Branching into the institutional market requires considering a number of factors that are different from the retail or high-net-worth market. Both types of investors are keenly interested in finding the adviser and managers who will increase the likelihood of their investment success. But the institutional investor comes with distinct objectives, expectations, and perspectives. The steps to developing an institutional business begin with recognizing these differences.

**High-net-worth Versus Institutional Investor**

The objective of the high-net-worth individual is to maximize and/or preserve wealth to meet stated, personal, long-term financial objectives that typically incorporate retirement income, philanthropy, and wealth-transfer goals. The institutional investor, on the other hand, operates as a fiduciary—that is, on behalf of others—and brings a whole different set of criteria to the task of searching for investment advisers or managers.

High-net-worth investors act in their own interest with their own money, and fear and greed drive their actions to a much greater extent than institutional investors, who are held to fiduciary standards. Retail investors are more apt to act with emotion than institutional investors and sell tomorrow’s winner and buy tomorrow’s loser. “Between 1984 and 2002, the return on the S&P 500 index was 12.9 percent a year, according to DALBAR, a mutual-fund research firm. Over the same period the average equity mutual fund returned 9.6% a year, . . . but the individual investor in equity mutual funds got an annual return of 2.7%, because of switching.”

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**Prudence** and **Fiduciary**

To become effective in the institutional market, one must become familiar with two much-used-and abused-words: prudence and fiduciary. Prudence is “good and careful judgment,” and fiduciary is “holding something in a special relation of trust for another.” The well-known case of *Harvard v. Amory* in 1830 set off a 175-year evolution of the meaning of “prudent conduct” and what is expected of people acting in a fiduciary capacity.

Guidance for proper fiduciary conduct is paramount to the institutional investor. If a fiduciary fails to live up to responsibilities, significant liabilities may fall to the fiduciary. Needless to say, the institutional investor focuses keenly on best practices and sound discretion at every step of the investment process.

**Governing Laws**

This focus on prudent fiduciary conduct requires an adviser to have a sound knowledge of such conduct, including the laws and legal precedents that govern the delivery of investment services to institutional investors. Whether you are targeting the pension marketplace (governed by the Employee Retirement Income Security Act or ERISA), the not-for-profit marketplace (governed by the Uniform Management of Institutional Funds Act or UMIFA), the public marketplace (which generally is state-regulated), or the trust marketplace (which is governed by the Uniform Prudent Investor Act orUPIA), you must understand the applicable rules, guidelines, and best practices.
Due Diligence and Documentation

The most important element regarding prudence, however, is that it is a process, not a result. A fiduciary is more likely to be judged on process than on result. What does this mean to institutional advisers? They must offer qualified expertise, sound guidance, and perhaps most importantly, documentation of procedural diligence. Documenting the care, skill, and caution practiced at every step in the investment process is paramount. If it can be determined that the fiduciary exercised extreme diligence at each step, the fiduciary is infinitely better positioned in the event of litigation.

For example, if you are engaged with a foundation, it is likely that the trustees are looking to UMIFA and its legal precedents for guidance. Trustees are best served by documenting each decision and decision process, including investment policy statements, asset-allocation strategies, investment manager searches, and ongoing investment manager evaluations. The adviser’s primary role is to provide expert investment guidance and to assist with documenting this procedural diligence.

Professional Presentation

Once you are knowledgeable about the regulatory environment and have established systems to assist with documenting your client’s procedural diligence, you must demonstrate institutional-caliber strength and depth in your research capabilities, investment process, and overall investment philosophy. These factors are of great importance to the institutional client, whereas retail clients may have additional trigger points (e.g., tax efficiency, budgeting, estate planning).

For the institutional investor, sound research from the adviser/manager lends credence to a higher level of diligence regarding actions taken in the investment program. Sound investment philosophy and process are an area wrought with differing opinions, varying methodologies, and an unending supply of mousetraps and silver bullets. The array of investment philosophies marketed to institutional investors reflects the vastly different approaches adopted by institutional clients around the world. Core–satellite, growth–value, active–passive, strategic–tactical, and portable alpha are some of the approaches used. Clearly, there is no fail-safe solution. Researching and understanding the different strategies, then determining how to position your services, is necessary before you can advise institutional clients in any capacity.

Sales Cycle and Time Horizon

Both the sales cycle and the time horizon in the institutional market are long-term. This is a byproduct of the technical aspects of plan administration and typical investment-committee operations. Most pension plans evaluate performance on longer cycles than an individual investor. Most investment policy statements explicitly state a targeted three-to-five-year period for proper manager evaluation. For those breaking into the institutional market, the sales cycle is anywhere from 12 months to 24 months. To be successful, an adviser must understand that decisions are made by an investment committee, usually made up of senior executives, investment professionals, and/or human resource professionals. These committees work slowly and diligently, often with an obligation to report or seek approval from a board of directors. Investment committee dynamics change as one goes from the private sector to public sector to Taft-Hartley and not-for-profits.

Conclusion

The final challenge to entering the institutional market is finding and selling your services to key decision-makers. Finding the right institutional contact, on the right committee, with the right authority to hire you can be a complicated undertaking compared with marketing to the high-net-worth client, where a sales prospect is relatively straightforward. Take care to avoid marketing your services to people who really have no influence regarding the decision at hand.

Both the institutional and high-net-worth markets offer unique challenges to investment managers and advisers. The steps to developing an institutional business involve familiarizing yourself with the institutional mindset, knowing the governing laws and legal precedents, developing systems to document diligence, having a strong professional presentation, understanding that it’s a long sales cycle, working persistently to find key people, and—last but not least—generating investment results.

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Endnotes


2. UMIFA and UPIA are available under the Legislative Section of the IMCA Web site under Statutes and Special Reports at http://www.imca.org/legislation. For information on ERISA, visit the Department of Labor Web site at http://www.dol.gov/dol/topic/health-plans/erisa.htm. To find out how to contact your state securities regulator, visit the North American Securities Administrators Association Web site at http://www.nasaa.org/QuickLinks/ContactYourRegulator.cfm.