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NEWS RELEASE

A LOOK INSIDE SCHWAB'S BIG DEAL WITH A SMALL ASSET MANAGER

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Originally Published By Brooke Southall, RIABiz

By most almost anyone's standards, Stephen J. Cucchiaro pulled off a coup.

The principal of Windward Investment Management Inc. is poised to sell his asset management practice for \$150 million in cash and stock – a major premium for a business with \$4 billion of assets under management.

Yet analysts believe that the real winner in the deal may be the buyer — The Charles Schwab Corp. The amount it is spending is petty cash in the big financial world, and strategically the San Francisco-based financial company may have found a terrific fit – ownership of a hedge fund-mimicking asset manager grounded in exchange traded funds.

Windward's assets have been growing at a compounded annual rate of more than 56% for several years and its easy to imagine – especially with the marketing power of Schwab behind it – that it could jump to \$8 billion or \$12 billion in short order, according to observers.

Pricing power

Windward also appears to have significant pricing power. It charges 1% to retail investors who invest directly with the company for balances up to \$5 million before reaching a breakpoint, according to its website.

Schwab declined to disclose the fees charged by Windward clients but one RIA says he pays an amount less than 1% but significantly more than .5%. Schwab plans to absorb client transaction costs associated with Windward after it completes its acquisition. [I'll add pricing information as it comes in.]

The one peril of the deal to Schwab is that Windward's broader risk management capabilities could be perceived as a threat to the RIA clients of Schwab Advisor Services.

"It could be controversial in that regard," says **Daniel Seivert**, CEO of **ECHELON Partners** of Manhattan Beach, Calif., an investment bank in the asset management industry. "This has the potential to be hot with direct investors and to disintermediate the advisor, but given the unique characteristics of these two customer segments, I believe that's not likely in any meaningful amount."

Windward should be another arrow in the RIA quiver and it appeals to a different kind of investor than the one served by RIAs, according to Bernie Clark, executive vice president of Schwab Advisor Services.

Stands apart

"This acquisition stands apart from the unique experience advisors offer their clients," he says. "Schwab's retail strategy is to provide scalable investment management solutions to investors who neither want nor need customized wealth management services, and Windward fits squarely into that strategy. Windward will also deepen our strategic offering for advisors who select them as a sub advisor for core strategies or as an alternative to hedge funds."

Windward's elixir starts with Cucchiaro, 58, an MIT-trained math major who combines his quantitative skills with a knack for real-world achievements. He qualified for the Olympics in sailing but didn't participate because of the U.S. boycott of the event. A Wharton MBA, he managed two technology companies that achieved big cash-outs – one sold to Lotus Development and the other one sold to Oracle.

Since 1994, he has patiently developed a product that now combines qualities of ETFs, hedge funds and separate accounts. It is a separate account. It holds exclusively transparent and highly liquid ETFs. It is able to capture much of the upside in good markets but dodge ugly losses in down markets.

Like the best hedge funds, it has someone — Cucchiaro — with a sustained wunderkind track record. For instance, its "diversified aggressive" portfolio was off 20.7% in 2008 compared to a loss of 37% for the S&P 500. The same portfolio was up 109% between Jan. 1, 2002 and July 31, 2010 compared to 13.4% for the S&P 500.

As recently as 2002, Windward had only \$100 million of assets under management – and as little as \$30 million in the late 90s. Cucchiaro started with \$3 million in 1994. Windward gained about a third of its assets through Schwab's separate management program.

The 38-employee company in Boston's financial district has discovered a niche with phenomenal potential, according to Seivert.

Hot space

"It's a very hot space. There are only 30 to 50 firms doing [allocation of ETFs]," he says. "I'd put it in the top three to invest in."

Windward's 50% plus earnings compound annual growth rate over the past eight years and likely continued strong cash flow growth due to Schwab's distribution justifies 15 to 20 time earnings multiple Schwab likely paid, Seivert says. This is about three to four times the multiple that many RIAs have sold for.

The move by Schwab is an important one, according to Celeste Mellet Brown, senior analyst for Morgan Stanley in New York.

"The deal will also allow Schwab to build its ETF managed portfolio business— which despite strong growth is in its naissance— at a much higher rate through an acquisition rather than organic growth."

Windward's specialized abilities caught the attention of Timothy Rowland, Chairman of Scottsdale, Ariz.-based Rowland Carmichael Advisors. He began investing a significant portion of his firm's \$360 million of assets with Windward in 2008, after the asset manager had established an audited five-year record.

Rowland says that he does not believe that Windward disintermediates his value. "The clients we work with are open to where we can find the best top-tier holdings."

An experienced investor in hedge funds and hedge funds of funds, Rowland was attracted by Windward's multi-faceted approach.

Rare combination

"They integrate strategic holdings and tactical holdings. A lot of ETF managers own strategic or tactical, and it's rare to find both," he says. Strategic holdings are ones that get held long-term and tactical ones are shorter-term weightings of sectors.

Walt Bettinger, Schwab president and chief executive officer says he was attracted to the acquisition by the same qualities.

"Among independent advisors and retail investors there is a growing interest in the kind of value Windward can provide – portfolio construction which puts risk management at its core – an ideal approach for today's world," he said in a release.

ETFs will experience compound annual growth rate of 23.4% between 2010 and 2014, Financial Research Corporation estimates that Schwab experienced a 38% increase in ETF usage among clients from June 2009 to June 2010, according to the company.

Schwab spokeswoman Alison Wertheim says not to read too much into Windward's use of ETFs. Schwab views the company more as a first-rate asset manager that happens to use ETFs, she says.

Still, the ETFs are a major attraction for Rowland. Because of their liquidity, Windward is poised to continue to grow exponentially without getting too big to stick to the strategies that have worked thus far.

Important to Schwab

Rowland expects the fund could easily jump to \$8 billion or \$12 billion of assets and so this was an important consideration for him in committing big assets to Windward. "That's probably important to Schwab as well."

Cucchiaro says he's looking forward to a brighter future where he can concentrate on his first love — investment research — and leave business management to someone else. "In speaking with Chairman Chuck Schwab, CEO and President Walt Bettinger and other members of Schwab's top management team, I perceived a "best of both worlds" opportunity," he writes on his website.

ABOUT ECHELON PARTNERS

ECHELON Partners (ECHELON) was formed in 2001 to offer investment banking and consulting to a subset of the financial services industry known as "investment product developers and distributors" (IPDADs). Since that time, ECHELON's professionals have helped hundreds of senior executives envision, initiate, and execute a multitude of complex business strategies and transactions. ECHELON's business is making companies more valuable through delivering advice and orchestrating transactions. Accordingly, ECHELON measures its success in the enterprise value it creates for its clients. Companies that strive to outperform their peers choose to work with ECHELON because we are as passionate about their results as they are.

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