Tony Arrell, C.M.
President,
Arrell Family Foundation
Chair & Co-Founder,
Burgundy Asset Management

IT IS MORE THAN JUST MONEY

Tony Arrell delivered the following speech to the CFA Institute, May 13, 2008, in Vancouver, Canada.

Every year, hundreds of investment management firms are established around the world; only a small percentage of these start-ups are likely to achieve ongoing success — in terms of investment results and critical mass. The majority of firms do not achieve index-beating investment results, after fees, in the long run. A small percentage will make it to their 10th anniversary with, say, AUM of $1 billion. But an even smaller percentage makes it to their 20th anniversary with $5 billion or more under management and value-added results.

It takes a lot of courage, self-confidence and energy to start a firm in our business. And no one wants to fail. So what happens? Why do the majority of firms fall by the wayside?

And what can be done to improve the odds?

Today, using my own firm, Burgundy Asset Management, as an example, I will discuss factors such as values and culture that, in my view, are vital to firms that are successful.

Burgundy is in the active equity business with a focus on long-term absolute returns. We follow a value style and run quite concentrated portfolios with typically 25 stocks and very low turnover. We try to think like fractional owners of a business and select investments based on the difference between price and estimated economic value. This is Ben Graham's concept of the "margin of safety." Since the inception of the firm, we have had positions in some great companies that we admire.

At the core, we are a research firm, and the majority of the senior people have a research background. Burgundy runs equity portfolios in several different geographies, including the U.S., Europe, Japan and Canada. We have had historic strength in small-cap equities in several markets.

Our investment approach is based on value, concentrated investments and a long-term orientation. It carries with it inevitable periods of painful underperformance. To get through such periods, a supportive and like-minded client body is essential. Clients with short-term, high-performance aspirations are not likely to embrace this philosophy. So a firm such as ours must choose clients wisely. As David Swensen of Yale University said in his book Unconventional Success: "Without steadfast investor support, the best investment firms in the world cannot produce superior results for clients."

We manage $8 billion in assets for wealthy families and institutions — primarily endowments and foundations. We have a team of 20 investment professionals; our total staff numbers 80, including client relationship people, accounting and administration.

I was involved in establishing Burgundy in 1991 following a 22-year career I had enjoyed as an analyst, director of research and senior executive at a major Canadian securities firm.

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Firms like Burgundy operate in an exacting industry. "Mr. Market" is a very tough adversary; far fewer than 50 per cent of his opponents will beat him over time. Unless a firm has some sort of competitive edge, the odds are stacked against it. In the thousands of firms in our industry, there are many very smart, well-educated, hard-working people all trying to gain an edge. John Maynard Keynes likened the investment world to the children's card game Old Maid. In that card game, you'll recall, everyone is trying to outguess each other and determine who holds the key card. Similarly, in the investment world, many participants are all trying to outguess each other to see what cards the other firms are holding. Instead, they should focus on valuing the companies they are investing in and comparing the valuations to the public quotations.

How can companies in our industry gain a competitive advantage?

What I will suggest today is that some of the critical factors that enable an investment firm to get an edge relate to things besides just money. In fact, the title of my talk is "It Is More Than Just Money."

> "Synergy of client and firm interests are enhanced when members of the investment firm have all or nearly all of their money invested at the firm; this is the way things operate at Burgundy."

The things that matter are things we can't touch, or see or feel with our hands — they are things we can only feel with our being. At the heart of any successful firm in our business is a set of core values, or deep-seated beliefs, which represent its very essence — its soul; or its culture. These values and beliefs are what I think give a firm the glue that holds it together, allowing it to attract and keep outstanding people, and assists the firm in achieving a competitive edge.

Let me elaborate on seven core values that I have found contribute to success in investment management.

1. PUT THE CLIENT FIRST

The first core value of really great investment firms is that they put the client first. While this sounds obvious, surprisingly, many investment organizations don't do it — and some, by their nature, cannot always put the client first.

Large financial conglomerates have obvious challenges in this area. Organizations that seek to sell their clients different funds or services face inherent biases. An international bank selling someone an internally run hedge fund versus an externally run long-only fund is an obvious example. In some firms, asset-gathering activity trumps efforts at maximizing client risk-adjusted returns. This would be a common situation at most firms. As I will discuss later, our firm has consciously limited asset growth in funds when more assets would be likely to limit returns to our clients over time.

To me, hedge funds have biases to take big risks in return for asymmetric big fees. This can easily lead to disproportional risk-taking, in my view. That is, the client gets more of the risk, and the manager gets more of the reward. The best way to serve the client is to make the firm's interests and the client's interests one and the same.

Synergy of client and firm interests are enhanced when members of the investment firm have all or nearly all of their money invested at the firm; this is the way things operate at Burgundy. We estimate that 90 per cent of Burgundy people's liquid net worth is invested at the firm. In this way, we eat our own lunch. It also helps us be tax conscious and enables us to enhance clients' interests by working hard to minimize fractional costs arising from turnover like capital gains taxes.

2. ATTRACT GREAT PEOPLE

The second core value of a successful investment firm is a focus on attracting and developing great people, and figuring out how to keep them for the long term. I have found over time that the best people always seek to hire people who are better than they are.

I always say that "first-class people hire first-class people. Second-class people hire third-class people." I have seen this over and over again in a number of different organizations. Most people are too insecure to hire people better than they are. But outstanding people are self-confident, bury their ego and hire people better than themselves, and see this as a road to success.

As head of Burgundy, I make people by far my top priority. In hiring, we look for the best talent we can find. We believe that the quality of people is one area where a firm can gain an edge.

At my firm, when considering a new candidate we look first at character. Because we manage other people's money, we feel it is essential to seek people who are principled, decent and stable. I always think, when interviewing, "Will this person represent our firm well?" In judging character, we try to learn a lot about people's family and interests. How is this person likely to deal with adversity? (There will be lots of this in an investment firm that tries to pursue market-beating policies and, by definition, will endure inevitable painful periods of underperformance!) People with fairly humble backgrounds who have seen adversity in their lives may have an advantage in temperament.

On the more personal side, we always arrange for someone senior in the firm to dine with the candidate and their wife, husband or partner — it is insightful in showing how they treat other people.

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Independent thinking is also important. Temperament and the willingness to stand apart from the crowd are critical in following an investment strategy like ours, which is often contrarian and out of sync with prevailing market conditions. We ask: "Is this someone likely to have the courage of his conviction?" What do they have to say about current events? Does the candidate simply regurgitate the news or do they have a deeper, more thoughtful perspective? I like to ask people about their reading habits and look for signs of both breadth and intellectual curiosity. At our firm, reading is kind of the company sport.

In addition to sizing up the integrity and intellectual curiosity of potential candidates, we look for good reasoning ability and judgment. We always give prospective analysts a test: we give them a file on a company to take away for a few days, with a request to come back with a company assessment. We purposely don't give much direction on the project, as we want to see:

- How resourceful are they? Do they just go to the IR websites and look at brokers' reports? Or do they go beyond the obvious sources?
- Is there evidence of original thought?
- What facts do they view as the most important?
- How well do they communicate their findings to us?
- How does the person handle extemporaneous, tough questions?
- How do they handle stress?

Finally, we are looking for people with a broad education. Math is a good background, and we have several analysts with engineering degrees. As well, we have one from forestry and one from agriculture. The point is, we don't have a simple rule book on backgrounds. We think diversity is really a good thing. In our case, this diversity is ethnic as well, which we think is a big help — particularly as the firm does more and more investing internationally.

Prior business experience is also an asset, but at Burgundy we have hired both very experienced analysts and inexperienced analysts. As time goes by, we more and more develop our own people. We feel that in this way we don't get people with bad habits or styles. It reconfirms the culture as well.

Stealing people from other firms is definitely not the way to go. Besides, if you are really good, good people come to you and you can build your own gene pool!

It takes a lot of time to develop people and many are not prepared to patiently build their human resources, but we think it pays off big in the long run.

3. PAY ENTREPRENEURIAL COMPENSATION

Third, to develop a successful investment firm, I think it is so important to create an entrepreneurial compensation structure. The compensation at our firm is not formulaic, but based on one's overall contribution.

A significant portion of operating earnings at our firm is set aside for what we call "merit bonuses." Every person is assessed in detail once a year and we do our best to determine their contribution to the overall firm. Half-year mini-reviews occur as well. Our president, Richard Rooney, and I approve final amounts.

For portfolio managers, long-term performance is the key thing. But we also ask: "Are they good partners; are they developing analysts to help them; are they involved in the community; are they good communicators?"

I feel that providing such entrepreneurial compensation — based on a manager's total contribution to the firm — creates a strong long-term incentive structure, with some short-term incentive as well.

A lot of companies are not prepared or not able to measure their employees' success in this way. Performance evaluation, compensation and troubleshooting take a lot of time. I spend a full month a year focused on performance evaluation and compensation. The fact that we have never lost a senior investment professional to a competitor shows that we must be doing something right for our people.

I doubt that a large firm with hundreds or thousands of people could do it as well; it is an advantage a smaller firm has. So, creating entrepreneurial compensation is an obvious critical success factor for investment firms. But that's only the beginning. It's also important to motivate them by creating the right culture.

4. BUILDING A MOTIVATIONAL CULTURE

The fourth way firms succeed is to have the sort of climate where outstanding investment professionals can flourish. We want an environment where there is great motivation to work hard and work smart, and an environment where there is a strong sense of respect and mutual trust among colleagues.

> "We also want people who are passionate enough to consider all aspects of an investment decision; seek others' opinions; push the envelope to gather new information; and pay attention to detail."

Often, the top people in investment firms don't create a positive environment. There may be no succession plan. The founder/president may not be able to let go, or admit that someone else can do the job as well or better. Key people may eventually leave this sort of firm, often because they perceive they have not been treated fairly or can't grow.

One defining characteristic of a motivational environment is that it is energized. Passion for the game is very important, as is a yearning for great success — we want people who want to win! We also want people who are passionate enough to consider all aspects of an investment decision; seek others' opinions; push the envelope to gather new information; and pay attention to detail.

Another aspect of the environment that successful firms create is a culture of hard work. At our firm, we don't have stated work hours or many rules about holidays. Our people work hard and take whatever time off they need. I think such standards stem basically from how the leaders of the firm conduct themselves.

Still another aspect of a good investment environment is that it encourages risk-taking — a supportive environment where people are not afraid to take risks or make mistakes. We accept failures as long as the process undertaken was right. We say we applaud thoughtful failures. It's an environment that encourages long-term thinking. I like to think it's an environment that is at once competitive, but friendly.

> “Being able to hold out the possibility of real equity to a young analyst gives an unparalleled hiring advantage to an investment management firm that is privately held. After all, who do you know who works harder for someone else than they do for themselves?”

We also praise successes and we celebrate personal achievements (such as weddings and births), business achievements (performance) and business acquisition feats.

Finally, we aim for a learning and mentoring environment, where the senior investment people act as the journeymen and the teachers; and the younger analysts as apprentices. There are many educational opportunities in our industry, and we encourage use of programs offered by the CFA Institute, universities and the accounting profession.

We are big believers in holding retreats where investment or business matters are discussed. Our annual corporate retreat lasts two days and everyone participates. Many good ideas have resulted over the years. At my farm, we hold small retreats where specific topics are discussed and good camaraderie takes place.

The environmental characteristics I’ve described are soft and touchy-feely. Hard to define. But, like great art, I think you know it when you see it.

At the same time, I suspect the “right” environment can be a fragile thing. Several of the wrong people could easily poison the well, and such situations, when they arise, are best to be swiftly dealt with. A breakdown of trust, say, between the firm’s professionals and the leaders of the firm could be very bad in a firm where non-formulaic compensation prevails. So we don’t take the current firm environment for granted.

Too great an effort to systematize and organize things can also harm an entrepreneurial environment. I always thought Peter Drucker had a great quote when he said, “There is nothing so useless as doing efficiently that which should not be done at all.” I think that statement has a lot to say about some aspects of our investment industry.

5. PROVIDE THE OPPORTUNITY FOR OWNERSHIP

Fifth, to develop a successful investment firm, provide worthy employees with the opportunity for ownership in the firm.

A 2005 article in the Harvard Business Review called “Every Employee an Owner. Really.” stated that “study after study proves that broad-based ownership, when done right, leads to higher productivity, lower workforce turnover, better recruits and bigger profits.”

At Burgundy, our key investment people own a large chunk of the business. And we don’t give equity only to our top investment people. Being able to hold out the possibility of real equity to a young analyst gives an unparalleled hiring advantage to an investment management firm that is privately held. After all, who do you know who works harder for someone else than they do for themselves?

Finally, we believe in making shares available to people in other departments who have performed well and who exemplify the firm's values. I still remember the transformation in one of our employees — a long-term executive assistant in our administrative group — when she bought her first share. She became even more devoted to this firm and adds value to it every day. She may have only a few shares, but being an owner has changed her life. There is a bounce in her step that really shows.

So, my advice:

- In distributing ownership, the top people can't be greedy.
- Buying and selling shares should be done on a very transparent basis with a simple formula for valuation.
- Arrange financing for new shareholders where needed. (You want purchases by employees to be based on merit, not ability to pay.)

6. CONTROL ASSET GROWTH

Sixth, to develop a successful performance-oriented investment firm, you really have to control asset growth.

There is, of course, a huge temptation to grow and grow quickly. But the simple fact is that when a firm gets too big, the strategies that made it successful may not work as well.

Firms that really have outstanding investment results over time likely can achieve these results only within defined asset sizes. Best results often come from asset categories that are inefficient in nature in which size is a significant limiting factor.

For example, some of our firm's best value-added strategies have been in small cap: in Canada, the United States and Japan. It is an area where detailed research on smaller companies really pays off.

Unfortunately, this can only be done with smaller amounts of money. Wise firms, who want to preserve their track record, recognize these limitations and close the strategy to new clients.

Another aspect of rapid growth is that if you get too big or too complicated, the top people can no longer focus on investing. Business and growth imperatives take over at the firm. More time is put into business plans and less into investment research. Top management becomes business-oriented rather than investment-oriented. Fee-income concerns prevail and get more attention than investment returns.

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And if you opt to grow by selling your firm to a larger company, controlling growth becomes impossible. The new shareholders are going to want to see growth — preferably every quarter — and running an investment management firm on a quarterly basis is certainly not desirable for the clients. The new owner, too, may be less comfortable with the contrarian thinking that is so necessary to earn outstanding long-term results, forcing you to lose some of the daring that led to earlier success.

When investment firms go public — a common occurrence today — there is always a public relations rationale that gets put out to clients, but the reality is that the principals wanted to monetize. It is hardly ever beneficial to the clients, long term. Nor is it likely to be desirable in terms of retaining staff or attracting new talent. It is not likely to promote long-term investment thinking and the willingness to endure periods of underperformance.

When it comes to growth, I am reminded of the words of Benjamin Graham, the guru of investing who wrote in The Intelligent Investor: "Obvious prospects for physical growth in a business do not translate into obvious profits for investors." Or, I might add, for their customers.

Every year I get calls from financial firms or roll-up companies that want to buy Burgundy. As long as I am around and involved, we will stay private and limit our growth; my colleagues feel the same way. I just think it is the right thing to do.

The things I'm talking about here, limiting asset growth and staying private, in the best interests of performance and the clients, mean that the firm is not following a profit-maximizing strategy. But, in our view, it is the right thing to do.

Because of this conviction I have about managing growth, I also feel strongly that the firm should be run by investment people, not marketing or business people. Great firms really don't need much marketing. In our case, most of our business comes from referrals. We have no salespeople, and client relationship people do not receive direct-drive compensation.

Our view is that strong investment returns, good service and a good reputation will lead to all the business you can possibly handle. This is our three-pronged focus at Burgundy.

7. BUILD YOUR REPUTATION

Seventh, to develop a successful investment firm you must build a solid reputation and protect it at all costs. Great firms realize that their reputation is everything. Along with your investment record and your people, it is really your most valuable asset. Warren Buffett always says that the test is how you would feel if your loved ones read about your actions in the daily newspaper.

Unfortunately, reasonably well-established companies with credible investment records, critical mass and good reputations sometimes get too cocky. Egos rise and this can lead to overreaching, a diminished work ethic or thoughtlessness toward clients. Carelessness can set in, and the firm's reputation gradually gets tarnished.

There is no place for egos in our firm. Our objective has always been to try to be the gold standard amongst investment firms; I can assure you, we have a long way to go. As Winston Churchill once said: "We are humble people with much to be humble about."

Building the firm's reputation involves everything I have described today. It requires that you put the client first, that you hire the best people and treat them well and that you provide opportunity for employee ownership and control asset growth.

> "We are humble people with much to be humble about."

CONCLUSION

In short, successful investment firms realize that a competitive edge delivering investment results requires a lot more than just paying people the most money. It is the collected values and attitudes of the firm that create the framework and the glue for the people. Successful investment firms are lucrative businesses. But it is not an easy business! Soft and subtle factors are crucial in creating an environment where really great people want to work.

The fundamentals I have described today as critical to the success of an investment firm are relatively general principles. But as Gary Hamel writes in his book The Future of Management, "Translating high-sounding principles into day-to-day management practices is hard, painstaking work. It requires an unshakeable faith in your tenets." It is easy to talk about but hard to do — like losing weight.

This approach requires a big commitment on the part of the firm's leaders toward people and organizational matters. It also requires that every single person understand these values, internalize them, and live and breathe them. When this happens, the organization does, indeed, have a spirit or a soul.

And this is what gives investment firms their sustainability.

So in building your firm, realize that it's not just the material things that matter, nor is it the capital assets. The bricks and mortar of investment firms are the intangibles; when you build from these basics, you will be building a firm that lasts.

Thank you and good luck! B

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BURGUNDY

ASSET MANAGEMENT LTD.

TORONTO

Bay Wellington Tower, Brookfield Place
181 Bay Street, Suite 4510
PO Box 778, Toronto ON M5J 2T3

Main: (416) 869-3222
Toll Free: 1 (888) 480-1790
Fax: (416) 869-1700

VANCOUVER

999 West Hastings Street,
Suite 1810, PO Box 33
Vancouver, BC V6C 2W2

Main: (604) 638-0897
Toll Free: 1 (833) 646-6807

MONTREAL

1501 McGill College Avenue
Suite 2090, Montreal QC H3A
3M8

Main: (514) 844-8091
Toll Free: 1 (877) 844-8091
Fax: (514) 844-7797

CONTACT

info@burgundyasset.com
burgundyasset.com