New Mandates for Emerging Managers

Institutional investors broaden the scope of their emerging manager programs in their search for alpha.

Emerging manager programs have operated more or less the same way for decades. New firms were assigned small allocations, traditionally confined to the U.S. stock market, and given a chance to show their investment skills.

During the past year to 18 months, however, several large retirement plans have expanded their emerging manager programs or announced plans to do so. Institutional investors are expanding these programs to include a wider range of asset classes and investment strategies as they seek additional alpha during difficult and volatile market conditions.

Among the asset classes and strategies added or being considered for emerging manager programs are: fixed income, international and private equity.

Perhaps the biggest reason behind the program expansions is the performance that smaller investment managers have delivered compared with their more-established counterparts. In fact, research by Ted Krum, vice president of portfolio management at Northern Trust, and presented in the white paper "Potential Benefits of Investing with Emerging Managers," found:

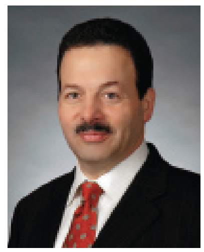
- Investors with minimum assets under management requirements often excluded top-performing managers. Roughly 40% of core U.S. equity managers in the top quartile of performance managed less than $2 billion.
- Emerging investment managers outperformed larger firms at the median, as well as at the top and bottom quartile levels. This result was consistent across all major style groups and implies that manager-selection skill may be better rewarded when applied to the small-firm universe.
- Small firms delivered better performance in down markets.

"Almost 20 years of data show that emerging firms have been more nimble," says Robert Furnari, managing director of Emerging Manager Programs at Northern Trust. "They can make adjustments to the portfolio in times of distress more quickly than larger firms."

He adds that other qualitative reasons for the performance of smaller firms include a less bureaucratic work environment, greater motivation and greater organization flexibility to deal with changing market environments.

Changing Asset Classes

The downturn in the U.S. stock market, combined with an increased urgency to find alpha, is increasing investor willingness to give emerging managers new mandates, says Margret Duvall, product manager for Manager of Managers Programs at Northern Trust. Duvall says some investors are beginning to hire emerging managers for core-plus fixed-income allocations. Other investors, she adds, are working with emerging managers in international equities and bonds, as well as small- and even micro-cap mandates.



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These mandate shifts within the emerging manager space also are changing the definition of an emerging manager (see "Emerging Is in the Eye of the Beholder" on page 4). For example, fixed-income managers tend to manage more money, necessitating that a pension plan increase the assets under management threshold from $2 billion to $3 billion or more.

Similarly, as programs become more internationally focused, the definition of minority managers, a subset of emerging managers, also is changing. "Is an investment manager based in Hong Kong a minority manager? Investors no longer look at their asset allocations through a U.S.-centric lens," Duvall says.

Best-of-Breed

Duvall says she also sees more interest in a new category of emerging manager called best-of-breed. Whereas a standard emerging manager program is built against a benchmark such as a Russell 1000 Index, best-of-breed portfolio construction methodology focuses on additional factors. For example, Northern Trust's portfolio construction team selects the managers first, then works on the portfolio construction optimization exercise and finally an asset allocation strategy to optimize performance.

"Best-of-breed is a very different portfolio construction exercise," Furnari says. "We start by selecting high-conviction emerging managers, then weighting them based on research and analysis. Factors considered include organizational stability and structure, breadth of staff, business mix, new business momentum, investment philosophy and process."

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"These factors, as well as the manager's perceived alpha-generating skill, are used to determine the amount of assets to allocate to a particular manager," Furnari adds.

"Best-of-breed portfolio construction enables investors to look for emerging managers they believe have greater alpha potential," Duvall says.

Emphasis on Due Diligence

Despite the stronger performance of emerging managers relative to more established firms, there is an inherent risk in doing business with a firm without a lengthy track record. As a result, many investors hire multiple managers, or turn to a manager of managers, to diversify this risk.

In addition, although comprehensive due diligence is important when selecting any manager, analysis of emerging managers should include other considerations.

"In evaluating emerging managers, you spend a lot of time understanding how the managers plan to run their business, including how they are staffed and how they plan to staff the business in five years," Duvall says. "Their business objectives become very important. Do they want to be an institutional or retail investment manager or both? How and why are they building the business the way they are building it, and what are their growth objectives? Where are their client assets now? Are they committed to adding resources to build the business in a reasonable way?"

This evaluation process should be ongoing, even after the emerging managers have been funded. For example, an investor or manager of managers should assess whether managers are using industry best practices.

"Often a manager of managers will work with managers in their programs on matters such as business development, positioning of marketing materials and analyzing their portfolio styles," Duvall says. "Discussions also might include distribution strategy, incentive structure, succession plans, growth financing, compliance, operations, improving processes, business strategy and staffing," she adds. "It's more of a two-way street with an emerging manager than with a traditional established money manager." ❖

'Emerging' Is in the Eye of Beholder

Experience, assets, geography among criteria used to evaluate investment managers

The definition of an emerging manager often depends on who is doing the hiring. Emerging managers typically are defined as firms with less than two years of experience and less than $2 billion in assets under management, explains Robert Furnari, managing director of Emerging Manager Programs at Northern Trust.

"Assets under management is a crude barometer," Furnari says. For example, he notes a small-cap manager with $2 billion in assets under management could be considered large, but a large-cap manager with $2 billion in assets could be considered emerging.

"Some investors consider emerging to be less than $1 billion in assets," adds Margret Duvall, product manager for the Manager of Manager Programs at Northern Trust.

Geographic location of the manager is often an important criterion for public pension funds such as state employee systems. "State funds typically prefer to use investment managers who reside in that state," Furnari says.

Philanthropic organizations with a charter to help community groups based on where their donations originate also are interested in investing with managers in a particular geographic area. "The feeling is that the managers should mirror where the donors and ultimate beneficiaries come from," he says.

Other criteria used to evaluate emerging managers include number of clients, years in business, number of employees and length of track record.