From Diversity to Diversification
The Evolution of the Term "Emerging Manager"

Thurman V. White, Jr.

"When we approach emerging managers for a mandate today, it's not because they are 'emerging' — it's because they are competitive with the household names."
*— CIO of a mid-sized corporate pension plan**

"A person can now go from the cradle to the grave without spending a nickel at an independently owned business."
— Fast Food Nation

In the 1990s a consultant coined the term "emerging manager" in the wake of concerns about legal challenges to affirmative action. The U.S. Supreme Court decisions in Bakke[1] and Adarand[2] — as well as California's Proposition 209 and a growing conservative mood in the country — challenged the concepts of affirmative action, targeting minority business set-asides and claiming reverse discrimination. Many minority advocates were concerned that minority-targeted inclusion initiatives in the investment management industry might come under attack, as such initiatives already had been challenged in higher education and federal contracting.

"Emerging Manager" — No Longer a Euphemism

"Emerging Manager" thus originated as a euphemism for "owned by women or minorities." In those early days, the term clearly was used to describe programs to create more inclusive opportunities and reduce barriers to entry for talented minority and female asset managers.

Fast-forward to the 21st century, when a woman and an African-American have a realistic opportunity to become president of the United States. "Emerging Manager" conjures the energy, talent and proven alpha potential of smaller investment companies, regardless of ethnicity. The term is no longer a euphemism for "entitlement program." Today, for many, "emerging manager" has become synonymous with "independently owned" and all the positives typically associated with employee-owned businesses — caring, originality, risk-taking, innovation and hard work by people with a real, long-term stake in their companies. Think local diner with the best food in town and a smiling owner/operator behind the counter, versus the sterile uniformity of a fast-food restaurant.

Fast-Food Versus Friendly Local Diner?

Too much of a stretch? Maybe. But for the sake of argument, let's bring the analogy back to the money management industry. Consider the alpha potential of an independently owned money manager with a focused, innovative investment strategy, run by an experienced team that has fled the bureaucracy of a giant financial services conglomerate. Then consider the alpha potential of the team left behind, back at the conglomerate, unmotivated by ownership and more driven by the need to hang on to what they have than to create something new. And — as has so often been the case over the past decade — perhaps they are distracted and dispirited by the latest round of layoffs or litigation against the parent company.

Of course it's not as simple as a fast-food franchise versus a friendly, employee-owned diner, and there are many well-run, litigation-free alpha engines among global financial services enterprises. But this scenario is real, and it does explain the rising demand for emerging managers in the broadest sense.

About the Author

Thurman V. White, Jr. is President and Chief Executive Officer of Progress Investment Management Company, LLC, a pioneering specialist in developing emerging manager investment portfolios. For the past 16 years, Mr. White has served in a variety of leadership roles at Progress. In 2004, he and a team of senior executives led the firm's management buyback, resulting in Progress becoming an independent, employee- and minority-owned investment company. Founded in 1990 and with $7 billion in assets under management today, Progress is recognized as the industry's largest and most experienced manager of emerging managers. Currently, Progress works with 60 emerging firms, managing 25 multi-manager investment portfolios for some of the world's largest, most sophisticated institutional investors.

About the Article

This article explores current definitions of the term "emerging manager," with an explanation of why emerging managers are becoming more attractive to institutional investors. "Successful Emerging Manager Strategies for the 21st Century," a companion article to be released in the Fall of 2008 on *www.progressinvestment.com*, looks at different ways to invest in emerging firms, with discussion of best practices in emerging manager investing.

* As background for this article and a companion article, we conducted interviews with selected Progress clients. We share their views here, with permission, on a for-attribution and, in some cases, not-for-attribution basis.

The Broadest Sense of the Term

In the 21st century, "emerging manager" is understood in the industry to include a mix of firms owned by women and minorities, as well as non-minority firms that fit certain definitional criteria. It can mean anything from a start-up owned by white males with an innovative approach to selecting large-cap stocks, to a spinout owned by the son of Haitian immigrants with an old-fashioned, yet highly successful approach to finding small-cap opportunities.

Size and Ownership

In most cases, plan sponsors have defined emerging managers in terms of size — i.e., assets under management (AUM) — and independent ownership (at least 51% owned by employees). As of this writing, the emerging manager AUM ceiling typically is $2 billion to $3 billion. During our history, Progress clients have defined the threshold as low as $500 million and as high as $3 billion to $5 billion. Definition by size, we believe, should be dynamic in light of industry growth.[3]

Geography

Others have combined emerging manager strategies with a geographic target (also known as "economically targeted investment strategies," or ETIs). Several Illinois public pension plans, for example, have sponsored an emerging private-equity fund of funds targeting investment by underlying funds in portfolio companies based in Midwestern states generally and Illinois-based portfolio companies specifically. Other plan sponsors, like the Teacher Retirement System of Texas, have expressed a policy preference for investing with emerging private-equity managers based in their states. The Oregon Investment Council targets managers and co-investment opportunities in the Pacific Northwest.

Investment Stage of the Firm or Product

In the private-equity and real estate markets, some strategies have defined "emerging" in terms of first- or second-time funds, in addition to the size of the fund (e.g., $300 million), and strategy focus (e.g., opportunistic real estate). In the public markets, Progress increasingly thinks about our manager-of-managers investment strategies as those where we're making early-stage investments not only in the managers, but also in their respective investment products and their future product capacity. In this framework, stage of investment (in addition to total firm size or assets in a particular investment product), allows us to expand our thinking about potential emerging candidates, providing a broader range of choices for our clients.

How Progress Now Defines "Emerging Manager"

Progress opened its doors 18 years ago with approximately 200 emerging firms and approximately 250 strategies in its proprietary database. Our database now comprises close to 900 emerging firms managing close to 1,800 investment strategies. For inclusion in the Progress database, we define emerging firms as:

(1) At least 51% independently owned by employees of the firm,

(2) $2 billion or less in assets under management (AUM) at time of funding, and

(3) All managers who are women or minorities, regardless of AUM.

Exhibits 1A and 1B show the relative size, ownership status and product diversity represented within our rapidly growing emerging manager universe.

This growth in the number and diversity of emerging managers indicates their widespread capabilities as well as their broad availability.

EXHIBIT 1A - The Progress Emerging Manager Database by Size and Ownership ($ in millions)

Ownership	All	1-50	50-100	100-500	500-1000	1000-2000	>2000
African-American	173	16	5	40	21	32	59
Asian-American	61	8	---	25	6	1	21
Disabled	3	---	---	---	---	---	3
Non-Minority	1251	161	110	435	254	265	26
Latino-American	32	6	---	8	8	7	3
Native-American	1	---	29	---	1	---	---
Minority Unclassified[1]	10	7	---	1	---	---	2
Woman	217	44	29	38	45	27	34
Woman/Minority-Owned[2]	12	---	---	---	4	8	---
Totals	1760	242	173	547	339	340	148

[1] Unspecified or multiple categories.
[2] Firms owned by women who also are minorities.

EXHIBIT 1B - The Progress Emerging Manager Database

Investment Strategy	Number of Strategies
Fixed Income - Cash Management	30
Fixed Income - Core	168
Fixed Income - Core Plus	12
Fixed Income - High Yield	27
Fixed Income - Interest Rate Forecasting	68
Fixed Income - Other	126
International Fixed Income	23
International Equity	110
Large Core or All Cap	402
Large Growth	215
Large Value	135
Mid Core	31
Mid Growth	54
Mid Value	43
Small Core	57
Small Growth	96
Small Value	77
SMID Core	11
SMID Growth	21
SMID Value	13
Other[3]	41
Total	1,760

[3] i.e.. real estate, derivatives and currencies

Why Have Emerging Managers Become Increasingly Popular?

The most important reason is performance. Emerging managers deliver. Various academic and practitioner studies conducted over the past several years confirm the performance advantage of emerging managers versus their larger industry counterparts. Some studies have specifically documented the risk-adjusted performance edge conferred by investing with emerging managers. Still other studies have found that investing early in the life of the product or firm yields the best likelihood of outperformance.[4]

Competitive investment performance is the primary factor driving rising demand for emerging managers among institutional investors — and a sine qua non for any fiduciary selecting investment managers. But plan sponsors report many other compelling reasons for their growing popularity:

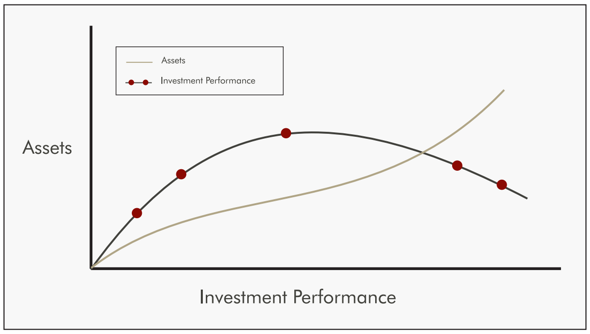
Access to New Investment Talent

Providing plan beneficiaries with more investment choices enhances the value of plan assets over time. Availability of more high-quality choices — as well as the introduction of new and innovative strategies — should lead to better returns. When institutional investors are asked why they decided to invest in emerging managers, along with the obvious (the need for alpha), they also often cite the need to tap into the next wave of talent.

The Inverse Relationship Between Size and Performance

These institutional investors want to find managers with a genuine information advantage and room to grow. They understand all too well the now well-documented inverse relationship between size and alpha-generation capability.

Asset Growth Often Hurts Perfomance



Diversification in the Ranks Of Firms Managing Plan Assets

The diversification brought about by hiring emerging firms helps to create a more competitive investment management industry. In addition to the obvious benefits of a more competitive environment, greater competition generates more favorable investment management fees for plan sponsors, resulting in reduced expenses for plan beneficiaries.

Portfolio Diversification

More investment options, quite simply, lead to the potential for reduced risk through portfolio diversification. The inclusion of emerging managers can diversify the total portfolio, especially in plans where most of the portfolio is indexed or allocated to larger managers with index-like characteristics.

Focus Through Specialization

Emerging manager investment teams, because they are small and driven by entrepreneurs, tend to be more focused. The rewards of success and the risk of failure are felt more keenly at a small investment firm with a tight-knit team managing only one or two strategies. "Paradoxically," says a Progress client interviewed for this article, "what some see as a constraint — only a handful of research analysts — often lends itself to focus and consistency in a way that becomes much more difficult at bigger firms."

Returns From Operational Improvements

Joseph J. Haslip, Deputy Comptroller for Pensions for the New York City Retirement Funds, which have invested in emerging managers for nearly two decades through several different programs, notes that emerging manager returns are more likely to come from "operational improvements to the companies as opposed to financial engineering." Indeed, an entrepreneurial, boutique investment firm is far less likely to expose investors to the esoteric securities — not to mention the accounting shenanigans — that have proven so distracting to investment managers owned by global financial services companies.

Reduced Organizational Risk

Conventional wisdom holds that organizational risks are greater for emerging managers. Certain Progress clients, however, have noted that, in their own experience, organizational disruption has hurt investment performance more often at established firms than emerging ones.[5] Including emerging firms in an institutional portfolio thus may mitigate exposure to the super-sized risks that super-sized companies are prone to taking. Recent massive investment write-offs by large, established firms — as well as the demise of a venerable investment company such as Bear Stearns — underline the risks that can hurt investors with larger companies. Investors with these companies are damaged not only by hidden portfolio risks, but also by subpar performance at companies experiencing lawsuits and turnover in key personnel. Recent events echo those of 2004, when many large, household-name investment firms suffered from organizational instability while being investigated for allegations of market timing.

Greater Exposure to Entrepreneurship

As a group, emerging investment managers might be expected to excel at one of the key aspects of investing successfully: taking calculated risks. One of their biggest calculated risks is their investment in founding their own companies. While of course not all succeed, we believe that the stability of money manager start-ups is likely to be higher than that of start-ups in other industries.[6]

Diversity

The investment success of emerging managers should not obscure one of the original reasons for investing with them: the need for diversity. Many institutional investors are experiencing demographic changes within the ranks of their plan's beneficiaries and pension plan trustees. Plan beneficiaries and trustees are asking for investment options that reflect these changing demographics by providing more diverse options.

So Much Enthusiasm, So Little AUM?

All of these strengths and benefits add up to another question: If investing in emerging managers is good for investors, then why haven't institutional investors committed more assets to these emerging firms?

Most plan sponsors — those with specific asset size parameters for their respective emerging programs — have typically committed 1% to 3% of total plan assets to emerging firms and strategies, with the remainder of the assets committed to larger firms. Research by Progress has shown that for all new manager searches, only 15% of 312 mandates from $1 to $99 million (allocation sizes for which emerging managers would qualify) were awarded to emerging firms. Our research also has shown that approximately 87% of the assets are managed by only 10% of the firms (i.e., the 80 firms with more than $20 billion under management).[7] A pension consultant speaking on a research panel at our annual conference noted, "Anywhere else, if you showed that level of concentration, they would call it some form of restraint on trade."[8]

There are many reasons — practical, political, psychological, but not necessarily justifiable — for this concentration of assets in larger investment companies. I will explore these in "Successful Emerging Manager Strategies for the 21st Century," a companion article to this one, to be released in the Fall of 2008 on *www.progressinvestment.com*.

At Progress, our mission is to change the face of the investment management industry. Our vision is an industry where capital is truly democratized and competition can flourish, where investors always have more choices rather than fewer ones. We don't believe that investors—or diners — should have to live in a world where global fast-food franchises are the only option. There should always be a place on the institutional investor's menu for independently owned, emerging manager boutiques.

This is the first in a series of publications by Progress, designed to share the firm's experience in creating emerging manager investment programs. We want to help the investment industry better understand the issues, strategy options and best practices associated with developing emerging manager programs. For more information, please contact Mona Williams, Executive Vice President, Marketing/Client Service (mwilliams@progressinvestment.com).

Footnotes

1. Regents of the University of California v. Bakke, 438 U.S. 265 (1978).
2. Adarand Constructors, Inc. v. Peña, 515 U.S. 200 (1995).
3. We further explore the need for flexibility in defining the size of emerging managers in the upcoming companion article to this one, "Successful Emerging Manager Strategies for the 21st Century." To be released in the Fall 2008 (*www.progressinvestment.com*).
4. Numerous research studies document different aspects of the emerging manager performance advantage. For a list of all known papers, please contact Progress Investment Management Company.
5. "Business Risk & Emerging Managers: Myth Versus Reality," panel discussion at the 2004 Progress Plan Sponsor and Emerging Manager Conference, Scottsdale, Arizona.
6. Based on data provided by the Small Business Administration, financial and insurance companies — the closest proxy for asset managers among the industry categories tracked by the SBA — experienced less company turnover, a possible indicator of greater stability, than company turnover overall during 2004-2005, the most recent period for which data is available.
7. White, Thurman, "Small Isn't What It Used to Be: The Changing Face of Smaller Investment Firms," June 2003, the Institute for Fiduciary Education.
8. "What the Research Tells Us About Emerging Managers," panel discussion at the 2004 Progress Plan Sponsor and Emerging Manager Conference, Scottsdale, Arizona.