

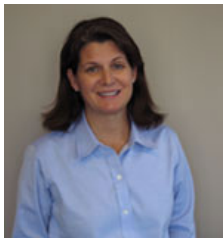


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COVER STORY

DC Plans and Mutual Fund Platforms Provide Fertile Ground for Emerging Managers to Grow Assets

By Portia Richardson



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In a world where defined contribution assets are growing exponentially faster than defined benefit assets, more and more emerging managers, or those with \$2 billion or less under management, are building assets as sub-advisors. Not only can emerging managers then focus on performance, but also they build assets as fund platforms sell them to retail clients. There are many ways to tap into fund platforms. Included are building relationships with consultants, and asset managers as well as brokers, banks and insurance companies that offer DC plans and registered investment advisors networks.

"DB plan assets are growing, but the landscape is contracting. Insurance companies, banks and brokers have separate accounts and 401(k) plans, which comprise the sub-advisory world that's growing," says Isaac Green, President and CIO at Piedmont Investment Advisors, with \$1.2 billion in assets.

The defined contribution (DC) world, especially 401(k) plans, are growing exponentially, while defined benefit (DB) plans are limited – no new plans are starting and most are closing to newer employees. In 2006, for example, DC assets rose from \$2.97 to \$3.27 trillion, compared to DB assets which increased from \$2.15 to \$2.26 trillion over the same period according to the Employee Benefit Research Institute. Individual Retirement Accounts (IRAs) spiked from \$363 billion to \$423 billion in 2006. Simply put, the magnitude of the mandates in dollars to asset managers as sub-advisors is overwhelming,” says Victor Hymes, CIO of Legato Capital Management in San Francisco.

“More recently, emerging managers have succeeded at winning mandates in the DC space,” Hymes adds, “and that will increase as they begin to populate Morningstar screens and 401K provider organizations. Emerging managers traditionally focus on new business in the DB area. But becoming sub-advisors is a gateway for becoming part of a larger organization.”

It makes sense. “It’s prohibitively expensive for most emerging managers to start their own funds,” according to Jay Rogers, of Los Angeles based Diamond Portfolio Advisors. So, sub-advising is a good alternative. But in Rogers’ experience many fund advisors have a size bias just like most institutional consultants who prefer Goldman Sachs, Alliance Bernstein, TCW, and others to smaller firms that are not as well known.

Finding Fund Platforms

Defined contribution providers and registered investment advisors are the most common fund platforms. Trade magazines survey DC providers annually and many of them are listed on Morningstar, a mutual fund rating agency. Consultants work with both DB and DC plans and want consistency in their recommendations to clients, so

there is more opportunity for emerging managers to work with consultants. Also investment advisory firms such as Legato search for high caliber managers and recommend them to investors. "What is amiss is that emerging managers haven't seen DC organizations as a stopping place to introduce themselves," says Hymes. Currently there are 568 mutual fund families listed on Morningstar of which 347 families have \$ 2 billion or less in assets under management.

Becoming a Sub-advisor

There are three ways to break into the network. First, you need to have an existing relationship with an advisor who can recommend you internally for review. Second, you can work with consultants for referrals. Finally, you can resort to cold calling fund providers. "It's a numbers game. You make 20 calls for one meeting," Hymes says.

Legato specializes in recommending managers, and recommended Piedmont Investment Advisors, with \$ 1.5 billion under management, as a large cap sub-advisor for San Francisco based Forward Management. Forward, a registered investment advisor, with \$ 2.5 billion under management, will act as a distribution channel for Piedmont's large cap fund, under ticker symbol FFLAX. "We manage the fund and they raise the assets, so we can concentrate on being asset managers," says Green. "We're very performance driven, and if we do a good job running the mutual fund over time, it will grow."

Forward looks for the same criteria in emerging managers as pensions or manager of managers, which are performance, track record and back office ability. "We want a unique product offering, an entrepreneurial spirit, and a product that offers a diversification benefit from other managers," says James O'Donnell, Forward's chief administrative officer. Forward collaborates with their sub-advisors by owning an equity stake, assisting them in product development, or identifying a niche strategy. Currently, they have a relationship with

Pictet & Cie, a Swiss bank with offices in London and Geneva for international fixed income and international equity. “We act like good partners with our sub-advisors,” says O’Donnell.

Ever the innovator, Forward focuses on nascent asset classes and offered one of the first real estate investment trust funds—today it has \$ 600 million in assets, as well as an international small cap fund, a long/short bond product, and international fixed income fund. They also offered one of the first micro cap funds in 1998. “We focus on asset classes that are good diversifiers and offer non-correlated returns,” says O’Donnell. “We round out asset allocations and find alpha opportunities that are non-correlated to large asset classes.”

Forward relies on its extensive network of contacts for finding managers, and likes Legato’s evaluation approach. According to O’Donnell Legato doesn’t take an antiseptic look at numbers, but uses a holistic approach to see how sustainable a manager’s performance is. “There are a lot of intangibles that are captured in Legato’s investment process, which are frequently overlooked by consultants,” O’Donnell says.

Many large brokers are a resource for emerging managers because they have investment platforms also and prefer having unique names, since the returns can be higher. The smaller names are broad based and across all asset classes. Operations capability is mandatory however. The smallest investment from a retail customer is \$ 100,000.

Raising Money Through Consultants

Arnerich Massena, a Portland based investment consultant, works with managers of all sizes including those early on in their life cycle to help them meet operational challenges. To help meet these challenges they often introduce them to fund platforms where they build assets in a variety of ways. According to Brian Loescher, Director of Research at

Arnerich Massena, "We find that manager's often produce their best investment performance relatively early on in their lifecycle, when their motivation is often at its highest and prior to becoming overwhelmed with assets under management. Hence, if we can help them overcome the significant operational challenges faced by emerging managers, we feel our clients are the ultimate beneficiaries. Outsourcing many of the operational aspects of running a firm or pursuing sub-advisory relations allow managers to focus their time on analyzing investments, not day-to-day operations. You do not have to be a multi-billion dollar firm to successfully execute within the defined contribution market. What you do need is a smart/efficient approach to managing operational demands and you'll need relations with investment consultants that place an emphasis on discovering and developing emerging investment talent." says Loescher. Arnerich Massena is an independent consulting firm, whose diversified client base consists of ultra high net worth individuals, endowments, foundations, DC and DB plans. "The diversity of our client base has led us to be more active/creative in finding solutions for all client types," he adds.

Arnerich Massena spends significant time and resources looking to identify and build relations with experienced investment professionals that are looking to start-up new investment practices. While the bar is high, those meeting their internal requirements will be selected to an approved list of managers. It is at this point that Arnerich Massena's research team will help advise them on a variety of fronts; types of investment vehicles to pursue, investment platforms to join, appropriate revenue sharing schedules and in some cases playing match-maker to distribution platforms looking for a new sub-advisor. Why all this effort? "We regularly see managers who do well early on and then simply allow assets to grow too large," says Loescher. "As you go down the market capitalization range, specifically small and

mid cap managers, capacity is a huge issue. There are too many managers that simply don't have the discipline to appropriately size their asset base," Loescher explains.

Selection Criteria

There are multiple institutional channels for sub-advisors such as brokers, banks, insurance companies, asset managers and mutual funds families, and they have different sub-advisor platforms, providers and products. "For example, some platforms limit their offerings to internally managed funds while others are externally managed, or offer a combination. There are different channels and it's a good balance for business," says Hymes.

Yet, without existing relationships with investment advisors, it's hard to be selected. Hymes is convinced fund platforms will take great interest in small cap managers because they are in limited supply. "Currently, there is a limited supply of value added managers, like those in small cap, so they have a greater potential for growth," he says. When Lesa Sroufe, of Seattle based Sroufe & Co., hung a shingle as a value contrarian manager in 2004, much of her \$ 125 million in assets came from registered investment advisors. She developed relationships with investment advisors during 14 year legacy as research director at Seattle based Ragen MacKenzie and prior to that, with Foster & Marshall, now a part of Smith Barney.

Familiar with the process, Sroufe highlights that there are different levels of being recommended as a sub-advisor. If a manager has \$ 400 million or more under management they can be considered for the preferred list, as long as they can handle the volume operationally. Managers with less than \$ 400 million likely won't be marketed as their large brethren by the fund platform. Either way, advisors come directly to the manager and propose them to the fund platform's consulting department as sub-advisors, who performs a due diligence review.

Loescher adds that there are a set of committees that review the managers making the process timely and thorough.

Similar to the DB plan manager review process, consultants look at performance, track record, team cohesion, and operations efficacy, however, the sub-advisor process may be more rigorous. Fund providers don't want to move managers in and out of their platforms because clients develop a comfort level with funds. "If a manager is fired for performance it's a painful experience and expensive. Fund platforms want to avoid that," according to Hymes.

Carlotta Oliver, managing director, Black Knight Asset Management, LLC, in Washington DC, believes the due diligence process is ongoing and that fund platforms want to do site visits where they can "kick the tires". Oliver will leverage her 20 year legacy in the fixed income market to build relationships among DC providers, though it's uncertain how long the process will take. Black Knight has just begun the process and believes it will be fruitful in time.

Overall, building relationships and undergoing due diligence may be time consuming, but in the long run it's a highly efficient way to build assets, especially in light of a burgeoning DC market. Fund platforms' brokers sell sub-advisors funds to retail clients, while emerging manager focus on investment research and performance.

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