

## COVER STORY

### Graduating Emerging Managers: Is the Process a Promotion or Punishment for Doing a Good Job?

By Portia Richardson



-Alexander Hsiao-



-Geoffry Gerber-

When it comes to graduating managers, it's a toss-up those who do and those who don't among manager of managers and pension funds. The consensus, however, is the criteria for developing managers is subjective and often based on asset size, having robust back office systems and promise for continued growth. One manager of manager who stands steadfast to graduating emerging firms is San Francisco based Progress Investment Management. "Our fiduciary role, and purpose in the market place, is to act as an agent to seeding emerging firms with the ultimate goal in becoming mainstream firms like Dodge & Cox, PIMCO, Grantham Mayo Van Otterloo & Co, and Bridgewater Associates," says Alexander Hsiao, Chief Investment Officer.

#### The Graduation Process

Progress' manager graduation program has evolved over the years, but presently is client

driven and founded on the clients' timing and needs as well as the manager's asset class, style, and strategy suitability. "Our clients have the benefit of choosing from a natural spring fed pool of managers from their own account or from the entire Progress firm wide pool of 65 funded managers," comments Hsiao. "Our typical approach at Progress before, we involve the client, is to determine, at the manager level, whether suitability based on a series of fundamental and quantitative criteria. We then inform the client based on the client's objectives of that manager's success, candidacy and readiness for direct hire or graduation. The client will then determine the appropriateness and timing on whether to graduate the manager.

### **Northern Trust**

Northern Trust Global Advisors (NTGA) graduates managers and uses a scoring mechanism to help decide on candidates. "Our program for graduating managers is two fold," says Larry Jones, Executive Vice President. "First, a client may ask us to propose a good candidate for a specific program. So we would look in our database and make two or three suitable recommendations." NTGA also would look at managers who are already in the assignment and not the whole universe. Secondly, NTGA graduates managers for its internal searches such as its Canadian operation or private wealth group among others.

The candidates are determined via a proprietary scoring process that looks at three categories. They look mainly at the managers' style, their Business Development in and assets base this includes the total assets, when the firm was started, what type of clients they have, and how fast their assets have grown in one, two, and three years. Secondly, NTGA looks at Business Resources and Incentives, such as employee ownership of equity in the firm, the number of key employees, growth in number of employees. Then finally, NTGA looks at one more issue: the Consistency of Investment Results, not the latest quarter or the year, but the proprietary combination of measures. They look at the risk adjusted return and some other proprietary measures of the consistency of investment results. Jones said, "A lot of manager call us and say they had a blow out quarter or year in their latest results. We want consistency." NTGA has nine managers who have graduated in 18 months. Managers can expect a larger dollar assignment from the client and greater fees in a direct graduated assignment.

In a typical graduation the client will promote a manager, whereby they get a significantly larger assignment and also a new emerging manager is added to the program or recycle the manager in essence. "The existing manager will get a larger assignment with the client and Northern will replace the emerging firm by recycling the funds in the emerging space," comments Jones.

However, Jones explains some clients may have a ceiling so firms with \$3 billion in equity assets are too large and each client sets the ceiling for equity fixed income and for international managers. "Some managers are too large to qualify in our emerging manager

programs. Also, we aren't able to recycle them if they have a certain size; we have to follow client's direction."

Typically NTGA includes firms who have \$95 million in assets in the program, Jones points out. "There's nothing magic about any number. It's compliance that is the issue. Companies come to us with business plans, key employees have been in business 15 years and have a glorious track record," he says. Yet, without adequate compliance, NGTA won't include them. "Sometimes you have to boost the compliance effort by hiring a consultant in compliance. It's hard for a two or three person shop to satisfy all compliance issues so third party vendors are crucial."

### **TWIN**

McMurray, PA-based TWIN Capital Management received a \$ 150 standalone mandate from a west coast public fund because the fund wanted to invest in the style category that TWIN was already managing for them in NTGA's program.

"We still manage assets for several clients of Northern Trust's Emerging Manager business, since our overall asset base still leaves TWIN in the emerging manager space," says Geoffrey Gerber, president. "Most programs stipulate an amount, of say \$2 billion, at which emerging managers are forced out of a program. Clearly, the hope for all emerging managers is to emerge and manage an asset base that is above the emerging manager asset cut-off," says Gerber. When TWIN does get to an asset base in excess of \$2 billion, they hope that the emerging manager clients would consider promoting them, and hiring TWIN as a direct manager in their overall investment program as the pension fund has recently done.

### **FIS**

Philadelphia based FIS Group doesn't have a graduating process but develops start ups into institutional quality players. "We don't punish managers for doing a good job," says Tina Williams, FIS Group CEO, "but continue to create opportunities and space for newer firms with promising talent." FIS selects managers for clients based on style profile, risk characteristics and capitalization. When managers reach a certain asset size, however, they are not eligible to receive new money. "It's an arbitrary ceiling but when they go beyond \$2.5 million or \$3 billion, they are ineligible to receive funds for new accounts for capital additions. "It would be counterproductive to fire managers for their success. They are eligible to receive funds from a rebalancing standpoint," says Williams. A ceiling is a bit arbitrary because \$3 billion, for example, is not enough for major allocations. "There is a point, say \$5 or \$6 billion, where everyone agrees it's time to move on," she comments.

Like FIS, Progress' process is intended to minimize, if not avoid, a manager from losing out as a result of graduation. "We don't believe graduation punishes a manager," Hsiao said. Progress' process is intended to reward the manager in multiple aspects, since our graduation model is client driven. Managers are generally made whole and in many cases, as a benefit of the graduation, the manager may receive additional assets over time. Once a manager attains

graduation status, they are at a capacity and category typically recognized by consultants and plan sponsors as direct hires given their mainstream status.

New York City Retirement Systems (NYCRS) looks at public market managers with less than \$1 billion AUM for its emerging manager program, and believes having top flight back office and risk management capability is critical. "The way New York views the investment world is how we look at the manager universe of zero to \$1 billion," says Joseph Haslip, assistant comptroller for pensions. "Some cross \$1 billion and can participate in a direct relationship if they have adequate back office and risk management in place. The Developing Manager program is designed to capture managers which may have been small but grew their assets beyond our ceiling which is between \$1 billion to \$5 billion."

FIS, a manager of manager for NYCRS, focuses on working with managers to develop world class back offices and trading systems in place as well as make their research robust. "The graduation process, broadly defined, is working with managers from startup to world class institutions names," explains Williams.

#### **LEIA**

San Francisco based Leading Edge Investment Advisors, doesn't graduate managers but develops them. "We manage separate accounts that are customized according to client guidelines and objectives. Each client will have their own specific criteria for graduation," says Clayton Jue, president.

Unless directed by a client, LEIA doesn't automatically graduate a manager because they've reached a number such as \$2 billion in assets. "We will continue to utilize a manager in the program as long as the firm continues to meet expectations and generate value added performance" says Jue.

Some pension funds develop their emerging managers by taking an equity stake or giving them resources. NYCRS doesn't take a stake in equity managers but develops them "We are exploring the possibility with counsel and contracting to see if there is a way to transition managers who are hired by managers of managers into a direct relationship, once they reach the ceiling" says Haslip. "When a manager crosses \$1 billion they can participate in a direct relationship as long as they have adequate back office and risk."

Haslip points out, consultants are slow to recommend emerging managers, or those less than \$5 billion in assets. "The National Association of Securities Professionals and American Alliance are attuned to smaller managers, but the consultants don't know them," he says. "Heightened attention to invest in smaller managers is increasing but consultants are responding slowly, and I have to emphasize slowly."

It's not uncommon for smaller pensions to use \$1 billion or even \$500 million as the threshold. It really depends on how large the pension fund is and the size of the average

allocation it makes to managers. "Most plans prefer not to be more than 25 percent to 30 percent of a manager's assets," says LEIA's Jue. Therefore, if the size of their normal allocation is \$500 million, they will not directly hire managers with less than \$1 billion in AUM.

There isn't a hard and fast rule for defining a manager by asset size, according to Daniel Bott, Sr., Managing Director, Investment Officer at Bott & Associates Investment Consulting Group of Wachovia Securities LLC, in Scottsdale. "Not everything fits in a box," said Bott. There could be a two person firm, with \$300 million in assets who has reached capacity. Or there could be a small firm who was part of a team, with back office support that can handle a lot more. "It's really subjective and based on capacity," says Bott. But large cap managers can handle more in a concentrated format, which is a portfolio of 20-30 positions. Many times when a manager becomes much larger they end up expanding the number of positions in the portfolio which makes them more like an index and tends to reduce the added value of their equity selection. He adds that this becomes an issue for small cap managers sooner, since they may reach capacity quicker than their large cap counterparts.

Bott sees three stages of development. The first stage is the start up phase whereby a small or mid-cap manager might have up to 30 positions, and wouldn't own more than five percent of a company, since when regulatory tracking issues surface. The manager may start with \$100 million, be able to operate as a solvent enterprise, and build up to \$600 million or one billion before it becomes a capacity issue. "I find early stage managers are where you get the best return," he says. "Our sweet spot is putting new money in companies who've been in existence for 3 to 5 years, but are still along way from reaching their logical or stated capacity"

The second stage managers have a lot of resources and usually a longer track record." At this point we look at how well they manage the business' growth, can they still manage a value added concentrated portfolio and maintain enough liquidity to get in and out of stocks they own," says Bott. For larger clients he prefers investing in second stage companies because, if they are still successful, the manager's asset base triples every five years or even quicker. At which point the larger client can add much larger commitments.

Bott points out the growth history of Brandes Investment Partners. Bott says, "I discovered Brandes when he had on \$80 million in assets back in 1985 and today they have ramped up to \$120 billion. To avoid having their fund diluted they would close funds off to new monies. They found a way to maintain quality within by limiting how much in assets they can manage while still providing the added value of what they offer and not become a closet index manager. Brandes went from 25 million in assets under management 1975 to 80 million in 1985. In the mid 80's they had only one style, which was all cap global and until they reached \$500 million in the early 90's capacity wasn't an issue. I was able to place money with them for over 15 years before they started to close down to new assets. As they incubated a small cap style we put assets with them in that style, the same went for mid cap and emerging markets. The point being, once a manager reaches a certain size they either mature and become average,

they launch another asset class utilizing their core philosophy and or they just stop taking new money and maintain as much control over quality that they can. That is why I have been always on the quest for good emerging managers for my entire career dating back to the mid 70's. Graduating a manager is a function of whether they can continue to manage money with the same value proposition that made them attractive to begin with, it's not rocket science, it just hard work the any good manager of emerging manager knows.

The final stage is when more managers can't produce the same excellent results because they either have too much money or their focus has become more passive or they have entered the exit strategy phase of their business plan, meaning they have sold all or a major portion of the ownership to a much larger firm. Bott comments, "If you find that your meetings are now being held with sales staff versus the principals and suddenly they're producing more slick brochures, lots of white papers and the senior partners can be found at the golf course or out of the office more than in the research department then the core value has shifted to revenues for the principals rather than revenues for the client" says Bott. The rewards of success has its price, this is the maturing stage, when the managers reach this point I become more concerned about where will the added value come from going forward. "At this point I am looking at a different kind of graduation".

TWIN is one example of a second stage company whose assets have grown significantly over the past few years. From December 2004 through June 2007, their assets under management have increased 234 percent, or by \$428 million. "The promotion we received has certainly helped TWIN attract additional assets and some new clients," says Gerber. TWIN has roughly \$750 million under management.

The final stage is when managers can't produce excellent results because they have too much money. "If they all of a sudden hire a marketing person and produce slick brochures then they are beyond the point where they can accelerate," says Bott.

Overall, managers need incubation from a manager program, or institutional investors to build critical mass. "A well conceived program is one where pensions develop a process that identifies managers, who have proven ability to deliver consistent competitive results and seamlessly receive larger direct assignments," explains LEIA's Jue. However, without the benefit of an emerging manager program they would more than likely have faced a difficult time getting to the \$2 billion mark, where they can then be considered for direct hire by all pension funds.

Copyright 2007 Focus Point Press. The information contained in Emerging Manager Focus may not be published, broadcast, rewritten or otherwise distributed without the prior written consent of Focus Point Press.

Published by Focus Point Press  
[www.focuspointpress.com](http://www.focuspointpress.com)