BERKSHIRE CAPITAL NEWSLETTER

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INVESTMENT MANAGEMENT & SECURITIES INDUSTRY REVIEW

GOOD NEWS BEARS.

The first half of the year turned into a case of predominantly good news for the U.S. economy, bad news for the markets. Strong first-quarter growth in GDP (up 3.9%) and corporate profits (up 25% on Businessweek's "Scoreboard" of 900 companies), combined with a sharp pick-up in employment (860,000 jobs added in March through May), provided compelling evidence that the U.S. economic engine is picking up steam. The job and profit data was all the ammunition the Fed needed to raise interest rates in June (the Fed followed up with a second quarter-point rate hike in August).

Meanwhile, investors spent much of the second quarter fretting about the potentially negative ramifications of higher rates, a factor in the flat performance of the markets. By summer, investors were able to add some new concerns: the rising price of oil and economic data that conveyed a less robust U.S. recovery. As a result, many money managers have opted to sit on their hands for the moment. The Wall Street Journal reported in July that 50 stock funds had 20% of their portfolios in cash, with such heavy hitters as the Clipper fund holding 30% cash, while 75 bond funds had 30% or more in cash.

The political situation in Iraq has also been weighing on investor psychology, with the U.S. inability to bring security a pressing concern. While it's always risky to read a nation's situation from afar, we'll continue to place our faith on the presumed desire of most Iraqis for some middle ground, following decades of tyranny. As a result, we are hopeful that the new Iraqi government will acquire the legitimacy it needs to manage the nation's security and set the stage for future prosperity — a state of affairs that would also benefit the larger region and the global economy.

BANK BUYING SPREE.

On a more positive note, the upturn in the U.S. economy has been reflected in the increased level of domestic M&A activity, which more than doubled by value (to $403 billion) and rose 12% by number of deals (to nearly 4,092), according to Thomson Financial. Worldwide M&A activity in the half-year rose 44% by value (to $869 billion) and 7% by number of deals (to 14,461). The financial services arena was particularly active, and our suggestion at year-end 2003 that the **Bank of America-FleetBoston** deal portended more of the same this year has turned out to be an understatement (see our 2004 Investment Management Industry Review). That mega-deal was followed in January by **JP Morgan**'s $58 billion bid for **BankOne** and many significant regional deals in the months after.

In May, the acquisitive **Royal Bank of Scotland** made a $10.5 billion offer for Cleveland's **Charter One**, through its U.S. subsidiary, **Citizens Financial Group**. RBS is paying more than 15 times 2004 expected earnings for the bank, which allows Citizens to extend its presence from the Northeast into the Midwest. A few days later, **SunTrust Banks** of Atlanta reached agreement to buy **National Commerce Financia**l of Memphis for $7 billion (18 times forward earnings), creating a more formidable competitor in the Southeast. In June, **Wachovia** reached a $14.3 billion all-share deal (18 times forward earnings) with Alabama-based **SouthTrust**, creating the largest bank in the Southeast and the fourth-largest in the U.S. as measured by assets. With all that activity, the U.S. banking scene remains highly fragmented, with many tempting targets for both domestic and European players.

In the asset management industry, our preliminary half-year count shows 50 transactions worth some $2.6 billion, with the number of deals and value off considerably from the same period in 2003 (73 and $4.5 billion). The transfer of assets, at $170 billion, dropped by $50 billion. The decline underlines the trend of the last few years toward ever-more focused transactions and fewer blockbusters. Buyers continue to seek niche players with strong track records that can provide focused investing expertise.

While Royal Bank of Scotland and **BNP Paribas** (with its $1.2 billion acquisition of North Dakota's **First Bankshares**) jumped into the U.S. banking deal spree, there was no similar rush among Europeans for American asset managers, though the strong euro continues to confer a currency advantage and European banks in general are flush with cash. With U.S. firms on the wrong side of the currency scale, it's not surprising that activity among U.S. banks and asset managers in Europe was similarly muted. **Citigroup** had been in talks to acquire **Deutsche Bank**, a mild courtship that began last summer, but objections from the Deutsche's board, domestic German politics and perhaps Citi's own questions about the value of Deutsche left the deal on the table. Several prominent U.S. firms did snap up Asian asset managers in the first six months (see Cross Border section).

The largest asset management deal of the year had been expected, involving the sale of **Strong Financial**, once the privately held company had settled its mutual funding trading issues with the government. **Wells Fargo** acquired the firm for a price that could reach around $700 million and in the process was able to significantly enlarge its mutual fund operations (see Mutual Funds).

MIDDLE KINGDOM CALLING.

We have for several years now been highlighting the potential for asset managers in China, including the activities of U.S. and European firms. Accordingly, we note with interest (but also with the proper level of skepticism for long-range projections) a report this year by research firm Matrix Services predicting an enormous increase by 2010 in AUM held by that country's fund managers, to $1.6 trillion. By comparison, the U.S. mutual fund industry currently manages $7.5 trillion in assets. Twenty years ago, the Coca-Colas of the world took pencil to paper and began calculating the impact of 1 billion consumers buying only one can or package of their products. In the years since, the population has reached 1.3 billion and with a lot more money stored away in its collective bank account, thanks to economic growth that's been averaging around 9% annually over the past two decades. Today, asset managers are doing their own back-of-the-envelope calculations.

Conducting business in the Middle Kingdom still requires infinite patience, and deals are fraught with peril. At the same time, the commitment of the Chinese people to taking their place among the great powers is unquestionable, as is their penchant for saving and investing. As the country opens up its financial services sector, there is little doubt that China will become a source of tremendous opportunity for asset managers in the decades ahead. At the moment, non-Chinese firms are involved in more than a dozen asset management joint ventures, in which they are limited to a one-third stake (a level that will rise to 49% by year-end).

Most recently, **AIG** announced that it had received approval to set up its first fund management joint venture. AIG already has a well-established insurance business in China. **Crédit Agricole** also announced it was searching for a JV partner (the French firm has fund operations in Hong Kong and Singapore and is also sniffing around India for partners). **Merrill Lynch**, which established a Chinese fund management venture with **Bank of China** last December, said in June that it might raise its shareholding, while laying out its vision to become "one of the premier domestic fund management businesses in China."

SECTOR REVIEWS

A review of some of the deals that took place between January and June of this year follows, by sector.

WEALTH MANAGEMENT

This sector, by far the hottest for M&A activity in the asset management industry in 2003, remained on fire in the first half of this year, with some familiar players enhancing their operations via highly focused transactions. Two aggressive buyers in the U.S. wealth market, **Wilmington Trust** and **Mellon Financial Corp.**, made acquisitions in April. Mellon bought Seattle-based **Safeco Trust** (AUM: $300 million) from insurer Safeco Corp., expanding its existing presence in the Northwest. Safeco is the fifth wealth manager Mellon has acquired in the last four years. In an April 12 interview with Dow Jones, Dave Holst, national director of Mellon Private Wealth management, said the firm would also seek to extend its footprint from the coasts into the Midwest via acquisitions.

Wilmington Trust inked an "affiliation" with **Grant, Tani, Barash & Altman Inc.**, a 12-year-old Beverly Hills firm providing comprehensive business management services to wealthy clients and their companies. The deal provides Wilmington with additional services it can offer its clients and enhances its presence in Southern California. Fast-growing **Lydian Wealth Management** of Maryland made two rapid-fire deals in the second quarter, of **Windermere Investment Associates** and **Copper Beech Advisors**. Windermere, based on Portland, Ore., provides Lydian with alternative investment capabilities, while Copper Beech adds a presence in Philadelphia and expertise in areas such as family governance and education. The wealth manager's parent, Lydian Trust Co., has filed for an IPO.

In the U.K., **UBS** made two acquisitions in the first quarter, in a continuation of its "bolt-on" strategy. The company nearly doubled its AUM in the U.K. to $18 billion by acquiring **Laing & Cruickshank** from Crédit Agricole, which bought the firm in 1987 but is exiting the U.K. wealth sector. UBS, which paid $290 million for the firm, followed up a week later by buying **Scott Goodman Harris**, a high net worth financial advisor focused on life and pension products. The company also made clear its intention to seek a bigger slice of the U.S. "ultra" high net worth market (those with at least $10 million in assets) when it announced in May the formation of its Private Wealth Management Group. The UBS presence in the U.S. wealth market is largely the result of its 2000 acquisition of Paine Webber.

Elsewhere in Europe, the saga of **Banca del Gottardo** took a new turn in March after parent **Swiss Life** announced that its two-year effort to sell the private bank had ended. A consortium led by Italy's **UniCredito** had been pursuing the bank earlier this year but dropped its bid because of pricing issues.

MUTUAL FUND

Equity funds in the U.S. continued to find favor with investors, as May marked the 14th straight month of inflows, albeit at the lowest level ($564 million) during that run. In a continuation of recent trends, deals tended toward the small, strategic variety. At the same time, the sector witnessed the largest U.S. deal since FleetBoston's purchase of Liberty Financial in 2001, when Wells Fargo agreed to acquire Strong Financial for a price believed to be around $500 million (with an additional $200 million possible based on performance). That one transaction alone could ultimately eclipse the total value of all mutual fund deals last year ($666 million), when the average acquisition price was just $24 million.

The sale of the privately held firm had been expected, with the deal taking place right after Strong settled federal and state suits alleging improper mutual fund trading. Although the scandal led many investors to flee Strong, with AUM dropping more than 20% since September, the firm retains $34 billion in assets (80% in mutual funds and the rest institutional). The deal will make Wells Fargo one of the top 20 mutual fund managers in the U.S., with $103 billion in AUM. The California bank did not indicate what it plans to do with the Strong brand name. Said Mike Niedermeyer, head of Wells Fargo's investment management business: "The acquisition blends the strengths of Well's Fargo's compliance and operations controls, investment capabilities and broad distribution with Strong's equity and fixed-income management, no-load funds and multiple distribution channels."

In a deal more typical of transactions in the sector, Wells Fargo also picked up three **Cooke & Bieler** mutual funds, with assets of more than $500 million. Under a subadvisory agreement, the Philadelphia firm, known for its value investing approach, will continue to manage the funds. "This relationship expands Cooke & Bieler's distribution capabilities and allows us to focus solely on investment management," said Kermit Eck, a partner with Cooke & Bieler.

The half-year tally reveals a number of similar deals, including **Dreyfus Corp.**'s acquisition of **Thompson Plumb Balanced Fund** managed by **Wisconsin Capital Management Inc**. Started up in 1987, the fund (AUM: $230 million) will be wrapped into the new Dreyfus Premier Balanced Opportunity Fund and benefit from the firm's formidable marketing and distribution capabilities but will continue to be subadvised by its original portfolio managers.

INSTITUTIONAL

The first six months saw a couple of notable management buyouts in the institutional sector. In the largest deal, **Delaware Investments**, the asset management wing of **Lincoln Financial Group**, reached agreement to sell its London-based **Delaware International Advisers** (DIAL) and certain affiliates to the newly formed **Atlantic Value Partners (No. 3)**, for 172 million in cash and additional obligations of around $27 million. Founded in 1990, DIAL has $19 billion in institutional assets and is one of the largest managers of international assets for U.S. institutions. Atlantic Value will maintain the value investing style it pursued while running Delaware International, and is also expected to retain a subadvisory role with Delaware Investments.

Orca Bay Partners, the Seattle-based private equity group that includes McCaw Celluar Communications co-founder John McCaw among its principals, backed the buy-out of **1838 Investment Advisors** from **MBIA Inc.** 1838, known for its tax-efficient style of investment, manages $3.6 billion for institutions and wealthy clients. Last year, Orca Bay sold its interest in another tax-efficient asset manager, **Parametric Portfolio Associates**, to **Eaton Vance**.

In addition to its deal for National Commerce in the first half, SunTrust acquired **Seix Investment Advisors**, a leading institutional fixed-income shop with $17 billion in AUM. The transaction makes SunTrust one of the top five managers of endowment trusts and foundation assets in the U.S. and meets a strategic priority of broadening the bank's institutional capabilities. New Jersey-based Seix will continue to operate under its name as a separate, fixed-income boutique.

Houston's **Sanders Morris Harris**, which took a 50% stake in Texas wealth manager **Salient Partners** in 2003, was back in the market this year, acquiring a 69% interest in **Charlotte Capital** from **Rosemont Investment Partners**, for $5.7 million. Charlotte manages $400 million for institutions, with a small- and mid-cap value investment style. SMH described the deal as part of its strategy to "be the leading Southwestern financial services firm serving affluent investors." In an East Coast deal, New York's **Forstmann-Leff** picked up the Boston-based small-cap institutional operation of **Schroder Investment Management**, adding $700 million in AUM. Just prior to the acquisition, the company had hired away a small-cap growth team from **Credit Suisse Asset Management**. Said

Rich Goldman, Forstmann-Leff President and CEO: "We have been looking to establish distinct investment capabilities to meet the growing demands that institutional investors require in today's challenging market environment."

CROSS BORDER

Transatlantic activity was virtually nonexistent in the first half, with the notable exception of **Affiliated Managers Group**'s purchase of a 60% stake in London-based institutional manager **Genesis Asset Managers** (AUM: $7.3 billion). Genesis, founded in 1989, provides AMG with emerging markets investing expertise. U.S. firms were active in Asia, however, with three major asset managers concluding deals. **Legg Mason** expanded its Asian business with the acquisition of **Rothschild Asset Management (Singapore)**, a deal that added $1 billion in assets, primarily in fixed-income accounts. The Baltimore firm plans to merge the business with its existing joint venture in Singapore. Legg Mason Chairman and CEO Chip Mason said the transaction offers the company "the solid and leverageable platform we have been seeking to expand our capabilities and client base in Singapore and other Asian markets."

Principal Financial enhanced its standing among trustees in Hong Kong's 4-year-old Mandatory Provident Fund, with the purchase of **Dao Heng Fund Management**, a Hong Kong firm that had been controlled by Malayasian banking billionaire Quek Leng Chan. Dao Heng manages $300 million in assets for both institutional and retail clients and adds 70,000 accounts in Hong Kong's retirement scheme to Principal's pre-existing total of around 330,000.
"This transaction is an extraordinary opportunity for The Principal to secure its position as one of the key players in Hong Kong's fast-growing retirement market," said Norman Sorensen, president of Principal International. In 2003, Principal entered into its second joint venture in India's mutual fund industry. **MassMutual Financial Group** expanded beyond its insurance operations in Asia with the purchase of a majority interest in Taiwan's sixth-largest mutual fund firm, privately held **Fuh Hwa Investment Trust**. Assets managed by Fuh Hwa have more than doubled since 2000, to $4.1 billion.

ALTERNATIVE

In real estate, **Regions Financial Corp.** picked up **Evergreen Timberland Investment Management** from Wachovia. The Timber business, based in Atlanta and founded in 1981, has assets of more than $1 billion and some 1 million acres under management. The deal allows Regions "to expand the investment choices available to institutional clients," said Ken Alderman, executive vice president of Regions Financial Corp. Previously, Regions had managed timberland for individual investors.

Hedge funds remained on the radar screen of investors worldwide, as fresh capital continues to pour into the sector and the number of new funds continues to multiply accordingly: TASS Research figures there are 7,700 such funds now with $850 billion in AUM. But deal-making was limited in the first half, with Mellon Financial's acquisition of **Evaluation Associates Capital Markets** the largest transaction. Established in 1984, EACM has $4.5 billion in AUM and follows fund-of-funds and manager-of-managers investing strategies. In 2002, Mellon acquired HBV Capital Management, which pursued a single-manager hedge fund strategy. Separately, the company reported that an "informal poll" of institutional investors indicated that 70% are looking to appoint fund-of-funds managers to gain exposure to alternative investment strategies.

In a management buyout, newly formed **Skylands Capital** acquired the hedge fund unit of Strong Financial. Skyland owner Charles Paquelet was a longtime investment manager at Strong. Another newcomer, **BayStar Asset Management** of San Francisco, acquired an interest in fund-of-funds manager **Ascendant Capital Partners** from Pennsylvania's **Turner Investment Partners**.

In a private equity deal of note, **Bear Stearns** acquired the private equity specialty finance business of **BDC Financial**, a Boston-based investment firm. Bear Stearns paid tribute to the history of innovation within the acquired group, including its creation of "a novel structured private equity fund-of-funds for institutional and high net worth investors."

SECURITIES & INVESTMENT BANKING

With significant consolidation among private client-focused securities firms having already taken place, the relatively modest deal activity during the first half of the year involved primarily non-retail firms. In the largest transaction, Boston-based buyout firm **Thomas H. Lee Partners** acquired 57% of New York's Refco Group, for $1.3 billion. Privately held **Refco** is a leading derivatives and futures brokerage firm with operations in 14 nations. Scott Schoen, senior managing director of Thomas H. Lee, said the deal "complements our long-term commitment to the financial services segment" and to "investing in growth companies with leading market positions and strong management teams." The company is expected to take Refco public in several years.

Thomson Corp. paid $385 million to acquire **TradeWeb Group**, a leading online fixed-income trading platform. Thomson could pay out an additional $150 million over three years to the consortium of eight investment banks that owned TradeWeb, based on performance. Sharon Rowlands, president and COO of Thomson Financial said the combination of TradeWeb's fixed-income expertise and trade execution capabilities and Thomson's content and analytical tools "will enable us to extend and accelerate our penetration and reach in the growing institutional fixed-income market." In a third major deal, **Robert W. Baird & Co.** management and employees acquired the 57% ownership in the firm held by **Northwestern Mutual Life Insurance** (employees had owned the other 43%). It was reported that Northwestern provided 80% of the financing for the deal.

In smaller transactions, **Linsco/Private Ledger** acquired the retail broker/dealer operations of **The Phoenix Companies**, which is focusing solely on its life, annuity and asset management businesses. LPL is the largest independent brokerage firm in the U.S., with more than 5,500 financial advisors. As part of the transaction, advisors affiliated with Phoenix will have the opportunity to distribute that company's products through LPL's representatives. In its seventh acquisition since 2001, **Ameritrade** purchased the online trading accounts of **JB Oxford Holdings** for a price not to exceed $26 million. Earlier in the year, Ameritrade closed on two deals announced in 2003, the largest of which involved **Bidwell & Co.**, with 100,000 accounts. JB Oxford adds 50,000 accounts, slightly more than half of which Ameritrade described as "qualified" (customers with $2,000 or more in assets). Ameritrade has a total of 3.5 million accounts.