

# Structuring an Endowment to Attain a Higher Probability of Meeting Performance Objectives

The Council of Engineering and  
Scientific Society Executives

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David J. Kudish

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## Disclosure Note

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## Current Market Environment

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- ◆ Today we are facing “challenging” market conditions.

Where are we in the long-term investment cycle?

And why should that matter to you and your organization now?

## Today's Agenda ...

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- ◆ Topics which we shall discuss...
  - Conflicts of interest in the financial services industry abound.
  - Some major consultants are terribly conflicted (surprise!).
    - Most of these practices are not illegal (yet).
    - They will be slapped by the SEC... but that will still not help you.
    - Once they disclose these conflicts, people will forget.
    - You need to understand the financial incentives for these conflicts and defend yourselves from the deleterious effects...

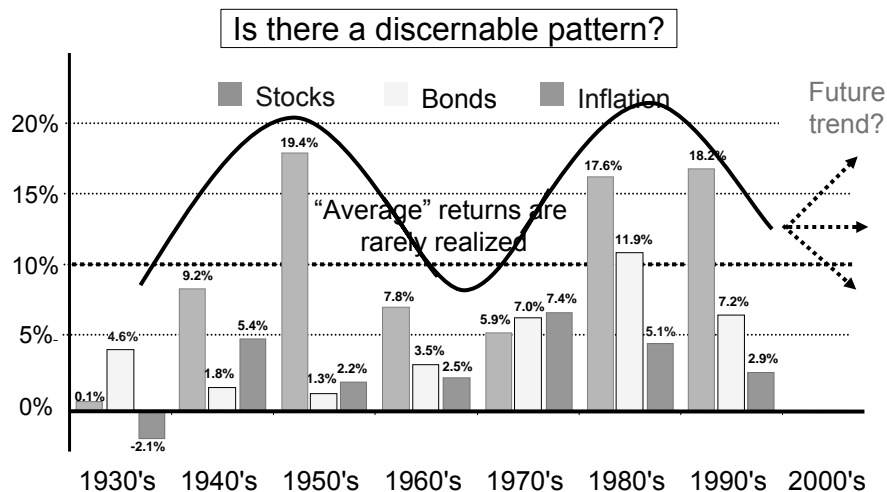
## Today's Agenda

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- You need to simplify your fund's complex investment structure.
- Be proactive in 'incentivizing' your consultant to 'do right' by you.
- You may feel comfortable hiring large, behemoth managers but there are reasons that this is NOT the most effective approach.
- "Small is beautiful" — the experts recommend small managers... for a reason.

## The Long-Term Capital Market Cycle

## Historical Returns by Decade Stocks, Bonds and Inflation



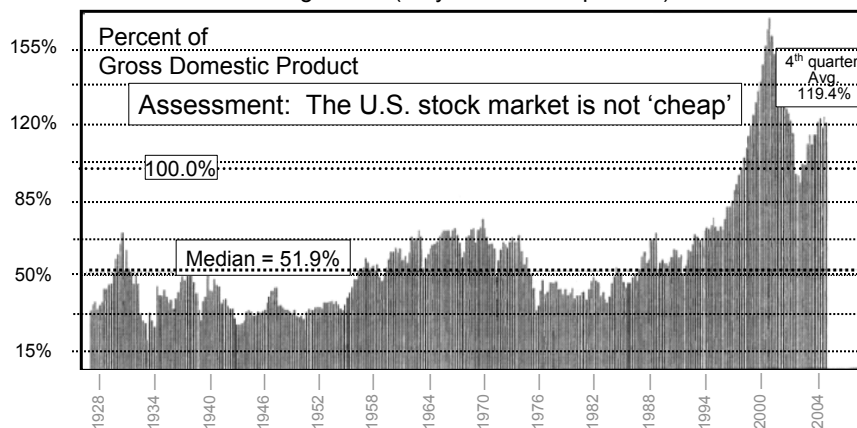
## Where Are We in the Long-Term Capital Market Cycle?

- ◆ The capital markets undergo long-term cycles.
- ◆ Economics and behavioral characteristics play into the valuation formula — how investors think and feel.
- ◆ Where we are in that cycle has a crucial bearing on your organizations:
  - Mission
  - Financial viability
  - Ability to execute your objectives.
- ◆ Let's take a brief look as to where Advocate thinks that we are in the cycle.

## Where Are We in the Long-Term Investment Cycle?

### Total U.S. Equity Market Capitalization / GDP

1926 through 2005 (80 years or 320 quarters)



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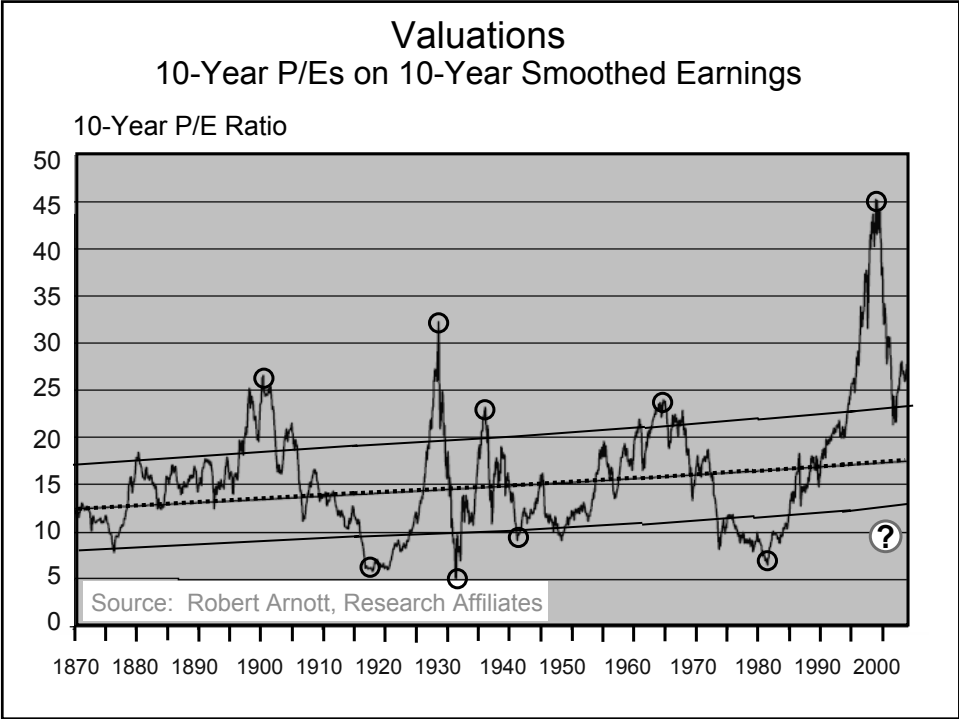
## And the Other Asset Groupings?

- ◆ Stocks are no longer inexpensive overseas in developed or emerging markets. These are opportunities... but the risks have risen along with price levels.
- ◆ Interest rates in the U.S. are near the lowest levels in over 50 years. The direction of interest rates is likely upward — in a secular rising trend. Long maturities should be avoided (for a buy-and-hold portfolio).
- ◆ Speculation abounds in other high-volatility, 'high-beta' sectors:
  - Small cap U.S.
  - NASDAQ
  - Commodities — energy and materials
  - Precious metals.
- ◆ Money flows to hedge funds and fund-of-funds is exacerbating these trends.



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A Brief Introduction to Advocate

## Introduction — Who is Advocate?

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- ◆ Advocate is registered with the SEC as a Registered Investment Adviser — fully discretionary.
- ◆ ‘Emerging manager’ with \$105 million under management.
- ◆ Successor to an investment advisory firm founded by the same principals in 1984.
  - Client relationships that date back over 20 years.
  - Deep roots in the investment consulting field.
    - Mike Kimbarovsky – Hedge Fund Research (President)
    - David Kudish – Hewitt Associates (Founder of practice; Partner)
      - Stratford Advisory Group (Founder, President)



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## Why the Name ‘Advocate’?

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- ◆ Why did we choose the name Advocate?
  - Witnessed firms that mislead clients to achieve internal revenue and profit goals.
  - They operated with conflicts of interest that caused us to say, “This is Wrong!”
  - “There has to be a better way”, an honest way, to earn a living in the financial services industry:
    - Provide services that convey value,
    - Speak the truth,
    - Represent the client’s best interests,
    - Get paid fairly... a fully disclosed fee based upon assets... without disadvantaging the client.
- ◆ We ‘advocate’ a higher set of standards of professionalism and conduct.



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## Introduction — What we ‘advocate’

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- ◆ We ‘advocate’ full disclosure and highly ethical practices:
    - No relationships with others in the financial services industry
    - No “soft dollars” or “directed brokerage” — *no ‘funny money’*
    - No referral fees — *no compromises for extra compensation.*
    - No shenanigans — *just because it not illegal doesn’t make it right.*
  - ◆ We ‘advocate’ the use of low-cost investment approaches:
    - Costs are the ‘killer variable’ in the investment equation.
    - Active trading is *against* the best interests of your fund.
    - We trade at 1 cent/share; most of your managers trade at 5 cents
    - We use index funds to build our portfolios (ETFs); we vary the mix
- ◆ The *real* goal is not relative performance; it is net returns after fees.

## Why Should You Believe Me?

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- ◆ Many of the concepts we ‘advocate’ (but not all) have been advocated and endorsed by luminaries such as:
  - John Bogel (founder of Vanguard Group)
  - David Swenson (CIO of Yale University’s Endowment Fund)and
  - Others in the industry who are “truth tellers.”

## On What Basis Are My Opinions Formed?

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- ◆ Visited with over a thousand managers in 22 years.
  - Keen understanding that all managers claim to have “the solutions”
  - Some add value over time; most do not outperform.
  - Profits and income from “successful selling” of financial services are huge.
- ◆ Bring a comprehensive perspective to the discussion.
  - Academic and empirical evidence leads the inquiring mind to real solutions to solving the investment puzzle.

## Goal: Challenge the Status Quo of Your Current Investment Approach

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- ◆ Determine if your funds are invested:
  - In an overly complex “investment structure.”
  - With large, behemoth financial service organizations.
  - Under-invested in low-cost approaches (such as index funds and ETFs).
  - And, by default, committed to paying very high fees.

## Goal: Challenge the Status Quo of Your Current Investment Approach

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- ◆ Most disinterested investment professionals would agree with the following basic steps to improve your investment program:
  - Keep your costs down; use index fund or their proxies (ETFs) for core positions in styles and sectors
    - Diminish the use of large, behemoth managers.
    - Use smaller managers that are not 'closet indexers'; they have the ability and flexibility to implement changes
    - Use managers that trade infrequently; reduce market impact.
  - Ensure that your outside service providers are aligned with your fund's interests. 'Incentivize' your consultant.
  - Consider reducing the complexity of your current investment structure.

## Goal: Challenge the Status Quo of Your Current Investment Approach

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- ◆ Will some investment professionals disagree with me?
  - Certainly... but probe to find if they have an 'axe to grind.'
  - Uncover their vested interests (if any)... and how this may be shaping their opinions and 'advice.'

## Goal: Challenge the Status Quo of Your Current Investment Approach

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- ◆ I will be pleased to address your questions.
  - Call, write or email me with your questions, challenges or observations.
  - This 'stuff' is important;  
The success of your mission depends upon getting the investment part 'right.'

## Outline of Presentation

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- I. The Problems
- II. The “Drivers” (of the problems)
- III. The Solutions (to the problems)

## I. The Problems

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- A. Systemic Conflicts in the Financial Services Industry
- B. Why do most Institutional Investors Underperform the Market?
- C. Examine Behemoth Financial Service Organizations (FSOs)

## II. The “Drivers”

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- A. The Crucial Role Played by your Consultants
- B. Complexity Creates Confusion
- C. Failure to Embrace the Lessons of the Past
- D. Using the Wrong Criteria to Select Managers

## III. The Solutions

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- A. Comparing Small Managers with Large Managers
- B. The Advantages of Hiring Small Managers
- C. Changing Your Fund’s Investment Structure to Improve Net Returns: The “Core-Satellite” Structure
- D. Creating the Right Incentives — Encouraging Your Consultant to Align with Your Best Interests

## I. The Problems

## I. The Problems

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- A. Systemic Conflicts in the Financial Services Industry
- B. Why do most Institutional Investors Underperform the Market?
- C. Examine Behemoth Financial Service Organizations (FSOs)
- D. Complexity Creates Confusion that Blocks Focus on the Key Variables

## A. Systemic Conflicts in the Financial Services Industry

### The 'Disconnect' Between What These Firms Say and What They Do

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- ◆ Examine those warm and fuzzy TV commercials.
  - *"You and US working together..."* To do what? To whom?
  - *"We do it the old fashioned way; we e-a-r-n it!"*
  - *The Wedding Toast* WHO earns it, you or us?  
*"... But, let's hear from her father. I'm just the financial advisor"*

*Tag Line*  
*"Someone uncommonly devoted to your dreams!"*

How come you have the yacht?

- ◆ Whose interests are *really* being served by this mush?

## Financial Scandals in the News

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- 1) Public companies
- 2) Brokerage firms
- 3) Mutual funds
- 4) Hedge funds
- 5) Insurance companies

## 1) Financial Scandals at Companies

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- ◆ Tyco (Dennis Kozlowski)
- ◆ Adelphia (John Regas)
- ◆ Enron (Kenneth Lay)
- ◆ WorldCom (Bernie Ebbers)
- ◆ Global Crossing (Gary Winnick)
- ◆ Imclone and Martha Stewart Living (Martha Stewart)
- ◆ Arthur Andersen (too many to mention)
- ◆ KMPG (and other major accounting firms promoting tax shelters)

## 2) Financial Scandals at Brokerage Firms

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- ◆ Conflicts of interest between investment banking and “research”

- Smith Barney
- Merrill Lynch
- Morgan Stanley
- CSFB (Credit Suisse First Boston)

} \$1.4 Billion Settlement  
(through NYS Attorney General Elliott Spitzer)

## 3) Financial Scandals at Mutual Funds

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- ◆ Late trading and “market timing” – trading after hours; trading against shareholders’ interests

- Putnam
  - Janus
  - Bank of America
  - Bank One
  - Strong Capital
- ◆ Illegal sales practices
    - Morgan Stanley – Extra commissions for in-house funds
    - Edward D. Jones – Steering clients to high-fee funds

### 3) Financial Scandals at Mutual Funds

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*(continued)*

- ◆ Revenue sharing – Fund companies pay brokerage firms to help cover “marketing costs.”
- ◆ Paying for “shelf space”- Mutual fund company paying Brokers to feature their funds.
- ◆ Brokerage firms “pushing” their in-house funds (“captive funds”).
- ◆ Excessive commissions – brokers failed to give clients the lower fees at posted “break points”
- ◆ Brokers (salespeople) selling the higher-fee share classes

### 4) Financial Scandals at Hedge Funds

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- ◆ Canary Fund
- ◆ Millennium Fund
- ◆ Bayou Fund
- ◆ Many, many others

## 5) Financial Scandals at Insurance Companies

- ◆ Marsh & McLennan — “bid rigging”  
(otherwise known as “kick backs”)
- ◆ ACE
- ◆ AIG
- ◆ AON

## *What Ever Happened to Ethical Behavior?*

- ◆ It must have been “engineered out” by Financial Service Organizations’ management in the relentless pursuit of:
  - Enlarged revenue growth,
  - Ever-increasing profits,
  - Extravagant executive compensation schemes.
- ◆ Is there a common thread or link that connects these seemingly disparate events?

## What is the Common Link?

- ◆ Public companies
  - ◆ Brokerage firms
  - ◆ Mutual funds
  - ◆ Hedge funds
  - ◆ Insurance companies
  - ◆ Consultants
  - ◆ Investment Managers
- All were involved in some scheme to defraud the public.
- All had considerable conflicts of interest that they:
- Couldn't manage
  - Didn't manage
  - Totally ignored.
- What groups are missing from this list?*
- The SEC is zeroing in on consultants' lack of ethical conduct... and the managers*

## Summary Observations: Systemic Conflicts in the Financial Services Industry

- ◆ Absence of an ethical foundation to anchor business dealings with clients and customers:
  - Financial scandals are evidence of widespread fraud and excessive greed.
    - Seems to have infected virtually every segment of the financial services industry.
    - Extent of greed and avarice is shocking and systemic throughout many firms.

Summary Observations:  
Systemic Conflicts in the Financial Services Industry

- ◆ Problems can be attributed to:
  - Remuneration — Excesses in compensation and incentives.
  - Time horizon — Focus on too short a time horizon and a need for near-instant gratification.
  - Clients' avarice — Awe with financially successful people (celebrities) and wanting to 'cash in on the goodies'.

Summary Observations:  
Systemic Conflicts in the Financial Services Industry

- ◆ The wide-spread denigration of clients' interests and the elevation of individual and company self interest is:
  - Flat-out wrong
  - Detrimental to the U.S. financial system.
- ◆ We see as part of our mission educating fiduciaries to think about making constructive changes so that they:
  - Operate more efficiently.
  - Improve the net after-fee returns on their funds.

## B. Why do most Institutional Investors Underperform the Market?

### Why do most Institutional Investors Underperform the Market?

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- ◆ Investment programs are too complex.
- ◆ Costs are too high.
- ◆ Fund fiduciaries enamored with active management
- ◆ Hire and fire managers for the wrong reasons.
- ◆ Overly depend upon recent top performance to make decisions.

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Source: EnnisKnupp (Chicago); talk before the Investment Management for Institutional Investors Conference, Nov. 16, 2005, San Francisco, CA

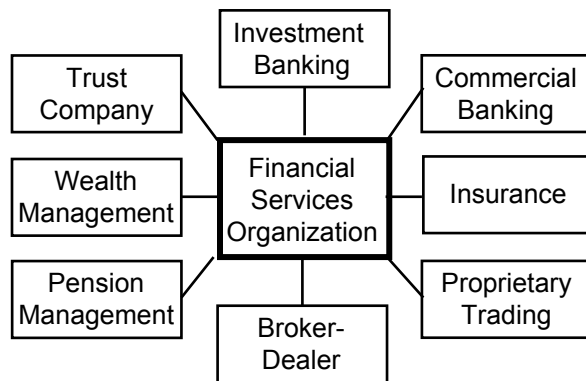
## C. Examine Behemoth Financial Service Organizations (FSOs)

1. Typical organization structure
2. How they operate: Competitors or Collaborators?
3. Feasting along the “Fee Food Chain”
4. Underlying objectives of the behemoth FSOs
5. The shockingly high cost of “Closet Indexing.”
6. “Size is the enemy of performance”

## FSO Operating Units

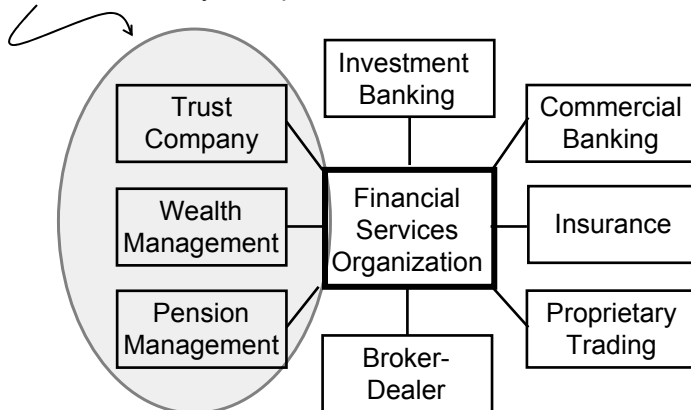
- ◆ Very large managers — the “Behemoth firms” — function across many product lines and in many lines of business:
  - Investment management
    - Separate accounts
    - Mutual fund family
  - Trust department
    - Trusts and related
    - Corporate trust
  - Private bank (wealth mgt.)
  - Custodial services
  - Investment banking
  - Broker-dealer
  - Proprietary trading desk
  - Fund-of-funds
  - Commercial banking
  - Insurance products
  - Credit card financing
  - Health service accts.

## Operating Divisions of Typical Financial Services Organization (FSOs):



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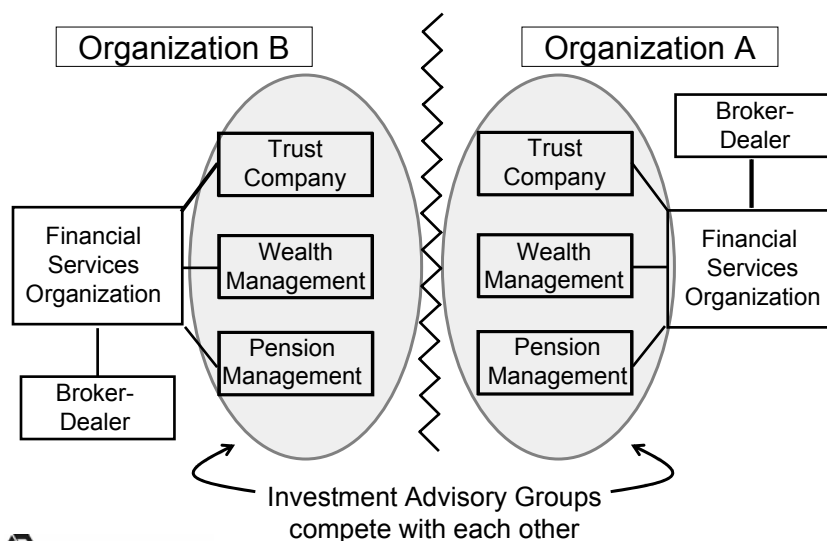
Investment Advisory Group



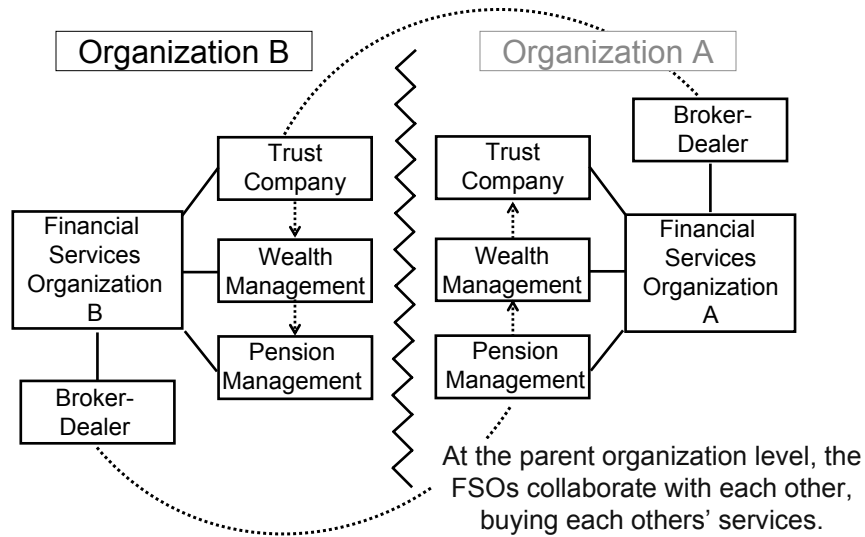
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### FSOs: Competitors or Collaborators?



## FSOs: Competitors or Collaborators?



## FSOs: Competitors AND Collaborators!

FSOs have four linked identities.

- Competitors
- Counter-parties
- Collaborators
- Customers (of each other)

## C. Examine Behemoth Financial Service Organizations (FSOs)

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### Feasting Along the “Fee Food Chain”

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- ◆ Financial service organizations (“FSO’s”) are:
  - Competitors (at the level of investment advisory division competing for new business), and
  - Collaborators (as total business enterprises as FSOs).

## Feasting Along the “Fee Food Chain”

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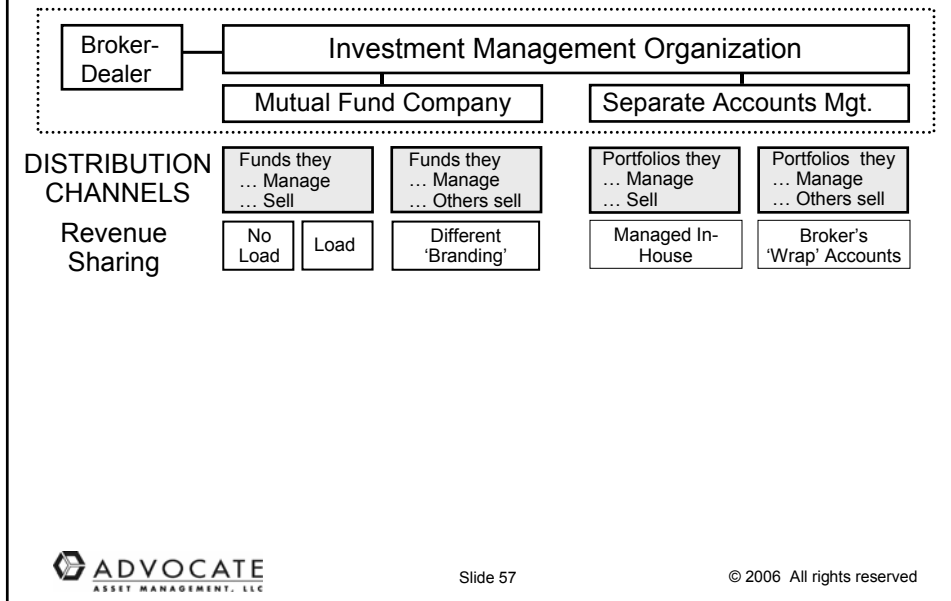
- ◆ They share revenues and customers across a wide range of services:
  - By charging a high fee, they ensure that they have enough ‘in the pot’ to pay for referrals.
  - By sharing a piece of their fee, then ensure that their collaborators are financially motivated to work with them.
  - This is vividly illustrated in the next few slides explaining how the “Fee Food Chain” operates.

## Different Types of Investment Managers

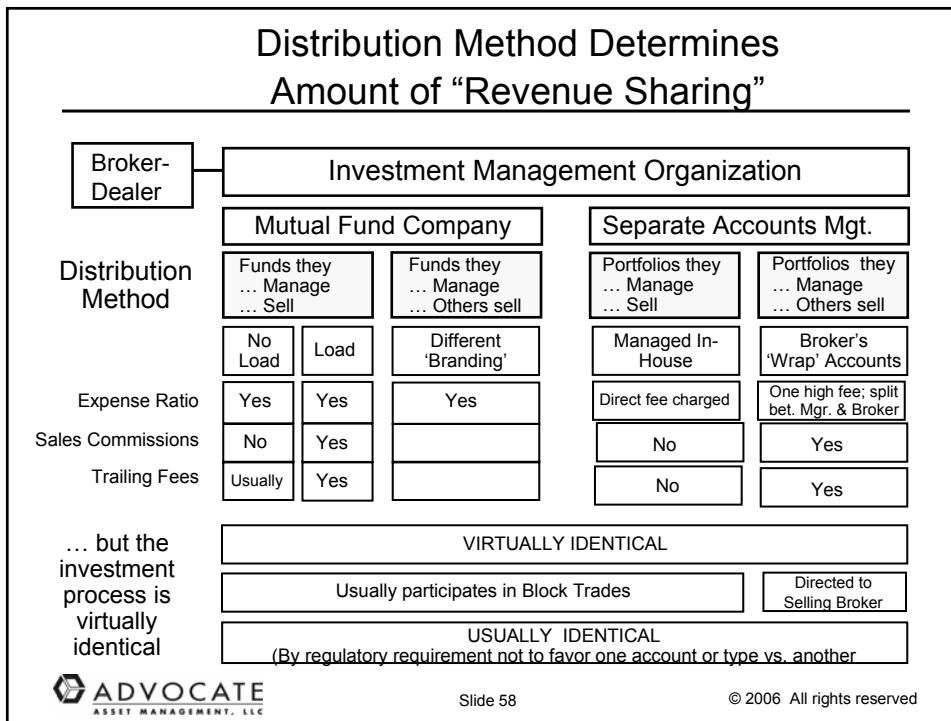
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	Mutual Fund Companies: <i>Differ in Distribution Capabilities</i>				Separate Accounts Managers: <i>Differ in Distribution Capabilities</i>	
	Family #1		Family #2		Manager #3	Manager #4
Managers' Specialty	Funds they ... Manage ... Sell	Funds they ... Manage ... Others sell	Portfolios they ... Manage ... Sell	Portfolios ... they Manage ... Others Sell		
Fee basis	No Load	Load	Low Load	Load	No additional fee paid	Referral Fee paid for 'Introductions'
Distribution Channel	Direct mail or Email	Thru Brokers who Earn 12(b)-1 Fees	Direct mail or Email	Thru Brokers who Earn 12(b)-1 Fees		

## Distribution Channels: Key to Revenue Sharing Along “Fee Food Chain”



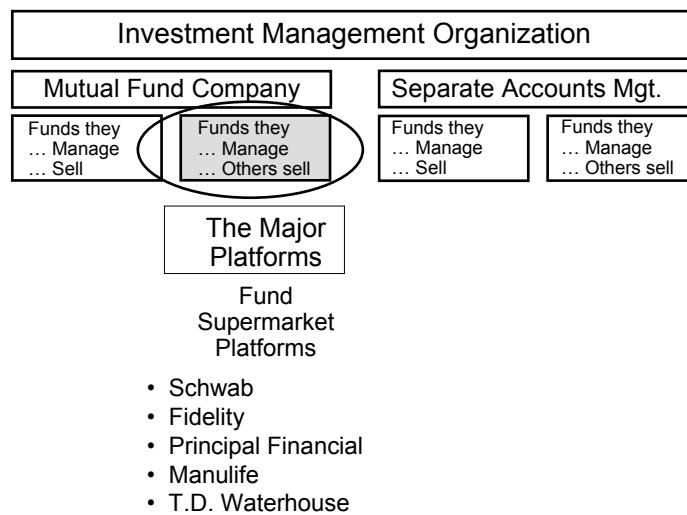
## Distribution Method Determines Amount of “Revenue Sharing”



## The “Fee Food Chain”

- ◆ FSO’s create software and service “platforms”:
- ◆ Their sales force may sell *others’* products.
  - Others are permitted to sell *their* products.
  - These platforms are known as “fund supermarkets”
- ◆ The fees generated are split according to which FSO:
  - Sells (and “Services”) the product (earning the larger portion of the fee), and
  - Holds the fund shares (the “platform”) and administers the account.

## “Fund Supermarket” Platforms



## In the “Fee Food Chain”, Your Fund is the Meal!

- ◆ The “Fee Food Chain” ties together the various behemoth organizations to ensure that they are enriched at their clients’ expense.
  - That is why they sell high-fee investment products.
  - Example a
    - 600% – Average S&P 500 index fund fee sponsored by an FSO is 60 bp.
    - more – There are low-cost alternatives with fees of 10 bp.  
(Source: Lipper ©)
  - Example B:
    - 400% – The average equity mutual fund expense ratio is 163 bp;
    - more – At Vanguard, the average equity mutual fund expense ratio is 43 bp. (Source: Morningstar ©)



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### C. Examine Behemoth Financial Service Organizations (FSOs)

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## Underlying Objectives of the Behemoth FSOs

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- ◆ Managers state that:
  - ◆ Their primary objective is to assist their clients to outperform their benchmarks.
  - ◆ Their efforts are focused singularly on this objective.
- ◆ They state that they will grow and prosper only upon accomplishing this objective.
- ◆ They claim that this places their interests along side yours.

We challenge the veracity of this statement (from most behemoth managers).

## Underlying Objectives of the Behemoth FSOs

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- ◆ Is the primary objective of most Managers:
  - To out-perform on your fund's assets?
  - Or, to retain your fund as a client of that firm?
  - Are these objectives not completely overlapping?
- ◆ *From their perspective, the worst situation is for that FSO to lose you as a client. The reality is:*
  - Under-performance leads to client defections.
  - Average performance leads to client retentions.

## The Financial Implications of Client Retention

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- ◆ Retention leads to increased revenues and profits.
- ◆ Increased profits leads to:
  - Increased bonuses, and
    - An increased enterprise value as a private entity, or
    - An elevated stock price (if the Manager is a publicly traded company).
- ◆ We surmise that the unspoken — but primary — objective is increased compensation for senior management.

## Implications for Your Fund?

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- ◆ If increased compensation is the primary objective:
  - This could mean that these Managers place *their* interests at a higher level of importance compared with *your fund's* interests.
  - John Bogel, founder of Vanguard, gave Congressional testimony during 2005;
    - FSOs allocated seven times more revenues to asset gathering than to improving investment research;
    - This implies that improving investment performance is a far lower priority.

## Implications for Your Fund ?

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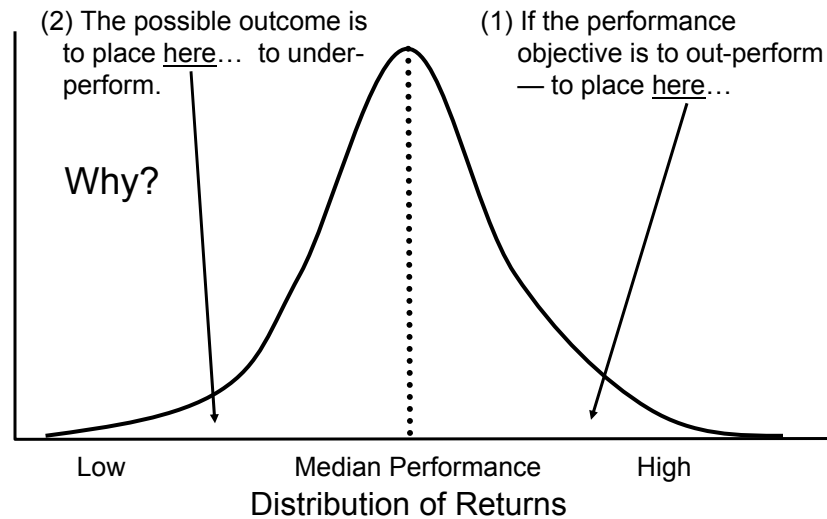
- ◆ Across the board, top managements of FSOs allocate substantial resources for advanced marketing and sales techniques...
  - To gather... more assets... even if this causes performance to deteriorate...
  - Rather than using internal resources to improve clients' investment performance.
- ◆ *Think about how this negates years of being told that your Manager operates from a position of trust!*

## Underlying Objectives of the Behemoth FSOs

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- ◆ Consequently, you should understand that the underlying objective of the behemoth organization on behalf of its clients is:
  - NOT to outperform the competition... but
  - To avoid underperforming the competition.
- ◆ What's the difference? And why is this important?

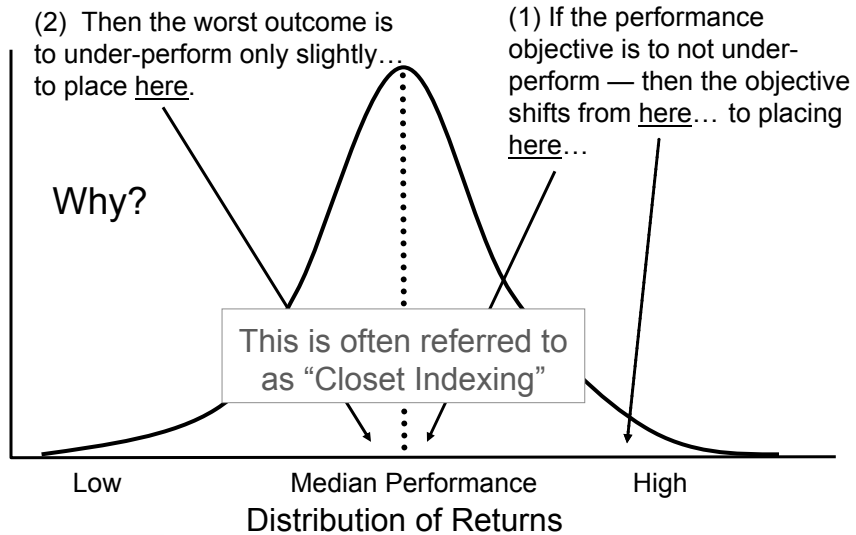
## Performance Objective and Possible Range of Rankings



## Why Such a Wide Range of Possible Outcomes?

- ◆ To try to achieve performance near the top of the universe, the Manager needs to select and weight the portfolio holdings so they are *very different* from:
  - The benchmark, and
  - The “average fund.”
- ◆ Doing this could result in a portfolio that ends up at the other extreme — that grossly underperforms the benchmark and the “average fund.”

## Performance Objective and Possible Range of Rankings



## Why Would a Manager Aim for "Average" Performance ?

- ◆ To try to achieve performance just above the universe median, the Manager needs to select and weight the portfolio holdings so they are very close to that of the benchmark and the "average fund."
- ◆ Doing this will likely result — in the worst case — with a portfolio that closely tracks the performance of the "average fund" with a slight performance give-up.
- ◆ *Why would a Manager want this outcome?*
- ◆ Because most Managers do not get fired for performing "about average."

## Underlying Objective of the Behemoth FSOs: DON'T GET FIRED !

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- ◆ The top management of FSOs understand that their organizations will generate more revenue from attracting new clients' assets than from growth in existing clients' assets.
- ◆ The objective is to gather assets and not take risk of underperforming with the existing clients' assets.

## Underlying Objective of the Behemoth FSOs: DON'T GET FIRED !

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- ◆ Consequently, top management controls the investment process to avoid too much deviation:
  - Within accounts, internally
  - Externally, to commonly utilized benchmarks.
- ◆ How does the FSO ensure 'average' performance?
  - By setting strategy so that it falls in the middle zone and conforms with the consensus of many other firms.
  - By structuring its clients' portfolios so as to not deviate too widely from the benchmark index.

## Ensuring “Average” Performance

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- ◆ How can you tell that this is occurring?
  - The tight “spread” between the quarter-to-quarter performance of your Manager and its benchmark index.
  - The high correlation between the returns of your Manager and its benchmark index.
  - Your Manager’s practice of reporting performance on a gross-of-fees basis... possibly to hide the deployment of this ‘index-hugging’ strategy.
- ◆ This is referred to as “Closet Indexing.”

### C. Examine Behemoth Financial Service Organizations (FSOs)

1. Typical organization structure
2. How they operate: Competitors or Collaborators?
3. Feasting along the “Fee Food Chain”
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## Ensuring “Average” Performance

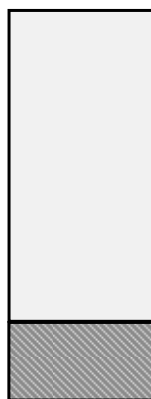
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- ◆ What might this imply as to the fee differences between:
  - Formal indexing strategies, and
  - Informal “closet indexing” approaches?

## The Shockingly High Cost of “Closet Indexing”

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### Client’s Portfolio



Assume:

Index-replicated  
Portion  
[80%]

Index-differentiated  
Portion  
[20%]

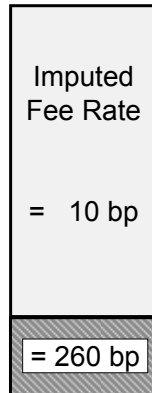
“Index-Replicated” means very similar weightings to the index:

- Industry groups
- Individual holdings

“Index-Replicated” portion tracks the index very closely.

## The Shockingly High Cost of “Closet Indexing”

### Client’s Portfolio



Index-replicated Portion [80%]  
Fee Component = 8 bp

Index-differentiated Portion [20%]  
Fee Component = 52 bp

### Fee Attribution

Total fee = 60 bp

Portion of portfolio index replicated = 80%

Comparable fee for indexing = 10 bp

Fee component = 80% x 10 bp = 8 bp

Residual fee component = 60 bp – 8 bp  
= 52 bp

Imputed fee for active management portion  
= 52 bp / 20% = 260 bp

## The Shockingly High Cost of “Closet Indexing”

- ◆ Would you pay a manager a 260 bp fee for ordinary garden-variety “active management”?
- ◆ If the manager closet indexed 90% of the portfolio, then you are paying an imputed fee of over 500bp for the 10% that is the actively managed portion!

◆ This is what your fund is — in effect — paying for a behemoth FSO to manage your index-hugging portfolio !

- ◆ *Is there a better way of choosing managers?*

## C. Examine Behemoth Financial Service Organizations (FSOs)

1. Typical organization structure
2. How they operate: Competitors or Collaborators?
3. Feasting along the “Fee Food Chain”
4. Underlying objectives of the behemoth FSOs
5. The shockingly high cost of “Closet Indexing.”
6. “Size is the enemy of performance”

## Large Managers Have Large Problems:

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- ◆ What the Experts Say About “Size”
- ◆ *“Size is the enemy of performance.”*
  - Dr. David Swenson
    - Chief Investment Officer of the Yale Endowment Fund
    - Innovator and top-performing in-house investment managers in the U.S.

## Lack of Flexibility

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- ◆ Behemoth managers lack flexibility to make changes
  - They have the resources to see problems on the horizon... but cannot easily implement strategic buying or selling... so they only make the tactical or micro decisions.
    - As large firms acquire smaller firms, there is usually a period of time that the key principals stay on.
    - After the contractual period ends, the better managers leave to start competing firms.
  - Large size no longer gives them unfettered access to top research because of the internet.
  - Regulatory restrictions choke off their size advantage.

## Lack of Flexibility

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- ◆ Behemoth managers lack flexibility to implement easily
  - Large size creates major difficulties in positioning securities across client accounts in a widely diverse distribution channel.
  - Regulatory restrictions compel them to treat all types of accounts fairly, giving no advantage within or among client categories.
    - Separate accounts (they manage and sell)
    - Mutual funds (they manage and sell)
    - Wrap-fee programs with brokerage firms (they manage others sell)
    - Fund supermarket 'platforms' (they manage and others sell)

## Size Masks Underlying Problems

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- ◆ Large size creates instability at the investment management subsidiary .
- ◆ Professional turnover is generally higher:
  - As large firms acquire smaller firms, there is usually a period of time that the key principals stay on.
  - After the contractual period ends, the better managers leave to start competing firms.
  - The behemoth firm's *real* interest was buying assets under management so these departures are acceptable.

## Size Masks Underlying Problems

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- ◆ Large size creates dis-economies of scale for active management;
  - Inability to execute opportunities brought to management by its professionals.
  - “Market impact” costs of actively trading are high and reduce clients’ net performance results.
- Large organizations are known for:
  - “training the best...”
  - and keeping the rest”;

## Inability to Transact Efficiently

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- ◆ Size in specific product area of your interest  
Excessive size creates distortions in the investment product and process:
  - Very large position sizes relative to average trading-day volume — Lack of marketability; difficulty in exiting a stock (i.e. Enron, WorldCom, etc.)
  - Excessive number of positions — By increasing the number of positions, the portfolio's correlation is driven toward the benchmark index; (replicates performance of the index?)
  - Style drift — Inability to acquire enough stock in certain style sectors (i.e. small cap) so the Manager drifts (i.e. to mid cap).
- ◆ Bottom line — Inability to transact efficiently in that firm's product offerings in that style area (commingled funds and separate accounts).

## Service Suffers

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- ◆ Large number of clients per principal
  - Service suffers
  - Principals stretched thin
  - Accountability is diluted
  - A “one-size-fits all” mentality emerges
  - It is not unusual for clients to feel “taken for granted”

## II. The “Drivers”

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- A. The Crucial Role Played by your Consultants
- B. Complexity Creates Confusion
- C. Failure to Embrace the Lessons of the Past
- D. Using the Wrong Criteria to Select Managers

A. The Crucial Role Played  
by your Consultants

## Consultant Controls Your Fund's Returns

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- ◆ Your Consultant is the 'gatekeeper' to your fund.
  - Managers that cannot get an 'audience' or a 'fair hearing' will not be introduced to your fund.
  - The competition to get in front of your consultant is fierce!
- ◆ Your consultant has far more impact than any one manager in a multi-manager investment structure.
- ◆ Yet, the consultant gets paid about 3 bp to 10 bp while the managers get paid about 50 bp to 150 bp — 10 to 50 *times* more per million.

## Consultant Controls Your Fund's Returns

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- ◆ Some consultants are envious of the managers' fees.
  - These consultants attempt to augment consulting fees with services sold to managers.
  - Managers 'buy' these products or services because they want to remain in good standing with the consultants.
  - Consultant 'reward' these managers by placing them into 'manager searches.'
- ◆ This type of consultant has serious conflicts of interest... that may not have been disclosed to its clients.
- ◆ These types of consultants should not be retained by your funds. Period!

## Impact of a Skewed Manager Search Process

- ◆ The types of Managers selected by your Consultant has an enormous impact on your fund's resultant performance... for years to come.
  - Manager selection decisions tend to be multi-year decisions.
  - IF the Manager search was skewed by the Consultant's self interest, the damage to your fund could be felt... for years to come.
- ◆ This is why you MUST select a Totally Independent Consultant.!



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## How Do Some Consultants Screen Manager Candidates?

All Managers



What are the qualifying questions posed by some Consultants?

- ◆ "What makes your firm *really* 'good' "?  
(*This takes a lot of work to assess.*)

What are the qualifying questions posed by some *other* Consultants?

- ◆ "Will you subscribe to our performance measurement and ranking service?"
- ◆ "Will you attend our conferences (for a fee of \$50,000 per year)?"
- ◆ "Will you place brokerage commissions through our affiliated broker-dealer?"

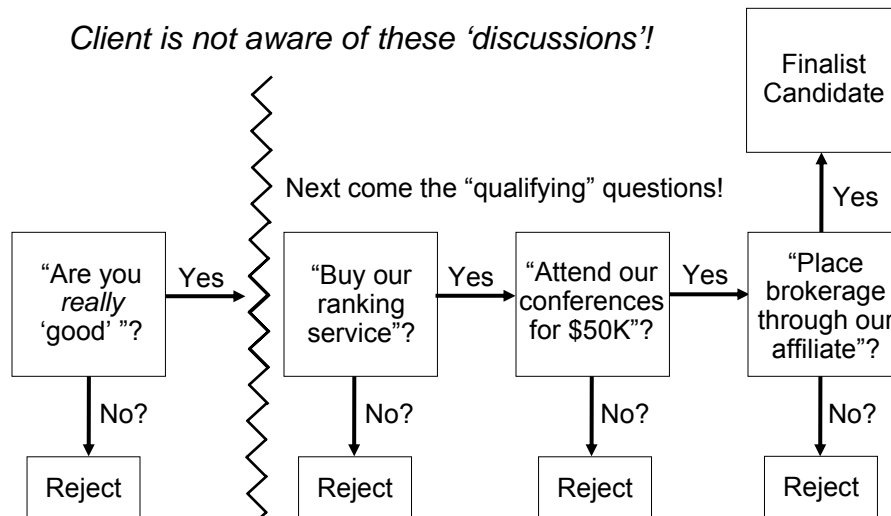


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## The Non-Independent Consultant

*Client is not aware of these 'discussions'!*



## The "Bottom Line"

- ◆ IF your Consultant is NOT Totally Independent — totally unbiased — then your fund's:
  - Fees and expenses could be substantially higher than they ought to be.
  - Returns — net of all fees and expenses — could be substantially lower than they should (or could) be.
  - Your fund is likely being exploited in the "Fee Food Chain."

## The “Bottom Line”

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- ◆ You, as the ultimate fiduciaries, need to really understand how your Consultant operates its business.
- ◆ Failure to take this due diligence step — vetting your Consultant with an in-depth analysis — is hazardous to the health of your funds. You need to:
  - Have a clear understanding of the different business activities, if any, of your Consultant.
  - Know what — if any — affiliations it has with others in the financial service industry.
  - Understand how this can adversely affect your fund.

## The “Bottom Line”

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- ◆ Consider the SEC’s investigation into Consultant conflicts of interest.
  - Some of the funds affected are the largest in the U.S. ... and they didn’t know what was going on!
  - These funds have large internal staffs working with these Consultants.
- ◆ Does this give you an inkling as to how well these conflicts are covered up?

## The “Bottom Line”

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- ◆ And, do you think that the SEC investigation will change anything?
  - Advocate believes that — after the media exposé subsides — things will change just a little to meet new regulatory requirements.
  - Once the attorneys get involved, full disclosures will be made... but it will be buried in the fine print of the required regulatory documents.
  - Then, it will be “business as usual.”
- ◆ We urge you to take these warnings seriously; not all Consultants have your best interests at heart.



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### B. “The C<sup>3</sup> Effect”: Complexity Creates Confusion

## Investment Process Confounds Investors

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- ◆ The investment process confounds both professional investors and their non-professional clients... but for different reasons.

## Investment Process Confounds Professional Investors

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- ◆ Professional investors understand the highly uncertain nature of their work.
  - The range of possible outcomes is so large.
  - Factors and influences... and their importance... change without notice.
  - Trends continue... until they don't.
- ◆ While managers describe a very disciplined investment process to the outside world, there are many subjective factors that they evaluate... including their intuition.

## Investment Process Confounds Non-Professional Investors

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- ◆ Non-professional investors misunderstand the factors that lead to investment success and disappointment.
  - Rely on past performance as the single factor that is responsible for investment success.
    - As the sole quantitative tool, it is 'fact' and measurable.
    - Other substantive but subjective factors are downplayed or ignored.
  - Think that professionals know more than they do.

## Investment Process Confounds Non-Professional Investors

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- ◆ Non-professional investors depend on psychological comfort factors in spite of evidence that this works against their best interests.
  - Choose behemoth firms in spite of their inflexibility.
  - Chase recent top past performance.
- ◆ Accept as fact unproven assumptions about what works.
  - Buy the story that top past performance is a function of:
    - Superior research
    - Experienced stock pickers.
  - That active management is superior to passive (indexed) management.
  - That recent trends will continue unabated while evidence suggests that mean reversion is a powerful investment force.

## Consultants Endorse Complex “Investment Structures” for Fiduciaries

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- ◆ What is “Investment Structure”?
- ◆ Definition: “Investment Structure” is the number, types, specialties, and mandates — the operating guidelines — of the various managers retained for a fund.

## Consultants Endorse Complex “Investment Structures” for Fiduciaries

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- ◆ Many consultants (and most clients) are seduced by complexity in Investment Structure.
- ◆ The most complex structure is the “specialization” investment structure.
  - If recommended by their consultant, clients assume that it must be an effective method for managing institutional investment assets.
  - Clients think that this approach is “sophisticated.”
    - Many other funds embrace this approach.
    - There is ‘safety’ in numbers.

## Consultants Endorse Complex “Investment Structures” for Fiduciaries

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- ◆ As a consequence of consultant’s endorsement, many funds embrace a “specialization” investment structure.
  - Under a “specialization” investment structure, consultant selects many different managers — one for each style box.
  - Each manager is:
    - Retained for a specific, highly specialized mandate.
    - “Pigeon-holed” in a specific slot.
    - *This is best viewed by a graphical example.*

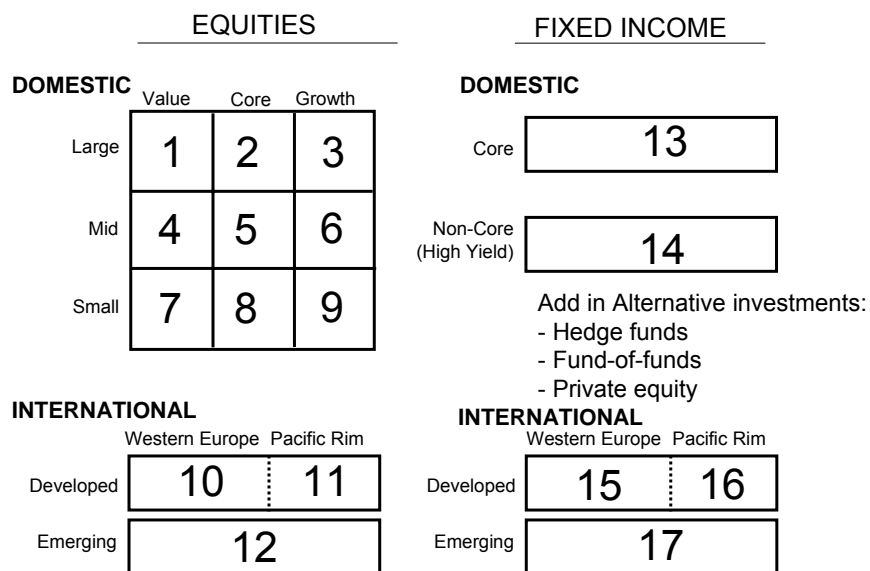


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## “Style Map” of Domestic and International Capital Markets

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## Complexity Creates Confusion

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- ◆ The “specialization” investment structure model promotes the retention of talented specialist managers for each segment of the capital markets.
  - Each manager is:
    - Retained for a specific, highly specialized mandate.
    - “Pigeon-holed” in a specific slot.
    - Restricted as to what that manager may purchase for its segment of the client’s portfolio.

## Consultants Endorse Complexity for Fiduciaries

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- ◆ “Specialization” emphasizes the “best-in-breed” concept.
    - Useful analog for skill-based, experiential fields such as:
      - Cardiac surgery
      - Executive search
      - Sports team top scorer
      - A military hierarchy
- } Go with a past winner
- ◆ However, erroneous methodology for manager selection.
    - Outcome is not deterministic (not a quality-control model)
    - Outcome is not the result of hard work only but of:
      - Random movements in external variables (securities prices)
      - Internal factors (style tendency of manager)

## Consequences: The “Pigeon-Holed” Manager

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- ◆ Managers are restricted as to what they can invest in; style drift is prohibited.
  - *(For a manager to complain is to commit ‘marketing suicide’.)*
  - Result is that performance results of similar-style managers are in a fairly tight distribution curve.
  - Performance is almost predictable... it closely matches the benchmark (before fees are deducted) for that specialty.
  - Often, random factors — not ‘smarts’ — becomes the key differentiator between ‘good’ and ‘not so good’ performance..

## Consequences: The “Pigeon-Holed” Manager

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- ◆ Managers use this to their advantage
  - Motivates managers to expand their product lines to other specific ‘specialties.’
  - A few products are always ‘hot’ and benefit by fund cash inflows.
- ◆ Alters managers’ strategy
  - No longer solely interested in outperforming.
  - New unmentioned goal is to avoid under performing.

## Cost and Performance Impact of Specialization

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- ◆ Result: far too many managers are hired; costs rise
  - Each manager is at the high end of its fee schedule
  - Each manager's trading adds to overall cost increases
  - Consultant fees rise — Search costs; performance measure fees; travel costs.
  - Other service providers costs rise — Trustee fees and custodial fees.
  - Under-utilization of low-cost investment approaches.
    - “Best-in-breed” mindset convinces clients to avoid index funds
    - This is a fatal error in the drive to improve investment performance... net of fees

## Advocate's Opinion of “Specialization” Investment Structure

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- ◆ We think that this structure increases clients' fees and results in sub-par investment performance net of fees...
- ◆ But it does tends to maximize the consultant's fees.
- ◆ This my NOT be the fund sponsor's objective.

## C. Failure to Embrace the Lessons of the Past

## II. – C Lessons from the Past

1. Indexing works
2. Lowering costs and expenses works
3. Reducing turnover works
4. Chasing past performance doesn't work
5. Working with advisors whose interests are unaligned with your fund doesn't work.

## Lessons from the Past: # 1

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### Indexing works

Extensive academic research backed by growing empirical evidence proves that indexing outperforms the average active manager over multi-year holding periods.

- Certain areas of the capital markets are “more efficient” and therefore it is more difficult to outperform a passive index.
- In the large-cap segment of the U.S. market, indexing typically outperforms 80% of active managers.

## Lessons from the Past: Indexing Works

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### Caveat

*Sometimes, indexing outperforms by a smaller margin... or slightly underperforms the average manager.* Usually, this occurs during periods whereby Small-cap is in favor. During these periods, the cap weighting of the S&P 500 is a particular drag on performance and therefore on performance comparisons.

However as the measurement time period lengthens, the superiority of indexing becomes more evident.

## Past Superiority of Indexing: Comparing Net-of-Fee Performance

Percentage of Actively Managed Funds in Morningstar® Category that Outperformed their Respective Index  
Ten Years Ended Dec. 31, 2004

Morningstar® Fund Category	Value	Blend	Growth
Large-Cap [Style out-of-favor for past 6 years.]	34%	18%	16%
Mid-Cap	11%	21%	5%
Small-Cap [Style in favor for past 6 years.]	32%	47%	37%

Source of Data: Morningstar® and Vanguard®, performance net of fund's expense ratios

Format: Advocate Asset Management, LLC

Are these results affected by "Survivorship Bias"?

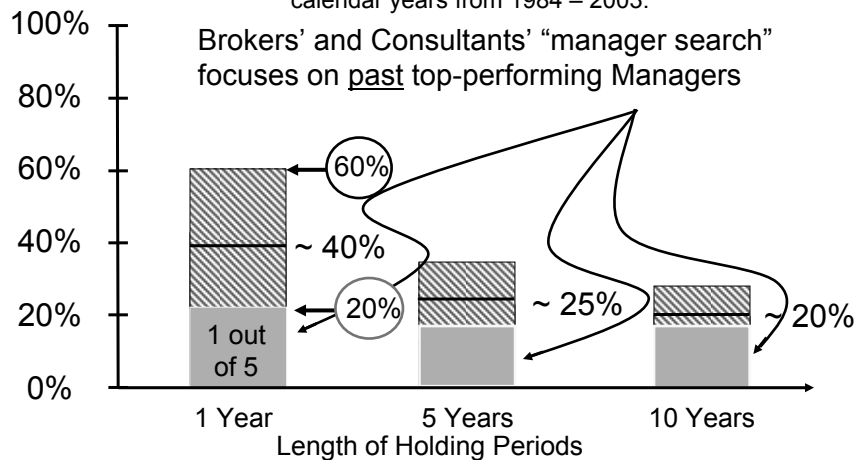


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## The Unbiased Performance Record

Percent of Large-cap Active Managers that 'Beat' the S&P 500 Index during calendar years from 1984 – 2003.



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## In What Market Sectors is Indexing Compelling?

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- ✓ Indexing is compelling in certain “efficient” areas of the capital markets:
  - U.S. Large cap
    - Growth style
    - Value style
  - U.S. Core bonds
    - Governments
    - Corporates
    - Mortgage derivatives
  - International – developed markets
    - European markets
    - Pacific markets

## In What Market Sectors is Active Management Compelling?

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- ✓ Active Management is compelling (or at least a calculated ‘bet’) in certain less-efficient areas of the capital markets:
  - U.S. Small cap
  - U.S. Non-core bonds
  - International – emerging markets
- ✓ Active Management is compelling:
  - Private equity
  - Hedge fund strategies (such as distressed securities)

## Why Isn't Indexing Used for a Larger Portion of Most Funds?

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- ◆ Indexing is disparaged by many investment professionals. Why?
  - For the simple reason that it would seriously harm their business... even though it would help their clients.
  - They have a vested interest in keeping their clients ill informed about the benefits of using low-cost investment approaches.
- ◆ Benefits of indexing:
  - Reduced brokerage commissions.
  - Reduced "market impact" expenses.
  - Reduced investment advisory fees.
  - Reduced consultants fees.
  - Reduced fees from other service providers (trustee, etc.)

## Disparaging Indexing is Misleading and Disingenuous

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- ◆ Investment professionals *know* that past performance is not predictive. Yet they *imply* that past results have 'information content' about the future.
- ◆ By implying that they *can* introduce their clients to better-performing Managers, Brokers and advisors mislead their clients.
- ◆ Investors *want* to believe that smart professionals can outperform an index... so they are predisposed to the suggestion that some Managers can outperform.

## Lessons from the Past: # 2

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### Lowering costs and expenses works

Costs and expenses involve the following:

- Investment management fees
- Sales 'loads' and trailing 12(b)-1 fees
- "Market impact" of active management — due to active trading by (usually) very large investment managers with billions under management in a given investment specialty.

## Lessons from the Past: Lowering Costs and Expenses Works

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Costs and expenses also involve the following:

- Brokerage commissions
- Custodian or trustee fees (holding and safe-keeping of assets)
- Consulting fees –
  - Establishing investment policies
  - Asset allocation analysis and projections
  - Manager search fees
  - Performance measurement fees

All-in 'performance drag' = is about 2% to 4%.

## Lessons from the Past: Lowering Costs and Expenses Works

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### Investment advice

Average equity fund expense ratio: 150 bp (half are higher!)  
Estimated marketing surcharge [12(b)-1]: 25 bp (up to 100 bp)  
OR  
Actively managed separate account: 65 bp to 125 bp

### Market Impact (Trading cost )

Estimated market impact cost: 50 bp (for Large cap)  
OR  
225 bp (for Small cap)

All-in 'performance drag' = 200 bp to 400 bp

This is about 2.0% to 4.0%



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## Lessons from the Past: Lowering Costs and Expenses Works

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It is important to reduce "all-in" fees to no more than 100 bp (or 1.0%)

This is especially important during a low-return market environment.

- We have been in a low-return sideways market for several years.
- If equity returns are sub-par at, say 7%, reducing "performance drag"...

  - To no more than 100 bp
  - From 200 bp to 400 bp
  - A reduction in costs of 100 bp to 300 bp net is very significant.

Gross returns may be 7%.

- However, net returns (after fees) will be 1% to 3% lower.
- Removing these excess costs and expenses elevates net returns.
- Net returns are elevated from 3% or 5% to nearly 6%.



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## Lessons from the Past : # 3

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### Reducing turnover works

Choosing reduced-turnover managers lowers costs and expenses... (and taxes, for taxable portfolios).

High-turnover strategies are usually speculative. If they succeed — some do — they usually generate short-term gains.

But, even if the fund is tax exempt, the costs of high-turnover strategies are a drag on long-term performance... net of fees and expenses.

- The largest hidden expense is the “market impact” of behemoth firms’:
  - Buying securities (thereby driving up the price over time)
  - Selling securities (thereby driving down the price over time)

## Lessons from the Past : # 4

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### Chasing past performance doesn't work

Analysis of long-term cycles reveal that “reversion to the mean” is a powerful investment force.

Chasing past performance may give temporary psychological comfort to those uncertain about how to invest properly for the long term but is a deficient investment approach.

- Usually results in:
  - Buying near a ‘top’
  - Selling near a ‘bottom’

## Lessons from the Past : # 5

Working with advisors whose interests are unaligned with your fund doesn't work.

Of ALL the factors that work for — or against — the best interests of your fund, the most important is the allegiance of your outside advisors... the service providers to your fund.

An advisor that is specifically silent on this issue or makes vague, nebulous statements and avoids committing vigorously — in writing — to serve as a fiduciary of your fund is usually non-aligned with your fund's best interests.

Unfortunately, in today's world of avarice and greed, the fund fiduciaries must demand positive, demonstrative actions — not just words — to ensure that their fund's best interests are being served.



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### D. Using the Wrong Criteria to Select Managers

## Using the Wrong Criteria to Select Managers

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- ◆ Typical Selection Criteria
- ◆ The Expert's Selection Criteria
- ◆ Problematic Factors
  - Profit-maximizing Business Plans
  - Assessing Market Impact Costs
  - Understanding How Managers Evolve Over Time

## Typical Criteria in Manager Selections

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Factors Assessed as "Important"	How Important <i>Really</i> ?		
	High	Moderate	Low
Past performance record?			X
Size of firm? (Assets under management)			X
Existing client list? (Recognizable companies)			X
Industry contacts? (competitor endorsement)			X
Recommendations from friends?			X
Referral from brokers?			X
Formal search by paid Consultant?			X
Reputation and 'branding'?			X
Marketing brochure?			X

## Other Less-Important Criteria Used in Manager Selections

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Factors perceived as important... but are incidental to a Manager's success.

- Staffing headcount (Number of 'bodies')
- Location of firm ("hometown" advantage)
- Décor of office ("Look successful; act successful.")
- Name recognition (recognized from TV ads during championship sports competitions)
- Used by others in your industry ("Good enough for them, good enough for me.")

## Using the Wrong Criteria to Select Managers

---

- ◆ Typical Selection Criteria
- ◆ The Expert's Selection Criteria
- ◆ Problematic Factors
  - Profit-maximizing Business Plans
  - Assessing Market Impact Costs
  - Understanding How Managers Evolve Over Time

## What Do the Experts Say?

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What are the factors deemed essential to a manager's success from the perspective of an informed insider?<sup>1</sup>

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<sup>1</sup> Main Source: David F. Swenson, PhD.  
Manages the Yale University endowment fund.

*"Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment"; 2000*

- Has direct responsibility in the management of about \$20 billion.
- Developed a novel strategy that has outperformed other endowment and pension funds by a wide margin.



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## Swenson's Success Factors in Manager Selections

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- ◆ Integrity — The actions of the Manager are in sync with the interests of the fund sponsor client.
  - *Problem: No metric for measurement. All Managers claim that they are ethical when — in fact — some are not.*
- ◆ Work ethic - Obsessive focus on their work;  
passion for learning and growing
- ◆ Entrepreneurial mindset of firm and its principals
  - Totally independent from all other financial services firms
  - Flexible
  - Adaptable
  - Innovative



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## Swenson's Success Factors in Manager Selections

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- ◆ Smaller-sized firm (“Large size is the enemy of investment performance.”)
  - Small in terms of assets under management (in that style or product area)
  - Small in terms of number of key people
- ◆ Direct ownership structure
  - Self owned by principals
  - Incentives aligned with clients' best interests
  - Psychic ownership
  - Principals invest their own capital in the specific strategy

## Swenson's Success Factors in Manager Selections

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- ◆ Strong and loyal client base
  - Tends to improve morale during the 'difficult' times that each Manager faces (from time to time).
  - Gives Manager 'breathing room' to take a longer-term time perspective.  
Pressure for near-term performance forces decision-making for non investment reasons and usually hurts long-term performance.
  - Attracts clients who have the courage — and foresight — to look beyond a “name-brand” firm; choose firm that may lack standard institutional credentials.

## Advocate's Additional Criteria: Success Factors in Manager Selections

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- ◆ How the Manager operates — Positive attributes
  - Does the Manager take a long-term view and trade infrequently?
  - Does the Manager recognize the superiority of indexing in many areas of the capital markets by not disparaging this approach?
  - Are the Manager's fees relatively low compared with competitor firms (in each product area)?

## Advocate's Additional Criteria: Success Factors in Manager Selections

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- ◆ How the Manager operates — Positive attributes
  - Is the Manager "client centric"? — Does it opt out of the "Fee Food Chain?"

The "Fee Food Chain" is the practice of collaborating with others in the financial services industry who sell a manager's products for referral fees and service fees (a substantial initial fee and on-going commissions).

- Does the Manager resist the temptation to charge additional fees on its products to improve distribution and assets under management (such as front-end or back-end 'loads' and 12(b)-1 fees)?

## Advocate's Additional Criteria: Harmful Factors in Manager Selections

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- ◆ How the Manager operates — Negative attributes
  - Does the Manager participate in “Pay-to-Play” schemes?
    - Purchases performance measurement services from Consultants?
    - Sponsors Consultant-client social events... for a fee?
    - Participates in “Consultant Institutes” (conferences) for an enormous participation fee (\$50,000 or more per year)?
    - Buys “marketing advice” from Consultants?
    - Directs brokerage commissions to Consultant’s affiliated Brokers?

## Advocate's Additional Criteria: Harmful Factors in Manager Selections

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- ◆ How the Manager operates — Negative attributes
  - Permits its trading desk to pay a higher rate-per-share on its fund-sponsor clients’ portfolios:
    - Allows brokerage commissions to be paid on clients’ portfolios (“soft dollars”) to buy research for that manager (rather than pay for research out of its own pocket );
    - Encourages “directed brokerage” schemes;
    - Supports “commission recapture” programs.
    - Disparages indexing in efficient sectors of the market.
  - Allies with brokers who sell its products in “wrap-fee” programs.

## Using the Wrong Criteria to Select Managers

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- ◆ Typical Selection Criteria
- ◆ The Expert's Selection Criteria

- ◆ Problematic Factors

- ■ Profit-maximizing Business Plans
  - Assessing Market Impact Costs
  - Understanding How Managers Evolve Over Time

## Profit-maximizing business plans

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- ◆ Emphasizing rapid and sustainable asset growth ... with little concern about the effects of this growth on its existing clients' portfolios.
- ◆ Resulting in benchmark-hugging investment strategies (known as "closet indexing").
- ◆ Re-focusing energies:
  - From trying to outperform the benchmarks
  - To trying to not underperform the benchmarks

## Using the Wrong Criteria to Select Managers

---

- ◆ Typical Selection Criteria
- ◆ The Expert's Selection Criteria
- ◆ Problematic Factors
  - Profit-maximizing Business Plans
  - ▪ Assessing Market Impact Costs
  - Understanding How Managers Evolve Over Time

## "Market Impact" Costs

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- ◆ "Market Impact" is the extent that a price of a security is:
  - Raised by prolonged buying
  - Lowered by prolonged selling
- ◆ "Market Impact" is primarily caused by:
  - Very large firms
  - Active trading
- ◆ "Market Impact" at current average levels of portfolio turnover (100% per year) may diminish performance significantly:
  - Large-cap sector by 0.5% to 1.0% per year.
  - Small-cap sector by 4.0% per year.

## Impact of Total Transaction Costs on Returns

(Total Transaction Costs =

brokerage commissions + "market impact" costs)

A            B            C            D = B + C            E            F = D / E            G = A - F

MARKET SEGMENT	GROSS RETURNS	Estimated Round-trip Costs		TOTAL COSTS	Average Price Per Share	TOTAL COSTS	NET RETURNS
Capitalization Ranges		Brokerage Commissions (cents/share)	Est. Market Impact Costs (cents/share)	(cents per share)	for Cap Range (per Share)	(Percent of Avg. Price)	Returns AFTER Costs
Largest 500	14.1%	6	25	31	\$47	0.7%	13.4%
Second 500	16.3%	10	50	60	\$33	1.8%	14.5%
Third 500	17.4%	12	75	87	\$27	3.2%	14.2%
Fourth 500	17.8%	14	75	89	\$22	4.0%	13.8%
Smallest 500	18.6%	16	75	91	\$17	5.4%	13.2%

Source: Aronson + Partners, Wilshire Associates (based upon data from 1991 – 1999). Assumes 100% annual turnover. Excludes Berkshire Hathaway's price. Data based on Wilshire 2500 Index (which is the largest 2,500 stocks in the U.S.).

## Impact of Total Transaction Costs on Returns

(Total Transaction Costs =

brokerage commissions + "market impact" costs)

1            2            3            4

MARKET SEGMENT	GROSS RETURNS	TOTAL COSTS	NET RETURNS
Capitalization Ranges		(Percent of Avg. Price)	Returns AFTER Costs
Largest 500	14.1%	0.7%	13.4%
Second 500	16.3%	1.8%	14.5%
Third 500	17.4%	3.2%	14.2%
Fourth 500	17.8%	4.0%	13.8%
Smallest 500	18.6%	5.4%	13.2%

Small-cap advantage maybe reduced considerably by transaction costs.

Source: Aronson + Partners, Wilshire Associates (based upon data from 1991 – 1999). Assumes 100% annual turnover. Excludes Berkshire Hathaway's price. Data based on Wilshire 2500 Index (which is the largest 2,500 stocks in the U.S.).

## “Market Impact” Costs

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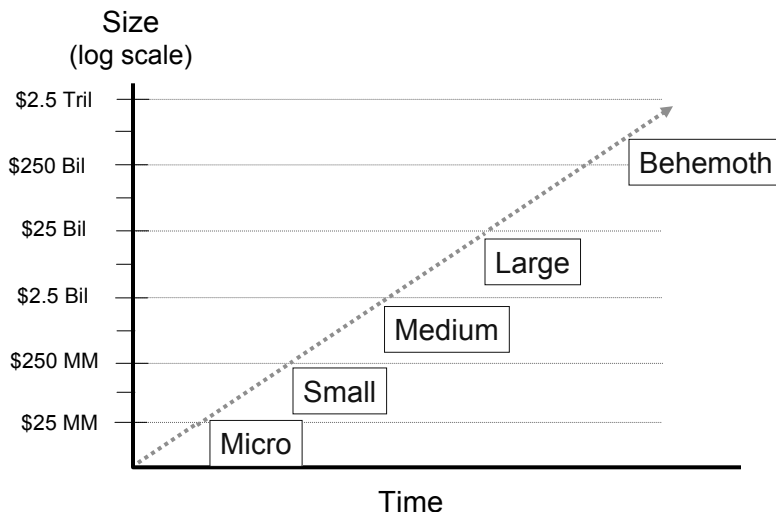
- ◆ “Market Impact” is usually not considered by most Consultants in structuring fund sponsor portfolios.
- ◆ “Market Impact” from active management is one reason why indexed portfolios tend to out-perform.
  - Index funds (and ETFs) trade much less than active managers.
  - Reduced trading directly diminishes overall costs... and increases after-fee (“net”) returns.
- ◆ Fund sponsor’s net portfolio returns are elevated by reduced market impact costs.

## Using the Wrong Criteria to Select Managers

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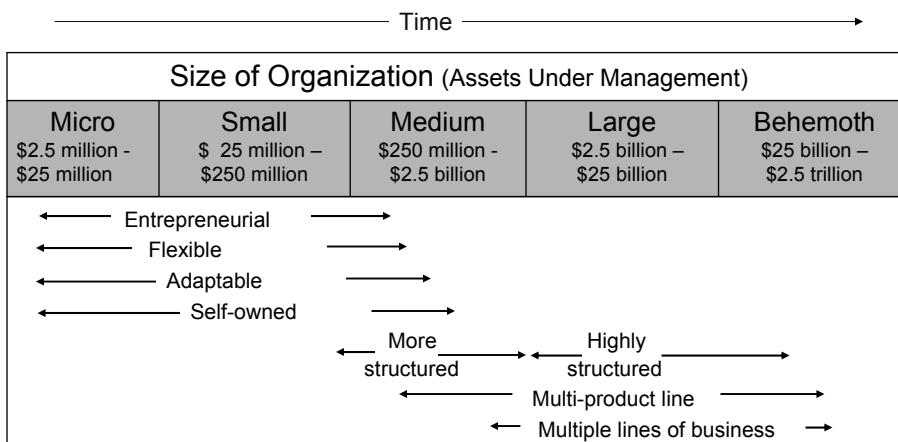
- ◆ Typical Selection Criteria
- ◆ The Expert’s Selection Criteria
- ◆ Problematic Factors
  - Profit-maximizing Business Plans
  - Assessing Market Impact Costs
  - ▪ Understanding How Managers Evolve Over Time

## The Stages of Manager Evolution



## Size Compels Evolution of Managers

Inevitable Growth Trajectory (most Managers)



## Manager's Evolution

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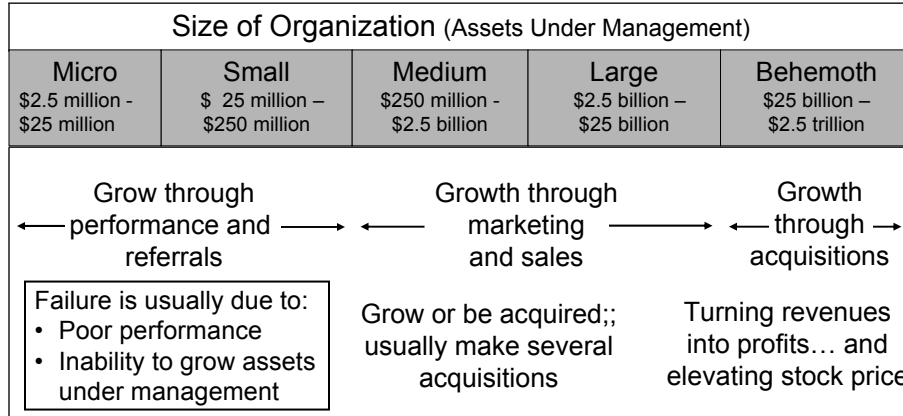
- ◆ A Manager's evolution is driven by the passage of time:
  - Firms must "grow or die"
  - A few firms try to freeze their size by declining to accept new assets... but this is incredibly difficult and very rare for a firm to do firm-wide (outside of periodic specific-product closures).
  - Growth in assets under management is driven by rates of return that increase fee revenues... and profits.
  - Usually, increased revenues supports the ability to engage sophisticated marketing types and talented sales people to gather assets... even if performance is lackluster.
  - By diversifying into many different product lines, there will always be a few that randomly are star performers; these are the funds that are heavily promoted.

## Manager's Evolution

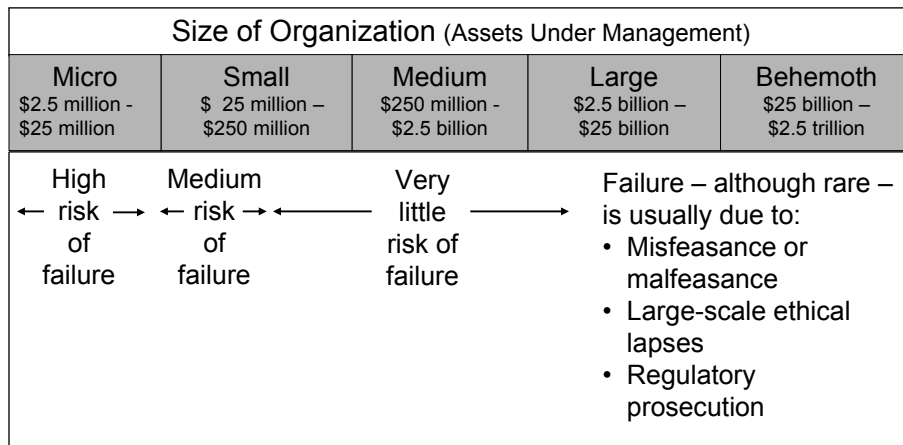
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- ◆ As entrepreneur-founders age, they have a natural desire to:
  - Monetize value of firm by establishing a market value for the business enterprise; willing to accept offers to buy them out.
  - Realize the value of what they have built during their lifetimes.
  - "Cash out" and diversify their assets.
  - Take care of their families... and themselves.
- ◆ Consequently, firms will become more structured and therefore less capable of adding value (above the benchmarks) over time.

## Size of Manager Determines its “Growth Dynamic”



## Risk of Business Failure



## Some Spectacular Large-Firm Flameouts

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- ◆ “Demise” due to regulatory problems
  - Kidder Peabody (Joseph Jett)
  - Barings – Nick Leeson (losses of £850 million)
  - Arthur Andersen
- ◆ And, some “reincarnations”
  - “Salomon Brothers Smith Barney” to “Smith Barney”
  - “Merrill Lynch Investment Management” to “Princeton Investment and Research” (now part of BlackRock)

## III. The Solutions

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- A. Comparing and Contrasting: Small vs. Large Managers
- B. The Advantages of Hiring Small Managers
- C. Changing Your Fund’s Investment Structure to Improve Net Returns: The “Core-Satellite” Structure
- D. Creating the Right Incentives — Encouraging Your Consultant to Align with Your Best Interests

## A. Comparing and Contrasting: Small vs. Large Managers

### Behemoth Managers are Considered 'Safe' and Represent a 'Deep Pocket'

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- ◆ Behemoth Managers have the following desirable characteristics:
  - Convey a sense of safety and continuity — generate “comfort.”
  - Are recognizable “brand names.”
  - Have replacements on hand when professionals depart,
  - Client-Fiduciaries perceive that they will not be held personally responsible if “something goes wrong.”
  - Their reports appear very professional — full of colorful charts, data and statistics.
  - Office environment connotes prestige and wealth.

## But, Fund Sponsors are Frequently Frustrated with Behemoth Managers...

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- ◆ Clients don't like the following characteristics:
  - Bureaucratic (*"I'll have to get back to you about that."*)
  - Rigid (*"This is the way we do it."*)
  - Inflexible (*"We are not [fill in the blank]; we can't do that."*)
  - Not adaptable; changing conditions often leave them incapable of responding in a timely manner.
  - Only the largest clients receive good service
  - Most clients assigned to the less-experienced junior team
  - Virtually nothing is tailor made to meet clients' needs.

## Fund Sponsors Value the Attributes of Small Managers...

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- ◆ Small manager attributes:
    - Energy and enthusiasm
    - Commitment to and passion for investing
    - Smart and curious
    - Entrepreneurial
    - Flexible and adaptable
    - Control their own destiny
- Higher probability of out-performing their benchmarks

## ... But They Fear Being Held Responsible if “Something Goes Wrong”

---

They waiver because of ‘misgivings’:

- Perceived higher risk of business failure.
- Impact on firm of death or disability of the key principals.
- Risk that there might be a reduced level of compliance oversight within the firm’s management.
- If the portfolio lost money, they might be reprimanded for poor judgment.
- Fund’s assets may be difficult to access.



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## ... But They Fear Being Held Responsible if “Something Goes Wrong”

---

They waiver because of ‘misgivings’:      Overcoming the negative perceptions:

- Perceived higher risk of business failure.      →      ▪ Monitor manager more frequently and more closely.



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## ... But They Fear Being Held Responsible if “Something Goes Wrong”

---

They waiver because of ‘misgivings’:      Overcoming the negative perceptions:

- Perceived higher risk of business failure.      →      ▪ Monitor manager more frequently and more closely.
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## ... But They Fear Being Held Responsible if “Something Goes Wrong”

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- If the portfolio lost money, they might be reprimanded for poor judgment.      →      ▪ Big difference between market cyclicity and misfeasance /malfeasance.

## ... But They Fear Being Held Responsible if “Something Goes Wrong”

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- Perceived higher risk of business failure.      →      ▪ Monitor manager more frequently and more closely.
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- Risk that there might be a reduced level of compliance oversight within the firm’s management.      →      ▪ Query manager about compliance oversight process
- If the portfolio lost money, they might be reprimanded for poor judgment.      →      ▪ Big difference between market cyclicity and misfeasance /malfeasance...
- Fund’s assets may be difficult to access.      →      ▪ Require a third-party custodian to hold assets.

## B. The Advantages of Hiring Small Managers

### Why Small is Better

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- ◆ Why your manager search should focus on small managers:
  - Behemoth managers rarely add value over time. They don't perform — because they can't perform.
    - They are structurally unable to adapt to changing conditions.
    - They ride the market up and down.
  - Advice from a “Grand Master”, David Swenson (Yale University) “Size is the enemy of performance.”
  - *Who ‘in the know’ seeks inflexible multi-billion dollar managers for valued-added investment management?*
  - The Northern Trust study — year 2000, repeated in year 2005 — provides substantial supporting data that the greater flexibility of smaller managers gives them the opportunity to add ‘alpha.’

## Recent Research from Northern Trust: Small Managers Outperform Large Managers

Size Category	Percentage in Data Base	Percentage in Upper Quartile	Representation Factor
< \$ 2 billion	1.0%	39%	39x
\$ 2 to \$10 billion	<b>Data not made available by Northern Trust</b>	21 %	<b>Data not made available by Northern Trust</b>
\$10 to \$20 billion		10%	
\$20 to \$50 billion		14%	
> \$50 billion		15%	

Study by Northern Trust Company during 2005 (which updates a 1995 study by TNT)  
Study covered 521 active core-U.S. equity strategies offered by 287 firms.  
Emerging managers defined as managers with less than \$2 billion in AUM.



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## What are the *Real* Barriers to “Small”?

- ◆ What are the key impediments to choosing emerging managers?
  - The “IBM - Big Blue” effect:
    - No reward if it goes ‘right’
    - Penalized if it goes ‘wrong’
  - Concerns about:
    - Firm continuity
    - Theft of assets
- ◆ These concerns are easy to mitigate; take simple steps to protect your fund contractually.
  - Ensure transparency
  - Custody assets elsewhere (not with the small manager)



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## C. Changing Your Fund's Investment Structure: The "Core-Satellite" Structure

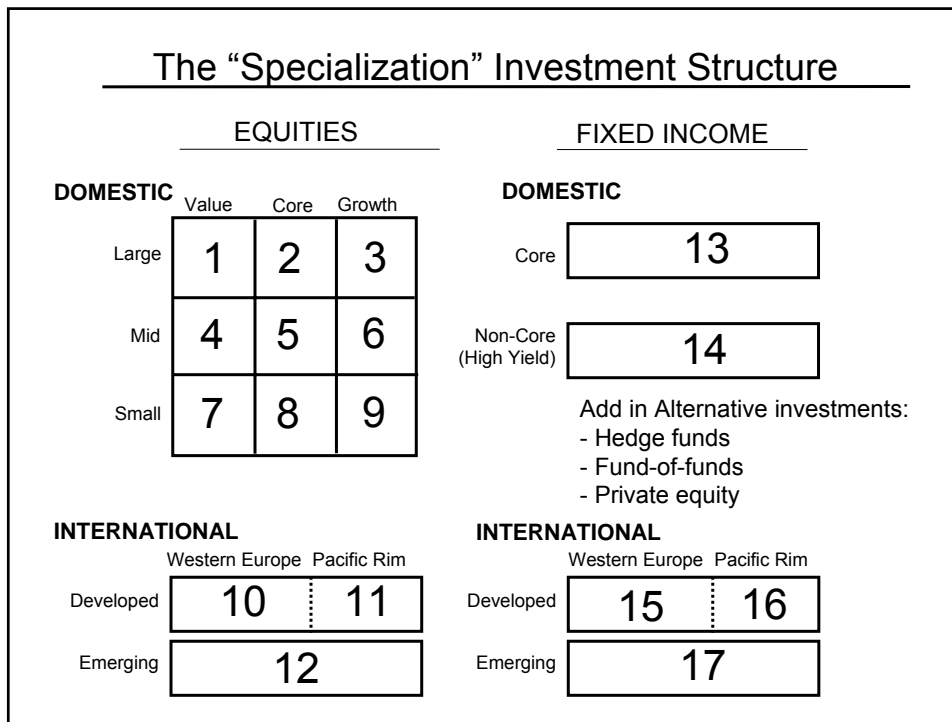
### Straight Advice from Advocate: Opt-out of "Fee Food Chain"

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To improve net after-fee returns, your fund must "opt out" of the Fee Food Chain... with its crushing levels of redundant fees for unneeded services.

- ◆ Your fund needs to alter its Investment Structure.
  - Dump the "specialization" investment structure — the one with all of the style boxes.
  - Replace with the "Core-Satellite" investment structure — to be explained momentarily.

## The “Specialization” Investment Structure



## “Specialization” Promotes Faulty Concepts

- *Faulty Concept #1: “One can regularly select manager that can outperform in the future.”*

Fact: One cannot extrapolate past performance... even though the manager may have performed well during the recent past.

Fact: Past performance has little to no information content that applies to the future.

Fact: Chasing top recent past performance is a recipe for future poor performance due to reversion to the mean.

## “Specialization” Promotes Faulty Concepts

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- *Faulty Concept #2: “Active management can and will out-perform indexing.”*

Fact: The majority of active management has not — and will not — out-perform indexing due to several factors:

- The drag on performance from competitive firms trying to outdo one another,
- The high management fees,
- The costs and expenses from active trading.

Fact: These cumulative costs and expenses are too high and unduly penalize gross returns to get to net returns.

## “Specialization” Promotes Faulty Concepts

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- *Faulty Concept #3: “Costs don’t matter; performance does.”*

Fact: Costs (fees and expenses) do matter... although the financial services industry would like you to believe otherwise.

Fact: There are many very smart and dedicated investment professionals competing to outperform one another. They do try hard but the cost structure of their business enterprises are too much to overcome relative to a low-cost, low-turnover approach that replicates the index.

## The Case Against “Specialization:” The Evidence Shown by the Data

---

- ALL of the evidence proves that Active management :
  - Less likely to outperform indexing over 1-year periods
  - Much less likely to outperform indexing over 5-year holding periods
  - Virtually never outperforms indexing during most 10-year holding periods.
- Active managers fail to beat the indexes because
  - The cost structure of active management and
  - The market impact of active trading management are so onerous.
- That the degree and regularity of failure is linked to the level of market efficiency within the sector.
- You cannot build a structure on a faulty foundation such as sand.



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## The Case Against “Specialization:” Buying in to Complexity.

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The “Specialization” investment structure ‘buys in’ to complexity:

- Complexity alters your focus.
  - It distracts you from the ‘overview’ onto the specific details.
  - It clouds your perspective.



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## The Case Against “Specialization:” Choosing the Wrong Performance Objective

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- All managers are expected to beat most other managers in their ‘style.’
  - This is a *relative* performance objective.
  - You cannot pay pension benefits with relative dollars.

## The Real Goal!

---

The Fund’s real goal should be to increase the probability of outperforming its liability hurdle... to provide:

- An adequate pension benefit to its membership.
- An adequate return to cover the endowment’s or foundation’s spending policy while growing the corpus slightly over time

This is an *absolute* performance objective.

## The Real Goal!

---

- The real goal should be to increase the probability of your fund outperforming its liability hurdle... to provide an adequate pension to its membership.
- This is an *absolute* performance objective.

## The Real Goal is Achieved by...

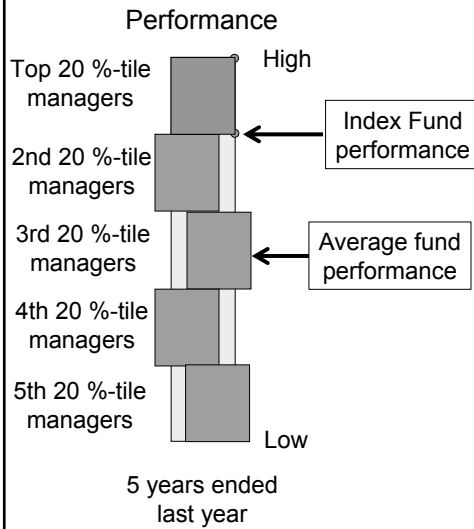
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- Cost savings — reducing fees on asset management in areas of the capital markets that are efficient, and
- Reduction in redundant services that add little to no value (and may impose negative value)

Cost savings is crucial!

- Saving 100 bp is identical to outperforming by 100 bp.
- Saving 50 bp to 250 bp in “market impact” fees from active trading is 5% to 25% of long run return expectations from equities (i.e. 10% return).

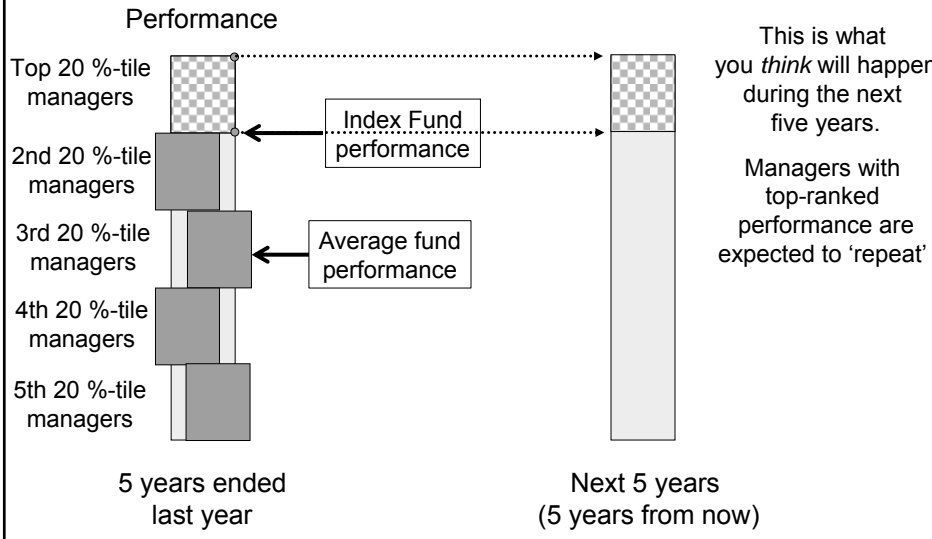
## The Case Against "Specialization:" Performance Attribution



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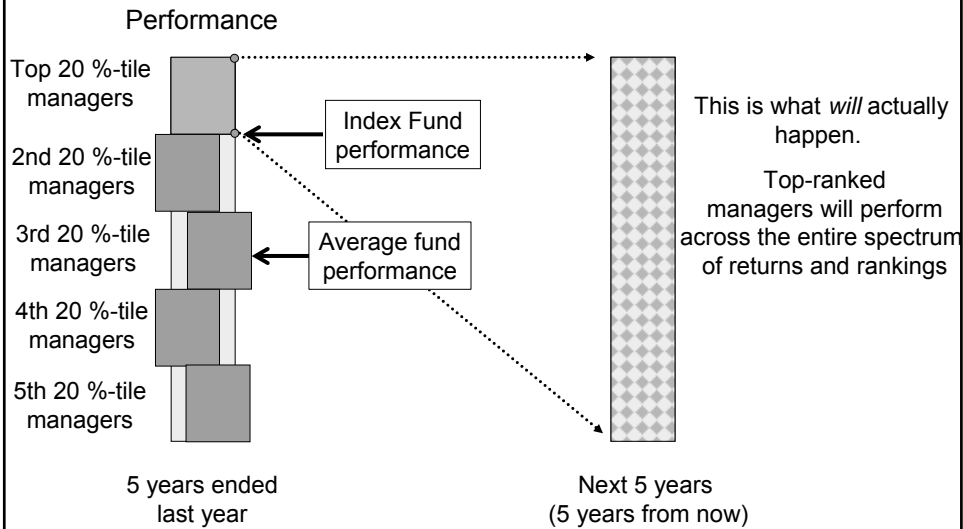
## The Case Against "Specialization:" Performance Attribution



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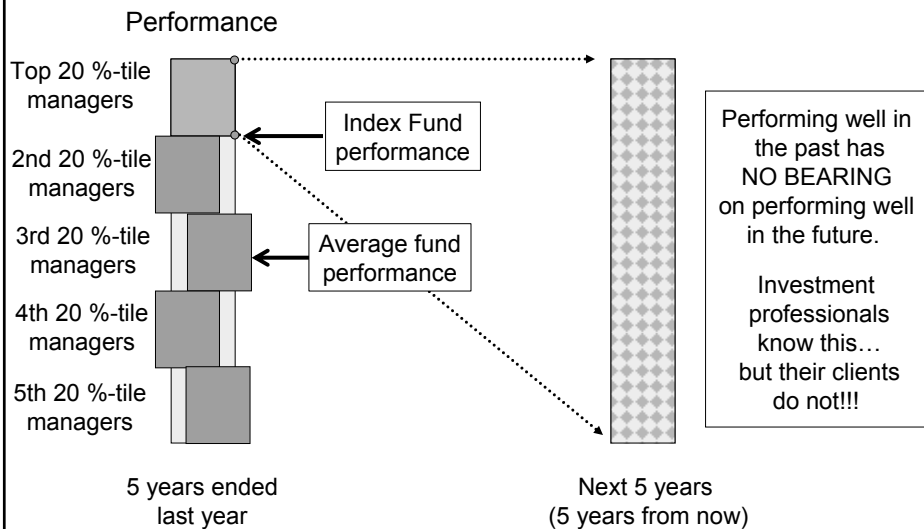
## The Case Against "Specialization:" Performance Attribution



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## The Case Against "Specialization:" Performance Attribution



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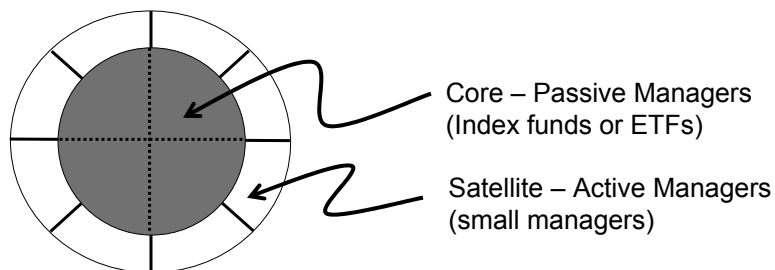
## Is there an Alternative to this Past Pattern of Repeated Disappointment?

There is an alternative to the “Specialized” investment structure model. To understand what is required, you need to know the following:

- In order to perform better — to achieve a higher after-fee return net of fees — your funds **MUST** be structured differently.
- If your fund is structured the same as most other funds, your performance result will be about the same as most other funds!
  - “Doing what most others are doing results in... getting what most other funds get.”
  - *“Cannot make a silk purse from a sow’s ear.”*

## Introducing the “Core-Satellite” Investment Structure

- ◆ For the core, utilize low-cost market baskets (index funds and ETFs)
- ◆ For the satellite, utilize managers with the potential to add value... emerging managers (smaller firms),



## Comparing Investment Structures: By Cost

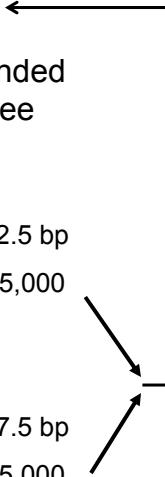
Investment Structure	Indexed	Active	Total	Blended Fee
<u>Specialized</u>				
Allocation	15%	85%	= 100%	
Fee Rate	10 bp	60 bp		52.5 bp
<u>Core-Satellite</u>				
Allocation	65%	35%	= 100%	
Fee Rate	10 bp	60 bp		27.5 bp


  
 -47%  
 (reduced fee)

## Comparing Investment Structures: By Cost Assume Assets of \$100 Million

Investment Structure	Indexed	Active	Total	Blended Fee
<u>Specialized</u>				
Allocation	15%	85%	= 100%	
Fee Rate	10 bp	60 bp		52.5 bp
Fee	\$ 15,000	\$510,000		\$525,000
<u>Core-Satellite</u>				
Allocation	65%	35%	= 100%	
Fee Rate	10 bp	60 bp		27.5 bp
Fee	\$65,000	\$210,000		\$275,000

Savings = 25 bp per year  
= \$250,000 per year



## Benefits of Core-Satellite Structure - 1

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- ◆ Obtain low-cost management for the areas of the market that are proven to be “efficient.”
  - Save all of the headaches, costs and time of chasing the elusive “next hot manager.”
  - Go with the solution that will likely outperform...
    - 8 out of 10 active managers over the next 5 years;
    - 9 out of 10 active managers over the next 10 years.

## Benefits of Core-Satellite Structure - 2

---

- ◆ Improve the probability that the active managers that you do select:
  - Are structurally capable of outperforming, and
  - Have some evidence that their investment approach is:
    - Flexible,
    - Consistent,
    - Reproducible,
    - Can outperform.

## Benefits of Core-Satellite Structure - 3

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- ◆ Simplifies your investment structure considerably.
  - Heavy utilization of indexing dramatically reduces fees paid for investment advice.
  - It also reduces considerably ancillary fees for other service providers such as custody, clearing charges and brokerage commissions from active trading.
  - And, it also reduces considerably hidden expenses such as “market impact” costs — the drag on performance of large managers acquiring or disposing of securities positions... as much as 50 bp for large-cap managers and 250 - 400 bp for small-cap managers.

## Facilitating your Consultant's Alignment with your Fund

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- ◆ The key to this revised program is to NOT reduce your consultant's fee.
  - Currently, most consultants have “inducements” to seek additional sources of revenues outside of their consulting clients' relationships.
  - You need a way to break this pattern of conflicted alignments between your fund and your consultant.
  - Your objective is to better align your consultant with your interests; paying a fair fee is the first step.
  - As a complete change in mind-set, you need to avoid the temptation to retain the low-fee consultant;
    - There is a reason the fee is lower than the competition.
    - Usually, this is not in your fund's best interests!

## Your Consultant Suffers from “Manager-fee Envy”

---

- ◆ The educational requirements and certifications of consultants are usually identical to that of portfolio managers.
  - MBA (Master of Business Administration)
  - CFA (Chartered Financial Analyst)
- ◆ However, the compensation is vastly different... at the firm level (the ownership level) and the individual level.
  - Managers’ fees are typically 10- to 20-times higher than consultants’ fees.
  - This is because consultants are viewed as ‘information processors’ while managers are viewed as “decision makers.”

## Your Consultant Suffers from “Manager-fee Envy”

---

- ◆ Consultants feel entitled to a higher level of fee revenue but
  - Due to historical convention and intense competition, they cannot command fair fee levels.
  - Many consultants seek other forms of revenues to augment their consulting practices.
    - As managers are beholden to consultants – the consultants are the ‘gate-keepers – they are the ideal source to purchase un-needed services or products from the consultants...
    - ... and they have!

## Your Consultant Suffers from “Manager-fee Envy”

---

- ◆ To the extent that fund sponsors systematically undervalue the analytical capabilities of their consultants to add — or detract — from long-term value, the fund sponsors (in effect) encourage their consultants to commit ethically questionable practices.

## What If?

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- ◆ What if consultants were ‘incentivized’ to work only in the best interests of their fund sponsor clients?
  - What if consultants were paid to be pro-active and give advice instead of undecipherable choices?  
*“On the one hand and on the other”*
  - What if consultants’ recommendations were able to be measured and a performance record was established?
  - What if consultants’ fees were elevated to a high-enough level to ensure total alignment with their fund sponsor clients’ interests?

## What If?

---

- ◆ Would your fund pay more for good advice *versus* advice that:
  - Adds to complexity,
  - Adds to costs,
  - Keeps the consultant fully employed doing many different searches that adds little (or nothing) to returns... and
  - Reduces returns?

### D. Creating the Right Incentives for Your Fund's Consultant

## Benefits of Core-Satellite Structure

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- ◆ We suggest that you strike a different compensation arrangement with your consultant.
  - We recommend 'incentivizing' the consultant so they align its interests totally with your fund's best interests.
    - With the egregious conflicts of interest in the financial services industry , we urge you to raise your consultants fee.
    - Further, place the consultant on a symmetrical bonus fee structure with equivalent rewards and penalties.
  - The blended fee — the total fund effective fee of your consultant and your managers — should decline dramatically.
  - Trustee and custodial fees should decline also.

## Further Opportunity to Reduce Fees

---

- ◆ Consultants are envious of the level of fees that managers extract vis a vis the consultants time, effort and contribution to the overall fund
- ◆ The root of the conflicts of interest promulgated by some consultants is traceable back to this envy. (They want their 'piece.')
- ◆ Certain pro-active consultants *could* provide more value added ... if they were recognized for the effort and compensated accordingly.

## Place Your Consultant on a Performance Incentive Fee

---

- ◆ Novel idea: Consider adopting performance-incentive fees for your consultant (first) and managers (later).
  - Place the consultant on a symmetrical bonus fee structure with equivalent rewards and penalties.
  - If the current fee to the consultant is a flat fee, convert it to an asset-based fee. If your managers get rewarded or dinged by the movements in the markets, then your consultant should be on the equivalent arrangement.

## Place Your Consultant on a Performance Incentive Fee

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- ◆ Instruct the consultant what you are seeking... more proactive advice.
- ◆ Increase the consultant's fee by 15% to 20% — it is a very small level of fee rate to begin with.
  - Which asset classes and styles should be added or diminished in the fund portfolios?
    - Why (the rationale),
    - By how much,
    - When and
    - Through whom to conduct the transaction.
  - Which managers should be retained or dismissed.. and why (in writing)?

## Place Your Consultant on a Performance Incentive Fee

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- ◆ That 15% (or 20%) additional fee and 15% (or 20%) of the current fee — a total of 30% (or 40%) — needs to be placed by the consultant “on the line.”
  - They need to “buy in” to the performance incentive fee basis.
  - The range of consultant’s fee then is the same plus or minus 30% (or 40%).
  - If your fund just reaches its blended benchmark, then the consultant

## Performance Incentive Fee for you Consultant

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- ◆ For each 50 bp net earned by the fund above its blended benchmark (agreed to before the calculation time period is started), the consultant gets 2.5 bp additional or a 5.0% incentive fee.
- ◆ However, if the fund performs below the blended benchmark, then the 5.0% dis-incentive fee rate is applied and the fee is reduced from the amount owed to the consultant.
- ◆ The measurement time period is to be a minimum of a rolling 24-month period to avoid the possibility of ‘gaming.’

## Closing Thoughts

### “Rules of Engagement” — What YOU Need to Do

1. STOP listening to the “Marketing Message”; pay attention to the real costs and the after-fee returns.
2. Understand that the behemoth firms are not structured to deliver what your funds want or need... other than ‘comfort’... and a false sense of safety and continuity.
3. Instead of an expensive “closet indexer” masked as an established investment manager, use a ‘core-satellite’ investment management structure.
  - A. The ‘core’ are indexed-type of products
  - B. The ‘satellite’ is smaller, more entrepreneurial firms
  - C. Examine carefully all lock-up types of investments; they control your capital for years and charge a very high captive price.

## “Rules of Engagement” — What YOU Need to Do

4. Understand that the asset allocation studies using “mean-variance” algorithms are virtually worthless;
  - A. They extrapolate the past... and
  - B. Convey a false comfort.

*This is a very important subject that we would be please to discuss at another CESSE conference.*

5. The second most powerful investment force is “mean reversion”; (the first is compounding of returns). Do not get caught on the wrong side of a mean-reversion trend.
  - A. Chasing top past performing sectors, styles & managers — momentum investing — is a sure-fire formula to make a little money... and to lose a lot.

## “Rules of Engagement” — What YOU Need to Do

6. Asset classes, investment styles, sectors and industry groups go through long-term cycles. So do the stocks in these categories.
  - A. Shun the popular trends, the ‘five-star’ funds and top-performing managers.
  - B. Select out-of-favor and unpopular areas of the capital markets where the catalysts are in place for a major trend reversal on the upside..

## “Rules of Engagement” — What YOU Need to Do

7. Go back to “square 1.” Analyze whether or not your consultant is totally independent.
  - A. If not, then conduct a search for a truly independent firm.
    - i. This step determines your path over the next 5- to 1-years
    - ii. “Low cost” is usually the highest-cost alternative.
    - iii. Be smart regarding consulting fees; pay a few basis points more and get the best team to serve your fund’s interests.
  - B. If yes, proceed... but with a greater commitment to:
    - i. Low-cost market baskets (index funds or ETFs), and
    - ii. Choose some smaller, emerging managers that want to earn your business and can pass your due-diligence screens.



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