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Righting the Ship of State

Buffeted by subprime losses, staff turnover and client lawsuits, State Street Global Advisors puts Old Mutual's Scott Powers at the helm.

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RIGHTING THE SHIP OF STATE

AFTER A TURBULENT 2007 OF SUBPRIME LOSSES, STAFF TURNOVER, ANGRY CLIENTS AND LAWSUITS STATE STREET GLOBAL ADVISORS TURNS TO NEW CEO SCOTT POWERS TO SET IT STRAIGHT.

BY MICHAEL SHARI ILLUSTRATIONS BY NOMA BAR

Last November 27, Michael Travaglini, executive director of the Massachusetts Pension Reserves Investment Management Board, paid a visit to William Hunt, chief executive officer of State Street Global Advisors, the $1.9 trillion, 1,700-employee money management arm of custodial banking giant State Street Corp. Hunt's blunt-spoken boss, State Street chairman and CEO Ronald Logue, sat in on the meeting in a small conference room in State Street's sleek offices overlooking Boston's Inner Harbor.

MassPRIM was one of SSgA's oldest and biggest investors, and Travaglini had known Hunt and Logue for years, but this was no social visit. Travaglini was deeply unhappy. Accompanied by his CIO, Stan Mavromates, he

complained that many of the State Street executives and money management professionals his staff had worked with directly had left SSgA since Hunt had become CEO in January 2005. Travaglini rattled off a list: CIO Alan Brown in March 2005; institutional sales chief Christopher Pope in November 2005; his replacement, Penny Darcey, in April 2007. Just weeks before the meeting, Brown's successor, Sean Flannery, had also left, as had seven members of a highly regarded nine-person international active equities team that managed a $930 million portfolio for MassPRIM.

"Every single person who had authority on our account resigned," recalls Travaglini. He says Hunt and Logue defended themselves, pointing out that high turnover was normal in the money management industry, that SSgA had a deep bench and that they were taking steps to retain talent. (Hunt and Logue declined to comment on the meeting.)

But Travaglini had received similar assurances before, and he wasn't satisfied. "There are only so many times you can hear that story," he says. In December he shifted MassPRIM's $930 million to an SSgA passive index account. Travaglini also placed MassPRIM's entire remaining SSgA investment — about $7 billion in passive index accounts — "under review" for possible withdrawal. The decision, he notes, reflected "my frustration with the relationship." Early this year MassPRIM decided to move the $930 million to Mondrian Investment Partners in London and Pyramis Global Advisors in Boston.

Travaglini is not the only big SSgA client who was upset. In the midst of last summer's market rout, SSgA's actively managed fixed-income team delivered sorry performance numbers owing to bets on subprime-mortgage derivatives. Several irate institutional customers not only pulled money from the funds that had been hit but also sued SSgA, alleging that the firm had misled them about the levels of risk it was taking on. SSgA denied the accusations. Most of its active fixed-income team left, and the firm shut down a fledgling hedge fund unit the team had managed. Yet clients tell *Institutional Investor* that they complained to SSgA about a lack of responsiveness to their concerns and about being made to wait weeks for answers to questions.

Tensions came to a head on January 3, when Logue announced that SSgA was setting aside $625 million to settle the client lawsuits — a deep cut that slashed the firm's 2007 earnings to $41 million, or 2.15 percent of State Street's profits, down from 24 percent the year before. Logue also announced that Hunt was out and that he would be succeeded on an interim basis by James Phalen, 57, the affable head of State Street's international custody business. Logue promised to cast a wide net in searching for a permanent successor.

In April, Logue announced that he had found his new CEO close to home — just three quarters of a mile across Boston Common, in fact — Scott Powers of Old Mutual Asset Management. Powers, who declined to comment for this article — he officially takes over in mid-May — has his work cut out for him. Armed with a powerful drive and a knack for turnarounds, he comes well prepared for the task.

"Many investors will say, Before I give you new money, please explain to me what happened and what changes you have made."

— Robert Lee
Keefe, Bruyette & Woods

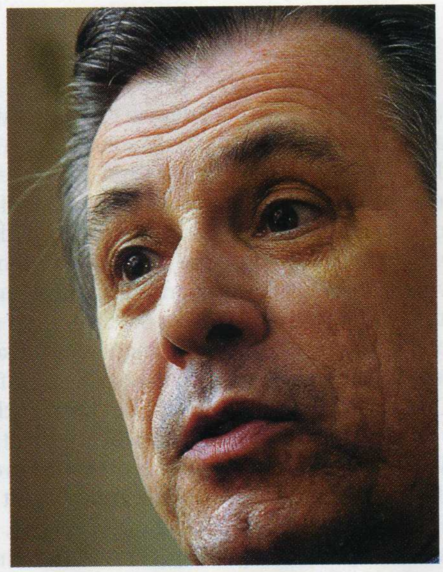
A former Harvard University hockey star who won an award for aggressive play, Powers has earned high marks for resuscitating Old Mutual Asset Management, which hired him as CEO just days after 9/11. Earlier in his career he helped rebuild the Boston Co. Asset Management after the walkout of then-CEO Desi Heathwood and 33 of the firm's partners in 1995. "Scott's got a big job ahead of him at State Street, but he's tough," says James Sutcliffe, CEO of Old Mutual in London, which owns Old Mutual Asset Management. "There's nothing you could throw at Scott that he would duck."

Founded in 1978, SSgA is, of course, a far bigger and more complex institution than either the Boston Co. or Old Mutual. But although it is blessed with great strengths, it has also repeatedly been humbled by missteps. After a decade and a half of extraordinary growth fueled by investors' seemingly insatiable demand for its index products, SSgA today ranks as the second-biggest money manager in the U.S., just behind San Francisco–based Barclays Global Investors, another passive-investment titan, which has $2.1 trillion in assets under management. SSgA has long since established a record of market savvy and innovation, thanks in no small part to its pioneering use of sophisticated quantitative investing strategies. But it has at times struggled to live up to its promise. The bulk of its assets remain in low-margin index accounts — or their somewhat more lucrative "enhanced" cousins — and its efforts to build a powerhouse active management operation to match its passive business and improve profitability have been fitful. SSgA was early to hedge fund investing, created the first exchange-traded funds and rolled out popular hedge fund–like 130/30 strategies ahead of most of its rivals, but has failed to exploit early-mover advantages.

Nowhere does this show more clearly than in direct comparison to BGI, the asset management unit of London-based Barclays Bank. SSgA moved into hedge funds in 1990, according to a representative. BGI waited until 1996 to launch its first long-short strategy and until 2001 to launch its first hedge funds. But by the end of last year, BGI had $25 billion in these profitable investment vehicles, according to the company, while SSgA had just started winding down its hedge funds, which had $4 billion in assets last summer. SSgA kicked off one of the investing world's great product booms, ETFs, with its 1993 launch of Standard & Poor's depositary receipts, or SPDRs. As of last month, according to Paul Mazzilli, who tracks ETFs at Morgan Stanley, SSgA had a 22.6 percent share of the $584.9 billion market; BGI, which launched its first ETF in 1996, commanded 52.4 percent.

Perhaps not surprisingly, SSgA has been consistently less profitable, although BGI's lead has been narrowing. SSgA's pretax margin for 2005 was 31 percent, compared with 41 percent for BGI; in 2006, SSgA's margin was 35 percent, compared with 43 percent for BGI. And last year — not counting the reserve for lawsuits — SSgA's margin would have been 36 percent. After the lawsuit reserve, the margin was 3 percent. BGI's was 38 percent.

Hunt became CEO in 2004 with a mission to straighten SSgA out, and for a time he seemed to be succeeding. By the end of 2006, the firm accounted for 24 percent of its parent's profit, up from 17 percent


Former Old Mutual Asset Management CEO Scott Powers (left) has an impressive track record of turning around asset managers with problems; State Street chairman and CEO Ronald Logue (center) picked Powers to succeed SSgA CEO William Hunt, who resigned in the wake of last summer's subprime market rout

POWERS: ALLAN PENN; LOGUE: REX USA

at the end of 2004 and just shy of Logue's goal of 25 percent. But employee turnover and client dissatisfaction were high. Then came last summer's market ructions and the sorry performance of SSgA's vaunted quantitative research unit, which had been the engine of the firm's growth.

SSgA is not in any danger of sinking, of course, but it has had some rough sailing, particularly with regard to client relations. Addressing that will likely be the first order of business for Powers, whose initial weeks on the job, according to an SSgA representative, will be spent in "a combination of activities, including client meetings with the SSgA management team and other employee groups and meetings and calls with clients," first in the U.S. and then overseas.

"Many investors will say, Before I give you new money, please explain to me what happened and what changes you have made," says Robert Lee, a research analyst for investment bank Keefe, Bruyette & Woods who covers asset managers.

So far there has been no sign of investors defecting en masse: the $930 million that MassPRIM pulled out was less than 1 percent of the $171 billion in active equities SSgA manages. Last year investors gave the firm $116 billion in new money, and total assets under management grew by $230 billion. Parent State Street is thriving. Despite the market chaos, its stock price is up 10 percent since July 1, 2007, whereas the KBW bank index is down 25 percent. State Street had significantly less subprime exposure than did most of its peers. That financial strength should help Powers as he tries to convince antsy investors of SSgA's commitment to clean up the mess of the past several months.

ALTHOUGH STATE STREET HAS BEEN IN THE ASSET management business for three decades, the 216-year-old institution has never quite gotten it firing on all cylinders. Spurred by the dollars that began to flow into retirement plans after the passage of the Employee Retirement Income Security Act of 1974, the bank formed a money management unit with $2.1 billion in assets in 1978 that was initially a sideline to the bank's core business. The fledgling unit got a boost from the custody bank's global network of client relationships and powerful information technology backbone. "We seemed to have a skill set in quant and index funds, as opposed to active stock management, because of our strong IT," recalls Marshall Carter, who was chairman and CEO of State Street from 1992 to 2000 and then nonexecutive chairman until 2001. He is now deputy chairman of NYSE Euronext.

Even so, the money management business grew slowly until 1992, when State Street created a separate division, giving it a higher pay scale to attract better investing talent. The following year, when assets under management surpassed $10 billion, SSgA made its ETF breakthrough and in the years that followed feasted on the great stock market boom of the era, particularly as institutional investors gravitated toward indexing, enhanced indexing and quantitative strategies. SSgA fought aggressively for new business, often lowballing its competitors on fees. In 2002 it established an international presence with the acquisition of Gartmore Investment Management's $25 billion indexing business. By the end of 2003, SSgA had blown past both Barclays and longtime No. 1 Fidelity Investments to become the biggest money manager in the U.S.

The same year, however, as equity markets slumped, net income dropped 41 percent on declines in trading and market-related revenue and on soaring operating expenses. SSgA recorded an operating margin of 19 percent, compared with an industry standard of 30 percent. By this time, too, according to Richard Bove, a banking analyst at Punk, Ziegel & Co., the firm had developed a reputation for infighting and high turnover. The following year was difficult as well. In July, State Street chairman and CEO David Spina stepped down for health reasons and was replaced by Logue. Then in August 2004, SSgA chief Timothy Harbert died suddenly of a heart attack.

New State Street CEO Logue moved to get SSgA back on course. As SSgA CEO he chose Hunt, who had joined State Street in Japan in 1994 and had earned Logue's confidence by turning a money-loser into a regional profit spinner. Hunt subsequently became head of SSgA's international business and then head of global client relations for State Street in Boston. (SSgA CIO Brown resigned, filed a still-pending lawsuit against State Street for what he claims is unpaid compensation and joined Schroders Investment Management in London as CIO.)

Hunt was under tremendous pressure from day one to help Logue meet his goal of growing the parent company's revenues by 20 to 22 percent a year. Logue set a target of nearly doubling, to 25 percent, SSgA's contribution to State Street's pretax profits.

To get there, Hunt set out to grow actively managed strategies. His accomplishments were impressive. He worked to increase the number of products under development and to get them out the door faster. To do so he knew he had to strengthen SSgA's quant models, which were critical to the growth of active strategies and had suffered a setback with the 2005 resignation of Anthony Foley as head of the Advanced Research Center, SSgA's product development unit. (Foley joined quant hedge fund D.E. Shaw Group.) Hunt promoted Mark Hooker, an ARC researcher and former Federal Reserve Board economist, to run the unit and grew the ARC team from 13 to 38 researchers.

By June 30, 2007, more than half of the new money flowing into SSgA was going to various active and enhanced strategies. One clear winner: SSgA's 130/30 long-short strategies, market-neutral products that take on average a 30 percent short position and a 130 percent long position in an equity portfolio. SSgA was among the first money managers to offer this strategy. The product, launched in early 2005, proved extremely popular among institutional investors. SSgA had a total of $12.8 billion under management in 130/30 funds at the end of last year; about half was managed by the international active equities team.

Hunt acted aggressively across the range of SSgA's products. Eager to reclaim SSgA's standing in the ETF market, he hired a new sales chief, poaching Anthony Rochte from BGI's Chicago office in October 2006. Rochte hired 18 wholesalers, bringing the team that sells ETFs to financial advisers and family offices up to 89 members. In 2006 and 2007 the firm launched a series of new ETFs, mostly based on emerging markets and U.S. bond indexes. In the first half of 2007, SSgA introduced 39 new products, mostly liability-driven investing strategies for defined benefit plans and asset allocation strategies aimed at the defined contributions market.

Under Hunt assets under management grew 7 percent in 2005, 22 percent in 2006 and 13 percent in 2007, beating the Standard & Poor's 500 index's appreciation each year by a comfortable margin. SSgA contributed more and more to State Street's growing profits — from 17 percent in 2004, SSgA's share of State Street's earnings rose to 24 percent in 2007 (not counting the reserve for lawsuits.)

Hunt was a demanding boss; turnover was steady. But he was getting results, and his boss was satisfied. When *II* spoke to State Street CEO Logue last July, he said: "When those people who are no longer here were here, we lost our lead in ETFs to BGI and we had a low-double-digit pretax profit margin. The defense rests."

At the same time, SSgA's performance in several active fixed-income funds suffered. In July, SSgA's Limited Duration Bond Fund, with $2.81 billion in institutional assets, fell 11 percent; it plunged a further 37 percent in the first three weeks of August. From July 1 to August 29, the Intermediate Bond Fund fell 11.83 percent while its benchmark, the Lehman Brothers U.S. intermediate government/credit bond index, rose 2.49 percent. From July 1 to September 5, the Government/Credit Bond Fund declined 25.44 percent, while its benchmark, the Lehman Brothers government/credit bond index, rose 3.07 percent. The Absolute Return Mortgage Fund, a hedge fund managed by the same fixed-income team as Limited Duration, fell nearly 40 percent from the beginning of June, when it had $120 million in assets, to the end of August, according to sources familiar with the hedge fund. All the funds had taken long positions in securities exposed to subprime mortgages, and, compounding the losses, they used leverage.

At the time, Hunt said SSgA had been blindsided by the abrupt repricing of risk just like everyone else. To be sure, quant funds throughout the business suffered, including renowned top-of-the-market funds. Goldman Sachs Asset Management's Global Alpha hedge fund fell 22.5 percent in August. As Hunt told *II* in September, "The severity of the events of July and August took many by surprise."

True enough, but many clients were unhappy. Among them was Brian Andrews, deputy commissioner of the State of Alaska Department of Revenue, which had invested about $300 million in the Daily Government/Corporate Credit Bond Fund. Andrews says the fund, benchmarked against the Lehman Brothers government/credit bond index, fell 15 percent in the first two weeks of August. He explains that he and his colleagues in Juneau couldn't understand why it was falling three times faster than the market value of the AAA-rated securities in the portfolio, which were down about 5 percent. State Street declined comment.

"The lightbulb came on when we finally learned they were using leverage and that the portfolio had a notional value of $900 million, or three to one. All of a sudden that 5 percent drawdown was looking like a 15 percent drawdown," says Andrews. On August 28, he withdrew $30 million of the $300 million investment and gave it to BGI. Other SSgA clients were also displeased. Public Employee Retirement System of Idaho, a longtime SSgA customer, pulled $60 million out of the Daily Government/Corporate Bond Fund and moved it to an SSgA passive index fund.

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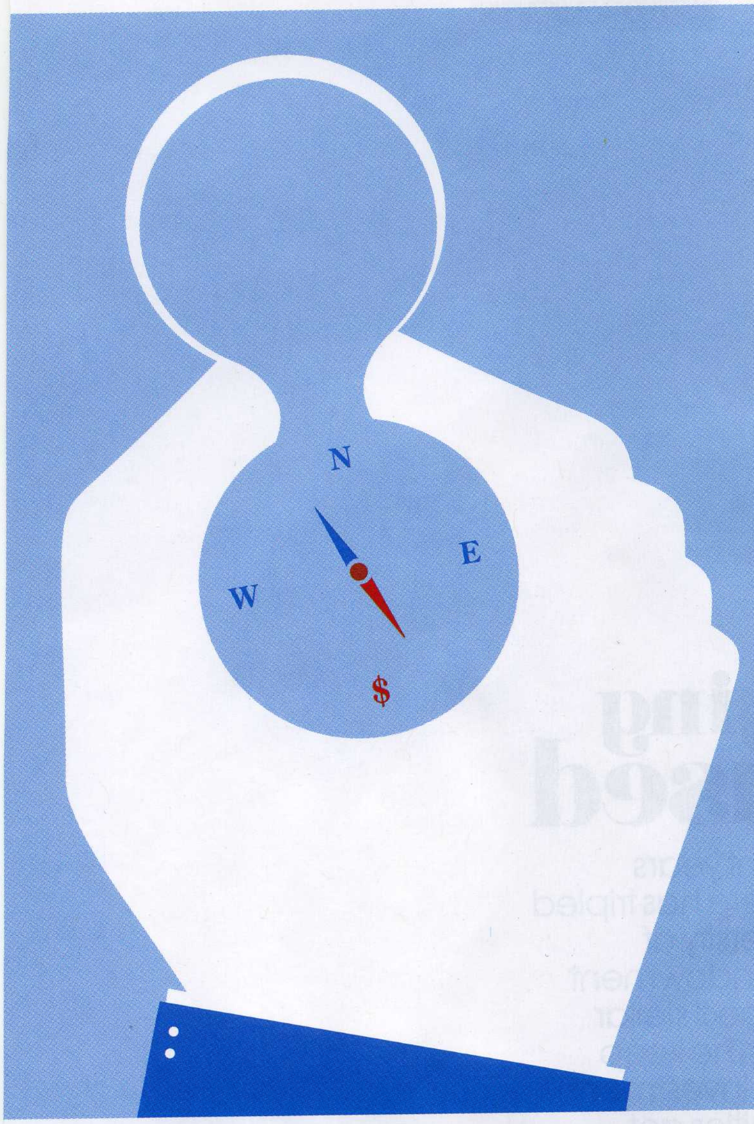
>
> **— Michael Burns**
> Alaska Permanent Fund

Another headache came from SSgA Capital Management, a $1.2 billion hedge fund operation Hunt had launched in February 2006. (SSgA itself and asset managers it contracts with managed an additional $3 billion in funds of funds and absolute return strategies.) SSgA Capital's Absolute Return Mortgage Fund, managed by SSgA's active fixed-income team, fell nearly 40 percent from June to the end of August. In October the firm shut down SSgA Capital Management and returned assets to clients, including the U.S., Canadian and Dutch units of British Petroleum, according to people familiar with the matter. Alarmed by the Absolute Return losses and concerned that fees for SSgA's other hedge funds were too low, according to people familiar with the matter, Hunt started winding down some of the firm's remaining onshore hedge funds and funds of funds. SSgA Capital CIO Chris Woods resigned in October to join hedge fund operator Man Group in London, and his boss, SSgA Capital president Jane Tisdale, left in November, as did most of the active fixed-income team.

Then on November 15, seven of the nine-member active international equity team, including leaders Paul Moghtader in Boston and Susanne Willumsen



in London, were hired away by Lazard Asset Management in a deal that allowed them to stay in Boston and work with former SSgA institutional sales director Christopher Pope.

In February the Alaska Permanent Fund Corp., which manages the state's oil revenue, withdrew its entire $504 million investment from an MSCI EAFE–benchmarked account managed by the recently departed active international equities team just 120 days after funding it, according to Michael Burns, executive director of the fund. Alaska Permanent redistributed the money among eight other managers, including Goldman and Morgan Stanley Investment Management. "In the same time frame, the CEO left, the CIO left, and then this team lifted out," says Burns. "With that kind of management turmoil, it's difficult for people to really focus on the customer and the mission."

Then there were the lawsuits. In October 2007, Prudential Financial sued, seeking repayment of market losses of $80 million to make whole 280,000 individual investors in 165 retirement plans it manages. Prudential alleged that SSgA had misled it about the level of risk in two bond funds: the State Street Intermediate Bond Fund and the State Street Government/Credit Bond Fund. It also claimed SSgA packed the funds with subprime-mortgage derivatives instead of the investment-grade government and corporate bonds that had been advertised. SSgA's parent, State Street, has moved to dismiss the suit.

By December, when MassPRIM shifted its $930 million to an index account, three corporate plan sponsors — New York publisher Unisystems, New Hampshire manufacturer Nashua Corp. and Massachusetts insurer Andover Cos. — had filed suits seeking unspecified damages over losses in SSgA bond funds, while making accusations similar to Prudential's. Just before Christmas, SSgA agreed to refund $6.3 million in fees to the Alaska Retirement Management Board. And as of late April, SSgA was discussing a similar deal with the Public Employee Retirement System of Idaho, according to the system's executive director, Alan Winkle.

THE FIRM IS NOT MAKING NEW CEO POWERS AVAILABLE to the press. State Street chairman Logue isn't saying what SSgA's plans are, though he told analysts on a conference call in January: "We are not abandoning the active fixed-income space, and we are committed to building both the team and the product line." Powers comes to SSgA with a track record of resurrecting troubled asset management businesses. He faces challenges similar to those that propelled his rise through the Boston Co. and its then-parent Mellon Bank Corp. In 1995, Mellon took a $220 million write-off to liquidate the Boston Co.'s securities lending portfolio, which had suffered sharp losses, and dismissed the managers of two funds. Boston Co. CEO Desi Heathwood abruptly resigned and formed a competing boutique. Powers worked with then-CEO Christopher Condron to recruit investment management professionals, introduce new institutional equity strategies and sign up large institutional clients — a rebuilding campaign for which Powers was promoted to COO in 1998. "We saved the Boston Co. in a very turbulent period, and he had a very big role in that success," recalls Condron, now CEO of asset management and insurance conglomerate AXA Financial.

At Old Mutual Asset Management, Powers presided over an even more daunting turnaround. In five and a half years, he realigned a collection of boutiques that the London-listed South African insurance conglomerate had acquired from United Asset Management Corp. Earnings before interest, taxes, depreciation and amortization grew by two and a half times, to $324 million, for 2007, and Old Mutual added $125 billion in new money from mostly institutional clients, bringing total assets under management to $332.6 billion. Powers cleaned up after the collapse of one firm and the breakaway of another and rebuilt a third, Pilgrim Baxter & Associates, which paid $100 million to settle civil fraud charges related to market-timing abuses in 2003. He also steered Old Mutual through a U-turn away from an already closed deal to acquire a majority stake in asset manager Forstmann-Leff Associates from commodities broker Refco just days after Refco CEO Phillip Bennett was arrested on fraud charges in 2005.

Powers has solid relationships with some of SSgA's most important clients. At the top of that list is MassPRIM CEO Travaglini, who was two years behind Powers at Harvard, where they were both students on financial aid in the late '70s and early '80s. Travaglini had a work-study job in the sports house near the rink where Powers played forward for Harvard's hockey team. In the mid-1990s, when Travaglini was executive officer of the Boston Retirement System, which manages pension assets for the city's civil servants, he dealt directly with Powers, then head of institutional client relations at the Boston Co. "State Street could not have made a better selection," says Travaglini. In fact, Travaglini says he's so pleased by Powers's arrival that he's decided to leave the $7 billion he had placed "under review" with State Street. Powers has a tough job ahead of him, to be sure, but he can already claim a big accomplishment.