



LOWRY HILL

JIM STEINER
MANAGING PRINCIPAL, LOWRY HILL

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UNEXPECTED LESSONS YIELD TWO SUCCESSFUL DECADES



There are three parts to my discussion this afternoon. First, I'd like to tell you about my disposition as a person and as an investor. Second, I'll briefly describe the history of Lowry Hill, which will provide some background for the last section of my talk. In that last section, I'd like to discuss four lessons that we have learned over the last 20 years that may have some application to you, your business affairs, and your own financial and investment planning.

MY BIAS AS A PERSON AND AN INVESTOR

My career in the investment world has been as an analyst. By that I mean that most of my adult working life has been spent reading and thinking about businesses. I have spent significant time walking about factories, hospitals and other places where business takes place, listening to CEOs describe their businesses and reading the annual reports for those businesses. I have then translated this information into various quantitative models that provide me with insight on what the expected return on an investment in a given company might be. I have done this with some success. It is part science and part art. After many years in this business, I have concluded that most of what I do is studying human nature, because—as much as we try to manage and manipulate human behavior—it is very consistent and defies much outside influence.

My second predisposition is that I tend to be wary of crowd mentality and popular opinion. Shortly after college, I took on various odd jobs to save enough money to travel to Poland and the Soviet Union. Poland was under martial law at that time, so it was not the safest place in the world. When I told my father of my plans, his response was, “270 million people want out of the place and my kid wants in!” I traveled anyway, and had an incredibly broadening experience. What I have learned since then is that the crowd is correct in many situations. But the ability to think through an issue carefully without being influenced by the popular opinion of the time is essential. It is “non-consensus” thinking that can make a real difference for an organization.

Finally, there is a trend in corporate America that is disconcerting to me. It is the thinking that organizations and the people who run them are not to be trusted. The corporate malfeasance of the late nineties has led us to assume that greed, dishonesty and corruption motivate all people and organizations and that the solution to this is regulation, excessive compliance and aggressive litigation. I do not believe this to be true. I believe that 99 percent of all human beings work hard, try to do the right thing and are honest. I know that human beings make mistakes. Sometimes these are honest mistakes; sometimes they are not. Organizations must carefully manage their risk, but they must do so in a manner that is not based on fear or excessive bureaucracy. We must work to instill a corporate environment where simple principles guide our behavior. As it relates to the investment industry, we must return to being a noble profession rather than a good business model. I fight against these pernicious trends in as many small ways as I can, since they have the potential of wreaking long-term havoc on our economy in a slow, methodical manner. We must once again find a way to celebrate the innovator in our society.

A BRIEF HISTORY OF LOWRY HILL

Lowry Hill began as Norwest Capital Advisers in 1986. The real genesis of the firm occurred when Peter Heegaard, executive vice president of the Trust Department of Norwest Bank of Minneapolis, and Jim Campbell, president of Norwest Bank of Minneapolis, met on the Friday morning after Thanksgiving in 1984 to discuss the trust business. Their primary goal was to address the unique financial and investment needs of individuals with wealth greater than \$1 million. It was clear to both Peter and Harry Stark, a then-current partner of Peter’s who had written a business plan for an investment business to serve these unique clients, that these families would be better served by a boutique firm that could provide very focused attention on their more sophisticated investment and financial planning needs.

The core concept was a service model that (1) limits each professional in the business to handling 25 families, and (2) pairs a partner with an investment background and a partner with

an estate planning, trust administration and/or accounting background to work with a given client family, so that the financial and investment needs of clients can be integrated.

As a result of these discussions, Norwest Capital Advisers opened its doors in 1986 with \$400 million of seeded assets from Norwest, including the Blandin Foundation. Blandin is the only Lowry Hill client whose identity I can disclose, since it is public information. We have enjoyed a long and fruitful relationship with Blandin, which does excellent work in rural Minnesota. I am always proud to say that we are affiliated with its staff and board.

The most important thing that we did in those early years was to align the economic incentives of the partners with those of the clients. This seems to be a logical thing to do, but it is rarely done in our industry. We contributed capital, received a percentage ownership of the firm and based our incentive payments on the earnings of the business. The simple message is that we want to be happy when our clients are happy, and we want to be displeased when our clients are displeased. We have since taken this one step further by creating LH Partners, LLC, an investment partnership to which all Lowry Hill partners contribute annually. It holds the same investments as our clients, so that we “eat our own cooking.” This incentive structure gives us a significant personal stake in our work and makes for better long-term relationships with our clients.

In 1991, the robust bull market began, and our assets began to climb. During the 1990s we changed the firm name to Lowry Hill. Through all 20 years, we continued to seek out and hire excellent professionals. The value proposition to a new principal is that his or her professional expertise can be used to help grow the firm by developing and maintaining long-term relationships.

Our success metric since we started tracking it in the early 1990s has been our 97 percent business retention rate. This resonates with prospective clients, and it also resonates with the professionals we are considering bringing on as partners. While most of our industry has gone to a “free agent” employment model, we have done just the opposite. Our partners depend upon one another for success, so the careful selection of a partner is critical. With each new employment decision, whether partner or other staff, we feel that we are making a minimum investment decision of \$3 million, our estimate of the long-term cost of employing a staff member for 20 years.

From an investment perspective, Lowry Hill began with only two investment options: large cap growth equities and fixed income. In late 1998, Tom Hull and I developed a strategy to invest in companies with a market capitalization of less than \$5 billion and significant free cash flow. At the time, we had most of our client assets in large cap securities.

We began with the premise that we wanted greater diversification against that large cap bias. Tom and I constructed a portfolio with a risk profile measured by beta that was significantly less than the S&P 500. We wanted to generate return, but more importantly, we wanted to mitigate risk through a return not correlated to our core equity strategy.

The Internet bubble years led us to think carefully about how we manage the risk of our client assets. We studied the work of David Swensen and his team at Yale and tried to create a similar strategy for the taxable investor.

The question we asked ourselves: How can we create client portfolios that manage risk and taxable return, yet significantly reduce the costs of managing the portfolio? We gradually built our investment capabilities to include equity strategies in real estate, international securities, income issues and private equity, to complement the small and large cap equity and fixed income strategies discussed previously. The combination of these investment strategies allows us to customize risk for each of our clients. We are very much in the risk management business.

Over the years we have also increased our capabilities in financial and tax planning. For our clients, these activities are as important, if not more important, than the investment activities. The financial and tax planning side of our business allows us to focus on the most important element of our business—understanding the core values of each of our clients.

A recent study found that the two most important things with which human beings are concerned are their health and wealth. Our wealth and how we interact with it is directly related to our core values. Lowry Hill's financial principals are highly skilled at understanding the nuances that can guide a family to take financial actions that are in concert with their core values. We do not write estate plans or prepare tax returns; we rely on a client family's professional advisers to do that. But we do provide good counsel, which can provide significant emotional and financial return over long periods of time. In many ways, it may provide more than the investment return.

Today, we manage more than \$6 billion of assets for nearly 300 families and foundations. Our business retention rate continues at 97 percent, and we continue to search for new ways in which to add value for our current clients. We have never had a designated sales person at Lowry Hill, though we do some modest marketing and advertising. Our view is that good work will lead to good results.

Throughout our 20-year history, we have had the support of Dick Kovacevich at all times. Dick is the chairman and CEO of Wells Fargo and truly understands the ingredients that make a niche business such as Lowry Hill's successful. Dick has been flexible and patient in letting our business plan evolve over the years. It is clear to me that we are in need of more "Dick Kovacevichs" in corporate America today.

And now, the four lessons we have learned from our first 20 years:

LESSON #1: PEOPLE MATTER

One of the important values we hold is that our organization is its people. They have different skills, want or need to grow at different paces, and occasionally want change in their work activities without having to move to a new environment. In sum, you must remain flexible. People can really mess up an organization if you like to peg them in nice, neat boxes.

We focus hard on attracting people who think well, get along with other people and want to grow as individuals and professionals. We try not to create a "job" but rather fit people to needs we have as an organization. And if an employee has a better idea, we evaluate it to see if it will meet both our needs and theirs.

An example of how this philosophy functions is John Lorentz. John came to us from the University of Minnesota Foundation. He had skills that were very different from others at Lowry Hill, and he thought about things differently. We hired him to be in charge of our private equity strategy, where he had experience. My sense is that John's responsibilities will evolve into doing other things for us, such as Monte Carlo simulation for our asset allocation models and other quantitative and operating activities that will add value for all of our clients.

We have continuity in our people. Four of the founding partners of Lowry Hill are still active partners; those that have retired remain in touch and come to our events throughout the year. I credit Peter Glanville and Peter Heegaard, my predecessors, with starting our people-oriented business philosophy. Both were willing to take a risk and hire that unique individual who didn't seem to fit perfectly into the standard "box" but who possessed strong skills that could benefit the business. In most cases, those decisions have turned out very well.

LESSON #2: CULTURE MATTERS

The second lesson flows from the first lesson. We have tried to instill a culture that fits our clients and ourselves. We want to delight our clients, manage our costs, focus on continuously adding value and create competitive advantage by attracting and retaining high-quality people.

The metaphors we use for this are as follows:

We want to be like a monastery with a different core focus. The monastery is one of the longest-lived corporate structures in the world. The first Christian monasteries began in the deserts of Egypt, as the Roman Empire was falling apart. They continue to this day, operating under many of the same simple but profound working rules: respect one another, be hospitable to guests, be patient, work within the skill sets of those around us and let our work give our lives dignity. When Eric Holman, our chief compliance officer, began to revise our policy and procedure manual a few years ago, I asked him to first read *The Rule of St. Benedict*, which I believe is one of the best policy and procedure manuals around. It may also be the oldest, as it was written in the sixth century.

The second metaphor we use is that of the studio of Leonardo da Vinci. In da Vinci's time, the studio was just off the street and filled with skilled craftsmen, each of whom made a unique contribution to a painting or other work of art. We are, in essence, in the business of creating an ever-changing work of art for our clients. Yet we have different skills that must come to bear on this changing tapestry. During this process, we must mentor and train new professionals to preserve the history of a client family and remain mindful of the short- and long-term goals of the family. Each work is unique, but the skills required to produce each work have commonality.

Finally, we want to be like the old country doctor. He listens to his patient. He comes to know all aspects of their lives. He understands his patients and their families as people. He makes no judgment, but patiently listens, collects information, and then brings his professional judgment to bear on the issues.

LESSON #3: BE CAREFUL WHAT YOU COUNT

About a year ago, I went into the office of Phil White, who is unlucky enough to have me sitting next to him, and said, "Our industry does not count things appropriately." By this I meant performance. Phil came back to me with a quote from Einstein: "Not everything that counts can be counted and not everything that can be counted should be counted."

This quote is a wonderful description of our business. So much of what happens in our business is a "beauty contest" between the short-term performance numbers of one firm versus another firm. But what really counts is whether or not a client will have the ability to fund the activities he or she wants to fund, be that a college education, a foundation, another home, a certain type of lifestyle or, in the case of a foundation, a 5 percent absolute annual distribution. Your assets must work toward these idiosyncratic issues rather than work against a standard performance number showing whether or not you are slightly better than your neighbor this week.

An important threshold for some of our clients occurs when they come to understand how their values and their wealth can work together for their family, their community and themselves.

One of my favorite quotes is from Jacobi, a mathematician who said, "Invert, always invert." If we all did this when thinking through our lives, we would undoubtedly be much better at finding the things that count. As it relates to investment management, we would do a much better job of compounding our assets. Such a perspective would inevitably drive us to using a

much longer time frame to evaluate our investment success than we would have first thought. Time is one of the greatest advantages that any investor can bring to the market.

An addendum to this lesson is a two-part observation from me, as a portfolio manager, on measuring investment performance today. First, standard performance measurement provides only limited information as to how any investment professional is doing. You must wrap into that performance the risk assumed, the taxes paid and the costs needed to accomplish the task—including trading costs, management fees and other hidden costs. The resulting number must then be compared to how well it meets the liabilities and activities that the client needs and wants to be funded. This is a difficult measure to come up with, yet it is one that we work hard at calculating for our clients. It is both custom and qualitative. You can actually “beat the market.” However, due to all of the other real costs that do not get counted in that standard number, you may end up compounding your assets at much lower rates than you need. The second observation follows from the first. Your spending rate will have as large an impact on your long-term compounding rate as investment performance.

LESSON #4: IT IS A WORK IN PROGRESS

Rabbi Tarphon, a first-century Rabbi, stated, “You are not required to finish the work but neither are you allowed to desist from it.” Lowry Hill, or any business for that matter, is an evolutionary process.

One of the things that we focus on is whether or not we are creating “evolutionary advantages.” How do the people, the culture, the technology and the other things that we typically consider to be the core components of a business renew themselves? How do they change as a result of the environmental “push” on them? How do we evolve of our own volition, as a result of the “push” of our own ideas on these core components?

For us, all change must be focused on the impact it will have on clients. Without clients, we have no business. Our clients must be at the heart of all we do. The second core principle of a continuous evolutionary process is an economic profit. We need to make an economic profit at Lowry Hill, since that is what allows us to attract talented professionals and thereby continue to add value for our clients. It is a continuous process, a constant balancing act and hopefully unending. It is enjoyable to be a part of this. We will not “desist from it.”

In closing, Chuck Jones, the Warner Brothers cartoonist whose best-known characters include Bugs Bunny and Wile E. Coyote, may have stated it best: “Pour in the love and whatever skill you have, and it will come out.” Over the last two decades this is what we have done at Lowry Hill—and this is what we will continue to do.

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