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A New Age of Regulation

The American business environment continued a metamorphosis in the first half of 2009 that at times bordered on the surreal. From his perch atop the heights of free-spirited American finance, Goldman Sachs chief executive Lloyd Blankfein told the Council of Institutional Investors that his industry needed to revamp its pay and incentive structure. "Compensation," he said, "should encourage real teamwork and discourage selfish behavior, including excessive risk taking."

Jack Welch, renowned for his laser-like focus on shareholder value and the quarterly numbers at General Electric, opined that the corporate obsession with short term profits and share price movement was a "dumb idea." In an interview with the Financial Times, Alan Greenspan weighed in on the side of bank nationalization, at least temporarily, saying it "may be necessary" in order to "facilitate a swift and orderly restructuring." Responded Princeton University economics professor Alan Blinder in the New York Times: "The financial crisis grows weirder by the day. When philosophical conservatives like Alan Greenspan start talking about nationalizing banks, you know you've passed into some kind of parallel universe."

The change agent driving all this soul-searching is Washington, which just 10 years ago repealed the provisions of the Depression-era Glass-Steagall Act separating commercial and investment banking. In mid-June, President Barack Obama followed in the footsteps of President Franklin Roosevelt — who signed Glass-Steagall during his much-storied "first hundred days" in office — by revealing a comprehensive overhaul of the financial services industry, with new rules aimed at reining in the industry's proclivity for risk as well as bankers' paydays.

The plan, contained in an 88-page U.S. Treasury Department document titled "A New Foundation: Rebuilding Financial Supervision and Regulation," grants the Federal Reserve and Federal Deposit Insurance Company more power over major financial institutions, while creating a financial services oversight council headed by the Treasury Department. It also requires banks to hold more capital and provides for "enhanced regulation" of securitization markets, including a mandate that issuers and originators retain an interest in securitized loans, as well as tougher scrutiny of credit rating agencies.

Hedge funds, the industry's longtime equivalent of the Wild West, will finally be compelled to register with the Securities and Exchange Commission and provide financial disclosure, as will private equity firms. There are also new rules to protect consumers in areas such as credit cards and mortgages and tougher requirements for brokers who provide investment advice.

The shift to stricter oversight of business is hardly unprecedented, having its roots in the Progressive era of the early 20th century. But the direct investment Washington has made since 2008 to prop up so many financial and industrial corporations is a departure, with the most recent high-profile addition to the federal portfolio being General Motors. (The Reconstruction Finance Corporation started up in 1932 by President Herbert Hoover provided loans to banks and other industries, a mandate that President Roosevelt expanded to include purchases of preferred stock.) That use of hundreds of billions of taxpayer dollars to bail out too-big-to-fail companies placed additional political pressure on Washington to take aggressive regulatory action. "The absence of a working regulatory regime over many parts of the financial system — and over the system as a whole — led us to near catastrophe," Obama said in unveiling his regulatory proposal. "We shouldn't forget that."

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“Demarcation point”

As the politics of the financial crisis played out, observers wrote obituaries for the free market ethos prevailing since the elections of Prime Minister Margaret Thatcher and President Ronald Reagan — and considered what lay ahead. “It is impossible at such a turning point to know where we are going,” wrote Financial Times chief economics columnist Martin Wolf in a special report on “The Future of Capitalism.” Like many observers, however, Wolf divines a future in which the “legitimacy of the market will weaken. The credibility of the U.S. will be damaged. The authority of China will rise. Globalisation itself may founder.” In his May commentary, **PIMCO** managing director Bill Gross calls the economic crisis a “demarcation point” representing “the beginning of government policy counterpunching, a period when the public with government as its proxy decided that private market, laissez-faire, free market capitalism was history and that a ‘private/public’ partnership yet to gestate and evolve would be the model for years to come.”

As Washington settled into its new role as crisis manager and quasi-central planner, there were some positive signs in the banking sector. In June, 10 financial services firms repaid $68 billion to the U.S. Treasury as part of the process of exiting the Troubled Asset Relief Program (TARP), including **Goldman Sachs, JP Morgan Chase** and **Morgan Stanley**. A number of global financial firms also turned in solid performances in the first quarter, including **Barclays, BNP Paribas, Credit Suisse, Deutsche Bank, Goldman Sachs** and **JP Morgan Chase**. **Citigroup** delivered surprisingly strong first quarter results and its first profitable quarter since 2007.

But many analysts question the sustainability of strong earnings in a fractured world economy, with commentators showing little consensus about the future save for a sense that a replay of the 1930s has been avoided. Niall Ferguson, a prominent academic and financial writer, in June told Barron’s: “Nobody has the faintest idea what next year is going to look like. It isn’t clear yet that this is just a common recession. This is probably more like a slight depression.” Testifying before Congress in May, Federal Reserve Chairman Ben Bernanke took a cautiously optimistic view, pointing to improved consumer spending and signs of price stabilization in the housing market in suggesting that the economy would “turn up later this year.” The International Monetary Fund (IMF) in June forecast negative growth of 2.5% for the U.S. economy this year, a slight improvement from its assessment in April.

In the first quarter, the U.S. economy sank at an annual rate of 5.5%, somewhat better than the dismal 2008 fourth-quarter performance, while the grim monthly job loss toll eased slightly in May. At the same time, unemployment reached a 26-year high, at 9.4%, while the broader metric incorporating the underemployed topped 16%. U.S. exports in April turned sharply lower but increased 1.6% in May, and profits for American corporations rose slightly in the first quarter after six quarters of negative growth, according to the U.S. Commerce Department. Consumer sentiment was also mixed as Americans continued to squirrel away money, in April achieving the highest savings rate since 1995, at 5.7% of after-tax income.

Europe remained in a similar fix, with the eurozone registering its worst economic performance on record in the first quarter, as GDP dropped by 2.5%, or an annualized rate of negative 10%, and April unemployment topped 9%. A zero percent inflation rate has also raised concerns about deflation. Germany’s economy was particularly sickly, with negative growth approaching 4% in the first quarter. A slight increase in exports in March raised hopes for somewhat better times ahead, but in a sign of the tenuous nature of such signals these days, the export and industrial production data a month later took a negative turn. The German government expects the economy to contract 6% for the full year. In the U.K., the economy is projected to decline 3.5% this year, even as the shaky Labor government of Prime Minister Gordon Brown ramps up borrowing to more than 12% of GDP.

With the financial sector continuing to bleed money, governments stepped forward to provide support. Germany pumped another $14 billion into **Commerzbank**, taking a 24% shareholding in return, and added a 90% shareholding in **Hypo Real Estate Holding**, while the U.K. saved two of its marquee financial firms, **Royal Bank of Scotland** and **Lloyds Banking Group**. Both countries also vowed to tighten the rules governing financial institutions, with the German legislature pressing for a bill to cap executive pay.

In separate speeches, U.K. Chancellor of the Exchequer Alistair Darling and Bank of England Governor Mervyn King called for new and tougher regulation of that nation’s outsized financial services industry. From Brussels, the European Commission announced its own supranational initiatives to oversee the Continent’s financial industry, via the European Systemic Risk Council and the European System of Financial Supervisors. Even Switzerland joined in, as the nation’s central bank began examining whether firms such as Credit Suisse and **UBS** were too large. “There can be no more taboos, given our experience of the last two years,” said Philipp Hildebrand, vice chairman of Swiss National Bank.

Government bailouts notwithstanding, many observers have chastised the European response to the financial crisis as insufficient compared with the more aggressive effort in the U.S. to recapitalize banks. The IMF figures European banks have raised only 40% of the $1 trillion needed to shore up their capital bases, compared with two-thirds by U.S. banks. Overall, the IMF projects worldwide writedowns from U.S. assets will reach at least $2.7 trillion, with another $1.4 trillion in losses possible when European- and Japanese-originated assets are added to the mix.

Amid the gloom in the U.S. and Europe, China was a relative bright spot, though slumping exports translated into first quarter GDP growth of just 6.1%, the slowest pace since the early 1990s. Beijing is adding considerable firepower to the economy with a $600 billion stimulus plan, but robust consumer spending has helped, too, including record car sales in March. Significantly, the government announced it will loosen restrictions on Chinese companies' financing of overseas units. Japan's economy remained weak, however, with the government projecting negative growth above 3% for the 2009 fiscal year and the Bank of Japan forecasting a return to deflation over the next two years. In May, the Bank did raise a glimmer of hope in noting that "exports and production are beginning to level out." The same month, the government approved its fourth stimulus bill since last summer.

Transitional period for asset managers

Buffeted by the financial crisis, the asset management industry has been a study in contrasts, as it embarks on a transitional period that is expected to leave a more concentrated industry in its wake. Banks and insurers, at one time aggressive buyers of asset managers, are now in a divestiture mode, as they seek to raise capital and reorganize businesses hammered by the credit crisis. The most notable example in the first half was Barclays' sale of its massive **Barclays Global Investors** (BGI) asset management unit to **BlackRock** for $13.5 billion.

In France, financial giants **Credit Agricole** and **Societe Generale** agreed to merge their respective asset managers in the quest for greater scale and profitability. The combination creates the fourth-largest asset manager in Europe, with $900 billion in AUM. Federally controlled **AIG**, which last year sold its Swiss private bank, has put the "for sale" sign on its entire asset management unit, with around $100 billion in AUM. **Bank of America**, which has received $45 billion from the TARP program, is shopping around its **Columbia Management** fund group as well as **First Republic** private bank.

UBS, another headline victim of the credit crisis, is mulling the sale of its hedge fund business to management. Insurer **Lincoln National Financial Group**, which accepted $950 million in TARP funds, has been seeking a buyer for its **Delaware Investments** asset management group, with **Aberdeen Asset Management** said to be among the interested parties. **Citigroup** is shopping its Japanese asset manager and is reportedly mulling the sale of its Italian private bank.

Beyond those high-profile deals and offerings, overall activity among asset management dealmakers was modest in the first half. In a continuation of the trend that began in the second half of 2008, many potential buyers remained on the sidelines waiting for stock markets and the economy to stabilize, or for the credit markets to free up acquisition funding. For example, **Affiliated Managers Group**, a steady purchaser of asset managers, cut its last deal a year ago and has indicated a preference for keeping its powder dry in the short term. Still, in announcing first quarter earnings, Sean Healey, president and CEO, emphasized the opportunities being created by the "accelerating trend of restructuring and divestitures of asset management subsidiaries by corporate sellers" and pointed to the near $1 billion in credit and cash AMG could tap "to generate strong long term returns."

Diversified financial companies aren't the only ones facing pressure to sell. The sharp drop in AUM suffered by the industry combined with an investor shift to lower-margin fixed income and money market investments is hurting the profitability of virtually every pure asset manager and putting a particular strain on firms that lack scale or a strong niche. Speaking in Singapore in May, Bob Doll, vice chairman of BlackRock, said half the asset managers in the world are either treading water or losing money. When the financial crisis comes to an end, he said, "There will be a number of large, broad-based successful global firms and a huge number of niche firms that are good in one or two things. The fund managers that are in the middle, which are trying to be all things to all people, they won't be able to get through." In a recent report, researcher Cerulli Associates said the global asset management industry will need five years to get back to the revenue peak it hit in 2007 of $170 billion.

Among publicly traded asset managers, first quarter results were predictably negative. **T. Rowe Price Group** reported a 68% decline in earnings and announced it was laying off nearly 6% of its employees. **Franklin Resources** saws it earnings drop 70% in its fiscal second quarter. **AllianceBernstein Holding, Federated Investors** and **Janus Capital** also reported sharp drops in profits. Privately held giants **Capital Group** and **Fidelity Investments** have joined numerous publicly traded asset managers announcing job cuts.

Deal activity in the first half was dominated by sales of institutional and mutual fund managers while the normally robust wealth sector registered just a handful of transactions, with **GenSpring Family Offices**, the ambitious Florida-based ultra high net worth firm, a notable buyer. Coming off the disastrous year of 2008, when industry AUM declined by a third and the survival of thousands of firms was thrown into question, the hedge fund sector was similarly inactive, with BlackRock acquiring **R3 Capital Management** prior to its megadeal for BGI.

Private equity firms, many sitting on large cash hordes, continued to make their presence felt. In April, **CVC Capital Partners** reached agreement to purchase Barclays' coveted **iShares** exchange-traded funds business for $4.4 billion, a deal negated by the broader BlackRock sale. An all-Australian transaction involved **Champ Private Equity**'s acquisition of **Centric Wealth Advisors**, while **Allied Capital Corp**. of Washington, D.C., acquired three fixed income investments. **Crestview Partners** of New York is part a consortium bidding for AIG Investment and a group of private equity firms is said to be mulling a bid for First Republic.

Wealth Management

In the five years through 2008, wealth management was the most active sector in the asset management industry, generating an average of 71 transactions a year, including a record 87 in 2007. There was good reason for the enthusiasm: the business was lucrative, customers were loyal, lots of new millionaires were being minted each year, and existing millionaires kept getting richer. But in a sharp drop-off, the sector registered just a handful of deals in the first half of 2009.

The breather being taken by dealmakers is due to several factors common to many sectors of the asset management industry. Traditional buyers such as banks are sidelined by their own travails for the moment and tighter credit markets have stymied potential buyers within the broader financial industry. At the same time, the steep drop in valuation is keeping opportunistic sellers in check. Just as importantly, in the near term, firms are zeroing in on servicing their restive clients as opposed to dealmaking.

Indeed, the magnitude of the decline in deals underlines the unaccustomed challenges wealth managers are suddenly confronting. For one thing, the financial collapse reversed the rapid and seemingly nonstop growth in both the ranks of the wealthy and the assets at their disposal. The latest Capgemini Merrill Lynch World Wealth Report, covering 2008, shows the number of individuals with at least $1 million in investible assets dropped 15% and their collective assets declined 20%.

The impact on the most-coveted clients — ultra high net worth investors — was worse, with the number of individuals in that category and their overall wealth declining by 25% and 24%, respectively. Additionally, wealthy investors are becoming more conservative, according to surveys, with the majority of millionaires surveyed by the **Phoenix Companies** now in asset preservation mode. Capgemini Merrill Lynch research shows that fixed income and cash investments made up half the investments held by millionaires, with equity investments dropping eight points to 25%.

The client loyalty that characterized the industry has also been impacted by both the financial collapse and the Bernard Madoff scandal. Wealth Bulletin estimates that $1 trillion in assets shifted homes last year, with UBS accounting for nearly 10% of the total outflows. The publication also suggests that close to half of the wealthy are prepared to switch private bankers. Anecdotally, there are indications that many clients are leaving large, full-service firms for independent wealth managers.

Among the small number of deals in the U.S. in the first half of the year, the most significant involved the acquisition by ultra high net worth firm GenSpring Family Offices of Denver-based **Epic Advisors**, a multi-family office founded in 1991 that serves families in the Rocky Mountain states. It marked the fourth acquisition since 2007 for GenSpring, which told Investment News that it expects to buy more firms this year and is discussing partnerships and joint ventures with single-family offices. “Single-family offices are coming to us and asking for help,” senior partner John Elmes told the newspaper. Maria Elena Lagomasino, CEO of GenSpring, said the purchase of Epic “accelerates our strategy of creating a national and international market leader that squarely sits on the family’s side of the table.” An affiliate of **SunTrust Banks**, GenSpring has $17 billion in assets under advisement and serves clients with a minimum of $25 million in investible assets.

There were two management buyouts involving a high-profile seller, **Boston Private Financial**. The company, which has suffered losses on its loan portfolio and last year received a $75 million investment from **Carlyle Group** as well as TARP funds, said both deals were done to rationalize its business. The larger transaction involved the company’s Palo Alto, Calif.-based affiliate, **Sand Hill Advisors** (AUM: $800 million), whose emergence over the years as a wealth firm created overlap with two other wealth managers Boston Private owns in California. **Fiduciary Network**, which backs buyouts for fee-only wealth managers facing generational changes, provided funding for the deal. Fiduciary, founded two years ago with **Emigrant Savings Bank** as an investor, takes a cut of future cash flows in return for a passive, minority investment. In the second deal, Boston Private sold its interest in **Boston Private Value Investors**, again citing “overlap” with other affiliates in New England. BPVI, which renamed itself **Granite Investment Advisors** following the deal, is an institutional and high net worth manager with $430 million in AUM.

The other U.S. deals featured small, independent players teaming up in similar markets to add scale. In the San Francisco area, two established firms, **Salient Wealth Management** and **Friedman & Associates**, merged to form Salient Friedman Wealth Management, with $600 million in AUM and “deeper capabilities and access to resources,” In a second merger set in Northern California, **Burr Pilger Mayer** joined forces with **Vista Wealth Management** to create a firm with more than $500 million in client assets.

In a deal between two Ohio-based firms, **Johnson Investment Counsel** acquired **Mead, Adam & Co.** (AUM: $350 million), a sale that Mead, founded in 1970, attributed to succession planning issues. With $4 billion in AUM, Johnson bills itself as the state’s largest independent employee-owned asset manager. The purchase of Mead, Adam expands Johnson’s capabilities in Columbus and Dayton and is the company’s first acquisition in 20 years. In a deal between two firms in the Kansas City area, **Barber Financial Group** acquired **Kasper Steck Wealth Management** to create a company with $700 million in AUM. In Pittsburgh, **BPU Investment Management** acquired **Paragon Wealth Management** as part of its expansion effort in that city, adding $100 million in AUM to the $650 million it already managed.

In an all-Australian deal, Champ Private Equity paid $65 million for a 75% stake in Centric Wealth, a privately held Sydney-based wealth manager with $4 billion in AUM, as well as a heavy debt load. Last year, Centric unsuccessfully sought both a public flotation and a rights issue that was to be underwritten by Champ, the Australian affiliate of New York private equity firm **Castle Harlan**. Centric has been an aggressive buyer of financial planners over the years.

Mutual Funds / Institutional

In marked contrast to other parts of the asset management industry, dealmakers in the mutual fund and institutional sector remained active in the first half, cementing more than three-dozen transactions. To a significant degree, the action was driven by distress sales and business reorganizations among banks and asset managers. This was certainly the case in the blockbuster deal between BlackRock and Barclays, as the British bank sold its massive asset management business to shore up a fragile balance sheet without resorting to a government bailout.

The $13.5 billion acquisition by BlackRock of Barclays Global Investors (BGI) creates the world's largest asset manager and sets a new threshold for deal size for a pure asset manager. It also nets BlackRock the exchange-traded funds business of Barclays, iShares. New York-based BlackRock paid close to eight times pre-tax earnings and less than 1% of AUM, with the payout evenly split between cash and shares. As a result, the British bank will have about 20% equity in the new company, **BlackRock Global Investors**.

The acquisition doubles BlackRock's AUM to a stunning $2.7 trillion, about twice the size of its nearest competitors, including **State Street Global Advisors** and **Fidelity Investments**. Just three years ago, BlackRock wrapped in the asset management business of **Merrill Lynch**, a $9.8 billion transaction that was the largest pure asset management deal up to that point. Barclays also adds a significant retail component and the fast-growing ETF unit, solid complements to BlackRock's institutional and fixed income focus. The iShares business will account for 57% of the combined firm's $526 billion in retail AUM, with institutions still comprising a hefty 80% of total AUM.

BlackRock's relationship with shareholder **Bank of America-**Merrill Lynch adds a further dimension to the deal, providing a powerful distribution pipeline for BGI's portfolio of products. (BoA's 49% shareholding in BlackRock will be diluted to 34% when the Barclays deal closes.) Although some observers question whether the deal has made BlackRock too big, in an interview with *BusinessWeek*, chairman and CEO Laurence Fink emphasized that a "good part" of the assets it is gaining are passive. "This is not $2.7 trillion of actively managed strategies," he said. Indeed, in the press release announcing the deal, Fink hailed the "combination of active and passive investment products" as "unsurpassed" and said it "will enhance our ability to offer comprehensive solutions and tailored products to institutional and retail clients."

The second major deal in the sector was also driven by recent events, as a desire to cut costs and enhance competitiveness led Credit Agricole and Societe Generale to merge their asset management units into a one of the largest such players in the world (see Europe section for more information). UBS continued to raise capital and realign its business by selling off its Brazilian investment bank and asset manager, **UBS Pactual** (AUM: $25 billion), to another Brazilian investment bank and asset manager, **BTG Investments**. For BTG chief and billionaire Andre Esteves, the $2.5 billion deal brings him full circle, as he sold his Pactual business to UBS just three years ago. At that time, UBS touted the deal as part of an aggressive Latin American expansion plan.

New York private equity firm **Aquiline Capital Partners** figured among the more notable U.S. dealmakers, purchasing Hartford-based **Conning & Co.**, an institutional firm with $70 billion in AUM, an insurance clientele, and a focus on fixed income investments. The sale was again driven by the reorganization of a parent company around its core business, in this case **Swiss Reinsurance Co.** Conning said the investment from Aquiline, which targets the financial services industry, will strengthen its business, including the pursuit of "strategic opportunities." A second deal with a transatlantic connection saw **Pioneer Investment Management** acquire a mix of 11 **RMK Select Funds** with $2 billion in AUM from **Regions Financial Corp.** The funds will be wrapped into existing funds with similar strategies managed by Pioneer, wholly owned by Italy's **UniCredit**.

There were a number of additional deals involving firms with AUM in the $2 billion to $4 billion range, including **City National Corp.**'s acquisition of a majority stake in **Lee Munder Capital Group**, an institutional and wealth management firm (AUM: $3 billion). CNC plans to merge its existing institutional manager, **Independence Investments** (AUM: $1 billion), with Lee Munder to create one primary institutional firm operating under the Lee Munder name. The new company will be an affiliate of CNC's Chicago-based asset management holding firm, **Convergent Capital Management**. Lee Munder, who retains a minority shareholding, said the deal positions the company for the "next stage of growth," with broader distribution and access to capital.

In a distress sale, management in the U.S. acquired the $1.9 billion **Babcock & Brown Infrastructure Fund North America** from **Babcock & Brown**, a heavily leveraged Australian investment bank that was placed in "voluntary administration" in the first quarter of 2009. Management was joined by **John Hancock Life Insurance Co.**, which took a shareholding in the fund. There were several additional buyouts, including at **Tortoise Capital Advisors**, a specialist in master limited partnerships in the energy sector with $2 billion in AUM. Management at Kansas City-based Tortoise was joined by another local asset manager, **Mariner Holdings**, which took a majority stake. Mariner, with $1 billion in AUM prior to the deal, has set a goal of managing $5 billion by 2013.

There were two very small deals of note involving targets with less than $1 billion in AUM. **Federated Investors** continued to make the sort of tack-on acquisitions that have become its signature, purchasing two equity mutual funds from **Touchstone Advisors** with total AUM of $233 million. The funds had been subadvised by **Clover Capital Management**, one of four acquisitions made last year by Federated, and will be wrapped into similar Federated Clover funds. **The Wayne Hummer Asset Management** subsidiary of Illinois-based **Wintrust Financial**

Corp. acquired a majority stake in **Advanced Investment Partners** of Florida, an institutional manager with $550 million in U.S. equity products. Wayne Hummer, with a focus on wealthy and mass affluent clients, said the deal allows it to expand into the institutional marketplace.

Alternatives

In May, the beleaguered hedge fund industry recorded its best monthly performance in nine years. Hedge Fund Research placed the average return that month at 5.2% and while the CreditSuisse/Tremont Hedge Fund Index had a lower number it was still an impressive 4.1%. The performance provided a ray of hope for money managers and investors, who since last year have watched helplessly as the industry's reputation as a port in financial storms was shattered.

In 2008, industry AUM declined by a third to $1.3 billion and an estimated 15% of hedge funds closed. Concurrently, the lucrative fee structure that drove so many traditional money managers to leave comfortable jobs and set up hedge fund shops came under considerable pressure, particularly from institutional investors. In March, **Calpers** sent a memo to its hedge fund managers demanding a new fee arrangement and greater transparency. "In recent years, institutional investors have displaced wealthy individuals as the main clients of hedge funds," the massive California pension fund said. "However, the hedge fund marketplace has not evolved sufficiently to accommodate what institutional investors require to maximize long term benefits for their beneficiaries." And if all that wasn't bad enough, the industry has been targeted for greater regulation as part of the President Obama's overhaul of the financial services industry.

With the industry at a crossroads, logic would dictate an increasing number of deals, but as in the wealth sector potential dealmakers preferred the sidelines in the first half. There were several high-profile buyers, however, most notably BlackRock, which acquired R3 Capital Management (AUM: $1.5 billion), a credit-focused hedge fund started up last year with a $1 billion investment from **Lehman Brothers** and run by former Lehman executives. Those former executives include R3 president and CEO Rick Reider, who was subsequently named head of BlackRock's fixed income alternatives portfolio group. BlackRock said the acquisition "enhances our credit, leveraged finance and distressed capabilities." Following its bankruptcy, Lehman sold its 45% shareholding back to R3 for $500 million, including a $250 million investment in one of the company's funds.

In a second high-profile deal among New York firms, **Fortress Investment Group** acquired $2.5 billion in AUM from **D.B. Zwirn** as part of a liquidation sale. Zwirn, which at one time had $5.5 billion in AUM, suffered significant redemptions following an SEC investigation that began in 2007 into accounting irregularities. The company attributed those problems to a former employee. Publicly traded Fortress, which beat out eight other bidders for the Zwirn assets, said the funds will be rebranded as Fortress Value Recovery Funds I. In the first quarter, prior to the deal, Fortress had private equity and hedge fund AUM of $26.5 billion, down 22% from the year-earlier period.

In another distress sale, Wisconsin-based hedge fund **Stark Investments** paid $7.3 billion for most of the assets of **Deephaven Capital Management**, adding $2 billion in AUM to the $10 billion it already managed. Stark, which will fold Deephaven's assets into existing Stark funds, could add another $37 million to the purchase price by 2011, based on performance and the number of Deephaven clients who stick around. In 2008, Deephaven's flagship Global Multi-Strategy Fund suffered a drubbing, with AUM sliding by more than half to around $1.4 billion, leading the company to halt redemptions in the fourth quarter. Deephaven was the hedge fund unit of **Knight Capital Group**.

Among the handful of deals in Europe, the most significant involved **Julius Baer Holding**'s acquisition of London's **Augustus Asset Managers** (AUM: $7.6 billion), which had been part of the Swiss firm prior to a management buyout in 2007 and had continued to operate as a subadvisor to Julius Baer branded funds. But "the new market environment" led both companies to determine that Augustus and its clients "will be better served as part of a larger organization," Julius Baer said. The deal was done through Julius Baer's large alternative assets manager, **GAM**. Separately, Julius Baer acquired an Italian wealth manager, **Alpha SIM** (see Europe section). In May, the company also announced plans to separate its wealth management and asset management businesses into two publicly traded entities.

In a second deal involving partners, **Sal. Oppenheim** acquired the 51% it did not own of **Integrated Asset Management**'s Paris-based hedge fund of funds business, **Altigefi S.A.** (AUM: $800 million). Sal. Oppenheim, a Luxembourg-based private bank that is IAM's largest shareholder and customer, paid $4.9 million for the business. IAM, an alternative asset manager that trades on the London Stock Exchange's Alternative Investment Market (AIM), decided to sell the 51% stake it had only just acquired in late 2007 following a poor performance by Altigefi last year.

Europe

The two key deals in Europe took place among domestic players and were both a result of the financial crisis. In France, the nation's No. 2 and No. 3 banks, Credit Agricole and Societe Generale, merged their asset management units to create Europe's fourth-largest money manager and a top-10 manager worldwide, with nearly $900 billion in AUM at the time of the deal in January. Last year, the two firms concluded a similar agreement for their brokerages. In explaining the deal, which excludes SocGen's alternative businesses (including **Lyxor Asset Management**), both sides cited a less profitable landscape that demanded ever-greater scale for future growth. SocGen's asset management business in particular has suffered losses and outflows during the crisis, while its banking business required an infusion of government capital.

The combined firm, which tilts heavily toward fixed income products and a retail clientele, will have a presence in 37 markets, including the U.S. through SocGen's 20% shareholding in **TCW** (AUM: $97 billion). Within its primary market of France, where banks dominate the mutual fund distribution pipeline and tend to peddle their own products to the exclusion of competitors, the combined firm will also enjoy a much stronger position. Prior to the merger, Credit Agricole was already No. 1 in France's mutual fund market, with a 19% share. In addition, the two companies expect the new entity to generate pre-tax savings of $170 million after three years. Credit Agricole is taking a 70% stake in the new company, in line with its proportion of the assets and stronger-performing unit.

The two banks have a "lock-up" agreement for at least five years but said they might consider a public listing for the asset manager during that time. "The agreement we have signed with Societe Generale is based on industrial logic, seeking to combine production efficiency with the power of distribution," says Georges Pauget, chief executive of Credit Agricole.

In the second key deal driven by events, **Henderson Group** acquired **New Star Asset Management**, a mutual fund manager founded in 2000 that enjoyed a meteoric rise until the financial crisis combined with the company's leveraged balance sheet to force a liquidity crisis. The U.K. firm, run by former **Jupiter Asset Management** chief John Duffield, was taken over by its creditors last year before London's Henderson made its $160 million cash-and-share bid in the first quarter. New Star, with $15 billion in AUM (less than half of the total in 2007), provides Henderson with greater scale in the U.K. retail market, where it will become the No. 5 player with around $90 billion in AUM.

There were several wealth management deals in Europe. In addition to its purchase of London's Augustus Asset Management (*see Alternatives section*), Julius Baer crossed borders to acquire an Italian wealth manager, Alpha SIM, which it wrapped into its existing Italian private client business. The company said the acquisition "will significantly strengthen" its "competitive position" in Italian private banking "and underscores our continued strong commitment to this important market." Alpha, based in Milan, has $560 million in AUM. In an all-Swiss deal, publicly traded **Norinvest Holdings** acquired wealth manager **Banque de Patrimoines Prives Geneve**, which it plans to merge with its Swiss private banking subsidiary, **Banque Cramer & Cie**.

Portuguese bank **Banco Espirito Santo** acquired a small Parisian wealth manager, **Marignan Gestion** (AUM: $280 million), as part of an effort to expand its onshore business in that market. The company's private bank in Switzerland has $7.8 billion in AUM, primarily for clients with a connection to Portugal. BES is part of Luxembourg-based **Espirito Santo Financial Group**, a leading banking and insurance company in the Portuguese market with a total of $25 billion in AUM through its subsidiaries, primarily in Portugal and Switzerland. In the five years through 2008, Espirito's private banking business, including companies in Miami and Panama, registered average annual growth in AUM of 12%.

Securities

As in asset management, the securities industry was notable in the first half for the divestitures taking place among high-profile and troubled banks and other financial services firms. Within the U.S., the largest such deal involved the joint venture formed between Citigroup and Morgan Stanley, **Morgan Stanley Smith Barney**. Morgan Stanley paid Citi $2.8 billion for a 51% stake in the new company, which merges Citi's Smith Barney unit with Morgan Stanley's Global Wealth Management Group to create the largest brokerage in the world, surpassing **Bank of America Merrill Lynch**. (Morgan Stanley also acquired Citi's managed futures business as part of the deal.)

At the time of the announcement in January, the pro forma numbers added up to 20,000 advisers, $1.7 trillion in client assets, 1,000 offices worldwide, nearly $15 billion in revenues and $2.8 billion in pre-tax income, with Smith Barney accounting for the largest share of the assets. Both companies said the deal provides enhanced scale, resources and intellectual capital and will generate $1.1 billion in cost savings.

For Citi, the deal is in line with its goal of trimming and reorganizing its business while generating capital. Additionally, the bank can generate revenue from the joint venture through its share of the profits and in the form of payments if Morgan Stanley chooses to exercise its option over time to buy out Citi's stake. Morgan Stanley, which in June repaid the $10 billion it had borrowed from the federal TARP program, is counting on the enlarged brokerage creating a stronger wealth business that can provide predictable earnings growth.

Citigroup is also restructuring its international business, with Japan a particular focus. In the first half, the bank sold its large **Nikko Cordial Securities** unit to **Sumitomo Mitsui Banking Corp**. for $7.9 billion, marking the first bank acquisition of a major brokerage in Japan. Sumitomo said the deal allows it to expand the investment options it can offer its banking customers. Citi also struck an alliance with Sumitomo to provide access to the American bank's corporate and investment banking network. In addition, Citi sold **NikkoCiti Trust and Banking Corp**. to **Nomura Trust & Banking Co.** for $200 million and has placed its Japanese asset manager, **Nikko Asset Management**, on the sale block.

AIG continued to raise capital and reorganize its government-controlled business with three securities-related divestitures, all to non-U.S. buyers, including a commodity index business it sold to UBS for $15 million, with an additional $135 million payout possible over 18 months based on performance. In addition, AIG sold its foreign exchange prime brokerage platform to BNP Paribas and its Taiwanese brokerage to **Bank of East Asia**, Hong Kong's largest independent bank.

Although UBS added AIG's commodity index business, it sold 55 branch offices in the U.S. to **Stifel Financial Group** as part of a restructuring of its wealth business in that market. St. Louis-based Stifel, which has made several acquisitions in recent years, including the capital markets group of **Legg Mason**, said the acquisition furthers its nationwide expansion plans. In Europe, UBS sold its base metals, oil and U.S. power and gas commodities trading books to Barclays, exiting those businesses. Barclays has one of the largest commodities businesses in the world, with more than 1,100 clients. Late last year, UBS divested its Canadian energy and global agricultural commodities unit.

Germany's troubled Hypo Real Estate Holding sold **DEPFA First Albany Securities**, a U.S. subsidiary specializing in the tax-exempt municipal bonds, to **Jeffries & Company** of New York. Hypo Real Estate, which required a massive bailout from the German government, is restructuring to focus on its real estate and public sector lending businesses in its domestic market and Europe.

Wedbush Morgan Securities, the largest broker-dealer headquartered on the West Coast, has been in an expansion mode, having made three acquisitions over the past year, including a deal in the first quarter for the investment banking business of **Pacific Growth Equities**. Based in San Francisco, Pacific Growth specializes in emerging growth companies in the life sciences and technology sectors. For Los Angeles-based Wedbush Morgan, the acquisition marks a significant expansion of its capital markets and equity research capabilities.