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Barclays Capital

THE STATE OF INVESTMENT BANKING

THREE WALL STREET LEADERS WEIGH IN ON THE INDUSTRY

Three GSB alumni leading major Wall Street firms gathered at the Union League Club in New York City on May 17 to share their views with alumni and friends. Debating banking models, competition, and the future of the industry were **Brady Dougan, AB '81, MBA '82**, CEO, Credit Suisse First Boston; **Thomas Kalaris, '78**, chief executive, Barclays Capital, Americas; and **Warren Spector, '83**, president and co-COO, Bear, Stearns & Co., Inc. Excerpts of their discussion, moderated by dean **Edward A. Snyder, follow.** By Melissa M. Bernardoni | Photos by Matthew Gilson

On universal banks versus investment banks:

Dougan: The question about universal banking, which has been a big feature of the market for the past decade, is the increasing emergence of large, aircraft-carrier-type firms that have everything—all the commercial banking systems, all of the balance sheet that's necessary, all the commercial banking products, in line with all the investment banking business. I think there will continue to be marriages of pure investment banking businesses with balance sheets and commercial banks, and we'll continue to see the formation of additional universal banks over the next four or five years. But I think there is also room in the industry for a variety of models.

Kalaris: Barclays is predominantly a fixed-income player, and if you look at the elements that make up investment banking, the universal banking model is particularly relevant to fixed

income. The question needs to be addressed at a couple different levels. If you're looking for the dominant model for the institutional investor or the broad retail marketplace, I think you'll find that scale is relative. It's scale in terms of capital, scale in terms of talent, scale in terms of portfolio effect. On a separate level, when you think about the margin where the innovation will occur, it tends to occur in smaller operations, because they breed that. When you think about the goal we have as institutions, which is a combination of high return on capital and long franchise value, we're convinced that the universal banking model is the right way for the broad institutional client base.

Spector: More than one model will succeed, but a challenge for the large banks is that there are at least a dozen universal banks competing to be in the top three of every major segment of the market. I wouldn't like to be one of the bottom half-dozen

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fighting my way up and incurring all the costs and franchise burden to get there. Firms that have gotten to market leadership positions generally earn very high returns, but there's a lot of competition to achieve that.

Our focus as an investment bank is high value-added, high intellectual content—certainly something that is consistent with having a Chicago MBA—so we're viewed as extra-special value to our clients. Secondly, we focus on being an extremely nimble organization. We want to be perceived by clients and employees as the best place to go to with an idea, the place that's going to be the most creative and responsive.

I joined Bear Stearns after business school because I thought it had an extremely flat organizational structure that gave me the opportunity to get involved quickly and get to know senior people. We work hard to maintain this culture today and to be a place where our clients and our producers feel they have access to the top of the organization. Being nimble, responsive, and innovative puts us in a very strong position that is sustainable no matter how large these universal banks we are up against become.

On the importance of culture:

Kalaris: The model is important, and it's a great guide, but the elements of the model get broken down into this: do you have enough scale in terms of focus of business or broad scale? Do you have a culture that allows you to compete and repeat business so you turn into a franchise? Do you, essentially, have the talent pool to operate effectively? There are lots of different niches, but I think the critical thing is that culture is very important, regardless of the model. A culture of transparency, meritocracy, and teamwork—which we have at Barclays Capital—is as attractive to potential employees as other incentives. It's also a compelling mix for clients when they are considering partnering options.

Dougan: Even in very large organizations, you have to create a culture where innovation can flourish. Since I started in this business, probably 80 percent of the revenue stream in our industry has been re-created. Over a 25-year period, you have seen a complete re-creation of the industry. So you must have a culture that can actually create, allocate resources to, and dominate those areas. That's how our

whole industry was made. If you do that and can continue to do it consistently, you'll have a model that will succeed. If you look at the big businesses now, they didn't exist or they were very tiny when we got started in the industry—whether it was mortgages, or mergers and acquisitions, or derivatives. I started out in derivatives and the first year we were the market leader, doing eight swap transactions that year. There were eight done between 8:00 and 8:01 a.m. this morning on the desk downstairs in our building, and probably across every firm across the street now.

On knowing your customers:

Spector: I literally know all our major clients. I don't mean they're my best friends, but I have a pretty good idea of what types of business we've done with them over the years, what problems and successes we've had. That's inconceivable at a universal bank. It gives not just me, but also the firm's senior management, the ability to be quite nimble in responding. When there's a problem or issue with a client, we don't have to get up to speed on them; we already know them. We know the business they're in, how they've treated us, how they think of us. We can deal with the problem very rapidly.

On competing for talent:

Spector: Ultimately, you must have a business that's perceived by the talent pool as a good place to be. If the career opportunities are perceived to be excellent at your organization, you're probably going to outcompete. You're going to attract highly talented people, they're going to work hard because they think the rewards are great, and as long as you continue that formula, you'll have a successful organization. If people start to worry about whether or not those opportunities are available, whether they'll actually get the reward,

whether they'll actually succeed at that organization, then you'll have a breakdown, and regardless of your model, you're going to fail.

Kalaris: This is a war for talent. The talent is assessing the net present value of the opportunities. Whether it's through efforts at diversity or efforts of equity participation, we're constantly trying to form an environment that attracts and retains people. And if I think about what's attractive about organizations, it's that feeling of belonging, of shared purpose—that somewhat emotional tie that attracts people to like kind. When we think about how you retain people, those elements are really as important as the financial elements.

On growth and scale:

Spector: Our goal is to scale the reach of the company and the level of relationships, but do it in a fashion that's consistent with the way we've succeeded in the past. What is difficult for the outside observer to understand is that we're measuring these businesses within the context of our company. When you're not trying to be one of the three largest banks in the world, you're not asking, "Can we get to 8 percent market share in European debt? Can we get to the top three?" You're saying, "We have a business, we like the way it is. It's small. Can we grow it 20 or 30 percent a year?" That's what we're trying to do. If we grow the business 20 or 30 percent a year, we'll have very good returns, be able to pay people very well, and continue to attract very good people to the organization. In some respects, we're able to come into businesses later than some of our competition because we're trying to earn a return on a smaller base, and study the mistakes people make, and try and get it right the first time. We see plenty of opportunities to scale our U.S. business into Europe and Asia, and we see plenty of businesses where we think we can be substantially larger in the U.S., but in neither case are we obsessed with trying to get to the top; we're trying to be most profitable.



Warren Spector, '83
Bear, Stearns & Co.

Dougan: There's a limit on both ends of the scale. You can't be too small or you won't have the ability to actually replicate these things and drive the businesses globally. You have to have a certain critical mass. But I also wonder if there's a limit on how scalable the business is. I was in Asia a few months ago, and one of the largest banks there has on the order of 20,000 branches; they have 250,000 people. They have more branches than CSFB has people. In fact, they said they've laid off 200,000 people in the past couple of years—the equivalent of 10 CSFBs. Is that scale manageable? I don't know. I think there are some absolute limits.

On the barbell business model:

Kalaris: In our industry, I think of a barbell because there are certain business lines that are absolutely technology driven, where it's purely and simply about lowest cost execution, or lowest cost in terms of providing liquidity. Those businesses

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can be very profitable but they truly, completely require their market-share-style businesses. There are other businesses that are bespoke in nature. There's much less of a commodity orientation to them, they're high-intellectual-capital businesses, they're high-touch businesses. Warren's point about knowing all his clients is a good example of a segment of the business where, if you don't have that personal call in to the president, it's not going to happen. What I see happening is the traditional models—whether it's universal bank or stand-alone investment bank—where going down the middle is increasingly going to be harder to do. Even those people that want to be in the entire business are increasingly splitting their businesses. The ends are where the real money is being made. A great example is the swaps business all three of us are involved in. That's a business where you are doing—can do—lots of transactions basically at the midpoint of the market, and you can sit there forever. And that's what it takes to get to execute business. On the other hand, there are some highly structured trades, like in the credit derivatives market, that require high touch and lots of intellectual capital. In the middle, no one's making any money, so it's either end.

Dougan: Being successful with that approach requires a lot more management. It's not one size fits all—we're not just a scale player in everything or a niche player in everything. You have to look at the businesses quite differently and manage them differently. You can have some very technology-intensive businesses, some capital-intensive businesses, some people-intensive businesses, and all can coexist on the same platform. It's a much more nuanced way to manage a business.

At CSFB we have a “high-touch” segment and an execution-focused equity business; it's a very barbelled approach. There are people who just want execution—the smarter and the cheaper, the better—but pretty much straight execution. Then there are people who really want the research, who want a high-touch service. You can profitably serve both of them, but it's a very different approach.

On employee longevity:

Spector: In 1983, when I was interviewing for jobs, a colleague at Chicago asked me where I wanted to go. I said I was interviewing on Wall Street, that I wanted to work at an investment bank. And he said, “How long do you figure you'll do that? Maybe four or five years

and then you'll go out on your own?” I said, “You know, my father had his own small business, and I'm not sure that's a good model. I'm just looking for a good place that will offer me a good career.” The thinking that you'll go someplace for a few years and use it as a launching pad to go someplace better has existed at business schools at least for my whole adult life. The number of people I work with every day—who I've been working with for years—who'll tell me any day I ask them, “I'm here for about five more years,” and have been telling me that 15 or 20 years in a row, is remarkable. If you have the right opportunities for people, and a good culture, and if people like coming to work every day at your organization, they'll continue to come to work at your organization, most likely. If they're frustrated or unhappy, if things aren't going their way, for sure they'll look for other opportunities.

On approaches to proprietary trading:

Kalaris: At Barclays Capital, we have market-making businesses and separate proprietary businesses. Our primary focus is executing client transactions, which inevitably involves an element of proprietary risk. We think it's helpful to our client base. We look at it as part of our position as an investment banker. We take a reasonably significant amount of risk in the markets that would be defined as proprietary risk.

Spector: We fall into the same category as Barclays in that we don't run a large separate proprietary group, but where we differ is that I wouldn't say we take a significant amount of proprietary risk. We focus on being a market intermediary, a market maker, and using our capital almost exclusively to support the business our clients are asking us to help them with. Our attitude has been that by not having a large proprietary organization, we have the least possible conflict with our clients. We're not looking to own what they're trying to sell for our own book, though we're obviously buying what they're selling and selling what they're buying every minute of every

day. We try to differentiate ourselves in terms of the volatility of our returns. We believe we have the lowest volatility of return of any firm in the industry. We run substantial inventory positions but very well hedged. We disclose on a quarterly basis our distribution of net trading revenue, daily net trading revenue. In a good year like 2003, the number of days we had where we lost money trading was zero. And that's obviously inconsistent with running large proprietary bets.

Dougan: We're in between the other two institutions. Proprietary trading is obviously an important part of the business; it's profitable and high margin. But I think it's been somewhat overemphasized in recent years. In general, in the industry, there are a lot of earnings coming to the bottom line from these activities, and I'm not sure how healthy that is. From my viewpoint, it should be in balance to your overall business. The multiples being put on those earnings by investors are higher than they should be, and at some point, it's going to end in tears when there's a correction.

The conflicts issue is very important; that is why our proprietary trading is run completely off the floor from our customer trading. It's completely walled off and separate; there are no conversations, no exchanges going on. Our dedicated proprietary trading happens completely in a vacuum from what happens on the customer side, so we know there aren't any conflicts. We've had a lower profile in the proprietary trading over the past few years, and we are looking to grow it in balance to the overall earnings. I think 20 to 25 percent of earnings coming from prop activities isn't bad—but it's the upper end of where you should be from a quality of earnings point of view.

On the most-feared mergers:

Dougan: I think the creation of more “aircraft carriers” will increase competition in the business. So if you had a pure investment banking player with a balance sheet, that would



Brady Dougan, AB '81, MBA '82
Credit Suisse First Boston

create one more person fighting for that top-three spot. That's what I'd be most concerned with.

On Chicago's era:

Dougan: This is the dawn of the Chicago era. The skills and the approach of Chicago are very relevant today and becoming more relevant over time. I think we're moving into a management era that's more collaborative and much more operationally focused, and that's going to be really important going forward. The quantitative, analytical approach is becoming more and more valuable, and I personally think that investment banking is going to be increasingly an environment that's well suited to the Chicago GSB education. ■