

**New City
Initiative**

Boutique Asset Managers

An SME Cluster

About the New City Initiative

NCI is a think tank that offers an independent, expert voice in the debate over the future of asset management.

Founded in 2010, NCI counts amongst its members some of the leading independent asset management firms in the City and the continent. The NCI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, a traditional “client-centric” approach has enabled entrepreneurial, owner-managed firms to emerge as an important force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

About the Author



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Foreword



As CEO of a boutique asset manager, I understand well the challenges that come from being a smaller business. However, these are not without counterbalancing benefits. NCI has previously talked about the unique culture that small and medium-sized asset managers have and how this leads to superior outcomes for clients; this current paper extends that work to benefits offered to the wider economy. Small and medium-sized enterprises (SMEs) provide a disproportionately large contribution to innovation in the economy, particularly broad-based innovation that drives deep-seated positive change. Financial services SMEs, like NCI's members, innovate markedly and collaborate together in open innovation as a cluster, much

like that commonly associated with Cambridge or other hubs of innovation.

NCI's view is that this SME cluster of small and medium-sized asset managers should be recognized and nurtured, as should the SME sector generally. However, support from government in one area, such as IMS II, does not offset the resource and financing constraints that limit SME innovation. By way of example, financial services and asset management SMEs, like certain other sectors, are unable to avail themselves of innovation funding or tax advantages that accrue to early-stage backers in other industry segments. NCI argues that this should change and that the unique and vibrant voice of NCI's members, acting as an SME cluster of innovation, should be recognized with representation on the Asset Management Taskforce and other bodies.

I am pleased to introduce this paper on SME clusters of boutique asset managers, proud to be partner and CEO of one of them, and honoured to be able to represent NCI's members as chairman.

Jamie Carter

Chairman, New City Initiative
Chief Executive, Oldfield Partners

Executive Summary

NCI considers the disproportionate contribution made by SMEs in driving innovation within the UK and global economy: this effect is magnified by the information exchange facilitated by physical and virtual clustering. These factors apply just as readily to financial services SMEs, of which NCI's members are exemplars and the backbone of a London-based and virtual cluster of innovation in asset management: financial services SMEs will drive radical change that will assist the UK economy to weather structural changes in the labour market. NCI calls for the UK government to recognize this boutique asset management SME cluster and to ensure consistency between its IMS II policy framework and practical support for the SME cluster: this must include access to SME financing, recognition of business model innovation, a proportionate regulatory regime and allowing SME asset managers direct participation in such initiatives as the Asset Management Taskforce.

Introduction

New City Initiative (NCI) has over forty members collectively managing around £400 billion of assets. Predominantly owner-managed, NCI's members align their interests with their clients' in a transparent manner and, more broadly, seek to encourage competition, innovation and consumer choice within the UK asset management industry.

However, NCI's members are also productively defined rather differently: they are the Small and Medium-Sized Enterprises (SMEs) of the asset management industry and an important cluster of such activity for the UK and global economy;¹ in acting as such, they promote innovation in the broadest sense with corollary benefits for society through economic growth, employment and global trade in services.

This paper explores these two themes, SME character and clustering, and concludes that small and medium-sized boutique asset managers, epitomized by NCI's members, are an important example of such virtuous contributors to innovation and the economy. NCI submits that they should be recognized as such and, like industries of a more manufacturing nature, given access to such support as the government offers to other SME clusters.

¹ New City Initiative, *Start-up Britain is Here in London: Why it is Crucial to Support Financial SMEs* (2011); New City Initiative, *The Significance of the SME Sector in the UK Financial Services Industry* (2011)

Broad-Based Innovation

There is a tendency to consider innovation through the lens of technological innovation, which naturally elides into innovation in manufacturing: the printing press, automobile or personal computer, for example. Yet, such a perspective is at best a substantial oversimplification:² the printing press is, for example, the technological expression of a more expansive innovation in thought, religion and politics that required broader dissemination; cars and computers, and the manufacturing innovations that allow their creation, build upon many different precursor innovations and their adoption by society.

Innovation, correctly defined, is thus much broader in scope: it is not just in process, but also in development of ideas and the connection between existing ideas and technologies, and; it is intimately connected with entrepreneurialism and hence SMEs.³ The disruptive change effected by this broader innovation, the origin of Google, Amazon and Facebook amongst others, is reflected in financial services. By way of example, alternative finance is, on one metric, a £4.58 billion industry in the UK alone;⁴ the pace of such change cannot but accelerate with the adoption of Open Banking, catalysed by the Competition and Markets Authority.⁵

Small and Medium-Sized Enterprises

SMEs are often perceived to be micro-businesses, yet the definition adopted by most agencies is broader. The factors determining whether an enterprise is an SME are headcount and either turnover or balance sheet: the EU adopts a standard definition in which an SME is any organization that has less than 250 staff and either a turnover of less than or equal to €50 million or a balance sheet below €43 million.⁶ Within this same definitional framework a small enterprise is one with less than 50 staff and relevant financial metrics below €10 million; a micro enterprise is one with less than 10 employees and relevant financial metrics below €2 million.

SMEs are dominant within the economy on various metrics: within the EU, SMEs account for 99% of all businesses and 85% of all new job creation.⁷ SMEs also show disproportionate leveraging of “intellectual assets” in producing economic output:⁸ this may be a natural consequence of the inability of SMEs to compete against larger organizations in a more direct manner, not having the advantages of large balance sheets and substantial research budgets. However, SMEs are not homogenous in the way in which they innovate: the method is linked to organizational culture as that drives both the method of innovation and its timeline and focus.⁹

² P. F. Drucker, *Innovation and Entrepreneurship : Practice and Principles* (Rev. ed. edn, Butterworth-Heinemann 2007)

³ Ibid

⁴ Cambridge Centre for Alternative Finance, *Entrenching Innovation: The 4th UK Alternative Finance Industry Report* (2017)

⁵ Competition & Markets Authority, *Retail Banking Market Investigation: Final Report* (2016)

⁶ Commission Recommendation of 6 May 2013 Concerning the Definition of Micro, Small and Medium-Sized Enterprises 2003/361/EC OJ L 124/36

⁷ ‘COSME: Europe’s Programme for Small and Medium-Sized Enterprises’ (European Commission) <<http://ec.europa.eu/growth/smes/cosme/>> accessed 11 February 2018

⁸ OECD, *Intellectual Assets and Innovation* (OECD Publishing)

⁹ P Wolf, S Kaudela-Baum and J. O. Meissner, ‘Exploring Innovating Cultures in Small and Medium-sized Enterprises: Findings from Central Switzerland’ 30 *International Small Business Journal* 242

SMEs have advantages in innovation compared to larger organizations. A smaller organization, run by a core team and less siloed, can be more flexible, adapt more rapidly to changing market conditions, and benefit from rapid internal communication:¹⁰ this is interlinked with the organizational culture as well as practical effects such as size and geographic location of human resources. The mechanism of innovation differs between SMEs and larger organizations: since SMEs lack resources compared to larger organizations, they tend to innovate project-by-project and such innovation is inseparable from business model innovation, the essence of broad-based innovation.¹¹

SMEs are more able to engage in disruptive or radical innovation rather than incremental innovation: incremental innovation, such as modest change to consumer product offerings, is directly correlated to organization size.¹² Larger financial services companies are prone to internal barriers, such as cultural risk-avoidance or inertia caused by systems architecture: these act as internal barriers to disruptive and radical innovation.¹³ As such, the disruptive innovation encouraged by initiatives such as the FCA’s Project Innovate is catalysed by recognition and support of SMEs. Furthermore, innovation that incorporates changes to the business model is persistent and can lead to value creation for customers or the organization: this can assist in avoiding commoditization of the product or service, a particular threat for financial services

SMEs are more likely to engage in open innovation, sharing with and drawing from broader collective ideas and even collaborating with other SMEs with similar interests:¹⁴ this reduces the likelihood of abandonment of the innovation strategy, an outcome that is more probable in closed innovation by an insular entity.¹⁵ Such collaboration, exemplified in membership of trade bodies such as NCI, allows a network effect between organizations: shared cultural values in this clustering mitigate the challenges of managing innovation partnerships within the network and can lead to superior outcomes.

Clusters

The idea that there are synergies through proximity between different entities, a network effect, is self-evident from human development models: markets and cities are manifest outcomes of the economic benefit of such clustering.¹⁶ The reality is rather more complex, with network externalities

¹⁰ T Cannon, ‘Innovation, Creativity and Small Firm Organisation’ (1985) 4 *International Small Business Journal*

¹¹ 33

¹² W Vanhaverbeke, *Managing Open Innovation in SMEs* (Cambridge University Press 2017)

¹³ B Forés and C Camisón, ‘Does Incremental and Radical Innovation Performance Depend on Different Types of Knowledge Accumulation Capabilities and Organizational Size?’ 69 *Journal of Business Research* 831

¹⁴ P Das and others, ‘Barriers to Innovation within Large Financial Services Firms: An In-depth Study into Disruptive and Radical Innovation Projects at a Bank’ (2018) 21 *European Journal of Innovation Management* 96

¹⁵ Vanhaverbeke

¹⁶ HW Chesbrough, *Open Innovation : The New Imperative for Creating and Profiting from Technology* (Harvard Business School ; Maidenhead : McGraw-Hill 2003)

¹⁶ P.M. Hohenberg and L. H. Lees, *The Making of Urban Europe, 1000-1950* (Harvard University Press 1985)

such as congestion and pollution; the synergistic outcome is dependent on complementarity and other factors.¹⁷ Contemporary economic networks have differing scales owing to technological developments such as modern transportation infrastructure and the internet, which may allow deagglomeration:¹⁸ however, complex interactions, reliant on trust and understanding, are likely to continue to benefit from physical proximity.

Such clusters, physical or virtual, can enhance innovation.¹⁹ The effect is not uniform and depends on moderators such as the degree of centralization, distance between members and the industry.²⁰ The mechanisms through which such clustering acts are various: skilled labour can be drawn from a single pool, specialist suppliers can develop, a market can reach scale by aggregation and knowledge can be shared, voluntarily or by “spillover”.²¹

Locations such as London for financial services and Cambridge for technology are especially amenable to cluster effects since they have a compact geographic core and the industries are knowledge based, facilitating information transfer. However, they are not alone: Silicon Valley, Israel, Munich, Taiwan, Colombia and Mexico are all the origins of case studies for the positive effect of clusters in supporting innovation and entrepreneurialism.²²

The establishment and maintenance of such clusters is not assured and relies upon action by both governments and entrepreneurs. Barcelona was ‘the Catalan Manchester’ in the late 1800s and early 1900s with manufacturing in industrial neighbourhoods such as Poblenou, yet by the 1970s these areas were marginalized and economically depressed: urban renewal catalysed by the city government for the 1992 Olympics and creation of an ‘Innovation District 22@’ have made it a model for redevelopment. Munich was subject to entrepreneurial success in the late 1800s and after World War II, producing companies like BMW, Siemens and Allianz, yet it has not sustained such global success despite continuing economic prosperity: regional government has financed initiatives at universities, which themselves co-operate to offer training and incubation to over 100,000 students. London’s recent development of a high-tech centre in East London has, in a more laissez-faire approach by government, been assisted by reform of visa and intellectual property laws, some funding and tax breaks for early-stage investors.²³

Hence, the framework established by governments, both national and regional, can greatly assist the development and persistence of innovation clusters. However, such policies must be well

¹⁷ E Meijers, ‘Polycentric Urban Regions and the Quest for Synergy: Is a Network of Cities More than the Sum of the Parts?’ (2005) 42 *Urban Studies* 765

¹⁸ E. E. Leamer and M Storper, ‘The Economic Geography of the Internet Age’ in John Cantwell (ed), *Location of International Business Activities: Integrating Ideas from Research in International Business, Strategic Management and Economic Geography* (Palgrave Macmillan UK 2014)

¹⁹ L Fleming, C King and Juda AI, ‘Small Worlds and Regional Innovation’ (2007) 18 *Organization Science* 938

²⁰ Fang Li, ‘Do Clusters Encourage Innovation? A Meta-analysis’ 30 *Journal of Planning Literature* 239; D J

Watts and S H Strogatz, ‘Collective Dynamics of ‘Small-World’ Networks’ (1998) 393 *Nature* 440

²¹ H Wolman and D Hincapie, ‘Clusters and Cluster-Based Development Policy’ 29 *Economic Development Quarterly* 135

²² JS Engel, ‘Global Clusters of Innovation: Lessons from Silicon Valley’ (2015) 57 *California Management Review* 36

²³ *Ibid*, pp 48-51

considered: the construct must be built on existing strengths not concepts; local adaptation is essential; educational institutions can be powerful enablers, and can do more than teach, and: interpersonal networks are a driving force, indicating the catalytic effect of trade organizations such as NCI. The experience of geographies as diverse as Israel, Taiwan and Colombia indicates that clusters of innovation can sustain regional competitive advantage.²⁴

However, the development and success of such clusters is not a project solely for government: it must be intimately cultivated by innovative firms, especially SMEs, and by entrepreneurs. This can be catalysed by early-stage funders and by more traditional asset managers across the entire lifecycle of corporate investment. These private entities can locate within the innovation cluster and themselves leverage relationships with universities, NGOs and governments.²⁵ In doing so, they can embrace open innovation and collaborate, developing a global perspective and reinforcing local competencies from the beginning: this is the core strength of SMEs, and applies as much to those in the asset management space, such as NCI’s members, as to other industries.

Boutique Asset Managers: Exemplars of an SME Cluster

Small and medium-sized boutique asset managers, such as NCI’s members, are themselves innovators: in investment process, in culture, and in much else that leads to superior outcome for clients.²⁶ Like other financial services, these innovations are not within the monolithic domain of manufacturing process innovation: they are, however, tangible in outcome with positive effects for clients and the broader economy.²⁷

NCI’s members are not just SMEs within the formal definitions of staffing and balance sheet or turnover. They are SMEs within the functional definition developed above based upon the capacity to innovate: they have a unique common culture that allows for collaboration and open innovation, enhanced by the transparent metric of published performance. NCI’s members are flexible, able to adapt to changing market conditions and have lean management structures composed of senior teams that have worked together prolongedly. Hence, NCI’s members should be well-placed to innovate within the broader definition, a form of business model innovation that creates persistent value for customers.

NCI’s members are geographically concentrated, mostly in London, and hence compose a natural cluster for innovation: they draw from a common labour market, support specialist service providers, recruit from common educational institutions, are perceived as an aggregated source of skill for external allocators, and naturally share knowledge and interpersonal contacts through membership of NCI. However, this cluster is not merely geographically based: NCI has many

²⁴ *Ibid*

²⁵ *Ibid*

²⁶ *New City Initiative, Alignment of Interest: How Culture Defines Boutiques* (2017)

²⁷ *Ibid*

likeminded members that are not located within London but share common cultural values.²⁸ Similarly, NCI's innovative members support ancillary service providers in industries such as settlement, professional services, law and so on.

NCI's members, the SMEs of asset management with consequent propensity to innovate, support a supercluster that expands beyond the London geography to the UK regions and further afield: this contribution should be acknowledged and husbanded by the UK government.

Catalysis for Innovation

The Role of Government

The role of government in catalysing the development and persistence of a cluster, particularly one associated with innovation, has been addressed above by reference to Barcelona, Munich and other examples. Nonetheless, UK government support for innovative SMEs is contradictory. Encouragement of a venture capital nexus in the UK to allow development of, and exit from, innovative SME businesses is not aligned with more granular economic incentives. By way of example, tax breaks to early stage equity funders through "venture capital schemes" have an extensive list of exclusions for any "trade" on a prescribed list: this list regularly grows and financial services, however defined and including asset management, are excluded from access to such tax incentives.²⁹ Such narrow definitions disbenefit NCI's members and future entrepreneurs in asset management or broader financial services; more holistically, they do not address the funding challenges met by SMEs and the consequent competitive disadvantage relative to larger incumbents.

Investment Management Strategy II (IMS II)

The UK government has recently published a framework to sustain and develop the investment management industry in the UK.³⁰ IMS II is structured around several 'guiding principles'. The first two of these refer to: the UK's role as a global centre for asset management, namely its role as a cluster, and; the support of innovation to drive economic growth and superior outcomes for consumers and businesses.

IMS II Guiding Principles, Abridged

Cluster: "The Government is committed to providing a stable environment to reinforce both the strength of the sector and the UK's status as a global centre for asset management."

Innovation: "The Government will look to support innovation within the asset management industry at every opportunity to create an environment that drives economic growth and continues to deliver the best possible outcomes for consumers and businesses."

²⁸ Ibid

²⁹ HMRC, 'Venture Capital Schemes Manual' (HMRC, 4 December 2017) <<https://www.gov.uk/hmrc-internal-manuals/venture-capital-schemes-manual/vcm3010>> accessed 31 March 2018

³⁰ HM Treasury, The UK Investment Management Strategy II (2017)

These are the core themes discussed at length above and to which, it is submitted, NCI's members are disproportionate contributors as innovative financial services SMEs. NCI welcomes IMS II but notes that many of its elements do not specifically address the needs of SME industry participants such as its members.

IMS II continues the broad theme of innovation, refining the government's position along six main heads. Whilst there is no explicit reference, these follow the general framework that Engel establishes within his comparison of different clusters for innovation.³¹ Enhanced communication between government and private sector parties is to be developed through the Asset Management Taskforce. The UK's attractiveness for investment management is to be maintained and enhanced through the tax and regulatory regimes, albeit there are few details and competitor jurisdictions such as Ireland and Luxembourg are themselves enhancing their attractiveness on these metrics. Development of skills through partnership with universities is to be welcomed, as is the focus on FinTech and application of FCA's Project Innovate to the asset management sector: NCI proposed more extensive use of Project Innovate, and the FCA's response has been most helpful.³²

These broad themes are welcomed by NCI: it agrees that the UK should enhance its standing as a global portfolio management hub. However, given that NCI's members, as the SMEs of asset management, are uniquely placed to innovate and develop an innovation cluster, NCI looks forward to more structured engagement through such fora as the Asset Management Taskforce: the SME financial services sector has as much to say, and likely more, than larger industry members.

Resource and Financing Constraints for SME Innovators

The analysis above has identified one core disadvantage that SMEs are at compared to larger organizations when seeking to innovate: the availability of resources and financing. This has been recognized by the EU in establishing its EASME/COSME initiatives with €2.3 billion of funding available to SMEs: 61%, €1.4 billion, of this fund is to catalyse access to finance, indicating the dominance of this constraint to SME innovation.³³ The UK government's tangible support has been more limited: Innovate UK offers Innovation Loans to SMEs of between £100,000 and £1 million but has only £50 million in total distributed over five £10 million competitive tranches.³⁴

In addition to the relatively modest size, the categorization of eligibility for Innovation Loans is limited to innovation in fundamental research, feasibility studies, industrial research and experimental development. This is not consistent with the more expansive definition of broad-based innovation developed above and practically excludes financial services SMEs; that financial services SMEs are also ineligible for participation in tax incentives for private sector funders, such as EIS, shows the fundamental tension between government support through initiatives such as IMS II and the contradictory policies at a more granular level in relation to access to finance. Support of SMEs, including those in the financial services sector, must provide a higher long-term return, particularly given structural changes in the economy, than the very significant subsidies given to legacy

³¹ Engel

³² New City Initiative, Supporting Innovation and Entrepreneurialism in Asset Management (2017)

³³ , 'COSME: Europe's Programme for Small and Medium-Sized Enterprises'

³⁴ Innovate UK, (Innovate UK,) <<https://apply-for-innovation-funding.service.gov.uk/competition/136/overview>> accessed 31 March 2018

industries such as car manufacturing: Rover provides a salutary example.³⁵ For SMEs such support need not be wholly financial: an innovative, proportionate and well-conceived regulatory framework, for example, could provide wider societal benefit without the disproportionate externality of onerous compliance costs that accrue to financial SMEs.

NCI Proposals to Support the Boutique Asset Management SME Cluster

NCI welcomes and supports IMS II. However, it regards the SME cluster composed of boutique asset managers as a sufficiently distinct source of value to the UK's investment management industry that it must be considered separately rather than subsumed within broader discussions. This is similar to NCI's position, acknowledged by the FCA, that smaller boutique asset managers need specific focus within Project Innovate.³⁶

NCI proposes the following, namely that:

1. Small and medium-sized asset managers be recognized as a distinct cohort within the financial services industry. They are at the productive interface between SMEs and financial services and are uniquely placed to innovate owing to business model and cultural factors.
2. This cohort of asset managers be appreciated as an SME cluster that innovates and contributes to the UK economy. This cluster is not solely based in London but extends beyond it and supports corollary services such as professional advisors and legal services providers.
3. The enhanced and structured communication between government and the investment management industry, through the establishment of the Asset Management Taskforce, include this distinct SME cluster so that its unique contribution can participate within the various aims of IMS II.
4. The boutique asset management industry be offered the same support offered to other SMEs: access to financing that overcomes the competitive disadvantage of limited access to resources and funding, and; a regulatory and compliance framework that recognizes the unique character of the SME finance sector, is proportionate and avoids unintended consequence.
5. The supportive language in IMS II be reflected in access to Innovation Loans or, for those who invest in such start-up financial SMEs, access to tax incentives, and; recognition and reduction of the explicit and implicit costs that accrue to the sector in the form of the compliance and regulatory burden, an opportunity for simplification of which is afforded by the UK's departure from the European Union

³⁵ D Bailey, S Kobayashi and S MacNeill, 'Rover and Out? Globalisation, the West Midlands Auto Cluster, and the End of MG Rover' (2008) 29 Policy Studies 267

³⁶ New City Initiative

Conclusion

The small and medium sized asset management sector is a unique cohort of firms that adds value in excess to its size. SMEs have the capacity to innovate in a manner that larger organizations cannot, and NCI's members, with their predisposition to develop a productive organizational culture, are exemplars of financial services SMEs. NCI's members mutually support each other's innovation by means of geographic and virtual economic clustering, thereby supporting larger economic superclusters of value. National and regional governments need to recognise, when developing economic and regulatory policy, the real contribution that can be made by the boutique asset management SME cluster. NCI welcomes further productive dialogue on this topic.

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