"Investing in the Future: Minority Opportunities and the Federal Retirement Thrift Savings Plan (TSP)"

TESTIMONY OF THURMAN V. WHITE, JR.
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Before the

SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND DISTRICT OF COLUMBIA
HON. DANNY K. DAVIS, CHAIRMAN

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
U. S. HOUSE OF REPRESENTATIVES

JULY 10, 2008

Mr. Chairman and Members: First, I would like to thank you for the opportunity to appear before you today, and also thank you for convening this hearing on such an important topic to our industry.

My name is Thurman V. White, Jr. President and CEO of Progress Investment Management Company, LLC (hereafter "Progress"), an employee-owned certified minority business enterprise and registered investment adviser. Progress has an 18-year track record of excellence in asset management. Today we manage almost $7 billion in assets for many of the nation's premier public and corporate institutional investors. Progress has been a pioneer in the area of managing "emerging managers", which includes minority and women-owned investment firms. Progress serves institutional clients as a manager of managers developing diversified emerging manager investment portfolios in various asset classes – equity, fixed income and private equity strategies. We execute our investment strategy by identifying and using new investment talent -- "emerging" investment managers -- that may often be overlooked and/or underutilized by traditional pension fund consultants and large pension plans. We then use these firms to create diversified, risk-controlled multiple manager investment strategies to deliver competitive investment returns.

In my testimony today, I'd like to make three brief points on why emerging managers are indeed an appropriate investment for the future, and should be an integral part of the asset allocation for the Federal Retirement Thrift Savings Plan (TSP) and other federal plans

such as the National Railroad Trust, PBGC and others. In addition, our firm has recently prepared two white papers on these issues (available via our website at www.progressinvestment.com), one of which I'd like to incorporate by reference for the record in this proceeding, and have attached hereto.

Who Are "Emerging Managers"?

Simply defined, emerging manager is a specialized industry term. Historically the term was synonymous with minority firms but it has evolved. Today, the term identifies promising investment managers who, by virtue of their relatively short firm investment track record and/or relatively small amount of firm or product assets under management, are traditionally overlooked by pension plans and their consultants in the searches that typically determine who manages institutional pension fund assets. In most cases, the industry has looked to total firm size, i. e. assets under management, as the primary definitional criteria for emerging firms. Today, "emerging manager' 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). Many minority-owned asset management firms in our industry fall within this category of "emerging managers" since they have less than the threshold $2—3B in AUM, and are relatively new firms. Thus, "emerging manager" includes, but is not limited to, minority and women-owned firms.

Progress maintains its own proprietary database of emerging investment firms. Criteria for inclusion in the Progress emerging manager database are SEC-registered investment advisers with: 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 close to 900 emerging firms managing over 1800 investment strategies in U. S. and non-U. S. equities, fixed income and 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 manger universe.

Why Hire Emerging Managers?

Many U. S. plan sponsors – with the notable exception of the federal retirement plans that are the subject of today's hearings – invest with emerging mangers in targeted strategies. These strategies are designed to capture emerging manager alpha potential (excess returns above market benchmarks), to access new talent and secure future manager capacity, and to provide more opportunities for newer and smaller firms to diversify the industry.

These large U. S. institutional investors – both corporate plans as well as public plans (states, counties and municipal entities) have committed billions of dollars in assets to targeted emerging manger investment strategies 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. See Footnote 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. In fact, one can consistently achieve market-competitive returns through emerging manager investment strategies.

Another reason to hire emerging managers is the diversification they bring to institutional portfolios. The investment management industry is conservative by nature, and slow to change. Despite actual portfolio results and research to the contrary, many institutional investors still perceive bigger as better and, therefore, prefer the large investment firm names that we're all too familiar with instead of seizing the opportunity to hire less well-known small entrepreneurial firms including those asset managers runs by talented minorities and women (many of whom got their initial experiences with larger firms then left to start their own firms). Ironically, the fact is there may well be more unintended risk in those portfolios managed by large firms than investors realize. The huge non-transparent mortgage derivative losses and write-downs suffered by large investment banks, and the recent demise of Bear Stearns, illustrates the many unknown and unexpected risks in large investment firms.

Hiring emerging managers can mitigate the large firm concentration risk that may be generally evident in many retirement plan portfolios, and specifically in the portfolios run by the Federal Thrift Savings Plans. Having such a large pool of assets managed by a single manger is very risky. Such single manager concentration runs contrary to prudent investment policy that typically looks to asset class as well as manager diversification as an efficient means to diversify risk and enhance returns in today's volatile market. In fact, we can question whether the TSP and its Advisory Council are upholding their fiduciary responsibilities to the Plan's beneficiaries by failing to adequately diversify manager as well as asset class risk (discussed below) within the TSP.

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

Industry "Best Practices" and How Other Large U. S. Pension Plans Use Targeted Emerging Manager Investment Strategies

Exhibit 2 provides a partial list of all of the U. S. pension plans that have utilized targeted emerging manager investment strategies to enhance overall investment returns, diversify their portfolios and reduce manager concentration risk, and provide opportunities for entrepreneurial firms to incubate and deliver new ideas and innovation to the industry – all to benefit the beneficiaries of these plans. That the Federal Retirement Thrift Savings Plan is not listed among these plans is shameful, and frankly puzzling.

Use of emerging mangers has become institutionalized in our industry. And this is a trend that appears to be growing. Many plan sponsors are utilizing emerging manager investment strategies in various asset classes – equities – U. S. and non-US; fixed income; private equity, real estate and even in hedge fund strategies. Not surprisingly, there are talented and competent minority and women-owned investment firms managing assets successfully in each of these asset classes. There are also emerging, and minority and women –owned managers managing enhanced passive strategies as well.

Many other U. S. plans have also sought to diversify the range of investment strategies within their respective asset allocations to include both active as well as passive investment strategies. Again, there may be as much diversification risk with using only one type of investment strategy, e. g., exclusively passive strategies like those of the Federal Retirement Thrift Savings Plan, as there would be in having only one political party in a democratic election. In either case, the risk of limited choice is too great a risk. The loser in such situations is the federal retirement beneficiaries – or in the case of a single party election – democracy itself.

Conclusion

The attached position paper outlines a range of best practice options and proven asset allocation ideas that the Federal retirement plans can use to invest in emerging managers. By doing so, the Federal plans can enhance their investment returns, diversify the types of managers in their portfolios, and provide opportunities for new ideas and innovation within their respective asset allocation policies.

I will conclude by providing an analogy that is often used by Rev. Jesse Jackson and his Rainbow PUSH/Wall Street Project that is appropriate here. It's a sports analogy about America's favorite pastime – baseball.

Much like we've seen in other industries, when the playing field is broadened to be more inclusive, everyone wins. After WWII, Branch Rickey of the Brooklyn Dodgers saw a pool of overlooked baseball talent that operated outside the mainstream of Major League Baseball as it was known then. That pool of "emerging" talent was the Negro Baseball League. Branch Rickey also knew one thing – he wanted to win. So Rickey began to scout the Negro Leagues and ultimately brought Jackie Robinson in as the first African American to play in Major League Baseball; the rest is history. Similarly, in San Francisco a few years later there was a Major League Baseball scout for our SF Giants named Alejandro ("Alex") Pompez. A former owner of the Negro League New York Cubans, Pompez knew about another pool of overlooked and unused talent in the Caribbean and South America – Latino baseball players. So Pompez began to scout this talent and signed several Latin American players on behalf of the SF Giants -- players like Juan Marichal, Orlando Cepeda, the Alou brothers and others. These were players of enormous ability who, when given the opportunity to enrich and make the game more competitive, did so and raised the level of play for everyone.

And our national pastime, and the many baseball fans, are the beneficiaries of this more inclusive brand of Major League Baseball as we know it today.

I believe that the same "win/win" phenomena can happen with the Federal Retirement Thrift Savings Plan, The National Railroad Trust, the Pension Benefit Guaranty Corporation and other federal plans. However, this win/win will only happen if the Federal plans become more inclusive, use emerging managers including minority investment firms and allow us to provide the benefits of alpha, diversification and diversity for their portfolios.

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

Footnote:

1. Research Papers on Emerging Managers

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Krum, Ted. "Insights On: Potential Benefits of Investing with Emerging Managers: Can Elephants Dance? 10th Anniversary" - Northern Trust Global Advisors September 2005

Footnote -- continued

Leading Edge Investment Advisors. "Performance Characteristics of Emerging Managers" - 2006

Progress Investment Management Company. "Small Isn't What It Used To Be – The Changing Face of Smaller Investment Firms" - 2003

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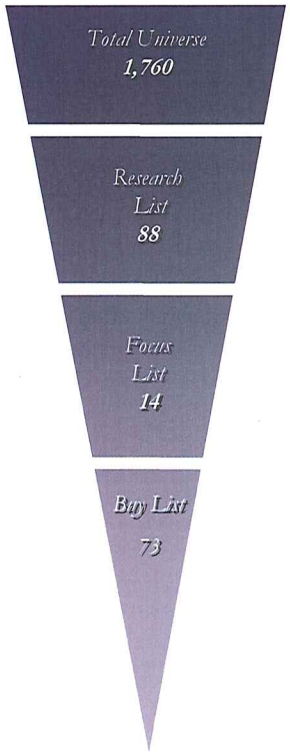
EXHIBIT 1 — THE PROGRESS DATABASE

Manager Research and Focus List (Strategies)



By Style

	All	African-American	Asian-American	Disabled	Emerging	Latino-American	Native American	Minority Unclassified	Woman-Owned	Women + Minority
Fixed Income - Cash Mgmt	30	9	2		13	1			5	
Fixed Income - Core	168	40	8		91	7			22	
Fixed Income - Core Plus	12	2	1		5	1			3	
Fixed Income - High Yield	27	1			17	1			8	
Fixed Income - Int. Rate Forecasting	68	5	2		51	2			8	
Fixed Income - Other	126	12	7		85	3			18	1
International Fixed Income	23	1			11	1			9	1
International Equity	110	4	7		83			1	12	3
Large Core or All Cap	402	22	12		319	3			46	
Large Growth	215	23	7	1	156	2			26	
Large Value	135	15	2		100	2	1	2	13	
Mid Core	31	5	1		21				3	1
Mid Growth	54	5	2		41	1			4	1
Mid Value	43	7			31	2			3	
Small Core	57	3	3		46				4	1
Small Growth	96	4	2		80	5			2	3
Small Value	77	8	3		58	1			7	
SMID Core	11				10				1	
SMID Growth	21	1	1		16				2	1
SMID Value	13	1	1		10				1	
Other	28	4						7	17	
Other - Equity Specialty	13	1		2	7				3	
Totals:	**1,760**	**173**	**61**	**3**	**1,251**	**32**	**1**	**10**	**217**	**12**

By Size & 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
Emerging	1251	161	110	435	254	265	26
Latino-American	32	6		8	8	7	3
Native American	1				1		
Minority Unclassified	10	7		1			2
Woman	217	44	29	38	45	27	34
Woman/Minority Owned	12				4	8	
Totals:	**1,760**	**242**	**144**	**547**	**339**	**340**	**148**

Specifications:

1,760 Strategies

All developing managers with less than $2B

All woman- and minority-owned managers

At least 51% independently-owned

Registered Investment Advisors only

PROGRESS INVESTMENT MANAGEMENT COMPANY

EXHIBIT 2

PARTIAL LIST OF U.S. PLANS USING EMERGING MANAGERS

The following is a representative list of known U.S. Pension Plans that have committed assets to emerging manager strategies:

- **1199SEIU Employees Benefit and Pension Funds**
- **Alameda County Employees' Retirement Association**
- **Arkansas Teacher Retirement System**
- **Bank of America Corporation**
- **Boeing Company**
- **Boulé Foundation**
- **California Public Employees' Retirement System**
- **California State Teachers' Retirement System**
- **Chicago Policemen's Annuity & Benefit Fund**
- **City of Kansas City Employees' Retirement System**
- **City of Philadelphia Board of Pensions and Retirement**
- **Coca Cola Master Retirement Trust**
- **Contra Costa County Employees' Retirement Association**
- **Detroit General Retirement System**
- **District of Columbia Retirement Board**
- **Exelon Corporation**
- **GE Asset Management**
- **Illinois Municipal Retirement Fund**
- **Illinois State Board of Investment**
- **Indiana Public Employees' Retirement Fund**
- **Liberty Mutual Retirement Benefit Plan**
- **Los Angeles City Employees' Retirement System**
- **Los Angeles County Employees Retirement Association**
- **Maryland State Retirement & Pension System**
- **Massachusetts Bay Transportation Authority Retirement Fund**

Exhibit 2 – continued

- Michigan Department of Treasury
- Municipal Employees' Annuity & Benefit Fund of Chicago
- New York City Board of Education Retirement System
- New York City Employees' Retirement Systems
- New York City Fire Department Pension Fund
- New York City Police Pension Fund
- New York State Common Retirement Fund
- New York State Teachers' Retirement System
- Ohio Public Employees Retirement System
- Oregon Public Employees Retirement Fund
- PG&E Corporation
- Pennsylvania Public School Employees' Retirement System
- PPL Services Corporation
- Public School Teachers' Pension & Retirement Fund of Chicago
- San Antonio Fire & Police Pension Fund
- San Francisco City & County Employees' Retirement System
- San Joaquin County Employees' Retirement Association
- Seattle City Employees' Retirement System
- Shell Oil Company
- State of Connecticut Retirement Plans & Trust Funds
- State Universities Retirement System of Illinois
- Teacher Retirement System of Texas
- Teachers' Retirement System of the City of New York
- Teachers' Retirement System of the State of Illinois
- The Pennsylvania Treasury Department
- Verizon Communications, Inc.

Successful Emerging Manager Strategies for the 21st Century

Thurman V. White, Jr.

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.

In a previous article, I pose a straightforward question: "Given the evolution and growing popularity of emerging investment managers, why aren't these entrepreneurial firms more broadly represented in institutional investor portfolios?" The purpose of this article is twofold: (1) to attempt to answer that question, and (2) to promote increasing investment in emerging managers by sharing portfolio allocation strategies and best practices.

Definitions of "emerging manager" vary depending on the goals of the investor. In 2008, "emerging manager" most often means "small" in terms of assets under management ($2 to $3 billion or less), independent (at least 51% employee-owned) and sometimes, but not always, firms owned by women or minorities.

Often, these are smaller companies created by an exodus of talent from larger investment firms. "Emerging Managers," says Joseph J. Haslip, Assistant Deputy Comptroller for Pensions for the New York City Retirement Systems, "have the same talent, educational background and acumen as the people at the larger firms, but they have opted to be more entrepreneurial." The City of New York, through its five different pension funds, has invested approximately $7 billion, or 6% of assets totaling $114 billion, with emerging managers through diverse investment strategies.* *(For more on New York City's innovative, diversified approach to pursuing emerging manager returns, see separate box on Page 5.)*

More Possibilities For Alpha

U.S. plan sponsors invest with emerging managers to capture their alpha potential, to provide more opportunities for newer and smaller firms, and to access new talent and future manager capacity.

Many studies over time have shown that small, employee-owned investment companies outperform their larger competitors.[1] It has almost become a truism in our industry that the greater the assets under management (AUM), the less the likelihood of outperformance. The inverse relationship between assets and alpha (assets up, alpha down) is part of the reason that many global investment firms position themselves as a group of small "boutiques" operating under the umbrella of their parent company.[2]

Says a public-fund investment officer and longtime Progress client, "When managers reach a certain level of assets under management, their risk becomes losing assets under management as opposed to market risk." Consistent with this perspective, this public plan's domestic-equity portfolio is almost totally indexed—except for two strategic allocations to active managers: Progress and another firm. Through strong performance and additional asset awards of $270 million, the Progress portfolio has grown from $100 million to more than $1 billion during the past 10+ years.

* 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.

Practical and Psychological Barriers To Entry

Despite the proven performance advantage of emerging firms, barriers to entry remain high. From a purely practical standpoint, it is impossible for many institutional investors to invest a meaningful percentage of assets with any one emerging firm. Restrictions often disallow pension plans from making an investment that would become more than a certain percentage of any one manager's asset base. Usually this limit ranges from 10% to 30%. For example, if a new firm has $100 million under management and a plan sponsor wants to invest $100 million, that plan would become 50% of the emerging manager's asset base, which may be disallowed by the plan's risk policy.

Research by Progress, however, has shown that only 15% out of 312 new mandates from $1 to $99 million—allocation sizes for which many emerging firms would qualify—were awarded to emerging firms.[3] What does this mean? It means that practical hurdles such as asset size constraints are far less significant than psychological hurdles.

The investment business is, by temperament and history, conservative and slow to change. Many investors still perceive bigger as being quite simply better, and many still prefer the known—the household names—to unknown start-ups run by entrepreneurs (many of whom, paradoxically, chose to exit employment with the household names). Whether consciously or not, these investors still would rather partake of the predictable mediocrity of a global fast-food franchise than take a calculated risk on a small, unknown diner with very possibly spectacular food.

Traditional pension fund consultant screens—e.g., minimum size and/or product track record—by definition reinforce conservative biases against emerging firms. Such screens exclude from competition talented new firms with significant performance potential. This is true even when these emerging firms are led by experienced industry professionals with strong prior performance track records.

None of these barriers has blocked the inevitable march toward change. Consultants may not always proactively perform due diligence on emerging managers and recommend the best emerging managers to their clients. But that hasn't stopped their clients from coming to them with requests for information about emerging managers. During a panel discussion at a Progress annual conference, a noted consultant said, "Pension fund consultants as a group are not the leading edge. We are the trailing edge. I got into [emerging managers] when my client said, 'we want to do this.'" [4]

"Part of The Mainstream of Investing"

More and more institutional investors are coming to their consultants and saying, "We want to do this. We want to find some good emerging managers." In fact, there is solid fiduciary support for initiating an emerging manager investment strategy. In our own Progress multi-manager portfolios, for example, 24 of 29 equity and fixed-income funds have outperformed their respective benchmarks since inception for the period ending May 31, 2008, including several with more than 10-year track records.[5]

While plan sponsors frequently refer to these strategies as "programs," these portfolios are just like any other equity, fixed-income or non-U.S. investment strategy. Says New York City's Mr. Haslip, "The real goal of these programs is to get to a point of comfort where you don't need separate programs, to where they become part of the mainstream investing."

Consistent with this view, emerging strategies are evaluated by the same investment metrics plan sponsors use to evaluate any other investment strategy—e.g., accepted industry investment benchmarks and standard risk metrics such as tracking error and information ratio targets. Similarly, plan sponsors should expect their staffs, consultants or manager-of-managers to conduct the same due diligence and use the same criteria to evaluate emerging firms that they use in evaluating well-established companies with substantial AUM.

The primary objective of an emerging manager investment strategy is to deliver investment returns. The additional benefits of diversity, manager diversification, opportunity and inclusion, while important policy considerations, nonetheless are secondary.

Strategies for Investing in Emerging Managers

Investment Vehicles

EXHIBIT 1 - The following is a representative list of known U.S. Pension Plans that have committed assets to emerging manager strategies:

U.S. Pension Plans	
1199 SEIU Employees Benefit and Pension Funds	New York City Fire Department Pension Fund
Alameda County Employees' Retirement Association	New York City Police Pension Fund
Arkansas Teacher Retirement System	New York State Common Retirement Fund
Bank of America Corporation	New York State Teachers' Retirement System
Boeing Company, The	Ohio Public Employees Retirement System
Boulé Foundation	Oregon Public Employees Retirement Fund
California Public Employees' Retirement System	Pennsylvania Public School Employees' Retirement System
California State Teachers' Retirement System	Pennsylvania Treasury Department, The
Chicago Policemen's Annuity & Benefit Fund	PG&E Corporation
City of Kansas City Employees' Retirement System	PPL Services Corporation
City of Philadelphia Board of Pensions and Retirement	Public School Teachers' Pension & Retirement Fund of Chicago
Coca Cola Master Retirement Trust	San Antonio Fire & Police Pension Fund
Contra Costa County Employees' Retirement Association	San Francisco City & County Employees' Retirement System
Detroit General Retirement System	San Joaquin County Employees' Retirement Association
District of Columbia Retirement Board	Seattle City Employees' Retirement System
Exelon Corporation	Shell Oil Company
GE Asset Management	State of Connecticut Retirement Plans & Trust Funds
Illinois Municipal Retirement Fund	State Universities Retirement System of Illinois
Illinois State Board of Investment	Teacher Retirement System of Texas
Indiana Public Employees' Retirement Fund	Teachers' Retirement System of the City of New York
Liberty Mutual Retirement Benefit Plan	Teachers' Retirement System of the State of Illinois
Los Angeles City Employees' Retirement System	Verizon Communications, Inc.
Los Angeles County Employees Retirement Association	
Maryland State Retirement & Pension System	
Massachusetts Bay Transportation Authority Retirement Fund	
Michigan Department of Treasury	
Minnesota State Board of Investment	
Municipal Employees' Annuity & Benefit Fund of Chicago	
New York City Board of Education Retirement System	
New York City Employees' Retirement System	

As emerging managers clear barriers to entry by providing competitive performance, they have grown significantly in number. Not only have their numbers increased, but today there also are many different ways to invest in emerging firms:

Manager-of-Managers (MoM)

Investing in emerging firms through a manager-of-managers has become popular for many reasons. The manager-of-managers approach allows a plan sponsor to invest in a portfolio of emerging managers through a

single point of contact, the MoM. This eliminates the concern noted earlier about becoming too large a percentage of any one manager's asset base. Just as an investor can achieve diversified exposure to micro-cap stocks through a fund, investors achieve diversified exposure to emerging managers through a manager-of-managers. And likely broader, more timely and efficient exposure than a plan sponsor might achieve otherwise through hiring directly—especially if this is the investor's initial foray in this strategy.

For many plan sponsors with limited resources, hiring emerging managers becomes possible by using a manager-of-managers, for several reasons. The manager-of-managers performs due diligence in selecting managers, monitors the managers and rebalances the portfolio, hiring and firing as necessary. The MoM also may provide expert assistance to emerging firms in managing their businesses, just as general partners assist portfolio companies in a private equity portfolio.

Private Equity Fund-of-Funds

Similar to MoMs in the public markets, several plan sponsors have used a private equity fund-of-funds as a means of implementing emerging manager investment strategies. Various Illinois public pension plans, the Virginia Retirement System and the Teacher Retirement System of Texas are among those that have taken this approach in private equity.

Multiple Manager-of-Managers Relationships

A new development is for investors to hire more than one manager of emerging managers with the goal of achieving specialist focus on complementary investment mandates. For example, one large public plan sponsor has as many as four MoMs, each focused on an equity sub-asset class and/or fixed income. These investment strategies are small-cap (Russell 2000 benchmark); non-U.S. equity (MSCI EAFE) and fixed income (custom Lehman Aggregate/Emerging Markets Index); and two MoMs focused on broad equity markets (Russell 3000 benchmark). The New York City Retirement Systems, the New York State Common Retirement Fund, the California State Teachers' Retirement System, the Los Angeles City Employees' Retirement System and several corporate plans are among those that have hired multiple MoMs to implement their respective emerging manager programs.

Direct-Hire

Working with a general consultant, a specialist consultant or with pension staff alone, several pension plans have chosen to hire emerging managers directly. Examples include the Minnesota State Board of Investment and the Illinois State Board of Investment. Several plans, including the nation's largest public plan, the California Public Employees' Retirement System, as well as the Los Angeles County Employees' Retirement Association, have also adopted direct-hire emerging manager programs focused on alternative strategies such as private equity, hedge funds and real estate. In these situations, a plan will invest with an emerging firm as part of its overall asset allocation in the same way that it invests with other external managers. Due to the relative size of emerging managers, the plan in some cases will hire emerging firms for somewhat smaller asset mandates than for other active external managers. As the emerging firms perform, the plan can award larger asset mandates, or even fund more than one product from the same emerging manager.

MoM and Direct Hire

The Illinois Municipal Retirement Fund, the State Universities Retirement System of Illinois, New York City Employees' Retirement System and Shell Pension Trust are all examples of plan sponsors that have hired emerging managers directly and used a manager-of-managers. This dual strategy assures a complementary, comprehensive approach using different criteria for direct versus MoM hiring. For example, in one case a public plan invests directly with larger emerging firms (those with more than $1 billion in AUM), while investing through its MoM in a multi-manager portfolio of emerging firms with $1 billion or less.

Direct Equity Investment

In this model, a plan sponsor takes a hybrid venture capital/public markets approach to investing with emerging managers, providing both operational capital and assets to manage. The plan sponsor potentially receives the benefit of both investment returns on the managed assets and venture capital-like returns when the plan exits its direct equity investments in the emerging managers. The plan will work with an external partner to form an investment fund (partnership or limited liability company) through which the partner can make both the direct private-equity investment in the firm as well as provide assets to manage on the plan sponsor's behalf.

A Nuanced, Thoughtful Approach to Capturing Emerging Manager Alpha

"Because domestic equity isn't what it used to be"

As part of its strategy to pursue alpha in non-traditional ways, New York City's pension plans have invested in emerging managers across asset classes and through diverse investment vehicles, including multiple manager-of-managers and direct relationships.

Not content to accept industry definitions by rote, New York City has created two emerging manager classifications for investing in the public markets: "emerging managers", with zero to $1 billion under management and "developing managers", with $1 billion to $5 billion. "We want to have more exposure to smaller managers in the public marketplace because domestic equity just isn't what it used to be," says Deputy Comptroller for Pensions, Joseph Haslip.

In private equity, New York City defines "emerging" as zero to $400 million under management in first- and second-time funds; in real estate, emerging is defined as zero to $300 million in first- and second-time funds. New York City also is in the process of evaluating a seeding program to make direct private-equity investments in emerging managers.

Providing seed money to emerging managers adds business risk to investment risk, and therefore must be weighed carefully, says Mr. Haslip. He nonetheless views seeding as "an integral component to keep a stable of top-performing talent in the market."

The California Public Employees' Retirement System (CalPERS) has championed this form of emerging manager investment strategy through its first-of-a-kind Manager Development Program (MDP). Since 2000, Progress has had the privilege of working in partnership with CalPERS, along with another service provider, in implementing the CalPERS MDP strategy. One of the most successful MDP graduates from the Progress portfolio to the CalPERS mainstream lineup is Arrowstreet Capital, a Boston-based, quantitative, international equity manager.

Strategies for Investing in Emerging Managers

Asset Allocation Considerations

Once the plan sponsor has decided upon the investment vehicle or vehicles, the next key decision is, "Where will our emerging manager allocation fit within our total portfolio?"

There are many different approaches to answering this question, depending upon the structure of the plan, the proposed allocation to emerging managers and the plan's philosophy of managing assets.

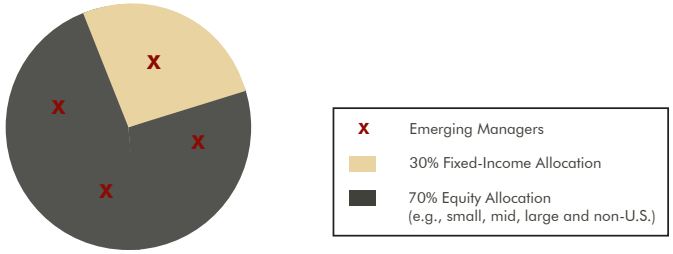
The exhibit below provides a simplified representation of different ways to allocate assets to emerging managers within the portfolio as a whole.

EXHIBIT 2 - Emerging Managers Asset Allocation Models

Part of the Total Allocation

Model 1

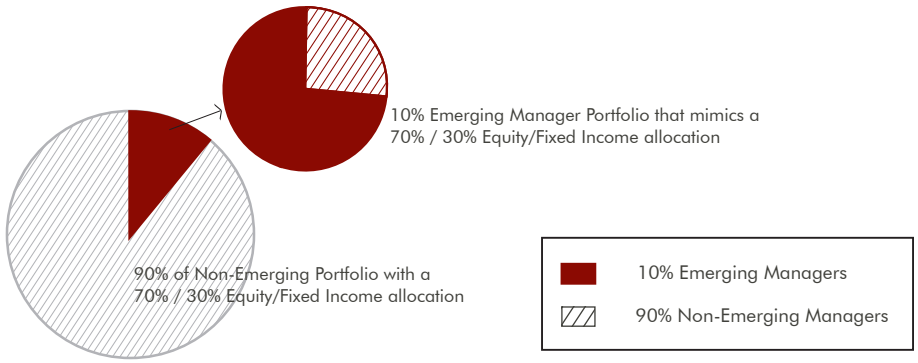
An equity/fixed-income allocation including emerging managers as part of the overall portfolio.



A Separate Allocation

Model 2

A separate emerging manager portfolio mimics the asset allocation of the overall portfolio.



In Model 1, emerging managers are included in the total asset allocation along with non-emerging managers, consistent with the investor's definition of emerging—e.g., $2 billion or less. Model 2 shows a different approach, whereby emerging managers are considered a discrete portfolio designed to mimic the asset allocation of the overall, non-emerging portfolio.

The Maryland State Retirement and Pension System and, more recently, the New York State Common Retirement Fund have developed a best-in-class approach to investing with emerging managers. Both plans created guidelines requiring the MoM to choose only the emerging managers with the highest performance potential, regardless of the benchmark. The goal of these plans is to assemble, through the MoM, a best-in-class emerging manager portfolio as opposed to an optimized fund. The plan sponsor then adjusts the portfolio as a whole for any unintended asset class or factor bets (e.g., size) generated by the best-in-class portfolio.

Strategies for Investing in Emerging Managers

10 Best Practices

We have considered different investment vehicles and asset allocation strategies. Now let's consider 10 best practices to facilitate alpha capture by emerging manager investing.

1. **Do not treat emerging managers as separate or different—it's all about alpha.** In the article preceding this one,[6] I discussed the origin of the term "emerging manager program" as a euphemism for "entitlement program for investment companies owned by women and minorities." Emerging managers today include talented money managers regardless of ethnicity, and the success of these programs in meeting diversity initiatives can be attributed directly to defining "emerging manager" in the broadest possible terms. In setting up an emerging manager investment program, investors should keep a sharp focus on what matters most: strong, long-term investment performance for pension plan beneficiaries.

2. **Incorporate the emerging manager program into the plan's overall investment policy.** As with all aspects of plan governance, the goals and fiduciary philosophy of an emerging manager program should be incorporated into the plan's investment policy statement. Regardless of whether the policy mandates an explicit portfolio allocation (see Best Practice #3 below), the emerging manager strategy should become institutionalized as a long-term part of the plan's mission. It should not be subject to bureaucratic whim or the loss of institutional memory that may occur due to turnover in a plan's trustees, staff or consultant. Says New York City's Joseph Haslip, "We thought it was critical to memorialize this [commitment to emerging managers] in our investment policy. … Sometimes you wonder why these pension plans didn't have these [emerging manager] programs before, and it's no secret why they didn't. Oftentimes, people don't approach investing in emerging managers with the same level of openness to new ideas."

3. **Let performance dictate the size of the allocation over time.** Some emerging manager programs initially establish a fixed allocation for the program—e.g., 1% to 3% of the total portfolio. Placing a ceiling on the initial emerging manager allocation may make sense as a clearly delineated starting point. But we believe that the asset size of the program should reflect its success, and many investors have grown their programs systematically as a function of positive performance. "The reason we allocate more money to our emerging managers is simply because they do well," says one of our clients, the chief investment officer of a mid-sized financial institution. "Our attitude is, 'Emerging managers are competitive—put them on the list!' As opposed to, 'We want to reserve some portion of our allocation specifically for emerging managers.'" Says another Progress client, an investment manager at a large corporate plan: "We have dedicated a portion of our plan to emerging managers. But there is no set dollar amount or percentage. We want to keep our strategy open-ended, to be able to invest more or less in emerging managers based on the opportunities available." This approach allows emerging manager allocations to grow not according to some arbitrary ceiling or quota but according to merit and opportunity.

4. **Be proactive in considering emerging manager sources of alpha—do not rely on your consultant.** You are a pension plan sponsor. One morning, you will be sitting at your desk and your general pension plan consultant will call you and say, "Have you considered emerging managers? They could add a lot of alpha to your plan's portfolio." And then you will wake up and realize it was all a dream. The reality, as one consultant has pointed out, is that plan sponsors—not their consultants—are promoting investment in emerging managers—and rightfully so. To initiate or expand an emerging manager strategy, you will need to be proactive and explicitly directive with your traditional consultant—or work with a specialist consultant or manager-of-managers.

5. **Be dynamic about the size definition of "emerging manager."** In an earlier article,[7] I discussed how a key definition of "emerging"—size of AUM—has evolved with the growth of the asset management industry. In 1990, when Progress began investing in emerging managers, we defined "emerging manager" as $500 million or less. Today, we define it as $2 billion or less, and some of our corporate clients have raised their emerging manager ceilings to $3 billion and even to $5 billion, depending upon the asset class (e.g., higher for fixed-income managers due to different scale considerations). It is important to not let the definition that guides your program remain static when the world around you is changing. When the largest asset managers have grown to more than $1 trillion in AUM, for example, you may need to ask, "Is $2 to $3 billion still an appropriate ceiling for an emerging firm?" By raising this ceiling with the growth of industry AUM, institutional investors broaden opportunities for smaller companies while broadening their own universe of alpha possibilities.

6. **Clarify how the definition of "emerging" should operate.** Another implementation issue that raises compliance concerns is how to treat firms that grow beyond the size definitions written into program guidelines. Many plan sponsors have chosen to define emerging managers as those with less than $2 billion in AUM. But what happens when a firm grows successfully beyond that $2 billion ceiling? Is that firm still an "emerging manager"?

   Our experience at Progress suggests that the firm should still be considered emerging. If such a firm does not maintain its emerging status, then it may fall into a no-man's land too large for the emerging program but too small to be considered for direct-hire or stand-alone mandates. This results in a program anomaly that doesn't create a "win/win" for clients or emerging firms. The key here is whether the emerging firm is below the AUM ceiling at the time of funding the manager for the program. An emerging firm that outperforms and demonstrates the capacity to gather and manage additional assets should be awarded additional assets—not penalized. As long as that firm fits the asset size definition at time of funding and continues to outperform, our preference is to allow that firm to remain in our programs regardless of subsequent AUM size—or to graduate the firm to direct-hire assignments with our clients. (Also see Best Practice #10 on the merits of establishing a clear graduation policy at the start of an emerging manager investment strategy.)

Experienced Emerging Manager Professionals

- More than 50% of founders or portfolio managers have 11 to 25 years of industry experience before founding their firms
- 76% of key portfolio managers have 16 to 25 years of experience
- 62% of key portfolio managers have more than 25 years of experience

Based on a 2006 study of the Progress funded-manager universe of 62 emerging firms.

7. **Stimulate product innovation through program flexibility—fund emerging products as well as emerging firms.** As the emerging manager universe has matured, emerging firms have become adept at developing new investment products. A Progress study shows that, although many of these firms are new and/or smaller in size, most are led by veteran investment industry professionals (see sidebar opposite). Not-withstanding their professional experience and relative success in performing and gathering assets, many firms nonetheless still face significant barriers to entry when introducing new products. This holds true even for companies with total firm AUM far in excess of the typical $2 billion to $3 billion ceiling. We, therefore, believe that the next generation of emerging manager program design should allow more flexibility to:

   (1) seed new products of funded emerging firms (subject to the new product successfully meeting the investor's due diligence criteria)

   (2) seed and include emerging products from firms larger than the program's AUM ceiling, where such products are otherwise competitive and suitable for a client portfolio

   (3) fund other innovative investment strategies in an "opportunistic" portfolio component

   In no event should this opportunistic component of an emerging manager strategy represent more than 10% to 15% of total emerging manager program assets.

   Progress has had positive experiences funding the second generation of products from existing funded firms with proven alpha engines, personnel and processes. We also have had positive experiences funding the second

generation of emerging firms—i.e., start-ups where the founder comes from a previously funded Progress emerging manager. Many of our emerging program mandates, however, unfortunately do not allow us the flexibility to exploit these potential alpha opportunities on behalf of our clients. We believe that greater program flexibility not only would provide more alpha possibilities, but also would stimulate product innovation and make emerging managers more competitive for the future.

8. **Extend emerging manager allocations across asset classes.** In most existing emerging manager programs, asset allocation has been focused largely on U.S. equities, followed by U.S. fixed-income, U.S. private-equity and, more recently, non-U.S. equities. Hedge funds (many of which by definition are emerging firms) are likely the next asset class where institutional investors will seek emerging talent. The experience and quality of emerging manager portfolio managers, as well as the breadth of products now available from emerging firms, support the extension of emerging manager program allocations to all asset classes:

   Traditional Asset Classes
   U.S. and non-U.S. equities—across styles and market capitalizations
   U.S. and non-U.S. fixed-income—including core, core-plus, high-yield and convertible strategies

   Alternative Asset Classes
   Private Equity—venture, buyout and distressed
   Real Estate—core and opportunistic
   Hedge Funds—including absolute-return, market-neutral and long/short strategies

9. **Consider whether to invest directly or via an emerging manager-of-managers, or both.** Just as investors dipping a toe into the waters of private equity often start with a fund-of-funds, many plan sponsors initiate their investment in emerging managers through a multi-manager portfolio run by a manager-of-managers. This makes sense because selecting emerging managers is time-consuming and requires a different skill set from that used to select established firms. Many of the traditional performance-measurement techniques simply do not apply or must be applied with considerable insight.

   In making the decision to invest directly or through a manager-of-managers, a plan sponsor needs to consider the size of its staff and its capacity to monitor additional smaller managers. As discussed earlier in this article, plan sponsors choose the MoM approach as an efficient way to gain access to multiple emerging managers through a single, expert point of contact.

   As emerging managers grow their assets with continued strong performance, the plan sponsor gains familiarity and comfort with certain managers and may decide to hire those managers directly (see Best Practice #10 below). Rather than terminate the MoM relationship, many of these plans graduate the top-performing managers to direct-hire relationships, while retaining the MoM as an evergreen conduit to fresh new talent.

10. **Establish a well-defined graduation policy at the start of the program.** A clearly planned graduation or exit strategy for emerging firms can create an even more compelling motivation for emerging managers to perform and grow. Over the years, we have urged our clients to think about this important component of their emerging manager investment strategies at the program inception stage—i.e., before they have a need for new talent. Perhaps the most compelling reason for an emerging firm's transition to a stand-alone mandate is a client's need for an emerging firm's style-specific capabilities in its overall asset allocation. Another primary benefit for a plan sponsor is to leverage its emerging manager talent pool to mitigate future manager-search expense by using top-performing firms for future direct hire or mainstream assignments.

    In addition to asset growth, the graduating manager should have sufficient tenure in the program and sufficient operational, reporting and compliance infrastructure to instill confidence in its ability to manage a significantly larger mandate. Many institutional-client stand-alone mandates for external managers range from $100 million to $500 million. Several Progress clients have successfully incorporated a graduation component as an integral part of their emerging manager programs. The Public School Teachers' Pension & Retirement Fund of Chicago and the New York State Common Retirement Fund are leading examples, with multiple emerging direct-hire graduates.

The Opportunity To Compete = An Opportunity For Everyone To Win

Emerging managers do not want special favors. They want an opportunity to compete. But the biggest barriers to true competition are still fear of change and comfort with the status quo. If pension plans continue to invest primarily in household names based on this comfort factor—and our research shows that they do—they are doing an immense disservice to their beneficiaries. Despite the proven performance track record of these talented, entrepreneurial firms, institutional investment portfolios on average have invested only a small percentage—typically 1% to 3% of their assets—in emerging investment strategies.

At Progress, our mission is to change this practice by crafting innovative alpha strategies that deliver value for investors. In partnership with our clients, our vision is "to become the company most known for changing the face of the investment management industry." By removing unneeded barriers and granting emerging managers the opportunity to compete, institutional investors democratize capital, thereby making the investment industry as a whole more robust and competitive—a better future for all.

Based upon investment performance and sound fiduciary policies, our hope is that more institutional investors will embrace these proven investment strategies. As a result, when we build successful emerging manager investment programs, we create "win/win/win" synergies—for clients and their beneficiaries, for emerging managers, and for our industry.

This is the second 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. For a complete bibliography of studies documenting the performance advantage of investing with emerging managers, please visit www.progressinvestment.com.
2. White, Thurman, "Small Isn't What It Used to Be: The Changing Face of Smaller Investment Firms," June 2003, the Institute for Fiduciary Education.
3. Ibid.
4. "What the Research Tells Us About Emerging Managers," panel discussion at the 2004 Progress Plan Sponsor and Emerging Manager Conference, Scottsdale, AZ. Note: This panelist has co-authored one of the most comprehensive, authoritative studies on emerging managers: "A Review of Developing Managers and Developing Manager Programs," April 2003, by Allan Emkin, Neil A Rue, CFA, Jeremy Thiessen and Sandra Parker. This paper is available under "Research" at www.pensionconsulting.com.
5. Progress Investment Management Company, LLC - Investment Committee Report, p. 1, May 2008.
6. White, Thurman, "From Diversity to Diversification—The Evolution of the Term 'Emerging Manager,'" July 2008.
7. Ibid.