

PROGRESS INVESTMENT
MANAGEMENT COMPANY

CALIFORNIA STATE SENATE COMMITTEE ON PUBLIC EMPLOYMENT
AND RETIREMENT HON. GLORIA NEGRETE MCLEOD, CHAIRMAN

SB 294 [Senator Price]
COMMITTEE HEARING
May 2, 2011

Changing the Face of the Investment Management Industrysm

Testimony of Thurman V. White, Jr.
President and Chief Executive Officer
Progress Investment Management Company, LLC
San Francisco, California

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PRESIDENT AND CHIEF EXECUTIVE OFFICER
PROGRESS INVESTMENT MANAGEMENT COMPANY, LLC
SAN FRANCISCO, CALIFORNIA

Madame Chair and Senators:

Thank you for the opportunity to appear before you today

My name is Thurman V. White, Jr. President and CEO of Progress Investment Management Company, LLC (hereafter "Progress"). Progress is an employee-owned certified minority business enterprise and SEC-registered investment adviser. We are based in San Francisco, with an additional office in New York City. Progress is the oldest and largest independently-owned firm focused exclusively on working with emerging managers. We have a 20-year track record of business excellence in asset management. We manage over \$7 billion in assets for thirty-one of the nation's premier public and corporate institutional investors including both CalPERS and CalSTRS. Progress serves institutional clients as a manager of managers developing diversified investment portfolios in various asset classes – U. S. and non-U. S. equities, fixed income and private equity strategies -- to deliver competitive investment returns. We execute our investment strategy by identifying new investment talent -- "emerging" investment managers -- who may be often overlooked and/or underutilized by traditional pension fund consultants and large pension plans.

In my testimony today, I'd like to make a few brief points in general support of SB 294. I testify as a 19-year industry professional whose firm has worked around the country with various public pension funds, and in states where there is similar emerging manager-focused legislation. So I have first-hand experience in jurisdictions where there is a legislative mandate for state public pension funds to hire emerging managers. I also testify as an advocate for increased opportunities for diverse emerging managers to manage state pension fund assets. Why? Because small financial services businesses are an engine of greater economic growth for the U. S. economy. And there are demonstrated investment performance benefits to plan beneficiaries from having diverse businesses manage assets across several asset classes.

Who Are "Emerging Managers"?

"Emerging Managers" is a term of art in our industry. Simply defined, an "emerging manager" is a promising investment firm that, by virtue of its relatively short firm investment track record and/or relatively small amount of firm or product assets under management, is traditionally overlooked by pension plans and consultants in the searches that typically determine which external managers manage institutional assets. Although the emerging firm may be new, these firms are typically led and staffed by experienced investment professionals. For example, over 70% of the portfolio managers that lead our 60+ Progress-funded public markets sub-managers have over 25 years of investment industry experience.

The industry has looked to total firm size, i. e. assets under management, as the primary definitional criteria for emerging firms. Today, as an industry practice "emerging managers" most often means those firms that are less than \$2—\$3Billion in assets under management, and that are independently owned (at least 51% of the firm is owned by individuals working in the firm). In some cases for specific asset classes like fixed income, the definitional ceiling is slightly higher – up to \$5 billion in assets under management. Historically, the term emerging manager was focused almost exclusively on minority and women-owned firms. Today the industry term "emerging manager" includes, but is not limited to, minority and women-owned firms. But in Illinois and New York emerging managers are defined by statute as minority/women-owned investment managers with assets of up to \$10 billion under management. I will discuss some of the highlights of the new emerging manager laws in three other states below.

Progress maintains its own proprietary database of emerging public markets investment firms. Criteria for inclusion in the Progress emerging manager database are: 1) at least 51% independent ownership by employees of the firm; 2) less than \$2B in assets under management; and 3) all minority and women-owned managers, regardless of size. Our Progress database now comprises almost 1,000 emerging firms managing over 1800 actively managed public markets investment strategies in U. S. and non-U. S. Equities, fixed income and some alternative strategies. Exhibit 1 depicts a graphic snapshot of our current Progress database

and the relative size, ownership status and strategy diversity represented within this fast growing emerging manager universe. The key point here is that there is a breadth of competent emerging manager talent available. The challenge for policymakers and pension plan sponsors is creating meaningful opportunities to access and utilize this talent to garner their full potential to deliver value for plan beneficiaries.

Why Hire Emerging Managers?

Increasingly, many U. S. public pension plans invest with emerging managers in targeted strategies. These strategies are designed to capture emerging manager alpha (excess returns above a passive market benchmark), to access new talent, to secure future manager capacity and new innovations, and to provide more opportunities for newer and smaller firms to diversify the industry.

The U. S. institutional investors – corporate, union, foundation and public plans (states, counties and municipal entities) – that have committed billions of dollars in assets to targeted emerging manager investment strategies have done so for one reason: They want to win in global capital markets!

With investment firms, size does matter – but not as traditionally perceived. There is a growing body of academic research that supports the fact that small, entrepreneurial investment firms, i. e., emerging managers, can and often do outperform their larger counterparts. FN 1. In addition to this research, the investment returns of firms like Progress and others in this industry represent solid proof that there's no loss of investment performance or undue risk when using emerging, minority and women-owned investment firms.

Another reason to hire emerging managers is the diversification they bring to institutional portfolios. Many institutional investors still perceive bigger as better and/or less risky. Therefore, these investors prefer the large investment firm names that we're all too familiar with instead of seizing the opportunity to hire the less well-known, small entrepreneurial firms including those asset managers led by talented minorities and women (many of whom got their initial experiences with larger firms then left to start their own firms). Ironically, there may well be more unintended risk in those portfolios managed largely by large firms than investors realize. The huge non-transparent derivative losses and write-offs suffered by large investment banks over the past few years and the demise of venerable Wall Street firms like Lehman Brothers and Bear Stearns illustrate this point about the many unknown and unexpected risks in large investment firms.

Finally, hiring emerging managers is a means to provide not only opportunities to new investment talent but also is a means to foster new ideas and investment innovation.

To summarize, the benefits of having institutional investors use emerging and minority/women investment managers include:

- *Alpha* – competitive investment returns
- *Diversification* – mitigates large firm concentration risks by including more diverse smaller firms
- *Competition* – inclusion of diverse smaller firms leads to greater competition and reduced investment manager fees thereby lowering overall investor expenses benefiting ratepayers
- *Diversity* – creates opportunity for new investment ideas and innovation; provides support for a next generation of sustainable pension industry and utility suppliers
- *Manager Search Expense* – inclusion of a ready pool of proven, performing diverse smaller firms obviates the need for manager searches thereby lowering overall investor expense to benefit ratepayers

Other States Have Recently Enacted Emerging Manager Legislation

Within the past three years, several states – Maryland, Illinois and, most recently, New York – have enacted emerging manager legislation.

An overview of the key provisions of these state laws is outlined below:

Maryland [2008]: SB 606/HB1277 – State Government – Brokerage and Investment Management Services – Use of Minority Business Enterprises

Requires the four state-run agencies with investment programs – State Treasurer's Office, Maryland Automobile Insurance Fund, the Injured Workers' Insurance Fund, and the State Retirement and Pension System – to diversify and expand opportunities, consistent with the fiduciary duties of the agencies and to the greatest extent feasible, to include more minority and women-owned investment fund managers and brokers. Makes reference to overall state minority and women business procurement goal of 25 %.

Law targets minority and women-owned brokers and investment managers [not “emerging managers”] as defined in Maryland state law.

Requires the four state-run agencies to submit annual reports to the Governor’s Office of Minority Affairs on their progress toward legislative goals.

Illinois [2009]: Public Act 96-0006

Broadly focused bill to achieve public pension ethics reform [e. g. all contracts for services including investment management pursuant to RFPs, disclosure of any placement agent fees, etc.], greater transparency and new governance structure [appointment of trustees, etc.]. Imposes various compliance requirements on Illinois public pension systems.

Declares the public policy of the State of Illinois to encourage trustees of public employee retirement systems, pension funds and investment boards to: 1) use emerging investment managers in managing assets encompassing all assets classes; 2) increase the racial, ethnic and gender diversity of fiduciaries to the greatest extent feasible consistent with fiduciary prudence; and 3) take affirmative steps to remove any barriers to full participation by diverse groups in investment opportunities afforded by state-run public employee retirement systems, etc.

Required public employee retirement systems by 1/1/10 to:

1. Establish separate quantifiable goals for utilization of minority-owned; female-owned; and disabled-owned emerging investment managers by asset class.
2. Establish policies and quantifiable goals for greater use of minority broker-dealers.
3. Establish policies and goals for increasing racial, ethnic and gender diversity for board fiduciaries including consultants and senior staffs.
4. Establish policies and goals for use of minority, female and disable-owned businesses in other contracts and services used by public employee systems.

“Emerging Investment Manager” defined as qualified investment adviser that manages an investment portfolio of at least \$10 million but less than \$10 billion and is a “minority-owned, female-owned or disabled-owned business as those terms are defined by Illinois state law.

Requires each of the public employee retirement systems to review its policies and goals annually.

New York State [2010]: S. 6888 2/A. 9976 New York State Emerging Investment Manager and MWBE Financial Services Strategy Act

Makes certain legislative findings and declarations concerning disparity between New York state minority population percentage and the percentage of MWBE expenditures on state financial services contracts in 2006. Compares New York state’s disparity in minority population vs. state contracts to those in other states like Florida and Illinois. Finds it to be in the public interest and a benefit for New York state economic development to increase use of MWBE financial institutions.

Requires the New York State Comptroller, New York State Teachers’ Retirement System Board, New York State Insurance Fund and New York State Deferred Compensation Fund, subject to fiduciary duties, to establish an emerging manager and MWBE financial institution strategy with “reasonable goals” for increased use of emerging investment managers and MWBE financial institutions as defined, and other New York-based MWBE professional services firms:

1. Invest externally managed assets of the various New York state retirement systems and funds with emerging investment managers;
2. Conduct public market equity and debt securities trades with MWBE financial institutions;
3. Make direct or indirect investments in MWBEs; and
4. Increase dollars spent with New York-based MWBE professional services firms and MWBE financial services institutions on contracts for accounting, insurance, legal, etc.

Requires New York state systems to conduct public media campaigns to publicize their respective strategies, conduct annual conferences to promote greater use of emerging investment managers and MWBE financial institutions, and to make an annual report concerning the systems’ implementation of their strategies to increase use of emerging investment managers and MWBE

financial institutions.

“Emerging Investment Manager” is defined as an asset manager in public equity or fixed income, hedge funds, fund of hedge funds, private equity (incl. venture), REITs that are minority or women-owned business enterprises as defined in New York state law, with significant presence in New York state, registered investment advisors, and with assets under management of less than \$2 billion for private equity, hedge funds and REITs; and with less than \$10 billion for public markets equity and fixed income managers.

In addition to these states, emerging manager legislation has been introduced in Texas and Michigan, and is under consideration in Ohio and Florida. As the Committee can see, emerging manager investment practice has become institutionally accepted within the industry and in public policy circles across the country. California policymakers can take comfort in knowing that proposed legislation like SB 294 is squarely within the mainstream of accepted state policy in the United States.

SB 294 is SMART Policy on Emerging Investment Managers

In business, we often use the acronym SMART – specific; measurable; actionable; results-oriented; and time-sensitive – as both a defining characteristic and a metric to assess the viability of the various strategic and business goals we set. In other words, SMART goals and strategies are more likely to lead to better business outcomes. In the same way, SMART can be used to characterize certain elements of SB294 as it relates to providing a framework for the legislature to collaborate with both CalPERS and CalSTRS on this important public policy initiative.

SB294 is SMART in several ways:

1. *Specific:* SB294 is directionally specific – it requires both CalPERS and CalSTRS to develop a 5-year strategic plan “to expand the participation of emerging investment managers across all asset classes”. While SB 294 in current form specifies a 15 percent participation goal, the bill is flexible in that it does not mandate additional specific evaluation benchmarks nor does it define, as do the other state bills, who is an “emerging manager”. It leaves this important element to the discretion of CalPERS and CalSTRS to define, then to report on the agency’s progress toward meeting and/or exceeding the benchmarks it deems to be most relevant in their annual reporting.
2. *Measurable and Time-bound:* SB 294 requires annual reports to the Legislature that will no doubt serve as a basis for an annual dialogue with policymakers about agency progress toward meeting measurable emerging manager participation goals and benchmarks. The bill also has a sunset provision. Hopefully, this will encourage both CalPERS and CalSTRS to incorporate this annual strategic planning into its own planning activities after the bill’s mandate ends.
3. *Actionable and Results-Oriented:* SB 294 requires both CalPERS and CalSTRS to take actions – to prepare a long-term strategic plan to increase the use of emerging managers across all asset classes within both pension plans, and to achieve certain specified percentage goals in current proposed language. As noted above, the bill leaves both agencies ample room to define “emerging investment managers” in light of their specific plan needs and respective asset allocation schemes. More important, SB 294 flexibly provides the agencies over two years (2014), to gear up their respective planning efforts before they have to present annual legislative reports regarding their progress toward meeting their specified plan benchmarks. This should result in both agencies producing [hopefully] concrete year over year improvements toward expanded participation of emerging managers as defined. This, in turn, should also result in the benefits of using emerging managers being more fully realized by the CalPERS and CalSTRS pension plan beneficiaries. It is safe to say that in Maryland and Illinois, the initial response to the state legislation has produced substantial increases in emerging and minority, women and disabled investment manager participation in public retirement system opportunities in those states. FN2.

Other Precedents to Expand Emerging and Minority/Women/Disabled Veteran Financial Services Business Participation in Public and Private Procurement

Two other related precedents are worth mentioning here. First at the federal level, the recent Congressional enactment of the Dodd-Frank legislation – *The Wall Street Reform and Consumer Protection Act* – is a historic new federal law. Dodd-Frank responds to the global recession, the mortgage crisis, the need to avoid further federal bailouts of big Wall Street investment firms and the need for greater consumer protections. In addition to creating a new independent consumer protection agency, Dodd-Frank requires various federal financial services agencies to establish new Offices of Minority and Women Inclusion (CSee, for example, Section 342 of the Act). These new offices will monitor and address agency employment, enhance contracting diversity and increase MWBE financial services firm opportunities. The Federal Reserve Board, the 12 regional Federal Reserve Banks, the Federal Housing Finance Agency, Fannie Mae, Freddie Mac, the Securities and Exchange Commission, Federal Deposit Insurance Corporation and several others are among the agencies required to have these new minority/women inclusion initiatives.

Since the 1988 passage of General Order 156 by the California Public Utilities Commission, most of California's regulated utilities have increased their spend with minority, women and disabled veteran-owned investment and professional services firms, and with other non-financial businesses.

SB 294 Will Reinforce and Provide Legislative Support for Current and Future CalPERS and CalSTRS Emerging Manager Initiatives

Both CalPERS and CalSTRS have long been active in developing strategies to increase the utilization of emerging investment managers. Our firm, Progress Investments, is proud to be one of the external managers working with both state public pension plans. Our investment strategy is designed to provide opportunities for firms with less than \$2 billion in assets to manage CalPERS and CalSTRS assets and deliver competitive investment returns. Once these small firms demonstrate their ability to consistently deliver, the strategy goal is for them to move to direct hire assignments as needed with both state plans.

Progress has worked with CalPERS in two different investment strategies since 2000. With the CalPERS Manager Development Program [MDP], we worked to identify a pool of smaller managers in which CalPERS could make an equity investment, and then also provide those firms with assets to manage. This was and is an innovative first of its kind program that CalPERS initiated to bolster smaller firms as well as help to create the next generation of larger and more successful investment managers with which it could have long-term relationships. The CalPERS MDP provided CalPERS with two streams of return for its investment – a private equity-return for its investment in the asset manager, and of course a return on its assets under management.

Today we work with CalPERS in another strategy: a \$145 million small cap U. S. equity fund of funds strategy wherein we serve as an intermediary to identify and oversee a pool of eight investment managers of which three are minority and women-owned firms.

We manage a similar fund of funds strategy for CalSTRS. Progress manages \$365 million in an all-cap U. S. equity fund of funds strategy where we oversee nine managers of which four are minority and women-owned firms.

Both of these strategies to date are successful in meeting the stated investment objectives for both CalPERS and CalSTRS.

CalPERS and CalSTRS have also conducted successful targeted outreach activities for emerging managers over the past several years. Both have convened annual joint "open houses" inviting emerging, minority/women investment managers to meet with them in Sacramento. In such meetings CalPERS/CalSTRS representatives explain how to do business with both entities as well as identify future strategic direction and asset class opportunities so managers may tailor their product and capability development to match future opportunities. Most important, these open houses create a forum to begin relationship-building. And it's through these personal one-on-one interactions that meaningful business relationships may be built and nurtured.

Conclusion

CalPERS and CalSTRS are industry leaders in creating greater opportunities for emerging managers to manage their plan assets across various asset classes. But board composition and policies, and even plan leadership, can and often does change. SB294 is a means by which the good work that both plans are now achieving can become codified as state law to ensure longer-term continuity. SB 294 is a measured bill that provides a framework for greater inclusion, diversity, dialogue and collaboration between CalPERS, Cal STRS and the Legislature. SB 294 will confirm that greater inclusion of emerging investment managers in opportunities to manage assets for the state is an important California public policy. If this bill is enacted the winners are the state plans, and emerging investment managers. But the biggest winner is the state's retirement beneficiaries. This is what is known as "win/win/win".

SB 294 provides legislative recognition that this "win/win/win" is good for California's public employment retirees. SB 294 will also provide greater opportunities for emerging investment managers -- many of which are California-based businesses. And with these new opportunities California-based investment firms can create more jobs for California investment professionals, pay more tax revenues and contribute more fully to the state's economy. This is a much-needed additional economic benefit for the state.

Thank you for the opportunity to appear before you today. I will be happy to answer any questions you may have.

Footnotes:

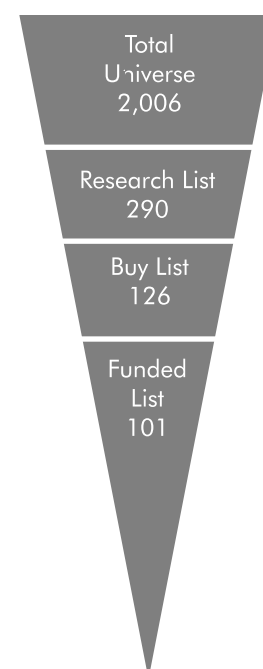
1. See attached for emerging manager performance research bibliography
2. See, for example, "Report on the Usage of Minority and Women-Owned Brokerage and Investment Management Firms by the State of Maryland for Fiscal Year 2009, Governor's Office of Minority Affairs, Annapolis, MD, page 1.

Exhibit 1. Progress database

The Progress Database (Size and Style Matrix)

	African American	Asian American	Emerging	Latino American	Main stream	Minority (O ther)	Native American	Unknown	Veteran/ Disabled + Minority	Women	Women+ Minority	All
0-50	55	16	167	16	1	1	2	116	2	50	6	432
50-100		1	37					6		11	7	62
100-500	22	21	253	13				19		75	4	407
500-1,000	21	15	129	2				9	2	18	1	197
1,000-2,000	18	11	167	5		8	4	17		16	8	254
2,000-5,000	26		274	15	13			32		26	2	388
5,000 and Above	16	10	94		121			13		12	0	266
Grand Total	158	74	1121	51	135	9	6	212	4	208	28	2006

	African American	Asian American	Emerging	Latino American	Main stream	Minority (O ther)	Native American	Unknown	Veteran/ Disabled + Minority	Women	Women+ Minority	All
All Cap Core	1	2	42	1	2			4		10		62
All Cap Growth	2	3	36	3		1		4		6		55
All Cap Value			45	2	6			1		3	1	58
Alternatives	1	2	13	1	5			17		2	1	42
Fixed Income Core	11	2	46	7	7	2		5		7	3	90
Fixed Income Core Plus	2	2	9	1	4	1		1		1	1	22
Fixed Income High Yield	3	3	20	1	7	1		4		8		47
Fixed Income Other	13	1	61	4	7			9		13	1	109
Hedge Fund	5	4	41	3	4	1	2	7		6		73
International/Global Equity	12	12	98	5	8	1		15		24	7	182
Large Cap Core	6	6	86	1	6	1		19		19	3	147
Large Cap Growth	23	7	100	4	6			13	1	28	3	185
Large Cap Value	15	5	106	4	8		1	12	1	16	2	170
Micro Cap Core			8							1		9
Micro Cap Growth			9					2				11
Micro Cap Value	1		5	1	1			2				10
Mid Cap Core	6		21	1	1			2		8		39
Mid Cap Growth	11	4	27	2	2			3		9		58
Mid Cap Value	10		26	2	4		1	1		1	2	47
Other Equity	5	5	64		35	1	1	57	1	4		173
Small Cap Core	5	2	49	3	3			10		14		86
Small Cap Growth	12	8	69	3	4			12	1	11	1	121
Small Cap Value	10	4	78	2	7		1	4		6	2	114
SMID Cap Core	3		12		2			3		3	1	24
SMID Cap Growth	1	2	35		1			4		4		47
SMID Cap Value			15		5			1		4		25
Grand Total	158	74	1121	51	135	9	6	212	4	208	28	2006



Specifications

2,006 Strategies

All developing managers with less than \$10B

All woman- and minority-owned managers

At least 51% independently-owned

Registered Investment Advisors only