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Why Not the Best?

Identifying Outperforming Emerging Managers and Capturing Alpha from a Long-Neglected Market

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The Power of Perspective

The photo on the cover shows the exquisite detail of the Tiffany dome of the Chicago Cultural Center, and the photo on this page shows the outside of the building. Together, these two photos illustrate how perspective shapes one's perception of reality.

At NexTier, we believe that many of the investment industry's most talented managers get overlooked because the institutional community is not looking at them from the proper perspective. We wrote this white paper because we believe institutional investors need a more informed perspective to properly evaluate the alpha-generating ability of emerging managers.

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In This Report

Larry Manson, Jim Casselberry and David Kushner of NexTier examine the current state of institutional searches for emerging asset managers and prescribe best practices for identifying and utilizing the most talented emerging managers:

- **Performance drivers:** Reasons top-tier emerging managers are able to outperform larger, established firms
- **Sustainability traits:** Characteristics of emerging managers that are able to generate sustainable alpha
- **Next steps:** Recommendations for improving emerging manager programs within institutional plans

A Flawed Search for Elite Talent

In the late 1990s, a young baseball player near Kansas City was putting up incredible stats and compiling numerous accolades as a high school player and then in junior college. His prodigious power and bat control were the sorts of things that usually made professional baseball scouts offer huge signing bonuses and fight each other to draft a player in the early rounds of the amateur draft.

Despite his dominating performance on the field, scouts were far from enamored with the young shortstop. Many scouts were concerned about the player's physical build. One scout's assessment described the player as having a "heavy, bulky body. Extra [weight] on lower half. Future [weight] problem."[a] Other scouts commented that the player's swing didn't look like the prototypical swing.[b]

In short, scouts discounted the player because he didn't look like what a future Major League star is supposed to look like. He didn't pass the "eye test."

Because of these optical concerns, the player who had dominated the high school and junior college ranks wasn't drafted until the 13th round of the 1999 amateur draft by the St. Louis Cardinals.

Two years later, that player, Albert Pujols, won the National League Rookie of the Year award and finished fourth in the MVP voting. He would finish in the Top 10 of the Most Valuable Player voting in each of his first 11 seasons in the Major Leagues, helping the Cardinals make the playoffs seven times during that span.

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Why Investors Should Care About Albert Pujols

What do Albert Pujols and amateur baseball scouting have to do with institutional investing? Quite a bit, actually.

The reason that 401 players were drafted in 1999 ahead of Pujols, a future first-ballot Hall of Famer, is largely the same reason that many of the most talented small and emerging asset managers aren't included on institutional investors' platforms.

Like the baseball scouts who discounted Pujols' obvious talent because he didn't fit the profile of what scouts had been taught to look for, plan sponsors, investment consultants and other institutional decision-makers largely ignore emerging managers because these small managers don't "look like" the large, established managers that dominate the manager ranks on institutional platforms.

Evaluators of investment managers have been trained to follow a rigid selection process that is essentially designed to identify managers that have many of the same characteristics of managers that have been selected in the past. The criteria evaluators use typically focuses on easy-to-quantify measures, such as assets under management (AUM), history and track record of the firm, number of employees and the credentials of the firm's leadership.

When they come across firms that don't fit this mold, evaluators don't know how to properly assess the risk and return potential of these non-traditional managers. As a result, many of the most talented managers are reflexively excluded from the institutional investment manager selection process.

The Alpha Imperative

Institutional investors and the constituents they serve can no longer afford to ignore an area of the market that contains many of the industry's most talented managers. As of November 2014, the combined underfunding of state public pension plans had risen to a staggering $4.7 trillion, representing a funding ratio of 36%, according to a report from State Budget Solutions.[c] As funding levels continue to deteriorate, it is more important than ever for the institutional investor community to utilize the talents of the managers who are best able to deliver alpha—regardless of what those firms look like or what corner of the investment universe those managers operate in.

When evaluating managers, institutional investors try to determine the manager's "net alpha" by adjusting outperformance to account for the manager's perceived or actual enterprise risk. While this approach makes sense, its execution has significant flaws.

The Alpha Imperative

The massive underfunding of public pension funds has created an unprecedented need for plans to improve their ability to identify the highest-performing managers, regardless of the size or background.

$4.7 trillion

Total underfunding of state public pension plans in the United States

36%

Funding ratio of state public pension plans

Source: State Budget Solutions, November 2014

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The Alpha Imperative Continued

Too often evaluators simply assume that a firm's enterprise risk is almost entirely a function of the firm's size. As a result, emerging managers are presumed to have significant enterprise risk, regardless of how these smaller firms are actually managed. Conversely, the presumption that large firms do not have enterprise risk is undermined by the many recent examples of large firms whose investors were exposed to significant enterprise risk in various forms, such as the key-man risk at PIMCO, poor portfolio risk management at Lehman Brothers and compliance malfeasance at Madoff Investment Securities and Bayou Management.

In this report, we examine the performance of emerging managers across asset classes and explore the reasons why emerging managers have been able to outperform their larger, more established counterparts. We will also explain how the institutional investment community can develop the skills necessary to accurately evaluate enterprise risk at emerging managers and identify the ones that can deliver sustainable net alpha. Finally, we will prescribe the changes that need to be made at the institutional investor level to improve the performance of emerging manager programs—both through direct investments and manager of manager programs.

Defining Key Terms

Throughout this report, we use the following working definitions of important terms:

Emerging managers

Any firm that has been excluded from the traditional institutional search process, regardless of the reason—be it AUM, ethnicity, gender, history of the firm, number of employees or asset class.

Managers of emerging managers

Investment managers who specialize in selecting emerging managers on a discretionary basis, creating and constructing portfolios of these managers by using commingled vehicles or separately managed accounts for institutional investors.

Net alpha

An adjustment of a manager's outperformance to account for any actual or perceived enterprise risk.

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Why Emerging Managers Outperform

Across asset classes and market cycles, emerging managers have shown the ability to consistently outperform their larger, more established peers. We examine the portfolio construction and operational characteristics that have contributed to the outperformance by smaller, younger asset managers.

Defining an Evolving Term

The term "emerging managers" originally entered the mainstream investment lexicon in the 1980s. Back then, it was generally used to describe asset management firms that were largely undiscovered because of their size or lack of a track record.

Starting in the 1990s, the term "emerging managers" began to morph into meaning minority- and women-owned firms. This shift coincided with state and local pension plans responding to political pressures to reflect greater gender and racial diversity within their manager selections.

While the gender- and race-based definition of emerging managers is predominantly used today, for the purposes of this paper, we will be using a much more expansive definition of the term. We broadly define an emerging manager as any firm that has been excluded from the traditional institutional search process, regardless of the reason—be it AUM, ethnicity, gender, history of the firm, number of employees or asset class.

From a practical perspective, we will use the terms "emerging" and "small" interchangeably. Although firms can be excluded from search processes for any of the reasons listed above, size (in terms of AUM) is the single criterion that most closely correlates to why emerging managers are largely excluded. It is important to note that what constitutes "small" can vary significantly across asset classes. For example, when looking at long-only, public equity managers, many people use $2 billion in AUM as the dividing line between "small" and "large" firms. When it comes to hedge fund or private equity managers, however, $500 million is often used as the point of demarcation.

Drivers of Emerging Manager Outperformance

Emerging managers' ability to outperform larger, more established firms is largely driven by emerging managers' portfolio management strategies and ownership structure.

- Focus on alpha-rich, less-efficient asset classes
- High-conviction portfolio construction
- Heightened focus by founders on portfolio management
- Selection bias among entrepreneurial managers
- Strong alignment of interests with investors

Behind the Numbers: Reasons for Emerging Manager Outperformance

A significant amount of industry and academic research over the past 10 years has been devoted to measuring the performance of emerging managers relative to larger, more established managers. Reviewing this research paints a very compelling picture of emerging managers' ability to outperform large managers across asset classes, investment styles and pre- and post-recession timeframes. (See insert on page 10, "Emerging Managers: Delivering Outperformance Across Asset Classes," for highlights of the research into emerging manager performance.)

When thinking about the case for investing with emerging managers, it is important to understand why smaller managers have been able to generate sustainable alpha. Having studied this issue from "all sides of the table"—in our careers we have served as asset allocators, institutional asset managers, consultants to investment management firms and consultants to plan sponsors—we have found that the reasons that emerging managers are often able to outperform their larger peers generally relate to two broad factors: 1) the construction and management of the portfolio and 2) the firm's ownership structure.

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Portfolio Construction and Management

Being small—whether in terms of AUM or number of employees—and nimble can provide several powerful advantages in terms of constructing and managing a portfolio.

Alpha-rich opportunity set: As institutional investors allocate an increasing portion of their portfolios to passive strategies, investors face even greater pressure to maximize alpha in low-correlation, actively managed portions of the portfolio. Smaller managers have many inherent advantages over larger managers in these asset classes.

Because they can own "smaller ideas," emerging managers are better able to invest in the less-efficient corners of financial markets where alpha still exists. Capacity constraints in asset classes such as small-cap equity and middle-market private equity essentially serve as a barrier-to-entry that reduces competition and preserves opportunity to buy assets at attractive valuations for smaller, nimbler firms.

Large managers are often precluded from investing in these alpha-rich areas. This is because larger managers are not able to move in and out of these markets efficiently without causing significant market disruptions. Any investment these firms make that would be substantial enough to make an appreciable difference in the firm's performance would essentially result in the firm "becoming the market." Smaller firms, on the other hand, are able to pursue these opportunities and make meaningful investments without disrupting market efficiency.

Avoiding "The Xerox Effect"

In the 1996 comedy *Multiplicity*, Michael Keaton plays an overworked construction manager who clones himself so he can spend more time with his family and his career. But because each "copy" of himself ends up being less sharp than the original and the clones are not able to communicate well with each other, the plan backfires spectacularly … and prerequisite Hollywood zaniness ensues.

Many founders of asset management firms find themselves dealing with multiplicity-esque problems every day.

As a firm grows and begins adding additional strategies and layers of co-portfolio managers, specialists and analysts to manage the rising asset levels, the founder—the person whose vision and investment acumen is what allowed the firm to grow in the first place—becomes further and further removed from the front lines of portfolio management.

Firms that are able to grow in a measured and structured way are able to avoid "the Xerox effect" by creating an infrastructure that allows the founders to remain focused on portfolio management as the firm grows its asset base.

Portfolio Construction and Management Continued

High-conviction portfolios: Because they do not face the same capacity constraints facing larger firms, emerging managers are able to devote a higher portion of their portfolios to their very best ideas in a particular asset class or strategy. To participate in less-liquid, higher-return asset classes in a meaningful way, large firms would have to spread capital across so many different investments that the firm's allocation of capital would become a de facto index. This would wash out the opportunity for alpha.

As a result of owning fewer names in a particular strategy, emerging managers are able to create portfolios that deviate significantly from the index. In a 2011 report, FIS Group found that smaller managers across most equity classes displayed significantly higher concentration in their portfolios and greater tracking error from the benchmark. More interestingly, the FIS report concluded that this heightened portfolio concentration contributed greatly to smaller managers' ability to generate more excess return per unit of tracking error in four of the five equity categories studied (large value, large growth, small cap, and global ex-U.S.) for the five-year period ending on Dec. 31, 2010.[d]

Heightened leadership focus on portfolio management: As firms grow, there is natural pressure on the founding principals to devote more of their time to running the business and less time on managing the portfolio. (See, Avoiding the Xerox Effect on page 8.) This results in the talented, proven people whose decisions drove the growth of the firm becoming further and further removed from portfolio management. Emerging managers usually have more streamlined structures, so the founders are able to spend a much higher percentage of their time focusing on portfolio decisions that create value for investors.

Ownership Structure

The ownership structure of emerging managers also contributes to their ability to outperform larger firms.

Selection bias: One reason why emerging managers have been able to outperform so consistently is the higher likelihood that selection bias is at work. Portfolio managers who choose to take the risk of starting their own firms are often the industry's most talented, driven and confident professionals.

At large firms, overhead expenses eat into profitability and the remaining profits are diluted among a widespread ownership base. As a result, managers with impressive track records and strong reputations may choose to start their own firms or work for smaller firms so they can keep a higher percentage of the value that they create.

Alignment of interests: Emerging managers tend to have a strong alignment of interests between the portfolio managers and the investors. Entrepreneurial managers whose livelihoods and personal wealth depend on their ability to grow and retain assets can't afford not to perform.

PIMCO reportedly paid Bill Gross a bonus of $290 million in 2013[e] —a year in which his Total Return Fund underperformed a majority of its peers. It is clear that Gross's ability to make his monthly mortgage payments in 2014 wasn't dependent on his fund's 2013 performance.

In addition to a strong correlation between personal earning potential and fund performance, emerging managers also tend to have a higher percentage of their personal wealth invested in the strategies they are managing. Investors are well served to put their money with managers who are hungry and have a significant amount of skin in the game.

Investors are well-served to be invested alongside managers whose net worth and income are highly correlated to fund performance.

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Emerging Managers: Delivering Outperformance Across Asset Classes

Over the past decade, many academic and investment industry researchers have studied the performance of emerging managers vs. larger, more established firms. Collectively, this research tells a compelling story of emerging managers' ability to outperform their large peers across asset classes.

Public Equity

Across most classes and styles:
small managers outperform with similar risk

Small Managers Outperformed	Small Managers Underperformed
• Large growth • Large value • Large core • Small growth • Small value • Small core	• Global ex-U.S.

According to research by FIS Group, from 2006 to 2010, small managers (<$2 billion for large cap and global ex-U.S. equity; <$300 million for small/mid-cap equity) outperformed large managers in every strategy except global ex-U.S. without incurring appreciably more risk.[f]

Large-cap U.S.:
small managers outperform at the median and top quartile

+72 bps

Median small manager outperformance

According to research by Northern Trust, from 2005 to 2010 the median U.S. large-cap equity manager with less than $3.6 billion in AUM outperformed the median large manager by 72 basis points annually. Despite representing 36% of the total sample, small managers made up 44% of the top performance quartile and only 28% of the bottom quartile.[g]

Private Equity

Small NAIC Firms Produce Big Outperformance, 1998 to 2011

	NAIC firms	All U.S. private equity
Median net IRR	15.2%	3.7%
Upper quartile net IRR	20.9%	11.8%
Average fund size	$156 million	$469 million

In its 2012 survey, the National Association of Investment Companies (NAIC) found that NAIC member firms—minority and diverse private equity firms and those focused on the U.S. Emerging Domestic Market—produced superior returns to the U.S. private equity benchmark.[h]

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Fixed Income

Younger Firms Outperform Older Firms

	Years 1 to 5	Years 6 to 10
Core	7.7%	6.6%
High-yield	11.9%	8.9%

According to research by Lorenzo Newsome, Jr. and Pamela Turner, for both core fixed-income and high-yield funds, younger firms have consistently outperformed older ones. With core fixed-income, average gross performance during the first five years of a fund's existence was 7.7% versus 6.6% during the next five years. For high-yield fixed-income, average performance was 11.9% for the first five years versus 8.9% during the next five years. The research looks at firms that were founded from 1985 to 2006.[i]

Hedge Funds

Small Beats Large

+220 bps

annual outperformance of $50 million - $500 million hedge funds vs. large funds

According to research from Beachhead Capital Management, hedge funds with between $50 million and $500 million in equity long/short AUM outperformed larger hedge funds by 220 basis points annually from 2003 to 2012. Smaller funds materially outperformed in both the pre- and post-recession environments.[j]

Young Beats Old

Cumulative Returns by Firm Tenure

	Young (0 to 2 years)	Mid-Age (2 to 5 years)	Tenured (5 plus years)
January 2003 to December 2013	210.6%	128.9%	123.7%
January 2009 to December 2013	64.9%	47.2%	48.3%

According to eVestment Research Division, from 2003 through 2013, younger hedge funds consistently outperformed older ones. Funds with track records of less than two years were the highest-performing group in both the pre- and post-recession time frames.[k]

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Identifying Sustainable Alpha in Emerging Managers

Despite widespread acknowledgement of the high-end talent within emerging managers, institutional investors and investment consultants often lack the ability to sort out the stars from the "also-rans" in this diverse field. We explain the characteristics of emerging managers that are positioned to deliver sustainable alpha.

Understanding the De-Selection Process

The research presented in the previous section about the outperformance of emerging managers across asset classes is compelling. But it's hardly groundbreaking. Countless sources we have talked to at leading investment consultants and institutional investors readily concede that many of the industry's best managers are emerging managers.

Despite this acknowledgement of the latent alpha-generating potential among emerging managers, the institutional investor community continues to largely exclude non-traditional managers from the selection process.

We believe this is largely the result of risk aversion among institutional investors and their consultants, as well as a lack of the expertise and resources to properly evaluate emerging managers.

In a 2012 interview with *Pensions & Investments*, Tyson Pratcher, an assistant comptroller for the New York State Office of the Comptroller, said: "No one is ever going to lose their job from investing in a large firm that doesn't go well because everyone is invested in it. But if you were invested in a smaller firm, it can be a little risky if they have an issue."[l]

A widespread "safety in numbers" attitude among investment evaluators results in many of the most talented managers never getting selected.

Pratcher's quote articulates a "safety-in-numbers" attitude that is widespread among the institutional community. Evaluators are hesitant to go outside of the pack and select a manager that doesn't fit the generally accepted description of a successful manager. As a result, many of the most talented managers go undrafted and never get a shot at the Big Leagues.

A lack of resources and expertise in evaluating smaller managers is another primary reason why the institutional search process often excludes emerging managers. The emerging manager market, by definition, is highly fragmented. Altura Capital's database alone contained more than 2,000 emerging managers as of March 2012, according to the *Pensions & Investments* article.[m]

Sorting through the universe of potential managers, of course, must begin with a rigorous screening process based on objective criteria. Unfortunately, the screening process usually results in emerging managers being eliminated from consideration at the outset because they don't "look like"—in terms of AUM, history of the firm, structure and other easily quantifiable criteria—the firms that have always been selected in the past. As a result, many of the most talented emerging managers get "de-selected" during the screening process.

Even emerging managers that are able to make it through the initial screening rounds still face an uphill climb because evaluators generally are challenged with assessing enterprise risk when looking at emerging managers. These firms generally have vastly different profiles and structures than the "usual suspects."

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Fundamentals for Evaluating Emerging Managers

If institutional investors are to harness the alpha-generating potential of emerging managers, it is essential that consultants and others involved in the manager selection process develop the skills necessary to identify smaller, non-traditional managers that are able to deliver sustainable alpha.

Based on our extensive experience working with emerging managers across asset classes, we believe that an accurate assessment of a smaller manager's sustainability must be based on these core tenets:

Enterprise risk is not defined by size: The single greatest misconception plaguing the selection process is that AUM is an accurate proxy for a firm's ability to manage the operational, financial, compliance and other business risks facing the organization. Collectively, we refer to these risks as "enterprise risk." (See sidebar.)

Enterprise risk exists within organizations of all sizes. Any presumption that large firms do not face enterprise risk simply by virtue of having a lot of resources at their disposal is quickly eviscerated by a quick look at the headlines over the past decade. Pimco's nearly $2 trillion of AUM[n] certainly didn't make the firm immune to succession risk following the departure of founder Bill Gross. Lehman Brothers' bulge-bracket status didn't translate to an institutional-caliber approach to risk management. Madoff Investment Securities and Bayou Management certainly didn't invest or custody the firms' purported massive stockpiles of assets in a compliant manner based on industry best practices. Clearly, just because larger firms have the money to fix a potential problem, that doesn't mean those firms are focused on fixing those problems.

Managing Enterprise Risk by Focusing on the Fundamentals

Enterprise risk refers to how well the firm manages issues related to business operations including but not limited to succession, compliance, investor transparency, financial stability and the myriad other factors that go into running a successful organization.

We believe managers of all sizes can best mitigate enterprise risk and create institutional stability by focusing on four fundamentals:

- **Document adequacy:** clients, vendors, employees and stakeholders
- **Financial health:** advisors, capital, staff and systems
- **Operational efficiency:** infrastructure, processes, staff and technology
- **Team dynamics:** compensation, credentials, culture and ownership

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Fundamentals for Evaluating Emerging Managers Continued

Not every small firm is under-resourced: Conversely, it is also important to realize that just because a firm is small, that does not mean the firms lacks the resources to adequately address enterprise risk. In some important ways, small firms face less inherent enterprise risk than larger firms.

Smaller firms have fewer moving parts—strategies, employees, layers of management, distribution channels, etc.—that need to be monitored, coordinated and controlled. Thus, smaller firms require less in terms of financial resources to properly address inherent enterprise risk.

Growth has to be a carefully managed strategy: Ironically, one of the biggest threats to a firm's ability to deliver sustainable alpha is growth. If firms do not have a strategy and appropriate infrastructure to grow, then firms can easily become victims of their own success.

The need to be strategic about managing growth applies to firms of all sizes, but it is especially important for emerging managers. We have seen many managers whose outstanding investment performance allowed them to attract new investors. But once those firms grew, the demands of serving more clients and managing more strategies and more employees created pressure and distractions that caused performance to suffer and clients to flee. "Round tripping" is tragically common for firms that don't have a strategic approach to growth, including building appropriate but not excessive infrastructure.

For managers in small-cap equity or other capacity-constrained asset classes, the need to grow AUM in a measured way is particularly acute. In these asset classes, fast-growing firms can quickly become "capped out" and find themselves unable to exit investments without causing alpha-destroying disruptions.

Fixing the Weak Link

Every organization or process has a weak link, and asset management firms are no different. The weak link can exist anywhere in the value-creation process, including but not limited to marketing, client on-boarding, hiring, compliance, portfolio management—and anywhere in between.

When a firm is small, it is relatively easy to hide or work around that weak link. But, more often than not, growth is the pressure that exposes that weak link and causes the chain to break.

With hiring, for example, when a firm first starts out, the founder can fill important positions by bringing on professionals whom the founder knows and trusts from earlier in his or her career. But once the company reaches a certain size, using only personal connections is no longer an effective hiring strategy. Without a scalable, professional hiring process in place, the firm risks bringing on subpar performers or devoting an inordinate amount of the senior partners' time to interviewing candidates—both of which can undermine portfolio performance.

When evaluating emerging managers, it is important to look for firms that understand what their weak link is and have a plan in place to proactively address it as the firm grows.

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Fundamentals for Evaluating Emerging Managers Continued

Distractions must be minimized: Successful managers of all sizes need to be able to minimize distractions and "keep their eyes on the road" when it comes to managing portfolios. These distractions can take many forms, including just the pressures of running a business, as well as any regulatory and accounting concerns.

When it comes to emerging managers, we have found that the firms that are best able to minimize distractions have a clearly defined plan for managing enterprise risks. Compliance is one of the biggest potential landmines and distractions facing small and large firms alike. Smart emerging managers understand the importance of building rigorous accounting and compliance systems. Emerging managers can also minimize distractions by outsourcing non-core front-, middle- and back-office functions; this allows the senior management to devote more energy to the functions that most directly add value for investors. Savvy emerging managers are willing to invest in high-quality legal counsel and auditing services. The advice from outside advisors is often worth its weight in gold.

Track records matter: One of the most effective predictors of a manager's performance is how the manager has performed in the past. Evaluators, however, often only look at the manager's track record at the current firm, rather than the manager's track record in that strategy throughout his or her career. As a result, young firms get eliminated from selection processes because they don't have a long-term track record.

Our experience has shown that managers who have been successful within a certain strategy in the past, have a very high probability of being successful in that strategy in the future—regardless of where they execute that strategy, assuming that they have access to adequate resources.

The bar for inclusion in institutional mandates is very high—and it should be. There is a tremendous amount of rigor that is required to be an institutional-caliber player. Not every firm that has shown impressive performance in the past is cut out for the Big Leagues.

Often, what separates the emerging managers that are able to generate sustainable alpha from those that are not is the ability to manage enterprise risk while creating and implementing a sustainable growth strategy. By focusing on the criteria described above, evaluators can develop a more discerning process for identifying and allocating assets to the very best emerging managers.

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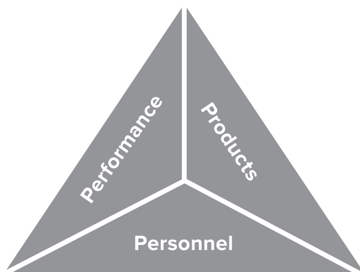
The New Paradigm for Manager Evaluation

The investment manager selection process is undergoing a shift in how managers are evaluated.

Current Industry Paradigm

In the recommendation process, investment management consultants primarily focus on the issues “above the waterline”: performance, products and personnel. This approach takes a two-dimensional view of an investment manager’s business.

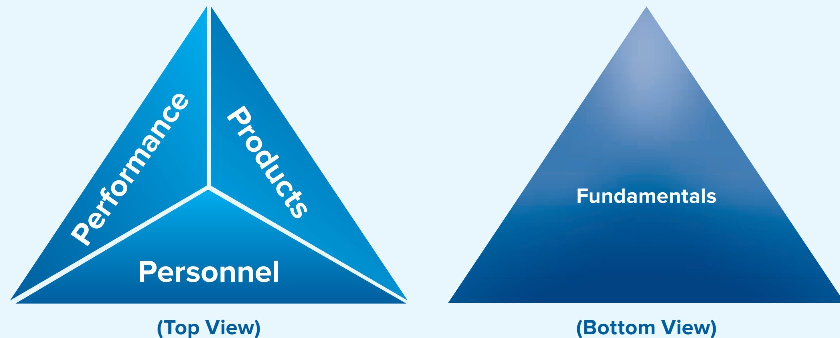
2-D View of Pyramid



The New Paradigm

The institutional investor community is becoming more aware of the importance of enterprise risk in determining a manager’s ability to deliver sustainable net alpha. As a result, the evaluation process is focusing more on the fundamentals “below the waterline” that support the core strength of a healthy investment management firm. This 3-D view focuses on the attributes that make up this foundation: document adequacy, financial health, operational efficiency and team dynamics.

3-D View of Pyramid



(Top View) (Bottom View)

This paradigm shift means that it will be more important than ever for investment consultants and other evaluators to develop the skills necessary to accurately assess the enterprise risk of emerging managers.

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Where Do We Go From Here? Recommendations for Improving Emerging Manager Programs

How can institutional investors better harness the talents and alpha-generating potential of emerging managers? We describe the structural shifts and attitude changes necessary for investors to identify and utilize the most talented emerging managers.

Recommendations for Improving Emerging Manager Programs

The overall failure within the institutional investor community to harness the talents of emerging managers is not limited to evaluators' inability to properly assess the enterprise risk and alpha sustainability of emerging managers. Much of the blame lies with institutional investors that have failed to create appropriate platforms for incorporating emerging managers into the overall strategic asset allocation and portfolio construction process.

We believe there is significant room for improvement in how institutional investors utilize emerging managers. This is true both for programs that invest directly in emerging managers and programs that utilize manager of emerging managers (MOEM) platforms. MOEMs are investment managers who specialize in selecting emerging managers on a discretionary basis, creating and constructing portfolios of these managers by using commingled vehicles or separately managed accounts for institutional investors.

Principles of Effective Emerging Manager Programs

To fully harness the alpha-generating potential of the best small managers, emerging manager programs must be:

1. Integrated into the plan's overall portfolio construction process and asset allocation strategy
2. Created for the right reasons
3. Focused on both selection and incubation
4. Driven by accurate assessment of the inherent enterprise risk for each manager

Wrong Reasons = Wrong Results

Many institutional investors we encounter have a dim view of emerging manager programs' ability to make a meaningful contribution to the performance of the overall plan. These views are often informed by anecdotal examples of programs that underperformed other aspects of the portfolio.

The investment community's view of emerging managers' potential should not be undermined by past performance of emerging manager programs. Because these programs have often applied arbitrary and capricious standards for the selection and retention of emerging managers, the results of these programs do not paint an accurate picture of emerging managers' true potential.

Many existing emerging manager programs are inherently flawed because they were created for the wrong reasons. Often the programs were developed as a response to political pressure to enhance diversity within the investment industry. As a result, these programs have often made manager selection, retention, graduation and termination decisions for reasons that are disconnected from strategic portfolio construction rationale.

We have seen emerging managers placed on watch lists and ultimately fired much sooner than mainstream managers who had inferior performance. Conversely, we have seen politically well-connected but horribly underperforming emerging managers avoid the chopping block indefinitely because the plan sponsor or MOEM didn't want to deal with the political fallout of firing the manager.

Both of these outcomes are wrong and contribute to the confusion that prevents institutional investors from understanding the true potential of emerging managers.

Principles of Effective Emerging Manager Programs

To fully and effectively harness the alpha-generating potential of emerging managers, institutional investors' emerging manager programs should be designed around the following principles:

Integrated into the plan's overall portfolio construction process and asset allocation strategy: Many of the emerging manager programs that were created over the last 20 years were created as a completely separate entity from the overall portfolio. As a result, emerging managers often face a different set of criteria for selection, retention, promotion and termination than mainstream managers.

These programs are also often hurt by not having an adequate "graduation" process for high-performing emerging managers. Ironically, the best-performing managers often find themselves evicted from the platform because they "outgrew" the inclusion criteria. When this happens, there should be a built-in process for graduating the manager into the plan's main program.

Designing emerging manager programs as an integrated piece of the overall portfolio will alleviate many of the problems that have plagued emerging manager programs in the past.

Created for the right reasons: The decision to include emerging managers within a plan should be based on asset allocation and portfolio construction reasons, not political reasons. Emerging managers' ability to generate alpha is not a product of ethnicity or gender. It is a result of their ability to operate nimbly in alpha-rich areas, strong alignment of interest with investors and streamlined business models.

Emerging managers should not be evaluated by capricious and arbitrary standards that do not apply to traditional, established managers. The decisions of whether to hire, retain, promote or terminate an emerging manager should be based on the firm's merits as an investor; not on political pressure or preconceived notions of the risks facing smaller firms versus larger firms.

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Focused on both selection and incubation: When institutional investors establish a MOEM program, the investor will often give the firm chosen to run the MOEM program a mandate to select not only the best underlying managers, but also to provide support and advice to help those managers grow. Having worked closely with and evaluated MOEM programs across the country, we believe that many MOEMs view the incubation and growth aspects of their mandates as an afterthought.

Institutional investors need to hold MOEMs to a higher standard. This applies not just to the selection of underlying managers, but also to the level of support and guidance MOEMs provide to the managers after the allocation process. A renewed focus on nurturing the most talented emerging managers will result in more of these firms reaching the next stage of their development.

Driven by an accurate assessment of the inherent enterprise risk of each manager: Although we made this point earlier, it is worth repeating that addressing enterprise risk is one of the most critical elements in a manager's ability to create sustainable alpha. It goes without saying that enterprise risk exists within all firms. The issue isn't existence but order of magnitude and nature.

Industry headlines are littered with examples of large, established firms that experienced significant business disruptions because the firm didn't properly use its ample resources to manage enterprise risk. Conversely, there are countless smaller, emerging managers that have been very disciplined, strategic and effective in their efforts to manage risk within their organizations.

Institutional investors will not be able to successfully harness the alpha-generating potential of emerging managers until investors and their consultants develop the skills necessary for evaluating enterprise risk at the firm level.

Should Emerging Managers be Viewed as a Separate Asset Class?

One of the most fundamental questions that the institutional investor community will have to address going forward is whether emerging managers should be viewed as a distinct asset class. Most emerging manager programs that are focused on the utilization of emerging managers have been driven by social and/or legislative initiatives versus capturing the value of finding these undiscovered and underutilized managers. The simple thesis is that all of the investment management talent does not just reside in the largest investment management firms, therefore it is prudent to create an allocation to emerging managers that is part of the overall allocation across asset classes and styles.

Most of the allocations have been based on arbitrary amounts that are seemingly based on the risk tolerance of a specific amount versus an allocated percent of the total asset allocation. To continue in this manner will most certainly provide for similar outcomes in the future.

The solution to this dilemma is not going to come from the implementation of ad hoc strategies, but rather the development of an overall program plan that will utilize different component strategies. The tenets of this type of program will include a robust and continuing process of discovering existing and new emerging managers, thus capturing the value produced by these managers not previously captured by institutional investors.

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Illinois Insight: Thoughts on Emerging Managers from One of the Prairie State's Leading Public Funds

Illinois has established itself as one of the most innovative states in its use of emerging managers in public pension funds. Louis W. Kosiba, executive director of the $33 billion Illinois Municipal Retirement Fund (IMRF), provides his perspectives on the opportunities and challenges of emerging manager programs.

What is IMRF's rationale for investing in emerging managers?

Kosiba: We want to find the best managers regardless of what type of firms they work for. Emerging managers can make a difference and provide the additional alpha that we all need as institutional investors. This is especially true in small-cap equity and other capacity-constrained asset classes. Emerging managers have the agility to invest effectively in niches that larger firms simply can't invest in.

How does IMRF view emerging managers from a portfolio diversification and asset allocation standpoint?

Kosiba: IMRF views diversification along multiple lines. In addition to diversification by asset class and investment style (passive vs. active), we also look to achieve diversification among the types of firms we invest in. We believe that no one type of firm or group of society has a monopoly on good ideas and investment talent.

What are the biggest challenges to evaluating emerging managers?

Kosiba: Because the market is so fragmented, being able to survey the entire field of emerging managers and identify the best ones presents bandwidth challenges for a plan of our size. Also, because emerging managers often face different sorts of business risks than larger firms, institutional investors need help understanding emerging managers and knowing what to look for.

How should an emerging manager program be structured relative to the plan's overall portfolio?

Kosiba: The emerging manager program should not be an add-on. It should be an integral part of the overall asset allocation. Plans need to be smarter about how to graduate high-performing emerging managers. If a manager is performing well, you shouldn't just jettison them because their AUM has grown above a certain threshold. Once you've found a good manager, you want to find a way to keep them involved.

What is your assessment of the talent level among emerging managers?

Kosiba: We believe that the entrepreneurial people who branch off to start their own firms often represent the crème de la crème of the investment industry. Large investment firms are developing extremely talented professionals, many of whom have the drive to start their own firms. Why not take advantage of that talent?[o]

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Conclusion: The Alpha Imperative Revisited

Earlier in this paper we described the unprecedented need for institutional investors to tap every possible source of alpha in their portfolios. We believe that emerging managers represent a pool of untapped investment talent that is both wide and incredibly deep.

Contrary to popular belief, accessing that talent will not require taking on additional risk or abandoning traditional asset allocation parameters. What it will require, however, is a fundamental rethinking of how emerging manager programs should be structured. It will also require a renewed commitment to accurately assess a firm's ability to generate net alpha based on the enterprise risk associated with a manager, not the size of the firm.

In today's investment landscape, utilizing the most talented managers is not a luxury—it's a necessity. The search for alpha—regardless of manager size, age, asset class, ethnicity or gender—should come down to one simple question: Why not the best?

About NexTier Consulting Solutions

NexTier is a consulting firm focused on helping investment firms compete more effectively in the institutional investment marketplace. We deliver expert strategic thinking and proven executional capabilities to help our clients enhance investment performance, increase assets under management, improve profitability and reduce business risk. Founded in 2012, the firm is headquartered in Chicago with consultants located in Atlanta, Denver, New York, Philadelphia and San Francisco.

About the Authors

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Mr. Manson has more than 30 years of business experience, including more than 25 years of private equity experience prior to forming NexTier. During his career, Mr. Manson has evaluated thousands of leveraged buyouts, recapitalizations, joint ventures or other types of investment transactions. In addition, he has individually or in conjunction with others: raised more than $130 million from institutional investors for alternative investment activities, substantially for funds, invested more than $530 million of equity or subordinated debt in various transactions, arranged debt financings in excess of $2 billion, closed more than 30 merger, acquisition or divesture transactions, participated in the underwriting of public equity offerings in excess of $250 million, managed several hundred employees, created and executed numerous strategic plans and provided consulting advice to many business owners.

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Past performance does not guarantee future returns. Manager returns are stated gross of fees and net of expenses. Index returns do not reflect the deduction of any fees or expenses. It is not possible to invest directly in an index. Performance greater than one year has been annualized.

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