Hiring a Money Manager – The Process

PAPERS Forum
May 21, 2015
Your Portfolio

Equity (50-70%)

- Public Equity
  - US Large Cap
  - US Mid Cap
  - US Small Cap
  - Developed Int’l
  - Emerging Markets
  - ACWI ex-US
  - Global
- REITs
- Private Equity
- Hedge Funds
  - Long/Short
  - Global Macro

Fixed Income (30-50%)

- Bonds
  - US Core
  - Global Core
  - Core Plus
  - High Yield
  - Bank Loans
  - Total Return
  - Unconstrained
- Private Real Estate
  - Core
  - Core Plus
  - Value-Add
- Natural Resources
  - Timber
  - Agriculture
The Investable Universe

- **Equity**
  - Domestic: 946 Firms, 3113 Products
  - International: 301 Firms, 905 Products
  - Global: 313 Firms, 584 Products

- **Fixed Income**
  - Domestic: 382 Firms, 1576 Products
  - Global: 93 Firms, 186 Products

Source: PSN Enterprise

An Example: Large Cap Growth

- 227 Firms managing 326 LCV products in the investable universe
- 50 products respond to RFP for LCG managers
- 25 products beat both 3- and 5-year index returns
- 5-10 names on short list
- 3 products selected for finals
- 1 selection
The Search Process

1. Determine that a search is necessary
2. Conduct the search
3. Conduct due diligence
4. Select finalists
5. Make a selection
Conduct Due Diligence

• Initial screens
  • Performance
  • Organizational structure
  • Investment team
  • Litigation history
  • Fee structures
  • Available fund structures
• Suitability
  • Investment Policy Statement (IPS)
  • P&G (Policy and Guidelines)
Statistics

- Rate of Return
  - Net of Fees or Gross of Fees?
- Alpha and Beta
- Standard Deviation
- Upside and Downside Capture
- Tracking Error and Information Ratio
- Turnover

Risks

- Liquidity
- Credit
- Counterparty
- Sovereign
- Operational
- Model
- Security Lending

The real risk is permanent loss of capital
Finals and Selection

Key criteria to consider:

• How a manager fits in the overall portfolio
  • Growth vs. Value
  • Do asset classes overlap with another allocation?

• Fee schedule and structure
  • Fees are *almost always* negotiable
  • Always worth it to ask for a Most Favored Nation (MFN)
  • Never underestimate the value of low-cost index funds

• Comfort and trust in team and relationship manager
The Search Process

1. Determine that a search is necessary
2. Conduct the search
3. Conduct due diligence
4. Select finalists
5. Make a selection
The Investment Vehicles

Separate Accounts
• Board has full discretion over assets
• Securities remain with custody bank
• Usually lower management fees
• Potentially higher trading costs, especially international
• The Board can impose any constraints it wants
• Highly liquid

Commingled Funds
• Board has no discretion over assets
• Securities reside with investment manager
• Management fees may vary
• Pooled vehicles with other investors
• Investors share trading costs
• Varying liquidity (daily-monthly)

Mutual Funds
• Board has no discretion over assets
• Securities reside with investment manager
• Usually higher management fees
• Pooled vehicles that are marked to market every day
• Investors share trading costs
• Withdrawals occur at the end of any day
• Highly liquid (daily)
## The Glossary in Plain English

<table>
<thead>
<tr>
<th>Term</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Rate of Return</strong></td>
<td>Average geometric annual return of the portfolio over some time period (e.g. 3, 5, 10 years)</td>
</tr>
<tr>
<td><strong>Net of Fees</strong></td>
<td>Return after fees have been paid</td>
</tr>
<tr>
<td><strong>Gross of Fees</strong></td>
<td>Return before fees have been paid</td>
</tr>
<tr>
<td><strong>Alpha</strong></td>
<td>Measures the excess return of a portfolio that’s unexplained by the market</td>
</tr>
<tr>
<td><strong>Beta</strong></td>
<td>Measures the risk of a portfolio explained by the market</td>
</tr>
<tr>
<td><strong>Standard Deviation</strong></td>
<td>Measures the dispersion of annual returns</td>
</tr>
<tr>
<td><strong>Upside and Downside Capture</strong></td>
<td>Measures how much of an up- or down-market the portfolio captures</td>
</tr>
<tr>
<td></td>
<td>High upside capture is good, low downside capture is good</td>
</tr>
<tr>
<td><strong>Tracking Error</strong></td>
<td>Measures how similar a portfolio’s returns is to the index</td>
</tr>
<tr>
<td><strong>Information Ratio</strong></td>
<td>A ratio of excess return to standard deviation of excess return</td>
</tr>
<tr>
<td><strong>Sharpe Ratio</strong></td>
<td>A ratio of excess return to standard deviation of total return</td>
</tr>
<tr>
<td><strong>Turnover</strong></td>
<td>Measure how much the portfolio changes</td>
</tr>
<tr>
<td><strong>Name</strong></td>
<td>Measures what percent of names enter and exit the portfolio</td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td>Measures how often each dollar is used in transactions</td>
</tr>
<tr>
<td><strong>Ticket</strong></td>
<td>Measures the number of actual buy/sell orders each year</td>
</tr>
<tr>
<td><strong>Most Favored Nation Clause</strong></td>
<td>A guarantee that no comparable client is paying less in fees</td>
</tr>
<tr>
<td></td>
<td>A variation may stipulate, instead, that no future client will pay less in fees</td>
</tr>
</tbody>
</table>
## The Glossary in Plain English - Risks

<table>
<thead>
<tr>
<th>Term</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity</td>
<td>Assets might not be easily sold at desired prices</td>
</tr>
<tr>
<td>Credit</td>
<td>Assets might lose all value (bankruptcy) or miss scheduled payments (default)</td>
</tr>
<tr>
<td>Counterparty</td>
<td>A guaranteeing organization may fail to secure the asset</td>
</tr>
<tr>
<td>Sovereign</td>
<td>A foreign government may undergo a major change, or may not have a favorable legal systems</td>
</tr>
<tr>
<td>Operational</td>
<td>Key members of the investment team may leave</td>
</tr>
<tr>
<td>Model</td>
<td>Key assumptions underlying investments may be wrong</td>
</tr>
<tr>
<td>Security Lending</td>
<td>Assets may be leant out to other parties for trading, secured by theoretically low-risk assets</td>
</tr>
</tbody>
</table>