Emerging Manager Monthly

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Graduation Day

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Emerging and Diverse Manager programs are critical for institutional investors to gain exposure to up-and-coming firms; ensuring they can matriculate beyond these mandates, however, requires a more strategic and flexible approach.

The case for emerging and diverse managers was opened and shut a long time ago. In private equity, if you ask most limited partners (LPs) about their favorite Roman Numerals, they'll cite "II and III," a manager's second or third fund, when emerging managers are experienced enough to find a rhythm and still hungry to make a name for themselves. And across the broader asset management landscape, one of the biggest challenges for institutional investors is to identify managers who don't fall into the groupthink that comes at the expense of alpha and amplifies risk when cycles turn.

These considerations, of course, have been proven out over time in the form of outperformance. Diverse companies — the target of fund managers — are more likely to perform better, according to a McKinsey study. And diverse fund managers, on average, outperform their peers who don't show a similar mix of ethnicities and sexes on their investment teams. This has been proven true in both private capital, according to a Harvard study, and in the public markets, according to Northern Trust research. And there is even evidence that diversity across the investment landscape regulates the markets, eliminating the pricing bubbles that bring systemic risk to the economy. Again, this is not a case that needs to be re-litigated.

The challenges for fund managers, however, stretch beyond a lingering stigma that commitments to emerging and diverse managers represent some kind of compromise on financial returns. Just as acute are the obstacles that confront even the most successful emerging and diverse managers, who have the team, the track records, and the vision, but need a path to matriculate from emerging manager programs to secure a place on the broader roster of institutional investors' portfolios. It's in this "graduation phase" that many asset owners also struggle to advance their emerging manager programs in a way that allows them to realize the full benefits of their inclusive efforts.

This was a recurring topic that came up during Meketa's most recent Emerging & Diverse Manager Research Days roundtable discussions, which attracted more than 135 asset managers across nearly 90 different firms this past October. During the LP panels — with senior representatives from CalSTRS, Illinois SURS, and the State of Connecticut — each participant highlighted how their respective institutions have adapted as their programs have grown and evolved. Two of the overriding takeaways were the importance of flexibility in constructing the program and the value of a regular dialogue to ensure that when opportunities arise, the usual suspects in a given category will be joined by new faces and fresh perspectives of those ready to transition from emerging and diverse manager programs, often coordinated through managers-of-managers, to the broader portfolio through direct investments.

The Managers-of-Managers Paradox

Consider, for instance, the challenges inherent to utilizing funds-of-funds (FoF) or managers of managers to gain exposure to new firms and spinouts. For large institutions, these curated exposures create efficiencies to access a wide range of diverse and emerging managers. In private capital, fund-of-funds firms are a particularly important part of the emerging manager ecosystem. Many of the very largest asset owners, for instance, may traditionally write checks two or three times the size of an emerging manager's first-time fund, but are limited to accounting for a maximum percentage of the managers' assets under management. So these FoF mandates create a mechanism for larger institutions to access and familiarize them-

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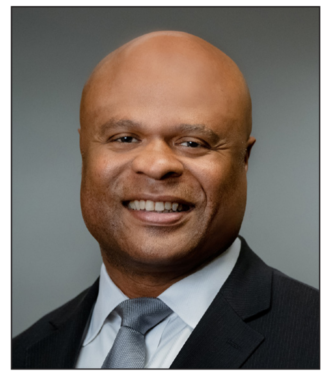

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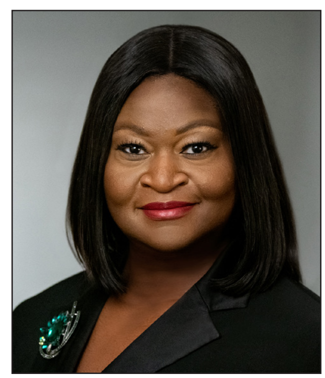

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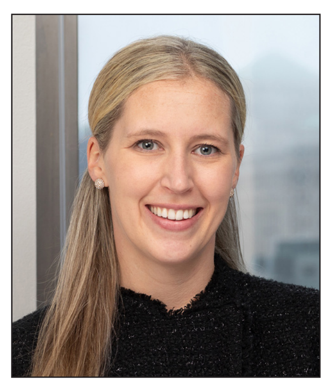

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MEKETA: Relationships, Timing Key Aspects To Emerging & Diverse Programs

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-selves with several emerging managers in a way that moves the needle for their broader investment program.

The catch, however, is that when the top-performing managers are ready to "graduate" and raise a larger fund, there needs to be some acknowledgement that the FoF managers, themselves, are losing a star performer, one who may have contributed an outsized share to the overall composite performance. Rather than penalize a fund-of-funds manager when a star contributor matriculates, institutional investors should instead view this as an attribute that supports the investment case for a re-up. Historically, some LPs have redeployed their pre-existing allocations for the fund-of-funds manager to go toward new direct investments in the graduating managers. A best practice, however, is for asset owners to continue to support the managers-of-managers who have established successful track records graduating emerging managers. This will help ensure the talent pipeline remains full in the future.

Relationship Building

Those who have been successful in cultivating their emerging and diverse manager programs know it requires far more than just capital. Again, communication is critical, not merely to understand the competitive advantages or investment edge of a particular manager, but to help a firm prepare for what's expected as they institutionalize their business.

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The leap from a proven investor to business owner is challenging for any fund manager. Reporting demands grow, fund administration becomes more complex, and portfolio managers are suddenly tasked with fundraising responsibilities, not to mention recruiting and other administrative "distractions." (Few, if any, portfolio managers got into finance so they could practice event planning, yet new firms will confront these and other challenges when they host their first annual general meeting.) In this sense, institutions can provide a valued mentorship role that helps ease the transition.

Timing Matters

It's also important for fund managers, themselves, to maintain open lines of communication. As one of the panelists noted during Meketa's recent LP roundtable discussion, among the biggest challenges for institutional investors in backing graduating managers is that without an ongoing RFP, their hands can be tied in making new commitments – at least temporarily.

It may be discouraging, but every manager – even seasoned firms on their fifth or sixth fund -- has heard, "It's not a 'no,' but a 'not now.'" This sounds like a soft rejection; however, asset owners will actually use their time in between RFP processes to better familiarize themselves with new managers, their decision makers, and their investment philosophies. And when a new mandate does open up, they'll be well versed on the graduating managers most appropriate for a given allocation. These relationships can also be critical to help emerging and diverse managers secure a waiver from normal procurement rules that might otherwise limit the pool of candidates to those able to check the box on more arbitrary considerations.

Finding the Balance between Fees and Performance

Beyond just the RFP process, flexibility is also important for institutional investors to create a foundation for success. A focus area in recent years, for obvious reasons, has been efforts to reduce fees. This is especially the case in the private capital arena, where the two-and-twenty fee structure stands out as excessive in a competitive market where fee compression has become the norm. Newer managers, without the brand recognition or tenure, can face the brunt of these efforts. Institutions should recognize, however, that if they're too aggressive, it will come at the expense of the newer and not yet fully established organization of the fund, their team and resources, and ultimately, their ability to build for the future and put larger sums of capital to work.

Several other takeaways from the roundtable discussion also resonated, and each of the LP panelists said they continually adapt their strategies based on new learnings and as their allocations grow. For instance, some have recalibrated to take a bottom-up versus a top-down approach "to go where the talent is," and not merely try to fill a certain asset class.

Others cited that allocation strategies for emerging and diverse manager programs actually match that of their broader portfolio. If U.S. large cap equities are considered to be too efficient to hire an active management style, there won't be an allocation for any actively managed products to matriculate into that part of the portfolio. And nearly all of the small and emerging managers we encounter in the market today employ an active style of management.

If it sounds like emerging and diverse manager programs require work and attention, it's because they do. But the payoff isn't about meeting an arbitrary goal, unconnected to the overriding mission of the institution or the fiduciary duties of the officers. As CalSTRS Deputy Chief Investment Officer Scott Chan emphasized on the panel, "Diversity leads to greater returns. It's as simple as that." And the work to create and cultivate new relationships will indeed pay dividends down the line, when asset owners who put in this work can then access the next generation of top-quartile performers.