



## THE 4Ps OF EMERGING MANAGER SELECTION

### Executive Overview

When evaluating emerging managers (EMs), institutional investment advisors consider a diverse array of individual characteristics. This study proposes that the individual characteristics can be classified into a framework of four distinct groups – Performance, Process, Personnel, and Platform. This paper will discuss each of these “4Ps” and highlight the emphasis that emerging managers’ place on these attributes when marketing their firms.

### Introduction

There are many nebulous aspects of the EM space. Even the definition of emerging managers is somewhat vague. While many in the industry loosely define them as firms with less than \$2 billion in assets under management (AUM), some evaluators identify these managers by more specific characteristics. For instance, FIS Group, an asset management and investment advisory firm that specializes in emerging manager portfolio construction, broadly defines EMs as “investment firms with an investment track record of less than five years and less than \$2 billion in assets under management.”<sup>1</sup> Meanwhile, Progress Investments, a manager of emerging managers, defines an emerging manager as a “registered investment advisor that has at least 51% employee ownership and \$2 billion or less in assets under management at the time of the initial evaluation.”<sup>2</sup>

After speaking with numerous investment professionals and experts, including institutional investment consultants, advisors and managers, retail platform managers, industry publication reporters and a C-level executive responsible for overseeing a \$40-50 million pension fund, this study identified a variety of approaches relating to the evaluation and ultimately vetting of emerging managers. However, while differences exist between the individual characteristics that institutional advisors find most influential, all of the varying factors and considerations can be classified into one of four distinct groups – Performance, Process, Personnel and Platform.

Evaluators of emerging managers do not look at firms’ characteristics in isolation, but rather at the qualities of an organization as pieces of a whole. The people, firm background, investment philosophy, performance, organizational structure, and business plan for the future all combine to form “a mosaic.” It is this montage that effectively serves to differentiate firms and lead to fund selection. Having identified the four distinguishing factors that emerging management consultants consider and the subsets of these groups, a survey was co-branded with and distributed by Emerging Manager Monthly to over 800 paying subscribers (66 respondents completed the survey), in order to ascertain the degree

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<sup>1</sup> <http://www.fisgroup.com/investment-products/manager-of-emerging-managers/>

<sup>2</sup> [http://www.progressinvestment.com/faq\\_investors.php#emerging\\_manager](http://www.progressinvestment.com/faq_investors.php#emerging_manager)

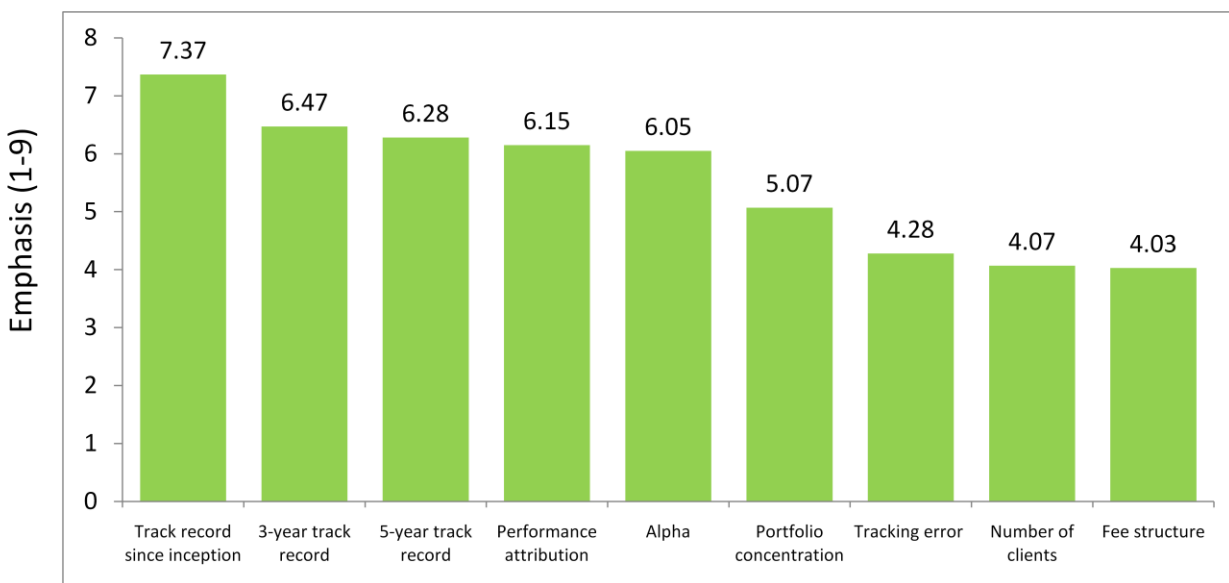
to which EMs attempt to differentiate themselves on the basis of the 4Ps<sup>3</sup>. In the paragraphs that follow, the paper aims to highlight the comments collected throughout the course of interviews (n=20) to provide a lens into institutional advisors' thought process, and to analyze survey data to determine whether the marketing mix of emerging managers is optimal.

## The 4Ps: Performance, Process, Personnel, Platform

### I. Performance

#### Exhibit 1

Emphasis placed on Performance-related attributes in the creation of marketing collateral by emerging managers (*author's note, 0=N/A and was omitted from evaluation*)



“Performance matters.” Not surprisingly, this comment was the most consistent thread among all of the interviews conducted with institutional investment consultants and retail platform managers. Although the phrase was usually delivered off-the-cuff, upon further pressing, a number of more nuanced insights were gleaned. Performance is actually comprised of several components with various weights as determined by consultant or institutional investor. Gross returns, alpha, attribution, benchmarking error and fees all play a roll, not to mention the various esoteric factors that are difficult to measure – as in the case of one consultant who claimed to view recent underperformance as a positive selling point, due to a natural regression to the mean.

A constant struggle for emerging managers and consultants alike is convincing institutional money of the benefits of investing with short track-record managers. Substantial research has been conducted on this subject, and the data has strongly supported the premise that investment managers with limited portfolios (<\$2B) can use their flexibility to achieve outsized levels of alpha relative to their larger portfolio (>\$2B) peers. A study by Northern Trust found that the smallest asset managers composed 39.1% of the top quartile in performance rankings, although these asset managers accounted for only

<sup>3</sup> <http://www.emergingmanagermonthly.com/advertise/>

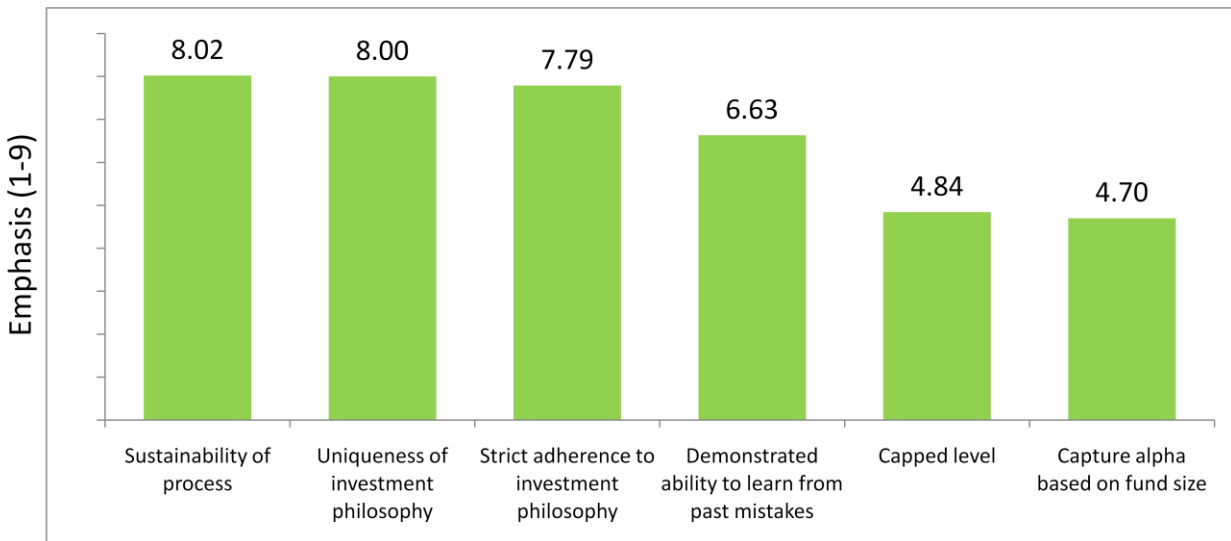
22% of the total sample<sup>4</sup>. Conversations with market participants indicate that the divergence of these returns is likely even more skewed at the lower ranges of AUM.

Given the theory that smaller funds are able to generate more alpha, it was surprising to see survey results that indicated managers with under \$100M in AUM actually under-emphasize the alpha-generating value of a PM managing a smaller fund. 59% of these respondents indicated that their firms did not place a significant marketing emphasis on the alpha-generating value of a small fund (which, for the purpose of this analysis, was defined as a survey ranking of 1, 2, or 3 on a 1-9 scale). Managers with over \$100M in AUM placed greater importance on this fact, with only 26% of these respondents giving it a low marketing emphasis.

**II. Process**

**Exhibit 2**

**Emphasis placed on Process-related attributes in the creation of marketing collateral by emerging managers (author’s note, 0=N/A and was omitted from evaluation)**

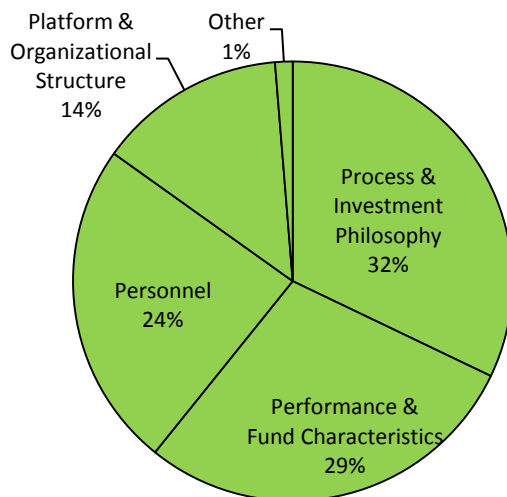


Consultants generally indicated that although performance allows an emerging manager to get through the proverbial “door,” the investment process, which incorporates many qualities of an investment manager’s philosophy and stock picking methodology, tells a more compelling story and enables firms to better differentiate themselves. According to one advisor, “Performance takes a back seat to philosophy – performance can vary, but I need to know that the investment process is sound.” This comment is reflective of a general sense in the entire market, both for institutional investors and fund managers alike. Survey respondents identified Process as the single most emphasized “P” in their marketing collateral (garnering 32% of the total marketing efforts vs. 29% for fund performance, which received the second most emphasis) (Exhibit 3).

<sup>4</sup>[http://www.ac.northerntrust.com/content//media/attachment/data/white\\_paper/0908/document/elephantsdance\\_wp.pdf](http://www.ac.northerntrust.com/content//media/attachment/data/white_paper/0908/document/elephantsdance_wp.pdf)

### Exhibit 3

#### Percentage of emphasis respondents said the 4Ps played in their firm's total marketing efforts



Process is possibly the most ambiguous “P,” with its composition varying dramatically depending on interview subject. As one consultant pointed out, “there is no way to apply a definition to what constitutes a sound investment process.” Uniqueness, sustainability, strict adherence to investment process, demonstrated ability to learn from past mistakes, and clear fund size cap were some of the most commonly mentioned factors that institutional consultants expressed play an important role. Survey results pointed to uniqueness of process/philosophy and sustainability as the most heavily marketed attributed of a firm’s Process (Exhibit 2).

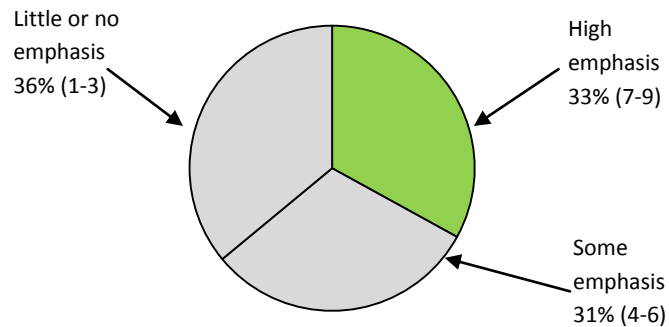
A holistic approach to investment process evaluation incorporates many factors. Several institutional advisors indicated that the investment approach has to be unique in some way, commonly mentioning terms such as “edge” and “advantage” in relation to stock screening and selection. Given the competitiveness of the emerging investment manager landscape in general, differentiation in investment approach was stressed to be highly valuable. Additionally, the sustainability of the investment approach across different macro environments is thoroughly analyzed by institutional investors. Finally, and very importantly, the fund attribution is not just evaluated relative to a benchmark, but is also expected to mirror the expected investment philosophy and style (i.e, instances of high portfolio turnover when expectations are for low portfolio turnover – these cases are frowned upon). As a part of the evaluation process, some consultants claim to carefully review trading records in order to identify trades or positions that are not aligned with a PM’s communicated investing process or philosophy. This practice sometimes continues even after gaining entry to a platform or receiving capital. In the words of one advisor, “If you don’t do what you say, I won’t be happy.”

Several consultants expressed an interest in “getting into the head of the PM.” For these investors, documented cases of poor investments and corresponding lessons learned offer valuable insights into a PM’s ability to adjust. A majority of consultants interviewed responded that they wanted to see bad investment decisions alongside success stories in the marketing collateral.

Another critical factor reviewed by institutional advisors, although not completely aligned with the other factors of Process, is a fund’s anticipated cap level. For those advisors that subscribe to the belief that

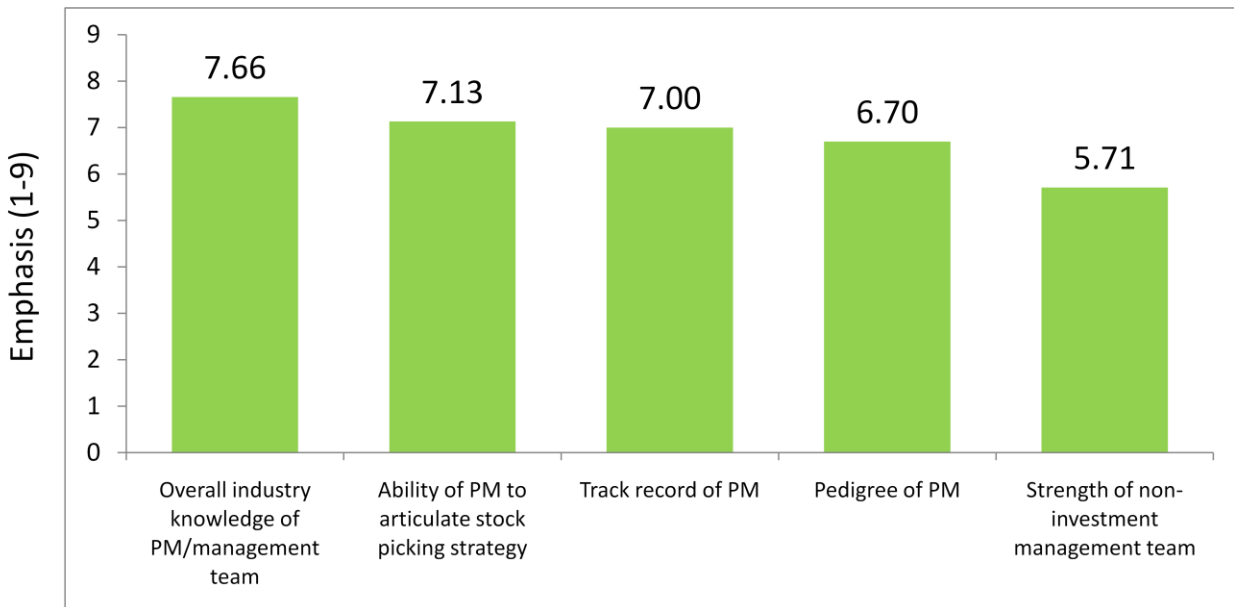
emerging managers can create more alpha as a result of smaller AUM, a projected cap level is critical. Small-cap managers, in particular, are evaluated on this point due to the limited market caps of the portfolio stocks. Interestingly, of investment managers surveyed, only 33% placed a high emphasis (which, for the purposes of this analysis was defined as a ranking of 7, 8, or 9 on a 1-9 scale) on this aspect of Process (Exhibit 4).

**Exhibit 4**  
**Emphasis placed on setting a clear fund size target**



**III. Personnel**

**Exhibit 5**  
**Emphasis placed on Personnel-related attributes in the creation of marketing collateral by emerging managers (author's note, 0=N/A and was omitted from evaluation)**



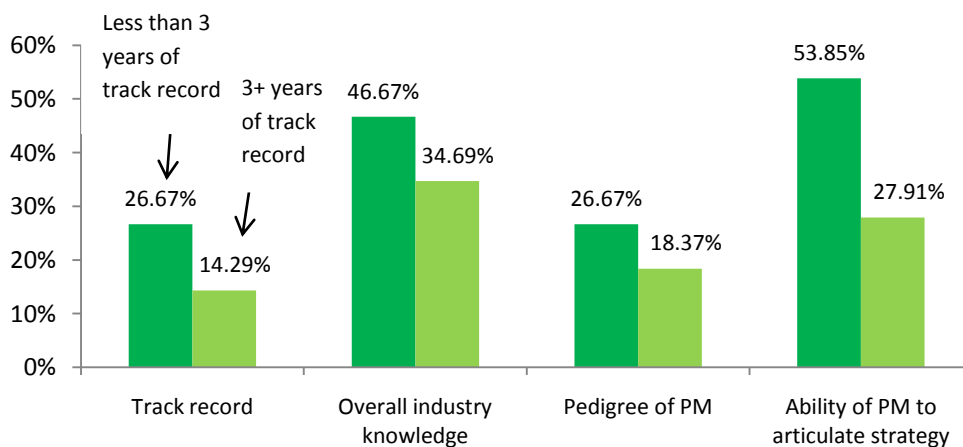
Consultants interviewed for this study indicated that evaluations of Personnel, particularly PMs and investment teams, are some of the most subjective decisions in the manager screening process. Factors

for screening include a PM’s pre-fund inception track record, pedigree (including education and pre-investment management experience) and name awareness in the industry (effectively a PM’s brand equity). One consultant summed up his explanation of the importance of Personnel by noting, “At the end of the day, your brand is essentially your reputation and your track record.”

An interesting point of consideration that was revealed in discussions with consultants is the value placed on a PM’s communication skills. While track record certainly matters, a PM’s ability to successfully articulate a unique investment philosophy is highly prized. This insight is in-line with the generally subjective nature of this evaluation characteristic. As one consultant put it, “I speak with hundreds of PM’s every year, and at the end of the day, I want to invest with someone I like – and a lot of that has to do with his ability to hook me on his investment philosophy and process. That’s a big confidence builder.” As seen in Exhibit 5, the ability to articulate a stock picking strategy is highly emphasized by emerging managers (it is second to the overall industry knowledge of PM with a 7.13 weight), and this ability was similarly a common theme throughout the consultant interviews.

Survey results point to a disparity in the marketing emphasis that firms place on Personnel related factors. In evaluating the Personnel attributes that received the highest ranking of a 9 (which represented primary emphasis), respondents with less than 3 years of operating history (defined as respondents who answered N/A for 3-year track record) placed significantly more marketing emphasis on the firm’s PM(s) than firms with over 3 years of operating history (Exhibit 6). These results suggest that as a firm grows and builds a track record, less emphasis is placed on the PM’s prior experience.

**Exhibit 6**  
**Percentage of respondents who ranked PM-related attributes the highest (9)**

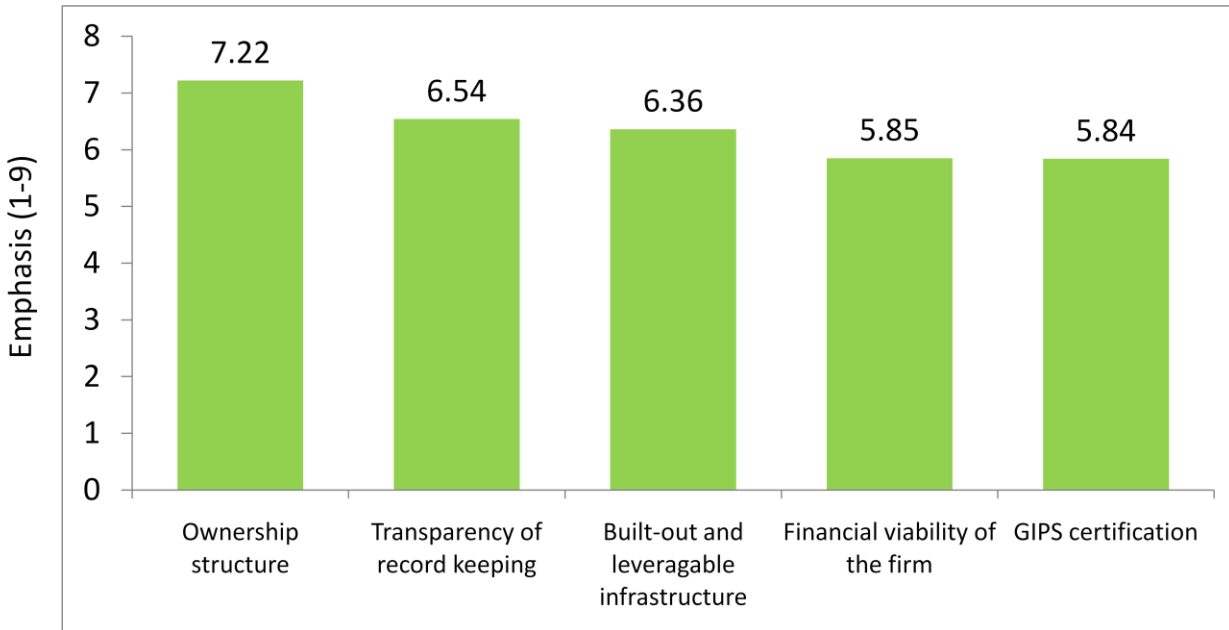


Personnel and process are often intrinsically linked when discussing the importance of PMs. Generally speaking, consultants are looking for PMs that can focus exclusively on doing what they do best, which is picking stocks. As one consultant noted, “When you start a firm, PMs often wear multiple hats. You don’t want investment professionals to be distracted by other areas of the business.” Therefore, it is not only the aptitude of the PM to articulate the stock picking philosophy that consultants are looking for, but also the ability of the PM to actually focus on making those stock picks.

#### IV. Platform

##### Exhibit 7

Emphasis placed on Platform-related attributes in the creation of marketing collateral by emerging managers (*author's note, 0=N/A and was omitted from evaluation*)



The non-investment aspects of a firm were consolidated into a single “Platform” factor. This attribute was consistently categorized as a major risk of investing in emerging managers as these funds typically deal with the same issues inherent in all new businesses. The primary issues repeatedly expressed by interviewees included unclear financial viability and limited infrastructure and record keeping. Emerging managers are not necessarily disqualified if a built-out infrastructure does not exist, but at the very least, a clear plan to develop one is required. When survey respondents were asked to assign weights to the 4 Ps as they relate to overall marketing collateral and efforts, Platform was given a 14% weighting, the lowest in the group (in comparison, Personnel, Philosophy, and Performance were weighted as 24%, 32%, 29% respectively as shown in Exhibit 3). It is unclear if this low weighting is a function of the firms’ lack of developed Platform, or if they perceive it to be not important enough to warrant extensive mention.

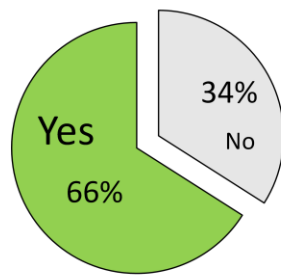
Aside from the operating risks associated with these issues, consultants indicated that there can be significant impact to “investment-related” activities at firms where Platform issues are unresolved. As presented earlier, PMs that are actively involved in general operating activities are perceived as being handicapped. One consultant noted, “I prefer to have investment professionals be minimally distracted, if at all. Very few of the emerging managers I see have an infrastructure that enables the PM to only focus solely on investing. Before I select a manager, they need to have a plan for the infrastructure in the future.” Survey results tracked qualitative comments, as only 13% of respondents indicated that PMs are completely removed from general operating activities at the firm. Interestingly, there seems to be a

break between a marketed “clear separation of investment and non-investment teams” and “PMs focused solely on stock picking.” Survey results indicated that 66% of emerging managers claim to have a clear separation of duties, a number that does not seem in concert with 87% of respondents indicating that PM(s) are involved in the firm’s general operations (Exhibit 8). There may be a variety of reasons for this discrepancy –three divergent explanations are that explicit divisions between the front and back office are over-stated; that many emerging managers are run by PMs on the business side of the operations (i.e. the PM is also the CEO); or that respondents have different definitions of what a PM being involved in the general operations may constitute.

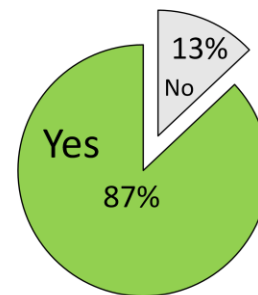
**Exhibit 8**

**Disconnect between stated and “actual” division of investment and non-investment functions**

**Is there an explicit division between front and back office?**



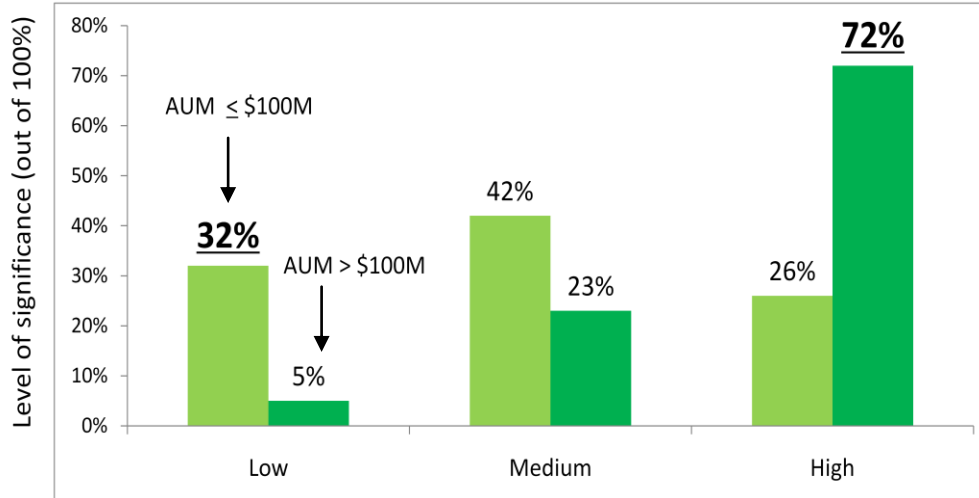
**Is your PM involved in general operations?**



Qualitative information supports the rationale that although a separate COO or marketing role may exist at an emerging manager firm, if the PM is also the CEO, it is hard, if not impossible, for the PM to completely abdicate him or herself from general management duties. On the smaller end of the AUM spectrum, this issue is particularly pronounced. Survey findings indicate that of respondents whose firm’s have under \$100M of AUM, 53% stated that there is an explicit division of investment and non-investment functions. This number jumps up to 75% for respondents whose firm’s have over \$100M in AUM. Similarly, respondents indicated that smaller firms do not emphasize a leverageable infrastructure in their marketing collateral to the same extent that the larger firms do. 32% of firms with under \$100M in AUM rank it “Low,” (which we defined as a ranking of 1-3 for evaluative purposes) vs. 72% of respondents whose firm’s have over \$100M who rank it “High” (defined as 7-9 for evaluative purposes).

**Exhibit 9**

**Built out and leveragable infrastructure received higher emphasis from firms with AUM over \$100M than it did from firms with under \$100M**



Other important aspects of Platform include ownership and compensation structures. Firms are evaluated on how PMs are incentivized because it can directly relate to performance and the mitigation of flight risk. As one consultant succinctly summarized it, “In a small and emerging manager, flight risk is big – having substantial skin in the game can limit the risk.” Survey respondents indicated that ownership structure is emphasized above all other aspects of a firms’ Platform when marketing (see Exhibit 7).

**Conclusion**

From extensive interviews with emerging managers, institutional consultants, and other industry experts, as well as the analysis of a survey distributed to emerging managers, Performance, Process, Personnel and Platform emerged as the four most important aspects in the evaluation of EMs and the creation of marketing collateral. This paper analyzed the importance of each of these attributes and provided some insight into how EMs are currently allocating their marketing mix. An anonymous survey respondent summed up the findings nicely by noting, “All aspects must be addressed since clients use different criteria in making investment decisions. We have to be capable of addressing ANY concern they may have. We are not in a position to tell them some attribute is not important.”

*About the authors:*

*This paper was prepared by a team of MBA students from the Tuck School of Business at Dartmouth. Any questions related to the information published within this paper should be directed to Tuck and will be responded to in a timely manner.*