of resources is scarcity. Scarcity value can be naturally occurring (a supply of hot stocks from a private client network), limited physically (the hours in a CEO's day), limited by risk-appetite (deploying capital or balance sheet), or created through excellence (access to quality investment ideas). In order to drive profitability, clients must understand that such resources are scarce: a corporate meeting has limited capacity; an analyst has limited time to speak with clients. Competition among clients for access to these resources can be used to manage client behavior and to drive profitability. Access to resources may be given to profitable clients on a priority basis. At the same time, the firm may invest its resources in clients that have the ability to pay more, or deny resources to clients that are not as profitable as they might be. Denying resources is the hardest action to take, but it can be most effective if communicated with tact and supported with accurate data on profitability.

Each firm should begin with an assessment of what is uniquely valuable and scarce. The following categories provide a starting point, and the time spent will be rewarded when the value proposition is later presented to clients:

- *Unique or valuable information:* investment ideas; macro-economic, quantitative, company-specific, or sector research; conferences and meetings; risk management, asset allocation, business consulting; tax, regulatory, or accounting solutions
- *Access to investment opportunities:* co-investment, private loans or equity, new issue calendar
- *Access to capital:* trade facilitation, market making, block purchases, distribution channels, discretionary investment capital, capital introductions, capital raising
- *Access to balance sheet:* secured loans in various forms; supply of hard-to-borrow securities
- *Access to markets:* use of local investor IDs or licenses; knowledge of related asset classes; broader product capabilities; connectivity to more markets and/or exchanges

- *Access to relationships:* management of corporate clients; influence over investment decision-makers; ability to arrange private transactions
- *Access to credit:* non-recourse financing; bridge financing; financing for term; rating as a counterpart to derivatives contracts
- *Access to services:* clearing, administration and/or custody; bespoke reporting or trade handling; client-facing technology; middle office solutions
- *Sales coverage:* assignment of the top salespeople

As an example of a broad value proposition, consider a bank with lending relationships to companies in the energy sector with a broker-dealer arm that also trades commodities, provides research, and makes markets in energy stocks and options. Such a firm differentiates itself through a deep understanding of the energy sector. Its valuable resources include: access to the bank's corporate clients, new issue supply, access to its research (including insights from the commodities markets), advice from the bank's risk managers on sector risks and their mitigation, and more reliable pricing from the bank's traders resulting from their unique insight. This package can be presented in a way that differentiates the firm and makes a strong case for more wallet share.

Tiering the Value Proposition

Finite resources must be allocated to clients according to a hierarchy, with higher-priority clients receiving resources until the resources run out. When clients are prioritized according to revenue production, the greatest resource allocation is directed at the clients in the top tier. Accordingly, the value proposition for lower-priority clients will include fewer resources or limitations on the number of times a resource may be accessed: the number of phone calls with a particular analyst per quarter; the number of meetings with corporate management per year. The type of resource interaction may also become less exclusive, tending towards group meetings or phone calls instead of one-on-one meetings.

Tiered value propositions can be used to incentivize clients to pay more. A thorough client planning process will provide a sense of a client's capacity to pay and its sensitivity to specific resources. Armed with such information, management can allocate resources proactively. If a client meets the set revenue target, it will begin or continue to receive access to the resources.

Tailoring the Value Proposition

Assigning a value proposition to a client should not be based on revenue alone. Investment style and strategy are also important. For example, access to research is generally of greatest value to fundamental investors and of little or no value to statistical arbitrageurs, regardless of their wallet. Research resources should not be reserved for the quantitative manager that would not use them and can be released to a lower-priority client. Understanding client behavior helps to refine the allocation of resources to maximize returns.

In the account planning process described later, more is learned about individual client needs and resource requirements. Before any fine-tuning can be done for an individual client, however, a framework is needed so that management can gain control over resource allocation across the entire client base. This approach leads us to segmentation. Each client segment is assigned a specific value proposition. It is a matter of choice whether to begin with the value proposition (as we have) or the segmentation; either way, once the initial segmentation and resource allocation are in place, they should be refined continuously.

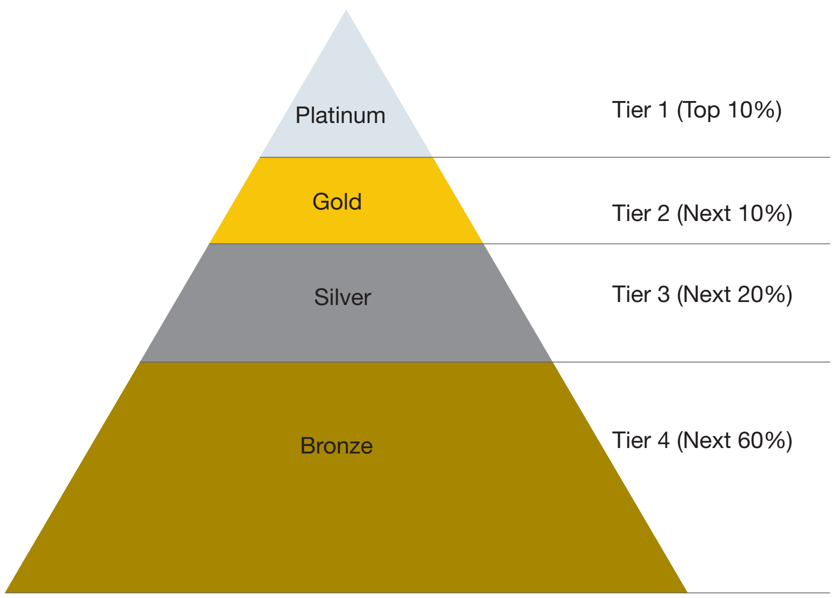
Segmenting the Client Base

Broker-dealers need economies of scale and operating leverage from their client businesses in order to grow. Covering a large number of clients is therefore an exercise in mass customization. Each client must feel well-served as to its individual needs; however, the broker-dealer must find solutions that accommodate multiple clients without increasing costs.

Segmentation is the process of sorting clients into groups with similar characteristics. By grouping clients, product and service bundles can be designed and delivered to the clients that are best served by them. Segmentation can also incorporate a hierarchy that establishes the priority or importance of the client to the business and the corresponding value proposition that the client will receive. A tiered segmentation is particularly useful when allocating scarce resources among the entire client base.

The hierarchy of metals shown in *Exhibit 6* is a useful segmentation that is easy for a sales team to remember and act on. Segmentation requires action or it is little more than a sorted list of clients. Clients must be monitored over time and promoted or demoted through the hierarchy to maximize revenues and return on invested resources.

Exhibit 6
Metallic segmentation of client base
Percent



Source: McKinsey, High Line Advisors

1st Iteration: Protecting Revenues

A good place to begin segmentation is product revenue, so that the business delivers the appropriate resources to existing clients and increases the probability that these revenue streams will continue. Segmentation by historical revenue alone is a defensive approach that protects existing revenues and may induce existing clients to pay more. Once the initial segmentation is established it can be refined into an offensive tool to help capture entirely new clients and sources of revenue.

Product Scope

The first decision is the scope of products included in the revenue analysis. The product revenues define the client universe by including all active clients that trade the respective products. Inactive and potential clients are not captured at this point but will be added in future iterations of the segmentation.

Products are the payment mechanism for clients. Ideally, all of the products used by the client should be included in the analysis to reflect the client's entire wallet. As a practical matter, the scope of the analysis is determined by management's span of influence over salespeople, products, and resources, all of which must share the common goal of maximizing client revenue to the firm. The typical scope of an institutional equity business would suggest capturing revenues in the product "buckets" shown here:

1. Cash: single stock
2. Cash: programs
3. Cash: electronic
4. Cash: new issue
5. Derivatives: convertible bonds
6. Derivatives: OTC options
7. Derivatives: listed options
8. Derivatives: ETFs
9. Derivatives: structured notes
10. Derivatives: futures (execution)
11. Financing: prime brokerage (margin, clearing, stock loan)
12. Financing: OTC total return swaps (other delta-one)

Too much granularity in product definitions can diminish the effectiveness of the analysis.[3] However, it can be useful to distinguish product revenue by currency (to see behavior across regions), to break down electronic execution to include derivatives, and to separate clearing from margin and stock lending (particularly for listed derivatives). The marketing value of this information emerges once the team begins to analyze client behaviors.

Revenue Reporting

For each product it is useful to collect client-level revenue for the prior full-year and for the current year-to-date, which may be annualized for comparison. Trailing 12-month revenue may be a more recent full-year measure, but discrete timeframes like calendar years are helpful for observing trends. If capital facilitation in cash or derivatives trading is included in the client value proposition, it is helpful to report top line revenues as well as net revenues after losses from client positions.

3 At this stage is more useful to know that a client trades OTC total return swaps (it implies the client has an ISDA agreement and relevant accounts open) than it is to know the type of swap or how swaps are used in the portfolio. Additional detail is useful for identifying new trading opportunities with existing or potential clients and is left to the marketing team as described later.

The report of product revenues by client can reflect all of this data as changes in revenue over time. For example, client revenues in a specific product that have declined more than 5% from the prior year may be shown in red, while clients showing a run rate greater than 5% higher than the prior year may be shown in green. A single report that reflects absolute revenues as well as trends leads to more efficient review of how clients are responding to their respective resource allocation.

The report of product revenues by client is sometimes referred to as a "product walk-across," as in walking across the firm's products to see a full picture of a client's activity. Designed to drive the segmentation and resource allocation processes, the report of product revenue by client is a powerful management tool for reviewing different groups of clients. For example, the report may be used to analyze clients of a certain type or strategy; clients in a particular geographic region; clients assigned to a specific salesperson; or clients targeted by a specific product group. This report, run against different groups of clients, is the single most important tool for managing a sales force. For the initial cut at segmentation, all clients with revenue attribution are included.

The "80-20 Rule"

In the pool of over 1,500 institutional investors in the U.S., most full-service banks or broker-dealers earn 80% of their top line revenue from approximately 20% of the largest hedge funds and traditional asset managers, or a total of approximately 300 clients – a manageable number for periodic, meaningful review. The tail can be very long, consisting of over 1,200 clients that must be continually mined for investment prospects. A key decision remains whether to ignore the rest or find a "no-touch" service model, relying on technology rather than humans for service, and allocating only resources that are scalable rather than scarce. A low-cost coverage strategy for smaller clients can provide early access to fast-growing clients and has little impact when clients fail.

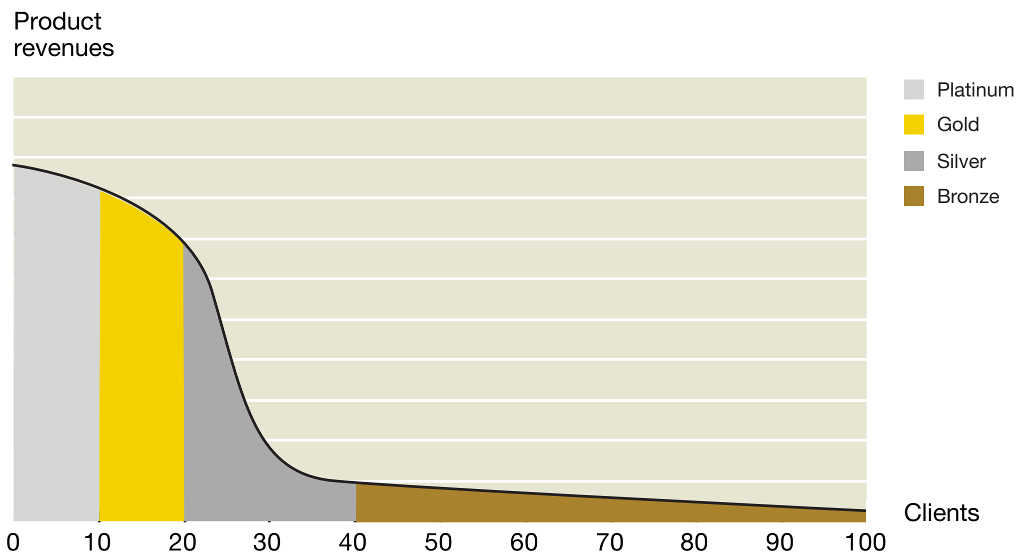
For a large, full-service institutional Americas equity business, this framework could result in the following segmentation (illustrated in *Exhibit 7*):

- Platinum: the top ten percent of clients, generally "house" accounts, often paying in multiple products or paying so much in one product that they are entitled to firm-wide resources (annual revenues > $10mm)
- Gold: the next ten percent (11th-20th revenue percentile) of clients ($2mm < revenues < $10mm), representing nearly 80% of total revenues for the product universe
- Silver: the next twenty percent of accounts (21st-30th revenue percentile), which may be smaller accounts or those trading in fewer products ($500m < revenues < $2mm)
- Bronze: all remaining clients, often receiving no resources or coverage from scalable "one-touch" or "no-touch" platforms and allocation of scalable rather than scarce resources

The next step in deploying client segmentation is to assign the correct value proposition to each segment. The value proposition is an investment in the client made in the expectation that the client will respond favorably. In some cases, maintaining current revenue is an acceptable outcome; however, growth in the business is dependent upon clients responding with additional revenue.

This first iteration – client segmentation and resource allocation based on historical revenues – does not reflect new or incremental sources of revenue. The grouping is then refined by assessing two additional factors: the client's ability to pay and the factors that influence its behavior. This data is used to enrich the process and drive revenue growth.

Exhibit 7
Client segmentation by total product revenue using metallic tiers
Percent



Source: McKinsey, High Line Advisors

Finding New Revenue Opportunities

Existing client revenues may be sustained or even increased in a bull market, but a firm stands a better chance of achieving growth even in bear markets if planning is deliberate and focuses on specific opportunities. New revenue opportunities are found through direct client feedback and some basic marketing, which together form the basis of individual client or account plans. Even a minimum amount of the right data can have a significant impact on revenue.

Developing Client Plans

Basic but useful client plans consist of three items: an organization chart of the client at the fund level, a budget showing revenue expectation at the product level, and one or more action items required to achieve the budget. Sales management can provide a template for this information to facilitate subsequent client comparisons.

At a minimum, the organization chart for an institutional investor should indicate:

1. *Assets under management* (using size as a rough proxy for revenue potential)
2. *Allocation of assets among various investment strategies* (using strategy as an indicator of product and resource needs)
3. *Decision-makers for each strategy* (individuals to target for relationship building and preference gathering)

It is best to ask the client directly rather than to rely on assumptions that may be incorrect or incomplete. A map of the client organization can expose any misconceptions regarding its investment activity and uncover new revenue opportunities. For example, a convertible bond salesperson may not register that the client also has a distressed equity fund until the salesperson is asked to map the entire client organization. From the investment strategies used by the client, one can compile a list of products that the client is likely to employ. Existing sales relationships in one product can provide the introductions needed to open up new trading lines. Simply “connecting the dots” in this way does not require elaborate planning and can yield immediate results.

The next step is to identify potential for revenue improvement. A detailed knowledge of a client’s wallet is not necessary to manage a successful sales effort. Instead, only a few key pieces of information are needed, and these may be readily extracted from the clients themselves:

1. *What is the firm’s rank with the client?* For each product the client trades (i.e., single stock cash), where does the client currently rank the firm? #1? Top 3? Top 5? First tier? Second tier? Allow the client to define the way it ranks its brokers.

2. *Is it possible for the firm to do better?* (Can it move up in the client’s ranking?)

3. *If so, what would be required?* Ask the client what actions or resources are needed for the firm to move up. Senior management attention? More outgoing calls from analysts? Changing sales coverage? Raising capital? These answers become the action items.

4. *How much more business would the client direct to the firm as a result?* Ask the client to estimate the incremental revenue opportunity to the firm if the actions are taken, and in which products the revenue would be recognized. The sum of historical revenues plus these incremental amounts becomes the client budget.

The questions should be posed by salespeople or independent persons who are not personally affected by critical feedback. It is in the interest of the client to answer these questions, because the firm is seeking to improve the relationship. Once the feedback is provided, an implicit contract is created between the client and the firm that if requirements are met, revenues will follow. It is equally important to find out if the client intends to reduce product trading or is not interested in expanded services.

When combined with historical revenues, the answers to these questions comprise a business plan for the client: prior revenues (reflected in the initial segmentation) may be adjusted by the amounts indicated by the client as potential increases or expected decreases. The plan must also document the actions or resources needed to achieve the budget. Clients with greater potential for increased revenues may reach a higher tier in the next iteration of client segmentation than suggested by their historical revenues alone.

Marketing Products and Solutions

While the interview process seeks to uncover opportunities from a client perspective, a product-driven process can yield additional results. Each product area should have its own view of the client base that covers existing clients as well as prospects. The priorities of the product areas can be represented in the segmentation discussion. A two-pronged analysis that covers the market from both client and product perspectives leads to a more thorough capture of opportunities. The matrix approach also improves governance, which is discussed later.

The “product walk-across” report is very powerful for introducing a client to additional products. Some opportunities are suggested by gaps in expected trading patterns. For example, hedge funds that trade ETFs may be candidates to trade index swaps; clients that trade cash and options in the U.S. but cash only in Europe are candidates to trade European options; clients that trade cash electronically may also be candidates to trade options the same way; macro investors that trade futures may be candidates to trade ETFs. Products that are similar or interchangeable may be new to the client or simply traded with another broker.

Product marketing is a process of identifying target clients and managing a concerted effort or “campaign” to introduce the targets to the product. Product marketers can identify candidates from gaps in the multi-product revenue report. They can also draw from anecdotal market information and industry surveys that highlight clients known to trade in specific products with other brokers.

Clients are more likely to try a new product if it solves a problem for them. The product on its own merits may be undifferentiated, but the broker can add value by identifying an application for the product in the client’s portfolio. Solutions-based marketing creates “demand-pull,” which can be superior to “product-push” in stimulating or accelerating product utilization. Clients are also more likely to take a meeting on portfolio themes than product presentations. Common thematic campaigns include risk management and hedging, emerging markets access, and tax efficiency.

The opportunities uncovered though product marketing can be cross-referenced and added to the client plans. The product-driven effort may reinforce findings from client interviews but should also find potential opportunities that the client itself may not have recognized. The effort can also identify clients that are not otherwise covered by the firm’s salespeople.

Refining the Segmentation

In addition to a better understanding of the client’s organization, the account plans should reflect a) the revenue history, b) a projection of future revenue, and c) a list of client demands that, if met, will be rewarded with the revenues. The individual client plans can be aggregated into a budget for the client business overall as well as for each product line. The “bottom up” process of client planning not only results in an estimate of revenue, but also affords an explanation and attribution of the change.

2nd Iteration: Investing for Growth

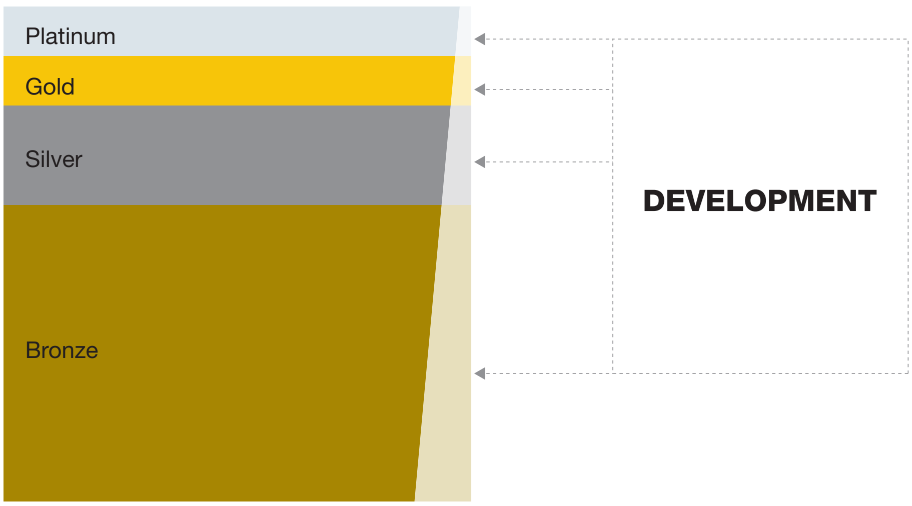
The initial pass at client segmentation is based on actual, historical revenue. It must now be revised to include revenue projections, identifying clients with the greatest potential revenue so that they may be given the necessary resources. Assignment to a tier of the segmentation implies that the client will receive the value proposition associated with that tier. Instead of thinking of the value proposition only as something that clients pay for, the value proposition may also be thought of as an investment made by the firm in clients that can and will pay more if properly served.

There are two ways to incorporate growth opportunities along with current revenues in the client segmentation:

1. Sort clients based on budget instead of actual revenue. Applying the metallic segments to the resulting list results in higher value resources being assigned to the clients with the greatest expected revenue. With value propositions linked to metallic tiers, the standard resource allocation may or may not address the needs that were identified during the client planning process and therefore may not attract additional revenue without further adjustment.

2. Continue to sort clients based on actual revenue and introduce an additional segment, called “development,” for clients with the most potential for increased revenue. The designation shown in*Exhibit 8* allows management to modify the value proposition the client would otherwise receive by investing specific resources identified in the account plan.

Exhibit 8
Development approach to client segmentation



Source: McKinsey, High Line Advisors

While the second approach stretches the metallic metaphor, it is the more common: experience shows that sales and trading groups are more comfortable working with actual revenues, at least until confidence in the budget process is raised. Note that clients may be tagged for development in any metallic tier.

Regardless of the approach, the client plan must be reviewed and the value proposition tailored to the client to raise the probability of success. At this point, review of client plans will reveal whether the client can be influenced by resource allocation and whether the needs identified by the salesperson (raising capital or financing illiquid assets) can reasonably be met. Clients that do not fit the firm's resources should be de-emphasized in the segmentation, no matter how large their potential.

3rd Iteration: Measuring Client Profitability

Because resources are limited, not every client will get what it requests. Putting a dollar value on resources and measuring the costs associated with covering the client provides a measure of the client's profitability and creates a tool for optimizing return on resources.

Profitability is ideally measured by revenues received in excess of expenses incurred for each individual client. However, as a practical matter, the attribution of all business expenses at the client level is extremely difficult to achieve, and insistence on such detail misses the forest for the trees. Fixed expenses (such as trading technology and operations) must be covered by revenues from all clients at any one time. The allocation of fixed expenses to specific clients often results in the largest clients appearing to be least profitable, leading to disputes and potential embarrassment over the accuracy of data. Our belief is that operations and technology must be optimized for their own sake, without relying on increasing revenues to hide poor operating efficiency. When the sales organization can maximize top line revenues from each client and the trading/product organization can minimize operating expenses, profitability of the entire business is maximized.

Sales should focus on the two kinds of expenses that can be controlled at the client level. The first are variable expenses that the firm incurs on behalf of the client, such as custom reporting or manual processes. These expenses can be justified by increasing revenues or eliminated if client coverage is dropped. The second are costs of limited resources that are allocated to the client – the core of the value proposition. These costs should be shared with clients directly. When clients understand the cost of limited resources, they may be inclined to pay more to make the relationship profitable for the broker. If resources are sufficiently scarce, the client may be inclined to allocate more wallet share to secure access to them.

When the profitability of a client is considered, its tier in the segmentation may change. Clients that have the potential to pay a great deal but consume expensive resources may be less attractive than clients that pay less but demand little from the firm. The profit margin, expressed as a percentage, is a helpful metric to rank clients. By allocating resources to maximize profitability, top line revenue will also be maximized.

4th Iteration: Tuning for Behaviors

One size does not fit all when it comes to institutional investors. Beyond the characteristics of the client institution are the preferences of its individuals. Individual client satisfaction correlates highly with client institutional profitability. Satisfied clients not only get access to what they need, but also are influenced by *how* they get what they need. The planning process should include additional client feedback, a refinement of the question of how the firm can do better: not only what it must do, but how it should do it. By raising satisfaction of the individuals, revenues will follow.

Many times the client feedback is surprising and leads to greater efficiency and scalability for the broker. For example, individuals who want information should be asked how they like to receive that information. The answer may be private phone calls, group meetings, emails, instant messages, blast voice mails, or podcasts. If a discussion with an analyst is the most expensive and scarce resource, individuals who will be satisfied with a phone call can be accommodated at lower cost, while the face-to-face meeting is given to a more demanding client, even if lower in the segmentation.

Behavioral analysis can apply not only to research but also to balance sheet or capital facilitation. Some clients that demand capital are simply never profitable, while others that do not make demands respond with more commissions when capital is offered. Useful knowledge about each client, be it the institution or the individual, should be captured in the client plans. Questionnaires are useful to ascertain how clients like to receive information (format and frequency), their expectations for timely responses to requests, and other preferences that can guide the coverage decisions.

Segmentation must become more granular to optimize return on resources. Behavioral segmentation is an important refinement not only to avoid wasting resources on clients that don't value them, but also to allow individuals to interact with the firm in the way that is most productive for them, thereby increasing their satisfaction.

Selling as a Team

The next step in coverage is to define a sales organization that can best deliver the value proposition to each client and collect payment. Most broker-dealers are organized by product, largely because product trading is where revenue is booked. At some firms, sales and product trading professionals are managed separately according to their function. The fact is that all client-facing professionals at a broker-dealer must work in concert when covering the same client institution. Without a means of communicating across borders, product-centric or functional organizations can miss overall client activity and related revenue.

To get parts of their organization to work together to capture a client's total wallet (as identified in the client planning process), firms generally rely on "cross selling." However, cross selling initiatives often fail to encourage client-centric behavior in essentially product-centric organizations. Incentives can even work against the intent, as sales professionals understand their compensation to be driven by revenues in one product line, and annual bonus discussions fail to reinforce broader behavior.

Harvard Business Review recently conducted an interview with Admiral Thad Allen, USCG (Ret.).[4] Admiral Allen's comments on crisis management can be applied to the coordination of multiple product specialists in covering complex clients:

"You have to aggregate everybody's capabilities to achieve a single purpose, taking into account the fact that they have distinct authorities and responsibilities. That's creating unity of effort rather than unity of command, and it's a much more complex management challenge."

In the context of institutional sales, "unity of effort" means coordination among separate individuals from different product areas covering multiple individuals at the same client institution. The "single purpose" they should aim to achieve is to maximize the profitability of that client to the firm overall.

What is needed is an approach to balance product discipline with client coverage across multiple products, i.e. "team selling." The team is collectively responsible for covering a client and collectively responsible for maximizing share of the client's wallet. Teams should be comprised of all salespeople who cover the same client. The coordination effort can be efficient and scalable if supported by the organization of the business. "Cross selling" is out-of-date, as it reflects the idea that people are paid primarily to sell only one product. "Team selling" reinforces the idea that salespeople must work with their peers to cover the whole client (PM, Trader, COO) in a coordinated fashion to capture the entire wallet.

Aligning with the Client

An effective sales organization for covering hedge funds reflects how the hedge funds themselves are organized.

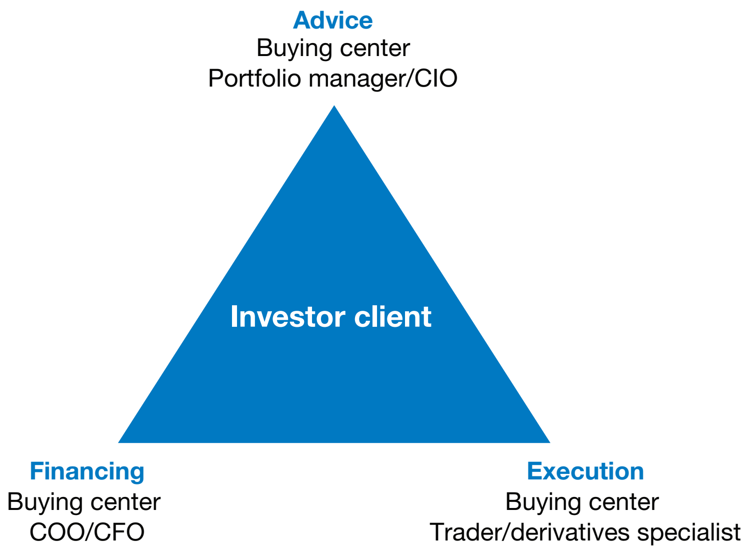
As shown in *Exhibit 9*, each hedge fund has three buying centers comprised of individuals who are primarily responsible for investment decisions, trade execution, and post-trade processes from financing to settlement. In general, the portfolio manager, chief investment officer, and/or analyst consume resources to determine what investments to make; the head trader or derivatives specialist decides how orders are executed; and the chief operating officer or chief financial officer decides how and where to source financing or borrow stock.

Traditionally, institutional equity sales teams are comprised of research sales professionals covering buy-side analysts and portfolio managers; sales-traders and derivatives salespeople covering buy-side trading desks; and prime brokerage or stock loan professionals covering the fund's COO and CFO. These traditional sales groups tend to be aligned with products: research sales and sales-traders associated with cash, derivatives sales with derivatives, and prime brokerage and stock loan salespeople associated with those financing products respectively. In a product-centric organization, these sales groups focus on maximizing the revenue in their respective products without regard for or regular communication with salespeople in the other product silos, even if they cover the same institution.

4 Ref. "You Have to Lead From Everywhere" by Scott Berinato. *Harvard Business Review*, November 2010.

Exhibit 9

Hedge fund broker-facing organization



Source: McKinsey, High Line Advisors

Organizing the Sales Force

Products and resources should be aligned with the salespeople and the client buying centers to deliver the firm's value proposition most effectively. By organizing sales functionally by client need (advice, execution, and financing) rather than strictly along product verticals (cash, derivatives, prime brokerage), it becomes easier to bring the right bundle of products and services together for any individual client.

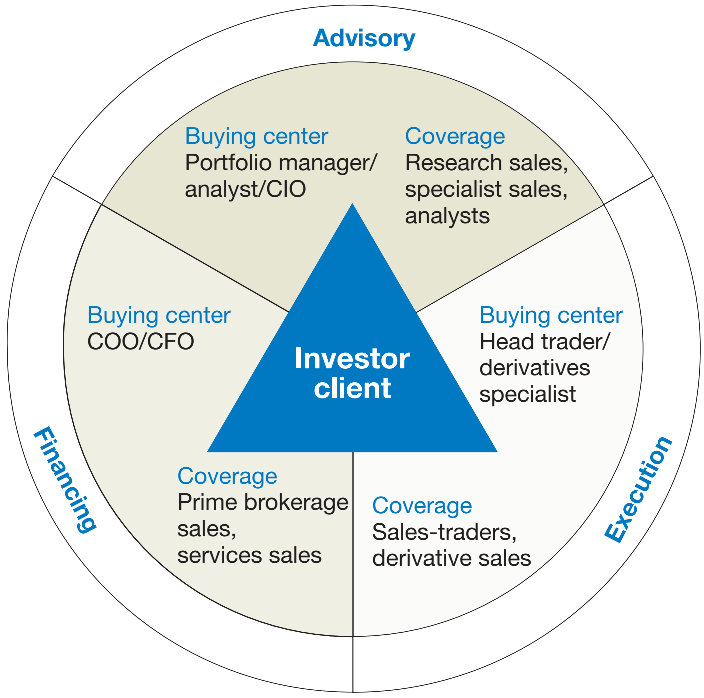
Exhibit 10 illustrates the three primary sales groups that emerge when products are aligned with the client buying centers:

- Advisory Sales, responsible for delivering access to research, ideas, and other information to client portfolio managers, analysts, and other investment professionals
- Execution Sales, comprised of traditional cash sales-traders and derivatives salespeople, responsible for trade capture across cash and derivatives
- Financing Sales, comprised of traditional prime brokerage, stock loan, and clearing salespeople, delivering financing products and post-trade services

Facilitation (risk taking and pricing of capital and balance sheet) and product structuring remain the purview of the product groups and trading management, who should have matrix oversight of the sales force to ensure that the goals of the product are met along with the needs of the clients.

Exhibit 10

Multi-product team coverage model



Source: McKinsey, High Line Advisors

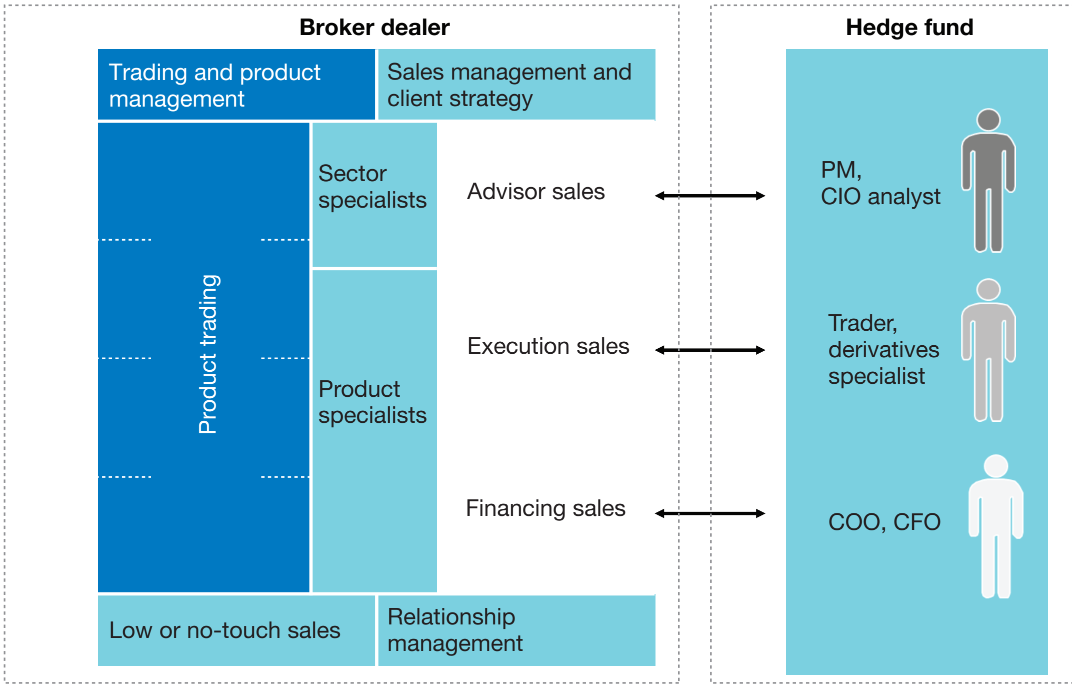
A client-facing organization ideally includes three additional groups:

- *Client Strategy* oversees the collection, analysis, and administration of client revenue and feedback data to support planning, segmentation, and decision making.
- *Product Specialists* (aka Product Marketers) are responsible for expanding product penetration into new and existing clients through education and problem solving. This group is accountable to Sales for client interaction and to Trading for product terms and distribution targets.
- *Sector Specialists* focus on industry- and stock-specific information, research, and ideas, both fundamental and technical. Sector Specialists are a powerful addition to a sales and trading business, not only by covering clients, but also by helping traders make more informed pricing, capital, and balance sheet decisions. Like Product Specialists, Sector Specialists should be accountable to both Sales and Trading.
- *Relationship Managers* are senior bankers who maintain strategic relationships with the most important accounts. Ideally, each client is assigned a salesperson to serve as the Relationship Manager and assemble the account plan. Certain clients require full-time attention when their activity or demands are sufficiently complex.

Exhibit 11 shows the internal view of an organization, with reporting lines to sales and trading management:

Exhibit 11

Sales and trading organization aligned with client



Source: McKinsey, High Line Advisors

Covering Smaller Accounts

The team selling approach is designed to capture the wallet of larger clients or those in the most critical segments: platinum, gold, and silver. The smaller clients of the bronze tier require a different approach, one that limits the points of contact with the firm ("low-touch" coverage), or relies on technology ("no-touch" coverage) so that clients can serve themselves. Not every firm is equipped to take on the challenge of covering the many clients in the bronze segment.

A long-term benefit of team selling is that sales professionals develop facility with more than one product. Increased sales bandwidth implies the ability to reduce sales headcount or add clients while maintaining the same sales headcount over time. Low-touch or "one-touch" coverage is designed to provide a single point of contact for smaller clients to trade multiple products. Low-touch coverage for hedge funds is a challenge because success may depend on using senior salespeople with broad product knowledge to cover the firm's smallest (but no less complex) accounts. A broker must decide if the revenue opportunity justifies assigning salespeople to the segment. Execution of trades in multiple products is the primary activity of the salespeople, as bronze clients are usually limited to printed research, webcasts, emails, or other scalable content.

In the extreme, no-touch coverage requires the ability to open client accounts and process trades at a low marginal cost, combined with the ability to offer access to resources without human intervention. Individual firms must determine if they have the operating leverage or capacity to capture the long tail of such client revenues.

Managing the Process

Governance of client coverage in Sales and Trading is critical but will fail if Management is too bureaucratic or disorganized. The client planning process already described seeks to include the most useful information that can be obtained with reasonable effort. Segmentation and data analysis can be done in the background, but the meetings themselves need to cover as many clients in as little time as possible, with the information needed to make decisions readily at hand.

Once the client coverage teams are identified and the process is set in motion, overall client production should be reviewed by sales management on a weekly basis, using a multi-product client revenue report that highlights variance from prior year and from budget, so that the relevant teams can be asked to explain as needed. In addition, sales management should run the two group meetings that are periodically required to manage the process. The first is a systematic review of clients with their respective sales teams. The second is a review of client segmentation and resource allocation with the resource owners.

Empowering Teams

The first goal in team selling is scalability. Scale is achieved when one team of salespeople from different product areas covers a single set of clients. The result is that fewer teams are needed and their team meetings can be less frequent and more efficient. Rebalancing coverage assignments is difficult but can be rewarding over time: the organization can oversee a large number of clients when teams operate independently and simultaneously.

Key account management programs fail when they treat the firm's best clients as exceptions and attempt to overcome product silos. In contrast, team selling achieves the aspiration of key account management for all clients. The larger the account, the more senior the team leader. Armed with the right information, anyone in the organization can contribute to or even lead a client team.

Without breaking the product-centric organization, management can encourage coordination across product areas simply by empowering teams with information on client revenue across all products (in addition to the traditional reporting of product revenue across all clients). With the common goal of maximizing wallet share and profitability, a client team can work together to make introductions, deliver resources, solve client problems, and fill revenue gaps across the product spectrum.

The ultimate goal of team selling is to create teams with more clients in common. These teams meet simultaneously to cover their shared clients, thereby achieving scale. In most organizations, individual relationships are random and the reassignment of coverage is initially disruptive. However, over time, managers can gradually rebalance coverage to align the teams. The teams become analogous to regions, which naturally deal with their local clients across all products.

Reviewing Clients

Segmentation is effectively a decision whether to support a sales team with the resources necessary to capture the incremental revenue indicated by a client plan. Resource allocation is subjective. It is based on information about a client's ability to pay and the quality of the client's business as much as the cost of the resources. Many characteristics must be considered when making coverage decisions, including whether the client trades in liquid or illiquid assets and developed or emerging markets, whether it borrows hard or easy stocks, uses modest or extreme leverage, demands little or no capital, or insists on new issue allocations.

Once resources are assigned to a client, regular account review is needed to confirm that the resources are being delivered and that the client is responding as promised. If revenues are not forthcoming, judgement is needed to determine whether to hold the course, raise the level of resource allocation (through promotion to a higher tier) or to pull back (through demotion to a lower tier). The segmentation reflects these decisions and drives the organizational response.

Best practice firms have an Account Review Committee (ARC) to make these decisions. The Account Review Committee can be staffed with people from management as well as representatives from other Sales and Trading areas. The rotation of members keeps the ideas fresh and the group engaged.

Individual client plans should be reviewed on a semi-annual basis for the platinum, gold, and development accounts, while silver accounts may be reviewed annually. This means that 10-12 clients must be reviewed per week. Client teams can meet briefly on their own to prepare the information. If the team covers many clients, the meeting can cover more ground. The account review meeting itself can last 1-2 hours, with 5-10 minutes allocated to the presentation of each client's status. Follow-up actions, including changes to segmentation, budget, or resource allocation, may be discussed offline with the team following review by sales management and client strategy.

The bronze tier contains too many clients for individual periodic review. A separate meeting is required to survey the segment for exceptional opportunities or changes in revenues. Clients considered for promotion from bronze to a higher tier (including development candidates) should be presented at the regular account review meeting.

Allocating Resources

Certain resources, such as the seniority of coverage assignments, are within the control of sales management, but not all. Agreement to support the client segmentation should be obtained from all parties that control a firm's resources. Departments that control the resources needed to drive client profitability include:

- *Trading* (for capital facilitation)
- *Capital markets/syndicate* (for new issue allocation)
- *Prime brokerage/corporate treasury* (for balance sheet allocation)
- *Tax* (for tax capacity or credits)
- *Investment banking* (for corporate clients and bankers)
- *Research* (for analysts and information)
- *Private Wealth* (for stock loan and distribution)

Best practice firms have a Resource Allocation Committee (RAC) designed to negotiate resource delivery and to monitor client profitability. Departments responsible for various resources should be allowed to provide input to the client plans and the segmentation decisions. Using Research as an example, the way in which analysts spend their time and interact with clients is a critical part of a client value proposition. Partnership with Research is necessary to make sure that analysts follow the value proposition assigned to the client. For example, an analyst traveling on the west coast might be inclined to visit a small client on the way to the airport. Client segmentation may determine that the best use of the analyst's time is to make a phone call to a large hedge fund on the east coast instead. In the interest of efficiency, sales management should prepare a subset of the segmentation that is limited to the clients that will interact with analysts, and a subset of the value propositions that are limited to the resources controlled by the Research department. Similarly, separate meetings (and client lists) are most efficient when discussing capital allocation with Trading, new issue allocations with Syndicate, or balance sheet commitments with Prime Finance.

Once initial agreement on the client segmentation and resource allocation is reached with each resource-controlling department, periodic meetings should be scheduled, with more active groups like Research meeting with the RAC as frequently as weekly. Other departments may convene quarterly or more frequently to address a situation identified during an account review.

Investors may also value resources that are "owned" by other geographic regions or product areas of the firm. Coordination across product and regional silos can yield additional revenues from investors that pay for resources indirectly via commissions in unrelated products. Only with the support of the firm as a whole can new business lines hope to grow, as it is otherwise difficult to compete in mature markets.

Creating Incentives

To encourage employees to embrace the team approach, they must be rewarded for overall increase in profitability of the clients they cover, not just the revenues in any one product. Client revenue production, product penetration, and profitability can be added to traditional sales metrics to determine compensation.

Client attribution of revenue is more important than attribution to a salesperson. Measuring the former results in client-centric behavior, while measuring the latter promotes individuals rather than teams. While cross selling is a product-centric behavior that is by its nature a secondary priority for salespeople, team selling encourages client-centric behavior and awareness of the maximum revenue opportunity of each client. The productivity of salespeople can be derived from client revenues, with the contribution of individual salespeople derived from time allocation, product revenues, and peer reviews.

Summary

Coverage of complex clients like hedge funds can be improved with the right data, organization, and governance, all of which may be, to quote Albert Einstein, "as simple as possible, but not simpler." While an institutional equity business has been used to illustrate this article, these practices may also be applied to Fixed Income and Commodities. Organizations first need to understand what they have that clients value and how they position themselves in the marketplace. Then they need to understand where they stand with individual clients relative to their competition, whether they can improve, and, if so, what improvement is worth so they can allocate their resources to capture the most revenue. An efficient program that can be followed by the whole organization makes it possible to cover large numbers of clients. Most importantly, a culture of teamwork with incentives tied to client (rather than product or individual) production will encourage all parts of the Sales and Trading business to act in concert to maximize client wallet share.

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