Insights on...

EMERGING MANAGERS

NO CONTEST: EMERGING MANAGERS LAP INVESTMENT ELEPHANTS

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Our most recent study indicates that emerging managers may help investors squeeze more out of their most important, and most challenging, asset class – core large cap U.S. equities. Despite market declines and portfolio reallocations, U.S. equities still make up the largest portion of many institutional client accounts[1], which make them a key driver of performance. Consequently, even small improvements in core equity returns can provide greater dollar benefits at the total fund level than bigger wins in peripheral asset classes. Emerging managers' investment performance also covers a broader range of returns, as shown in Figure 3. This makes due diligence all the more important for investors – the potential downside for selecting the wrong manager is larger, but so too is the potential reward for selecting the right manager.

SMALL FIRMS WIN AGAIN

In this, our eighth study[2] of emerging managers – which we define (see Fig. 1) as the smallest firms making up the last 1% of institutional market share – we find once again that they often can provide better returns and, strikingly, better downside performance than the household names. Investors seeking an edge should consider the following:

- Firms with less than $3.6 billion[3] under management gained 0.67% per year in their active large cap U.S. equity portfolios for the **five years ending June, 2010[4].** This equally weighted composite result outperformed the largest firms and all other groups studied, as well as the S&P 500 Index, which was down –0.80% per year over the same period (Fig. 2).
- Small firms tend to reduce risk when it counts the most – in bear markets. The emerging manager composite outperformed the S&P 500 Index in five of the eight bear quarters over the past five years (Fig. 4) by a cumulative 3.65% – the best results of the groups studied. They were also the only group with total volatility less than the index (18.1% per year versus 18.5%).

FIGURE 1: MARKET STRUCTURE OF LARGE CAP ACTIVE U.S. EQUITY INSTITUTIONAL MANAGERS

CLASS	FIRM AUM ($B)	# OF FIRMS	# OF PRODUCTS	SHARE OF TOTAL AUM (%)	CUMULATIVE SHARE (%)
1	124+	24	91	75	75
2	32 – 123	27	84	15	90
3	11.4 – 32	32	56	5	95
4	3.6 – 11.1	57	92	4	99
5	0.01 – 3.6	144	181	1	100
Total	$12,348 Billion	284	504	100	100

Source: eVestment Alliance, Marietta, GA, as of August 2010

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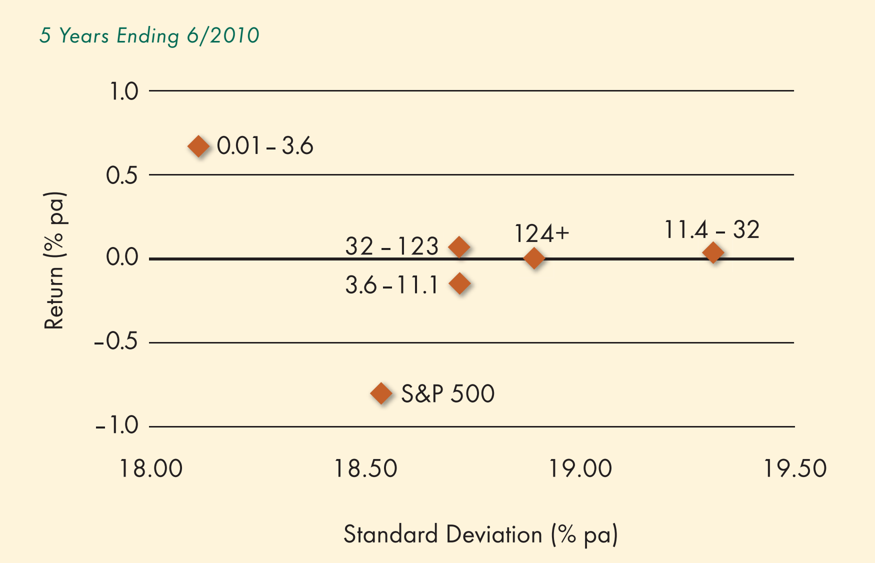
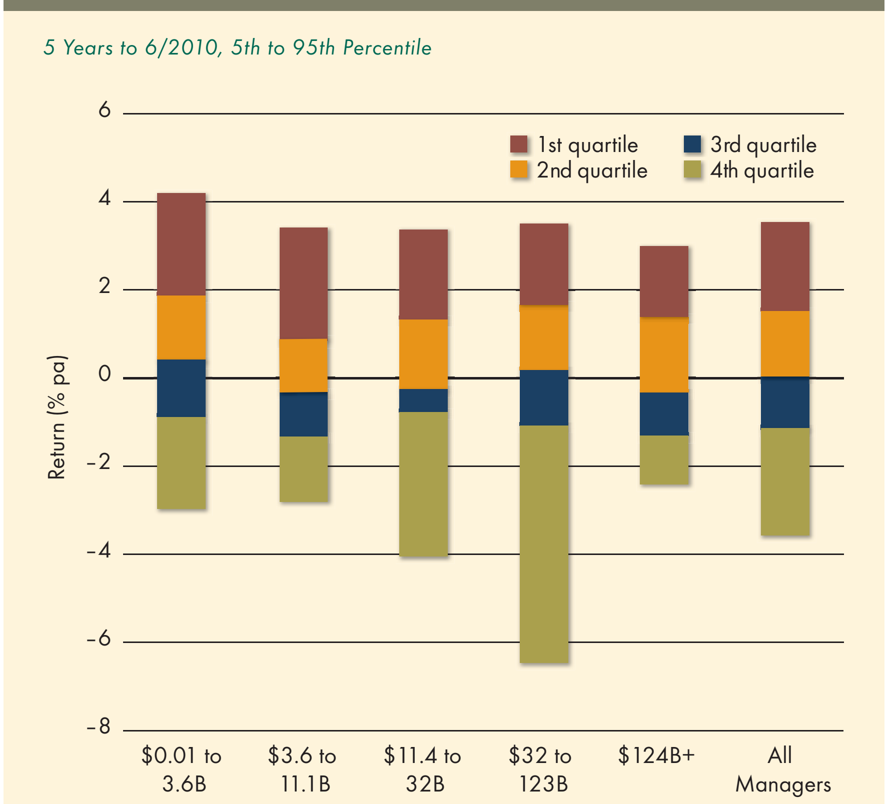
FIGURE 2: COMPOSITE PERFORMANCE BY FIRM AUM ($B)



Source: eVestment Alliance, Marietta, GA, as of August 2010

FIGURE 3: LARGE CAP PERFORMANCE BY FIRM AUM



Source: eVestment Alliance, Marietta, GA, as of August 2010

- The median small manager outperformed the median large firm by 72 basis points per year (Fig. 3), an advantage of more than $7 million on a typical $200 million institutional allocation over five years. The corresponding edges at the top and bottom quartile marks were 53 and 49 basis points, respectively. These spreads directly enhanced the financial return on dollars invested in manager research when applied to the emerging firm universe.
- When all active large cap U.S. equity products are pooled into a single universe, emerging managers make up 44% of the top performance quartile and only 28% of the bottom quartile, versus 36% of the overall pool. Large firm results are skewed in the opposite direction (Fig. 5). These results suggest that clients potentially can increase their chances of hiring a winner by expanding their search into the emerging universe.

MORE CONCENTRATION, WORSE RESULTS

Despite a decade of flat markets and weak returns, the largest investment firms keep getting larger. In 2001, for example, the top 30 firms had a cumulative 75% market share by assets under management, which ranged from $95 billion to $1.6 trillion. By the end of 2009, it took only the top 18 firms to make up the same 75% total market share, with AUM ranging from $215 billion to $3.3 trillion![4]

A large portion of these stunning totals is in fixed income or other asset classes other than U.S. equities, but the numbers clearly show how large the bulge bracket has grown. Increasing

FIGURE 4: MANAGER PERFORMANCE BY SIZE CLASS IN UP VS. DOWN MARKETS

5 Years Ending 6/2010

UP MARKET QUARTERS					
FIRM AUM ($B INITIAL)	QUARTERS AHEAD	AVERAGE RELATIVE PERFORMANCE	QUARTERS BEHIND	AVERAGE RELATIVE PERFORMANCE	OVERALL AVERAGE RELATIVE PERFORMANCE
124+	8	0.53	4	–0.37	0.23
32 – 123	9	0.48	3	–0.51	0.23
11.4 – 32	10	0.72	2	–0.78	0.47
3.6 – 11.1	8	0.52	4	–0.55	0.16
0.01 – 3.6	7	0.65	5	–0.67	0.10
DOWN MARKET QUARTERS					
FIRM AUM ($B INITIAL)	QUARTERS AHEAD	AVERAGE RELATIVE PERFORMANCE	QUARTERS BEHIND	AVERAGE RELATIVE PERFORMANCE	OVERALL AVERAGE RELATIVE PERFORMANCE
124+	3	2.31	5	–0.58	0.22
32 – 123	3	1.84	5	–0.42	0.21
11.4 – 32	3	1.54	5	–0.59	–0.09
3.6 – 11.1	3	1.70	5	–0.39	0.20
0.01 – 3.6	5	1.53	3	–0.27	0.72

Source: eVestment Alliance, Marietta, GA, as of August 2010

FIGURE 5: COMPOSITION OF FULL SAMPLE PERFORMANCE QUARTILES BY FIRM SIZE CLASS

	FIRM AUM ($B)					
QUARTILE	$0.01 TO 3.6B	$3.6 TO 11.1B	$11.4 TO 32B	$32 TO 123B	$124B+	ALL
1	44%	12%	10%	18%	16%	100%
2	40%	17%	8%	17%	17%	100%
3	32%	21%	17%	14%	15%	100%
4	28%	22%	10%	17%	24%	100%
Weight in Full Sample	36%	18%	11%	17%	18%	100%

Source: eVestment Alliance, Marietta, GA, as of August 2010

market concentration, a steady trend over the past two decades, was dramatically accelerated by the TARP and forced mergers of the past 18 months. While much ink has been spilled over "too big to fail" and concentration in the banking business, consolidation in asset management has gone largely unnoticed.

These large firms effectively *are* the financial markets in which they operate, in terms of assets, transactions and personnel. When markets enter a downdraft, trillion-dollar firms (of which there are now at least six) may have difficulty stepping aside. We believe that small entrepreneurial firms, in contrast, may benefit at such times from management focus, rapid decision processes and fewer liquidity constraints.

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CLIENT PERSPECTIVE

Institutional clients now face an extreme combination of performance pressure and market uncertainty, while working with tight expense budgets and fewer staff professionals. Every dollar, and every decision, counts. Under these circumstances, it can be immeasurably easier for investment committees to go right on giving their assets to the surviving marquee names in the asset management industry. Such market biases have rewarded large firms' investment mediocrity with business success, time and time again.

Emerging managers offer a different approach that may bring different and perhaps better results. To be sure, investing directly with smaller firms may involve greater administrative effort, due diligence or non-investment business risks. We recommend a manager-of-managers structure to address these concerns. Well-designed multi-manager programs do entail an additional layer of management fees as compared to direct investment, but they can also provide diversification and allow clients to work around the capacity limitations of individual small firms.

NOTES

1. Northern Trust Investment Risk & Analytical Services Fund Universe Book, Second Quarter 2010.
2. See "Potential Benefits of Investing with Emerging Managers: Can Elephants Dance?" *Journal of Investing* (Spring 2007) for full details.
3. While the term "emerging manager" has often been defined as a firm with less than $2 billion in assets under management, there is no clear consensus on this point. Our research series, the longest-running consistently repeated study of emerging firms in the industry, defines the group as the smallest firms that collectively manage 1% of all assets managed by the full sample.
4. Analysis of data provided by eVestment Alliance, Marietta, GA as of August 2010.