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# Emerging Managers In Review

## Bivium's 5th Annual Investor Summit

October 14, 2015

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# History of Emerging Manager Investing

## An Evolution

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|---|---|
| 1980s | Term "Emerging Managers" is used to describe undiscovered money managers, typically with assets under management of less than $500 million. |
| 1990s | According to the National Investment Managers Association, minority-owned firms and women-owned firms (MWBE) managed roughly $2 billion in assets. These firms also became categorized as "emerging managers". |
| 1996 | Passage of Proposition 209 in California which prohibited governmental institutions from considering "race, sex, color, ethnicity, or national origin", specifically in the areas of public employment, contracting, and education. |
| | Plan sponsors begin to focus on emerging manager searches, rather than on MWBE manager searches; however, MWBE firms win a majority of the slots in emerging manager searches |
| 2000s | Expansion of Manager of Managers programs and a shift towards best-of-breed and potential performance advantages. |
| 2002 | **Bivium Capital Partners formed.** |
| 2009 | Illinois Public Act 96-0006 revised the definition of "emerging investment manager" as "a qualified investment adviser that manages an investment portfolio of at least $10 million but less than $10 bilion and is a 'minority owned business', 'female owned business' or 'business owned by a person with a disability'…". |
| | Re-emergence of diversity as a more explicit consideration in certain programs. |
| 2014 | Emerging firms (with AUM <$2 billion) manage approximately $340 billion in assets. Those classified as MWBE manage approximately $360 billion (Payden & Rygel being the largest at $83 billion). |

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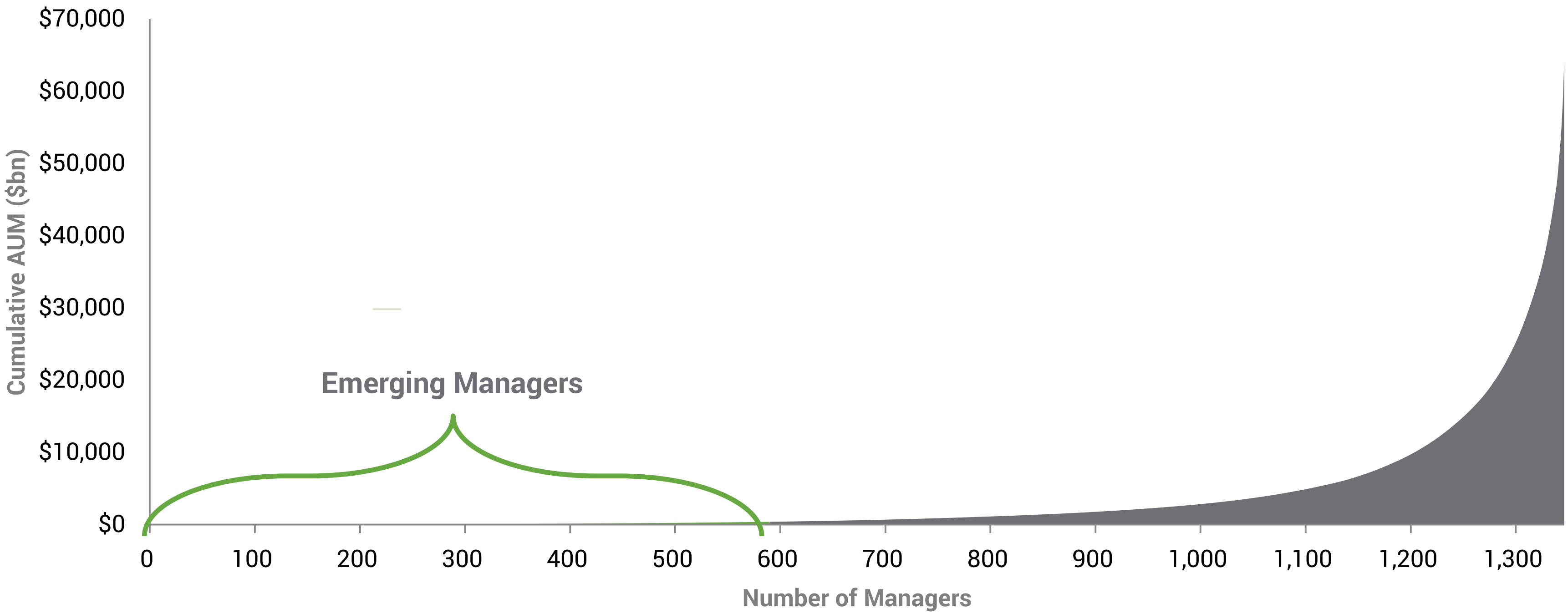
Sources: Bivium, Plan Sponsor, P&I, eVestment Alliance

# The Asset Management Industry

## Concentration at the Top




- As of the end of 2014, total asset management AUM was over $64 trillion. The top ten firms controlled around 31% of the assets. BlackRock alone oversaw $4.7 trillion.
- Emerging managers (defined as those with AUM below $2B) represented approximately 44% of firms in the universe but managed less than 1% of total industry assets

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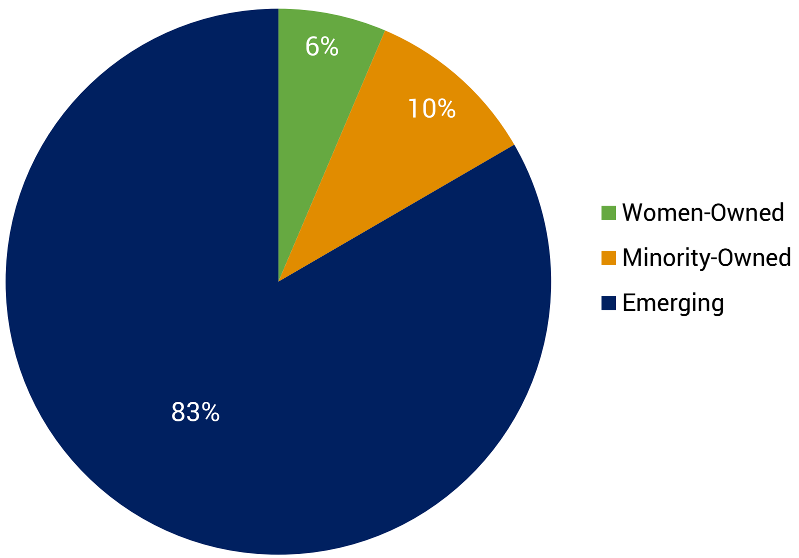
Sources: Bivium, eVestment Alliance

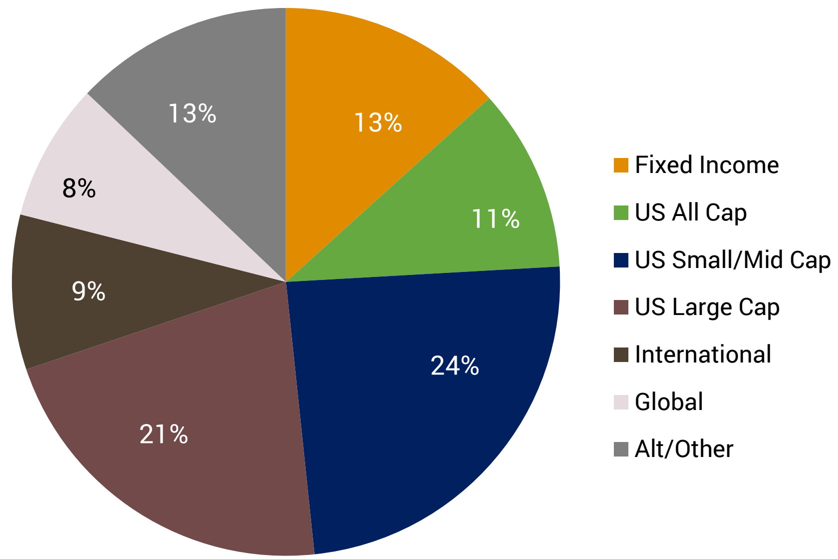
# The Emerging Manager Universe

## Classifications and Concentrations

### MANAGER CLASSICATIONS[1]




### PRODUCT CONCENTRATIONS[2]

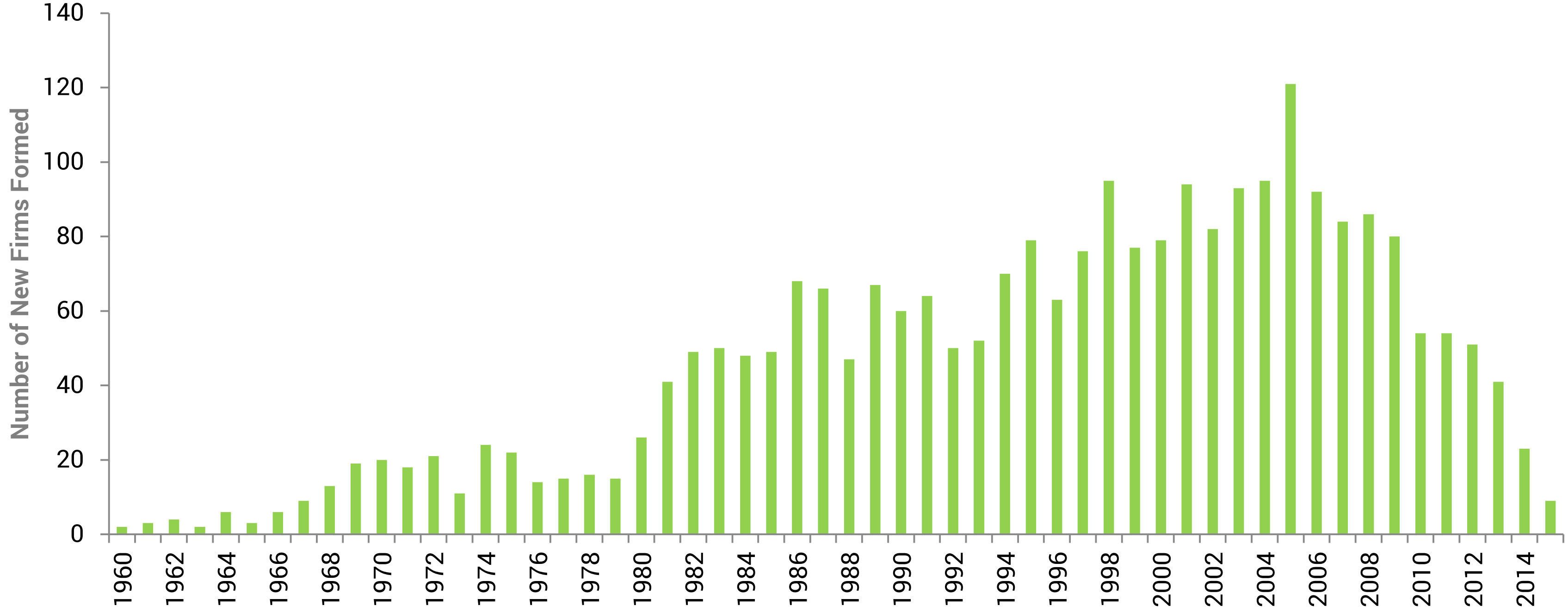



- There are 590 Emerging managers (AUM <$2 billion) in the Bivium database, 90 are minority- or women-owned. On the diversity front, there are another 34 MWBE firms with assets greater than $2 billion.
- For the Emerging managers, equity mandates constitute 73% of assets, with the bulk in US equity strategies (56%).

Sources: Bivium, eVestment Alliance
Note: (1) A firm is classified as (1st) minority, (2nd) women, and (3rd) emerging. Total number of firms is 1329. Firms defined as minority or women owned have greater than 50% minority or women ownership. Emerging Firm defined as AUM less than $2BN. As of 12/31/2014. (2) As of 12/31/2014.

# Challenging Time for New Firm Formation

## Declining Trend Since the GFC




- Since peaking at 121 firms in 2005, the number of new firms formed each year has sharply declined. Failure rates are harder to determine but, anecdotally, tend to be concentrated in alternative strategies rather than traditional.
- A change of personal risk assessments post the financial crisis of 2008 along with a challenging environment for active management may be some of the drivers of the recent trend.

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Sources: Bivium, eVestment Alliance

# State of the Emerging Manager Industry

## Diverse Group of Allocators

| | |
|---|---|
| **Programs** | 67 |
| **Total Assets** | $35 billion ($22 billion MoM / $13 billion direct) |
| **Mandates** | 111 MoM / 176 direct |
| **Managers** | Approximately 160 (in traditional MoMs) |

- The vast majority of sponsors were public plans. A handful of corporate sponsors had programs but did not disclose assets invested. E&Fs were notably absent, but that may be more attributable to classifications than a lack of interest.
- Many of the larger plans utilized a combination of manager of managers and direct investments.



Sources: Bivium, FINsearches, Emerging Manager Monthly

# A Typical Program
## Tailored to the Sponsor's Specific Goals

### Definition

- Qualification as an Emerging Manager is usually based on AUM.
- Most sponsors use a threshold of $2 bn, but this could be as large as $10 bn.
- Firms are independent (>50% employee-owned)

### Other Considerations

- Some sponsors incorporate diversity and geography considerations.
- These may be explicit or best-efforts.
- There may be limits on how much of a firm or product's assets the sponsor is comfortable with (eg 10%).

### Graduation Policy

- Graduation is ideally the transition of a firm from the emerging portfolio to the mainstream portfolio.
- AUM tends to be the trigger for an evaluation, but the determination is generally subjective.

PORTFOLIO

- Most programs are run as portfolios (eg benchmarked against broad market indexes). This may lead to selection bias in certain asset classes, particularly when diversity is considered.
- In Alternative asset classes, the AUM threshold for an Emerging firm is typically lower ($250 mm to $500 mm) with consideration given to the stage of the fund (ie first-, second-, or third-time funds) and length of track record.

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# Graduation In Practice

## A Question of Coordination

### Graduation Candidate

- Firm passes overall AUM threshold
- Shows strong relative performance
- Stable firm ownership and investment team
- Considered in mainstream searches

| | |
|---|---|
| (green) | Graduate into the Mainstream Program |
| (yellow) | Stay in the Emerging Program |
| (red) | Graduate to “Nowhere” |

- There are often no **definitive** paths for a graduating manager.
- **Timing** and differing **priorities** (between the Emerging portfolio and the Mainstream portfolio) tend to reduce the frequency of successful graduations.

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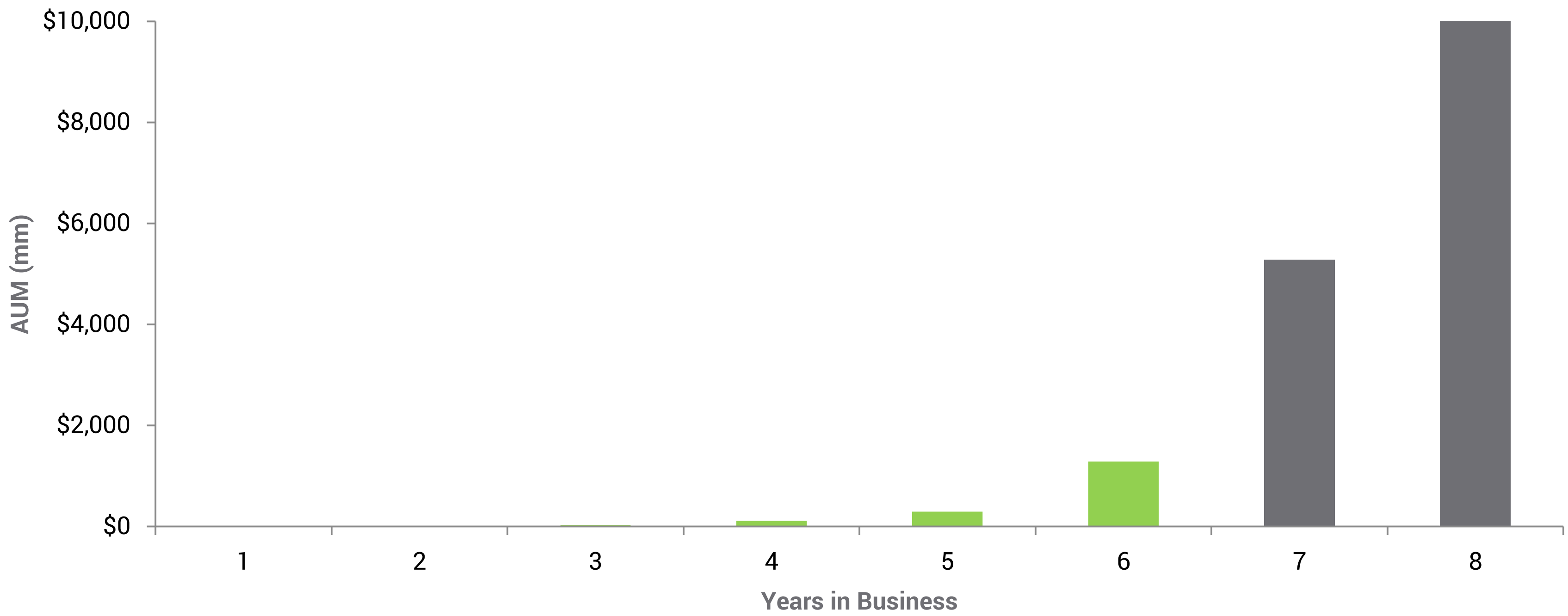
# The Desired Path of Growth

## Good for the Manager, But Good for the Program?




- This firm was founded in 2007 by a seasoned investor coming out of a larger boutique asset management firm. They opened to outside investors in 2010 after building out an institutional team and infrastructure.
- The firm closed to new investors in early 2015. Graduation at this point would leave a limited opportunity to increase exposure. Fees may also be less favorable for additional assets.

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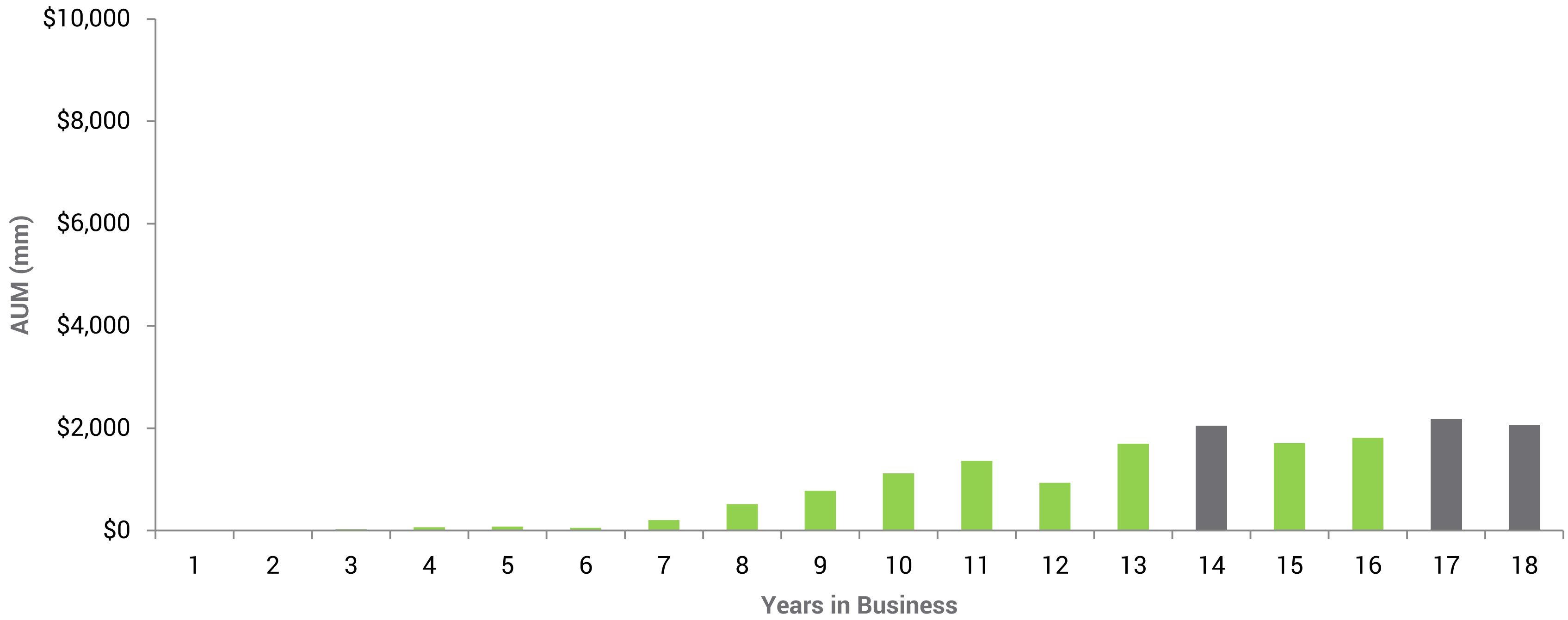
Sources: Bivium, eVestment Alliance

# The More Probable Reality

## A Long Journey




- This firm was founded in 1996 by a former financial consultant. It took 14 years to reach the "graduation" threshold. AUM has somewhat plateaued from there.
- This illustrates the "Emerging Gap" – a firm may become too big for emerging but too small for mainstream searches. The average Large Cap search is for $100 million. The average Small Cap search is for $65 million.

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Sources: Bivium, eVestment Alliance

# Drivers of AUM Growth

## Performance Is Only One Aspect

| | |
|---|---|
| Reputation | Principals are well-respected in the industry by consultants and clients |
| Infrastructure | Firm projects “institutional client ready” |
| Performance | Results over the critical first three years should be strong on a peer and benchmark relative basis |
| Asset Class | It helps to be in an asset class that investors are interested in and allocating to |
| Market Cycle | Some environments are going to be easier to start in than others (and it does not need to be a bull market) |

- Four out of five of these factors do not necessarily equate to value add for the sponsor. However, many graduation policies are driven by AUM considerations.
- For a new firm, breakeven AUM is typically around $200 - $300 million.

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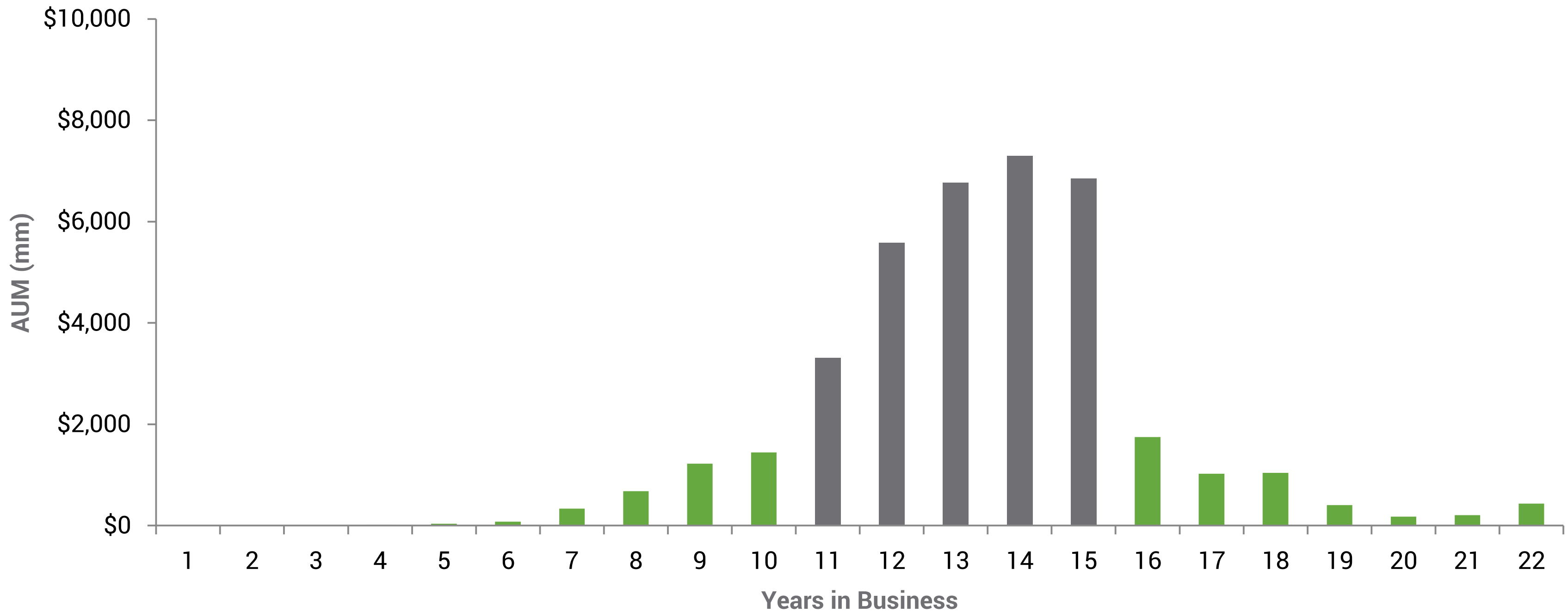
# A Cautionary Tale

## Success Can Be Fleeting




- This firm was founded in 1993 by a sell-side financial analyst. Having seen tremendous growth in the early half of the 2000s, a run of poor relative performance resulted in significant asset loss.
- Performance over the last several years has improved meaningfully, but only a much smaller base of clients participated in the rebound.

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Sources: Bivium, eVestment Alliance

# Redefining Graduation

## A Practical Evolution Focused on Improving Outcomes

### Graduation Candidate

- Firm passes revenue threshold to alleviate business risk
- Shows strong relative performance
- Stable firm ownership and investment team
- Operational maturity

Graduate into the Mainstream Program

Stay in the Emerging Program

Graduate to a "Bridge" Program

- Graduation should be thought of a "pull" from the emerging pool rather than a "push" from it.
- As long as the manager is adding value, the program should continue supporting the firm until it can fully qualify for mainstream searches. The threshold between Emerging and Mainstream becomes more fluid.

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# Closing Thoughts

## Redefining "Success" For Everyone

| | |
|---|---|
| Focus on Outcomes | Look at what is achievable by investment managers and focus on value-added outcomes of the sponsor. |
| Be Early | Build comfort in allocating earlier and more meaningfully in emerging managers by focusing on "true" operational risk. |
| Integrate Better | The Emerging program should be considered an integral part of the overall portfolio rather than a stand-alone allocation. |
| Embrace Flexibility | There should not be a one-size-fits-all approach to moving firms from the emerging portfolio to the mainstream portfolio. |
| Be Innovative | Consider a VC/bullpen model to identify and support future stars, with the acceptance that some investments may not yield results. |
| Invest in Future Diversity | When assessing diversity, look beyond ownership to key decision makers. Plant the seed for the next generation. |

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