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Inside McKinsey’s private hedge fund

McKinsey quietly runs an investment arm for partners but experts warn of conflicts of interest

Harriet Agnew, Miles Johnson and Patrick Jenkins JUNE 6, 2016

In 2012 a group of elite hedge fund managers were about to see a complicated trade finally pay off. Funds run by prominent Wall Street financiers Paul Singer, Louis Bacon and John Paulson had backed a private company that was buying up small American banks. Known as National Bank Holdings, it was about to list its shares, allowing early investors to pocket a healthy profit.

Listed alongside these high-profile investors on NBH's shareholder register was a less recognisable name: "Barfield Nominees Limited A/C CSC01". The ultimate owner of the Barfield account was an organisation even more famous than the billionaire hedge fund managers, and more anxious to keep a low profile — McKinsey, the world's most prestigious management consultancy.

The NBH deal was just one trade made by a $9.5bn internal investment arm. Few outside of the consultancy have ever heard of the McKinsey Investment Office, known as MIO Partners, yet it has established an operation as sophisticated as the world's best resourced hedge funds, employing 80 staff across offices in New York, London, Munich and Singapore.

Ordinary investors might have struggled to invest in a deal like NBH Holdings alongside the elite of the hedge fund world. While MIO worked with a bank on the transaction, there was also a deeper connection. Frank Cahouet, the NBH chairman, was a banking veteran who had ties with McKinsey going back decades, first as a client during the restructuring of Mellon Bank, and later through hiring one of its partners.

MIO Partners has existed inside McKinsey for three decades, yet until now the workings of its operations have remained little known on Wall Street or in the City of London.

McKinsey, which employs more than 9,000 consultants, advises many of the world’s largest companies on strategic questions, including whether to enter into a merger, change their business direction or downsize. This gives McKinsey consultants unique insights into companies and entire industries.

Its alumni often go on to have prominent roles in government or run major corporations. They include James Gorman, Morgan Stanley chairman and chief executive ; Ian Davis, chairman of Rolls-Royce; Sheryl Sandberg, chief operating officer of Facebook; and Jeff Skilling, former chief executive of collapsed energy company Enron.

McKinsey is owned by more than 1,400 current partners. The fact that former partners continue to have financial ties to an internal investment firm raises questions about potential conflicts of interest, experts say.

“I’ve never heard of that arrangement in a consultancy before,” says Dr Joe O’Mahoney, a reader at Cardiff Business School and former management consultant. “It ties in with the McKinsey philosophy, which is to use their alumni network as an asset. This is the financial aspect to that and it raises the question of conflicts of interest."

Management consultants are private companies that are not subject to regulation. "McKinsey prides itself on Chinese walls and ethical self control," says Andrew Sturdy, head of the department of management at the University of Bristol. "In the absence of regulation, we are left to trust management consultants, their clients and the elite groups they connect to regulate themselves."

A McKinsey spokesman says the firm takes "ethics extremely seriously". He added that MIO "operates on a 'blind trust' basis, with MIO's investment managers being unaware of the firm's clients, and consultants being unaware of MIO's underlying investments."

MIO is overseen by a board of 12 current and former McKinsey partners, including Vik Malhotra, head of McKinsey's practice in the Americas and the co-heads of its energy, private equity and investment banking practices. The McKinsey partners serving on the board do not mention their role on their official company biographies.

An MIO spokesman said that the board delegated investment decisions to MIO's managers, and had a "rigorous policy to avoid conflicts of interest".

Incentive to remain close

The spotlight on McKinsey's private investment office comes after a period of unwelcome attention for the consultancy. Valeant, the Canadian pharmaceutical company that is being investigated by the US Securities and Exchange Commission, counted a number of former McKinsey consultants among its management team, including Michael Pearson, the former chief executive, and its chief financial officer. This followed an insider trading scandal that centred on former McKinsey luminaries including Raj Gupta, its one-time managing director, who was sentenced to two years in prison.

Podcast

Finance: McKinsey's rich network

Three decades ago the management consultancy set up a private hedge fund for its partners and alumni in a bid to keep staff tempted by the financial rewards of banking and private equity. But some experts warn of possible conflicts of interest, say Harriet Agnew and Miles Johnson

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No current or former partner was willing to be quoted by name about the activities of MIO Partners. However, based on conversations with clients and a review of investor documents and filings with the SEC, the Financial Times can shed light on MIO and its investment process.

Roughly half of the $9.5bn fund consists of personal investments of McKinsey's network of current and former partners, and the rest is pension fund assets. It invests in external hedge funds and also runs proprietary trading strategies. McKinsey partners who buy in must be wealthy "accredited investors", meaning that they must have a net worth of at least $1m. One advantage for MIO clients is the offer of financial advice on a no-fee basis.

Other details remain sparse. Even McKinsey's internal history, published in 2011 and distributed privately to partners, includes just one page explaining MIO's origins and activities.

It provides a brief description of how the creation of the investment fund in 1985 by Ron Daniel, a long-time senior partner, was driven by a need to attract and retain employees who were being tempted by the financial rewards on offer in banking and private equity.

“Given what the firm invested in knowledge and people development, [McKinsey] was hard-pressed to match what prospective associates, or even veterans, might earn in investment banking and other financially lucrative fields,” the document said.

Mr Daniel set MIO up as a family investment office that could provide McKinsey partners with a range of investments.

“The idea was that by pooling assets and resources it would therefore open up opportunities that individuals can’t get on their own because they lack the scale, access or liquidity,” says a former McKinsey partner.

Over time, it has reinforced the consultancy’s famed alumni network. When partners leave the firm they frequently keep their money with MIO Partners, adding a financial incentive to remain close to the firm.

One partner, now a senior executive in Europe, describes how closely McKinsey keeps tabs on its alumni: “They get in touch on your birthday, they know all about your family. They send their best research to alumni. They’re part of your knowledge development. Sometimes it’s a bit irritating, a bit like Opus Dei — kind of sneaky and strange.”

Classed as a private investment office, MIO Partners does not need to disclose details of its investments and does not reveal its holdings to its clients. It generally employs a "fund of funds" strategy but can also make direct investments. When the MIO Partners name appears on public documents only a trained eye would be likely to be able to link it back to its famous parent. An MIO spokesman says it is "standard practice" for custodians and administrators to use nominee accounts like Barfield.

"It's the McKinsey style," says another former partner, also with investments in the fund. "They don't advertise, they pride themselves on keeping clients confidential. They're open about [MIO Partners] from inside the firm".

MIO's flagship fund is the Compass Special Situations Fund, a fund of hedge funds that is described by one client as the "crown jewel" in the investment office and a "great benefit" for McKinsey partners. He said Compass closely guards the names of the hedge funds in which it invests and will not even disclose these names to clients of Compass.

Enviable record

The Compass fund has a record that any hedge fund investor would be proud of. It has made money in 24 out of the past 25 years — a period that includes the dotcom bust and the global financial crisis of 2008-09 — earning hundreds of millions of dollars for McKinsey partners and alumni, according to an investor in Compass. Over the same period, the average fund of hedge funds has lost money in five years, according to data provider Hedge Fund Research.

Yet McKinsey's drive to bolster its partners' wealth has also risked causing embarrassment. MIO Partners was named as an investor in the Petters Group, a $3.65bn Ponzi scheme that resulted in businessman Tom Petters being sent to prison for 50 years in 2011.

MIO and McKinsey declined to comment on its investments. However, a person with direct knowledge of the fund says the financial interests of its clients never mixed with the day-to-day activities of McKinsey as a consultant. The McKinsey spokesman says MIO is "managed independently, and all its activities are separate from McKinsey's consulting operations, for example having separate offices and IT systems".

In SEC filings, MIO says it has created an "information barrier" between itself and McKinsey consultants to ensure no material non-public information ever crosses between the two sides. The filings note that McKinsey has "a variety of business engagements with numerous issuers of securities".

However, the filings also make clear that there is no barrier to MIO's funds investing in securities that are tied to McKinsey clients. MIO's funds "are not required to refrain from investing in such issuers", but MIO says it does not invest directly in individual public company securities.

Some MIO Partners investments show overlaps with past McKinsey clients and former employees. One example of this powerful use of the McKinsey network can be seen with MIO's holdings in private equity and venture capital. Northgate, a private equity fund in which MIO has invested, is run by Hosein Khajeh-Hosseiny, who worked both at MIO and at McKinsey as a senior partner working with asset managers and private equity firms.

Other investments previously disclosed by MIO also have ties to former McKinsey employees. Barfield holds shares in Pacific Alliance Asia Opportunity Fund, whose co-founder was a former employee in Hong Kong.

Former partners play down the importance of McKinsey's network to MIO Partners' investment success. The senior European executive acknowledges that the funds gave partners access to investment opportunities sometimes discovered through the McKinsey network, but does not believe that this was its main advantage.

"MIO is a very successful family office," the executive says. "But I would not overstate it."

No-one disagrees that the McKinsey network remains the firm's greatest competitive edge. "McKinsey's alumni network is better than anybody else's," says one alumnus. "You are constantly an ambassador for the brand."

Bumper year nothing out of the ordinary for MIO

In 2014 the average hedge fund returned about 4 per cent. That year, the MIO Partners' main fund, which manages the fortunes of McKinsey's partners, made nearly 14 per cent.

In private letters sent to its investors, MIO Partners celebrated the blowout year by describing how a series of shrewd bets helped the fund beat the market. The year represented "a bit of a 'perfect storm' where a high percentage of our relative value bets worked," wrote Todd Tibbetts, MIO's chief investment officer.

"A range of drivers contributed to the portfolio's positive returns last year," the letter said. "The largest portion came from the relative value 'bets' taken by our external managers and internal trading books.”

Mr Tibbetts outlined how MIO Partners’ diversification and ability to access external hedge fund managers, as well as its own trading skill, had helped it outperform.

“Special Situations [a group of MIO funds] is highly diversified, with investments in over 100 external managers — most of whom are significantly diversified themselves — and over a dozen internal trading books, each of which we closely monitor to ensure we are managing their market exposures to isolate alpha”.

Although the fund had done well, it was keen to stress that this outperformance was in line with MIO’s long-term record.

“Performance in 2014 has not caused us to revise our expectations for the future,” wrote Mr Tibbetts, noting that the fund’s long-term average “value added”, or outperformance, was 7.2 per cent since he started running it in 1999.

However, Mr Tibbetts warned McKinsey partners that they were more likely to continue earning the 3.5 per cent of annual outperformance MIO had made since 2004, which stripped out his big bets in the past.

The lower numbers “exclude the dotcom bust, in which some of our value-added came from a series of bold — and as it turned out, correct — market timing calls, which are less likely to recur,” he said.

MIO has four principals and is governed by a board of directors that consists of 12 McKinsey partners and advisers. Outside of the US, MIO’s president is Tim Church, who joined McKinsey in 1991 to head the firm’s European investment activity.

Listen to the podcast: McKinsey’s secretive investment arm

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