ORLANDO CASE STUDY: 1997 Educational Retreat

THE MONEY MANAGER MERGER THAT FLOPPED

Background of US Powerhouse

US Powerhouse Investments (USP) was a Chicago-based firm with a great track record as a domestic growth stock manager. While USP offered many investment styles to institutional investors, its flagship style was large cap growth investing. Even in years when growth style investing was out of favor, US Powerhouse managed to excel. The firm's research analysts drove stock selection. And this analyst team did an excellent job of uncovering unique insights into Fortune 500 companies that often gave them an edge over their competitors.

Charles Smooth, USP's CEO and CIO, had started this research-intensive process in 1989. He had already spent 25 years in increasingly responsible positions at four boutique shops, where he had honed his hands-on research skills. Smooth, in deciding to "go it alone", systematically hired the best analysts available to cover each growth industry. He deliberately recruited a staff that was ethnically diverse and regardless of gender. In later years, the financial press praised USP as a nurturing, successful leader of one of the most diverse talent pools in the business.

Because Smooth was independently wealthy, he was able to fund the startup internally. Each of the analysts was asked to buy an equal share of the firm and each did so. They paid for their shares out of generous base salaries and were comfortable with Charlie owning approximately 40% of USP. Assets rose rapidly, based on Smooth's past track record, his top-notch marketing and investment staffs as well as a $25 Million minimum account size (no commingled fund). Stellar 1990-1994 performance led clients to make large incremental deposits.

Starting in early 1995, Smooth began to focus on the firm's long term future. Certainly, USP was already secure, having $15 Billion under management at an average fee of 75 basis points (0.75%) per year. The only sizable clients to end relationships through 1995 were those switching totally to defined contribution plans or those who were merged into other companies. But USP had no mutual fund presence in a burgeoning defined contribution plan environment, e.g. 401(k) plans. Also, USP had essentially no exposure to international equity management. International equity allocation was becoming a mainstream component of most corporate and public plans, regardless of size.

Taking occasional time off from his investment duties, Smooth tried to create an international equity team from scratch. He was close to hiring an international CIO, only to have the candidate's wife refuse to leave her job in L.A. A second try failed when that candidate developed a crippling back problem and couldn't risk traveling from London to Chicago. At this point, Charlie decided to buy a pre-existing international firm, seeking one with approximately $5 Billion in international assets. He also wanted one with an intensive research bent - like that of USP.

Charlie got close to three acquisition deals. In the first case, he was outbid by a competitor. The second candidate firm lost its two key analysts after the deal was all but signed. The third deal involved a family-run firm. In the end, the family was not comfortable giving up control.

Smooth knew that he couldn't stay away from the investing side of USP. And he was batting zero at the moment regarding his expansion ideas. He pondered awhile and finally hit on a solution. He would hire a Wall Street merger and acquisition entity to seek a true merger. Charlie insisted that USP had to maintain investment control, but was willing to cede business control. Further, the acquiring manager had to be a player in international investing with experience in managing mutual funds. The merged organization would then have a presence in three key aspects of institutional investing: domestic equities, international equities and the DC marketplace. Charlie retained Big Fist, Inc. to make the match. After meeting six possible candidates over 15 months, Charlie focused on a Montana-based international mutual fund complex.

Enter Montana Equity

Montana Equity International (MEI) had its own great track record. Sam Dexter had been the head of MEI from its 1985 beginnings. Prior to that, he'd spent a career managing international portfolios for the highly regarded Hempelman organization. Since Sam was now in his mid-60's and plagued with minor health problems, he wanted to start succession planning immediately. Yet, he had no confidence that anyone at MEI could take over the CEO role. When they met, both Sam and Charlie thought theirs was a match made in heaven. Charlie, still in his late 40's, would run the whole show in short order. The potential synergy of the two businesses seemed terrific.

Sam's leadership style was different from Charlie's. Sam made the country and stock selection decisions at MEI. However, he relied heavily on his 15 junior staff members to do the field research and to make strong buy and sell recommendations. Nine days out of ten, Sam was a great boss. But he could become very stubborn

from time to time. On those days, it was just easier for the MEI staff to agree with Sam. The next day, they could usually convince him to change his mind. Sam's private secretary and all of the MEI senior staff shielded this personality quirk from clients and other outsiders. They felt that Sam's brilliance at country allocation far outweighed his occasional obstinacy.

Sam was an early investor in top-performing Eastern European companies. He also made a strategic move to stay out of Japan for the last five years, a very negative-performing period for the Japanese market. Astutely, Sam invested in Latin America right after the recent currency crisis subsided.

Sam was clearly the majority owner of MEI. He had gradually reduced his ownership to 75%, dividing the remaining small pieces among the ten most senior members of his staff. Sam Dexter had amassed a fortune in eleven years thanks to international equity fees that were much higher than comparable US manager fees; this fee differential was especially great among mutual funds. That is how MEI had the cash to buy USP. Owners of both USP and MEI approved the merger, which was consummated on December 30th, 1996. On that date, USP became a division of Montana Global Equity.

Merger Terms

The buyout was lucrative for US Powerhouse. The price was 2x latest 12 months revenue. Sam Dexter paid half of the purchase price up front and required two year contracts for most USP owners. He negotiated four year contracts with Charlie, the research director and the marketing head. One year non-compete clauses appeared in all of the contracts. Breach of contract would cost USP owners most of the remaining payout and any rights to special incentives. Everyone at USP happily signed, looking forward to the second half of their payout plus special incentives. No one at USP, least of all Charles Smooth, contemplated leaving after the contracts would expire. USP employees with no ownership were also happy. They received one-time bonuses and meaningful profit-sharing participation.

Recent Performance

Clients of both firms generally agreed that this merger was a winner. The only problem was that, since mid-1995, USP's performance was relatively sub-par compared to the large cap growth index and other similar managers. USP customers were used to top performance since 1990. As a result, six nervous clients (out of 42 in this style) placed USP on their watch list. Another three clients transferred their accounts to competitors by early 1997. However, most clients had a reserve of cumulative outperformance. The USP client liaison team assured them that

performance would return to normal. Sure enough, Q3, 1997 showed dramatic improvement. Preliminarily, USP large cap accounts gained 13.6%, 3½% above the growth index and 5.4% over the S&P 500.

By comparison, MEI's $4.5 Billion International Growth Fund performed well above EAFE for the latest two years (9/95 - 9/97). Likewise, its $500 Million Emerging Markets Growth Fund was the third-best performer for the latest five years.

Post-Merger Developments

As part of the USP-MEI integration process, Charles Smooth spent considerable time with MEI's senior staff. While there was similarity to USP in research intensity, the MEI group was not as aggressive in defending their buy & sell recommendations. Also, if an MEI analyst saw a country-wide or region-wide trend while conducting research, he simply focused on the industry's best stocks, country-by-country. The more macro decisions were left to Sam, Sam's research director and a senior analyst who had worked with Sam since the 1970's.

Charlie wanted much more bottom-up involvement by the MEI analysts. Since they were "close to the ground" in every region, Charlie believed they could and should contribute to country allocation. But they resisted for three reasons. *First*, even though Charlie had become global CIO, they felt they should still be guided by Sam. *Second*, the MEI team had little experience in such decision-making except the consensus agreement to zero-weight Japan. *Third*, why fix something that isn't broken? The current decision-making approach was working just fine. After six months of fruitless effort, Charlie shared his frustration with Sam. In a tone he'd never heard previously, Sam asked Charlie to "cool it" for a few months and then try again. Charlie did as he was asked and immersed himself in USP investing until late September. But instead of returning to Montana for the rest of 1997, Charlie shocked everyone by resigning on October 1st.

Dexter to the Rescue

Sam immediately started recruiting Smooth's replacement - after a few choice words with Smooth via phone on October 1st. This was a tough assignment, since Sam didn't want to manage the US team himself and still wanted to ease out of the international side. A year from now, Sam still envisioned making the regional allocation decisions. The rest of the investment process would be in the hands of the new global CIO. For a moment, Sam became very sad, regretting the heated exchange he'd had with Charlie. Maybe he hadn't supported Charlie enough. That behavior would **not** occur on the new CIO's watch.

Operationally, Sam would continue to "do his thing" for MEI products until Smooth's replacement was on board (probably in early 1998). He spoke with each of the USP product heads and gave them full responsibility for their respective styles. Alva Trenches was the team leader for large cap growth stocks which represented 2/3 of USP assets; she was known for her hard work and long hours. Alva had been a drug, financial and technology analyst during her career. She had a knack for learning obscure business details from CEO's and CFO's, even those from Fortune 100 companies. Business execs liked her intimate knowledge of company financials and humbly-stated suggestions for their improved bottom lines. Alva recommended the right stocks 80% of the time and was quick to cut her losses when she was wrong. Further, she had a soft-spoken, yet convincing way with clients; people felt they could trust her. She was Charlie's number one lieutenant since early 1995.

Sam further decided to make Alva interim US-CIO. Now, Alva had to deal with an unnerved staff and her leadership skills would be tested on the job. Overall, clients who worked with Alva thought she would be an excellent stand-in for three to four months. At the same time, the USP head of research, Martin Detail, became product leader for large cap growth. Marty was not well-known outside the firm, but Alva knew he had solid credentials and was well-respected by USP's 13 analysts. Nonetheless, with ¾ of USP assets in large cap growth, Alva planned never to be far away from Marty's office. She recognized that the firm's future hung in the balance.

The Rahway, Florida Pension Plan

You are the trustee's of the Rahway, Florida Public Pension Board. Your pension plan is well-funded and mature; city and employee contributions are one-third less than disbursements per year. Total market value of the pension fund is $300 Million, covering 2,000 active and retired lives. Because of special statute, your plan covers general employees, police and firefighters together in the same plan. Regulations 175/185 do not apply.

The current asset allocation is 66% stock, 34% bonds, invested as follows:

Rahway Pension Plan
9/30/97 Market Value

	Allocation by Account	%
Stock:	Mid-to-large cap growth[1]	35
	Mid-to-large cap value	15
	Small cap growth	8
	International[2]	8
Bonds:	Investment grade	20
	High Yield	10
Disbursement Account		4
		100%

All of the mid-to-large cap growth allocation has been with USP since 1990. The account has grown through performance and periodic contributions. Disbursements have not been made from this account.

Your Role in This Situation

It is October 16th, 1997, the day you normally meet as trustees to review administrative matters relating to the pension plan. But instead, you are developing a game plan to cope with the USP situation. First, you review events of the last three weeks. The only reason you are up to speed today is that one of the Rahway trustees heard about Charles Smooth's departure at a pension conference he attended on October 3rd. Formal notification from USP only arrived by regular mail on October 9th. You and the other trustees hastily called a meeting on October 6th. By that time, you saw a short article about USP in a weekly pension news magazine. There it was in bold print: "Charles Smooth moves on after getting nowhere with the Montana International staff." The article went on to say that everyone at US Powerhouse was upset. They all had looked forward to working on a global investment mandate with Smooth. The final part of the article mentioned the rumor that two of the USP analysts were job hunting. However, that couldn't be confirmed.

Two of the trustees had been appointed at the October 6th meeting to make an urgent fact-finding visit to USP in Chicago. The two made the day trip on October

[1] all with USP
[2] 70% EAFE, 30% emerging markets

13th, a day when Sam Dexter also would be present to meet with them. The trustee committee met with Sam, Alva, Marty and the client liaison staff.

Sam and the USP staff talked up the team player concept at USP and said they expected Smooth's replacement within four months. The reason for the delay was to make a thorough search for a world class CIO. The trustees detected defensiveness on Sam's part regarding Charlie's departure, but he did apologize for not informing Rahway more quickly. Sam seemed firmly in control and both Alva and Marty convinced the trustees that they were completely knowledgeable about the large cap growth portfolio. They noted they were both comfortable with the situation because they had been managing together since the firm's inception in 1989. While Alva said she expected some clients to leave near-term, she was confident that good performance by USP would convince most clients to stay. Marty added that the USP marketing and client liaison people would be providing clients with monthly updates and would be available to meet clients at any time.

The trustee committee has just reported its findings to you. You decide to outline what needs to be done in the form of questions:

1. What are the positive and negative aspects of US Powerhouse today?
2. Given that money manager mergers have been occurring frequently for several years now, do you have confidence in USP's ability to correct its problems?
3. What specific steps need to be taken? Over what period of time?
4. What is your bottom line about USP?

Unfortunately, your consulting firm is not available to you. The firm, known as We Know & Associates is in the midst of a legal fight with its biggest client about fiduciary oversight. But your consultant has provided some attached statistics for you to review.

USP Performance Comparison (Large Cap Growth Style)

Calendar Year Returns

Year	USP (%)	Quartile Ranking Among Similar Competitors (1 = best)	Indices: Large Cap Growth (%)	Indices: S&P 500 (%)
1990	10.6	1	-0.3	-3.1
1991	68.0	1	41.2	30.5
1992	3.2	4	5.0	7.6
1993	3.8	3	2.9	10.1
1994	6.7	1	2.7	1.3
1995	33.1	2	37.2	37.6
1996	21.3	3	23.1	23.0
Q1 '97	-1.3	4	0.5	2.7
Q2 '97	15.0	4	18.9	17.5
Q3 '97*	13.6	1	10.1	8.2

* Includes estimated return for September 1997

USP Performance Comparison (Large Cap Growth Style)

Annualized Returns

Periods Ending 9/97*	USP (%)	Quartile Ranking Among Similar Competitors (1 = best)	Indices: Large Cap Growth (%)	Indices: S&P 500 (%)
1 Year	36.5	3	39.6	41.4
2 Years	27.7	4	30.2	30.4
3 Years	28.4	4	30.9	30.2
4 Years	23.8	3	24.1	23.0
5 Years	18.7	1	20.2	20.9
6 Years	19.2	1	18.6	19.2
7 Years	23.9	1	21.3	20.9

* Includes estimated return for September 1997

Sharpe Ratios

	USP	Large Cap Gr	S&P 500
3 Years	1.95	2.62	2.74
5 Years	1.40	1.42	1.74
7 Years	1.26	0.87	1.06

USP
Portfolio Characteristics
6/30/97

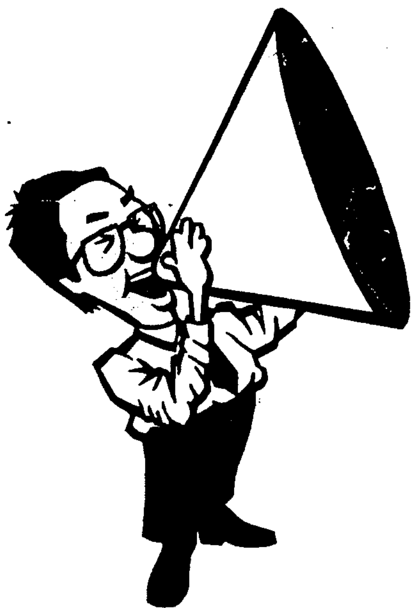
Characteristic	USP	Indices Lge Cap Gr	S&P 500
Price/Earnings	19.8X	28.6X	21.5X
Price/Book	5.7X	6.1X	3.5X
Dividend Yield	1.6%	1.0%	1.7%
5 Yr EPS Growth	22.9%	20.7%	17.2%
Median Market Cap	11.7B	3.1B	6.1B
# of Stocks	32	594	500
Large Cap Growth $	970M	-	-
Total $	970M	-	-

MEI Performance Comparison
(EAFE Mandate)

Annualized Returns

Periods Ending 9/97*	MEI (%)	Quartile Ranking Among Similar Competitors (1 = best)	EAFE Index (%)
1 Year	29.4	1	11.4
2 Years	21.8	1	10.0
3 Years	18.4	1	8.6
4 Years	19.1	1	8.9
5 Years	22.3	1	12.2
6 Years	18.2	1	8.7
7 Years	17.9	1	10.5

* Includes estimated return for September 1997



LATE BREAKING NEWS!!

1) The rumor mill proves true regarding the two USP analysts. They are leaving to form a new large cap growth firm. But their industry specialties, consumer non-durables and drug companies, are also covered by two other analysts at USP. Sam Dexter will replace the departing employees quickly and immediately improves the compensation package for the remaining analysts.

2) Luckily, Sam has found a new CIO who will probably be in place by mid-November. The candidate currently works for a London-based firm and has a good track record managing U.S. stocks for UK clients. The candidate, who holds the title of Earl, is from a long line of "blue bloods".

3) Two USP clients, representing $400 Million of assets, have since terminated their USP relationship.

4) At the same time, two new clients have just hired USP. Interestingly, these new clients are well-known to demand substantial fee concessions from their managers.

5) Small and mid-cap stocks have assumed market leadership recently vs. the mega-cap names. USP has always had an approximately 15% exposure to smaller companies. Alva Trenches announces that she will step up this exposure in the mid-cap area. But the companies must meet the same rigorous earnings growth criteria and company management must meet the same high standards as required by the USP analyst team.