Investment Stewardship Guidance

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Don't You Know, We're Talking About An Evolution?

Addressing The New Challenges Facing The Diverse Manager Community

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Introduction

In recent years, some proactive and thoughtful pieces[1] have spurred constructive dialogue within the investment consulting and plan sponsor communities on the measurable benefits of incorporating "diverse" investment firms within their various investment programs. In short, a diverse investment manager can be defined as a firm that is women owned, minority owned, or a combination of the two.

This newsletter strives to enhance the ongoing series of constructive discussions and solutions featuring Marquette, the diverse investment manager community, and the plan sponsors who wish to advance diverse manager initiatives. It is Marquette's view that broader conversations about the diverse manager community should deliberately acknowledge the existence of newer structural headwinds that diverse managers face in today's market. By focusing on these material hurdles - some of which are highlighted in this newsletter - the plan sponsor, diverse manager and consultant communities will be in a stronger position to formulate practical solutions to these challenges. These structural changes and material headwinds include:

- A growing demand from plan sponsors for low-cost index products;
- Intense competition for asset flows in the asset management industry;
- A low projected return environment, requiring plan sponsors and consultants to look beyond "traditional" or "staple" asset classes, and;
- The emergence of defined contribution (DC) plans as the retirement vehicle of choice for employers; a headwind since diverse managers have traditionally seen the bulk of their asset flows come from outside of the DC segment

What's in a Definition?

During the 1990s, "emerging manager" initiatives grew in popularity, particularly amongst public plan sponsors. Given the demographics of our country, public plans - generally speaking - have typically supported diverse annuitant bases; for such plans, selecting an emerging manager was an effective method to invest with boutique, entrepreneurial and ethnically diverse investment managers with the goal that these managers would outperform their benchmarks (i.e. adding alpha) over the long term.

If we fast forward to 2017, the term "emerging manager" has evolved considerably: Whereas in the 1990s the term "emerging manager" was synonymous with being an MWBE (Minority and/or Women Owned Business Enterprise), today the classification of an "emerging firm" is significantly broader. For example, during the 1990s any investment firm that was labeled an emerging firm was by default an MWBE.

[1] Examples include: Casting a Wider Net (ReFund America Project, Roosevelt Institute and SEIU) and Who Manages The Money? A case study of the W.K. Kellogg Foundation By Thurman V. White, Jr. in cooperation with ABFE: A Philanthropic Partnership for Black Communities

Today, however, the term "emerging manager" can be used to reflect that the firm's total assets under management (AUM) are less than $2 billion and have nothing to do with the race, gender or ethnicity of the firm's owners.[2] In other words, based-off their AUM, MWBE entities and non-MWBE entities in today's environment can both qualify as emerging managers whereas decades earlier, the term emerging manager applied exclusively to MWBE asset managers.

Given the evolved definition of an emerging manager, along with the fact that there are a growing number of MWBE managers with track records greater than 10 years (thus making them neither "new" to the asset management industry nor "emerging" from a performance perspective), we will avoid using the term emerging manager for the remainder of this paper and, in its stead, use the term "diverse manager".

In aggregate, diverse managers still represent a relatively small percentage of total industry assets and while some such firms have seen steady growth, positive re-invention, expanded product lines and the development of a strong brand, the overwhelming majority of diverse asset management firms today still fall under the category of a boutique investment firm. Clearly, when it comes to MWBE firms there is significant room for growth and expanding their share of the asset management pie.

Key Structural Changes and Their Implications For Diverse Managers

Exhibit 1: Current State of Diverse Ownership

Vehicle Type or Strategy	Total Female Ownership (% of Total Industry AUM)	Total Minority Ownership (% of Total Industry AUM)	Total Diverse Manager Ownership (% of Total Industry AUM)
Mutual Funds	0.9%	0.3%	1.2%
Hedge Funds	<1%	<1%	<1%
Private Equity	1.5%	3.4%	4.9%
Real Estate	0.3%	1.5%	1.8%

Source: Diverse Asset Management Project Firm Assessment – Bella Research Group; Timeline of Diverse Ownership for Mutual Funds: every quarter from Q1 2011 through Q2 2016; Timeline of Diverse Ownership for Hedge Funds: since 2010; Timeline of Diverse Ownership for PE and Real Estate: since 2004.

The representation of diverse firms within the investment industry, as highlighted by Exhibit 1, is relatively – if not shockingly – small. To assist with the meaningful growth of MWBE managers, Marquette believes that it is critical to discuss the supply and demand mismatch that currently exists between diverse manager product offerings and the staple (i.e., non-faddish) asset classes that have seen growing demand from plan sponsors in recent years.

The eVestment database shows that there are 28 diverse fixed income firms that manage 137 different products; 119 diverse equity managers that manage 392 products, 16 diverse firms that offer multiple asset class offerings across 25 different products and 4 diverse real estate firms that manage 12 products.

Exhibit 2: Looking at the Universe

Firms

Fixed Income	Equity	Balanced/Multi-Asset	Real Estate
28	119	16	4

Products

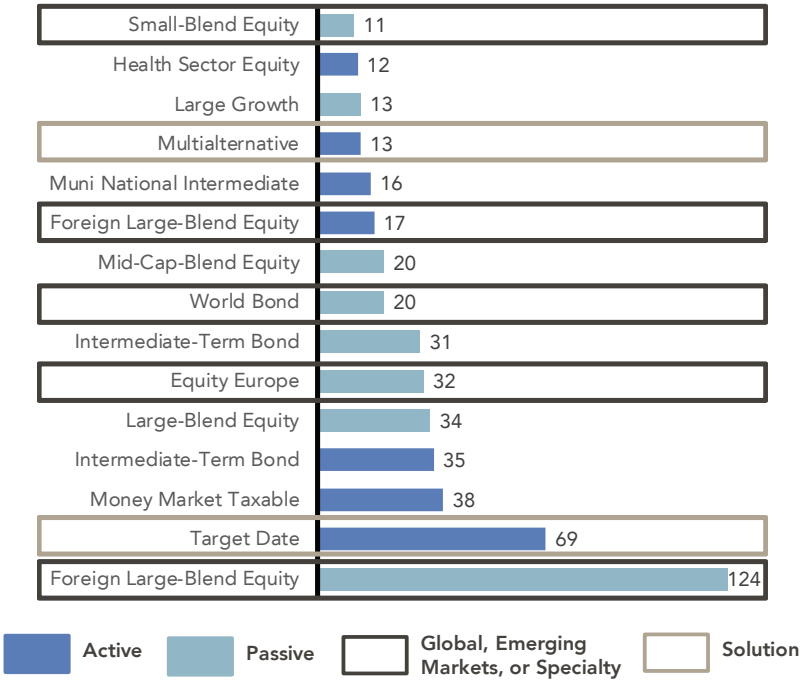
Fixed Income		Equity		Balanced/Multi-Asset		Real Estate	
137		392		25		12	
U.S.	Non-U.S.	U.S.	Non-U.S.	U.S.	Non-U.S.	U.S.	Non-U.S.
116	21	260	132	9	16	7	5

Source: eVestment (universe data for period ending June 30, 2016)

[2] DePaul Business and Commercial Law Journal (Vol 13, Issue 1 – Fall 2014), Pensions & Investments - Public pension funds' definition of emerging manager still a work in progress

While the number of managers (167) and the number of strategies that they collectively manage (566) is encouraging, it is important to look further at these numbers to see how the 566 strategies are distributed and, what percentage of these strategies are in asset classes that have seen significant growth in recent years. In 2015 for example, 60% of the top 15 asset classes that saw the most inflows within the U.S. were allocated to passive (index) options, while other strategies such as target date funds that are popular within the DC channel also saw considerable growth that year and are expected to see a greater accumulation of assets over the long-term.[3]

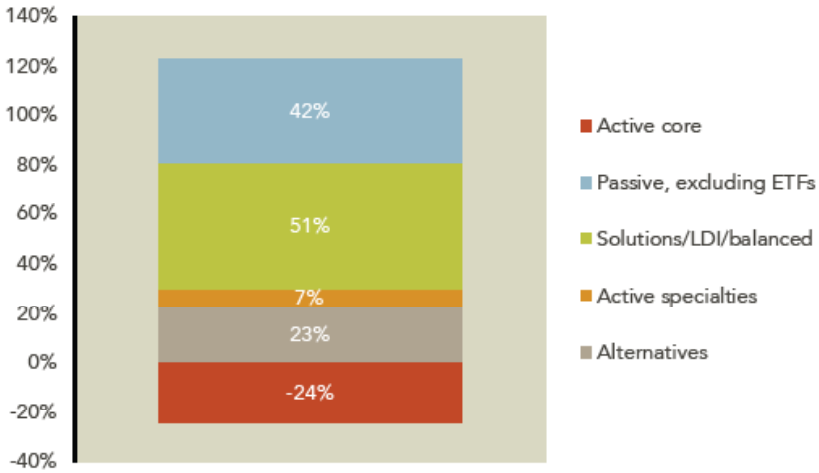
Exhibit 3: Breaking Down Asset Flows (Top 15 Strategies By 2015 Net Flows, $billions)



Source: Boston Consulting Group: Global Asset Management 2016

Asset classes such as international equity and strategies like target date funds are expected to see a disproportionate amount of industry asset flows in the coming years; herein lies the concern when we switch our attention back to the diverse manager universe and the distribution of the strategies that are generally managed by this subset of managers.

Exhibit 4: Estimated Share of Cumulative Net Flows (%) (2016-2020)



Source: Boston Consulting Group

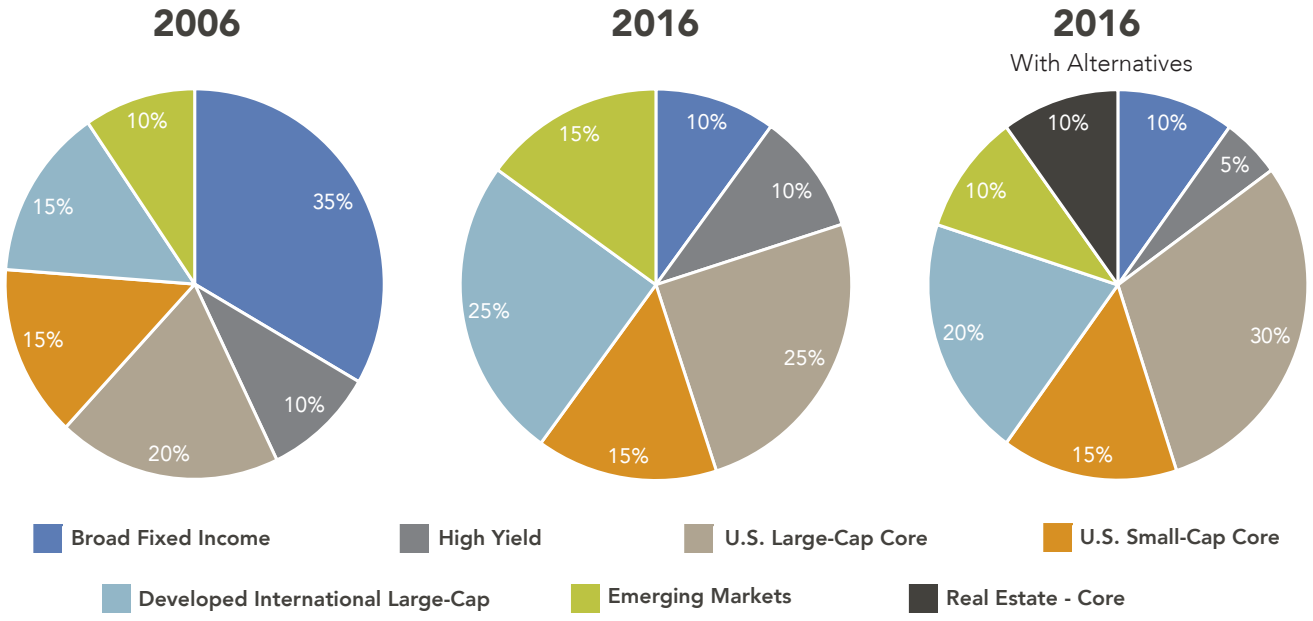
[3] Sources: Boston Consulting Group: Global Asset Management 2016, Source: Morningstar Direct Asset Flows Commentary: United States, Barrons, CNBC

To conclude, the broadly changing demand for various asset classes and vehicles by plan sponsors has been driven by three key factors:

1. Significant growth in demand for passive products;
2. The rise in assets allocated to DC plans like 401ks and Individual Retirement Accounts (IRAs), and;
3. As highlighted by Exhibit 5, material changes in the long-term return expectations for the major asset classes. Shifting return expectations have materially impacted the demand for certain asset classes; in 2006 for example, a plan sponsor would have expected to achieve its long-term target rate of return of 7.5% with the following allocation:
   - 35% – Core Fixed Income
   - 10% – High Yield
   - 20% – U.S. Large Cap
   - 15% – U.S. Small Cap
   - 15% – Non-U.S. Large Cap
   - 10% – Emerging Markets

As compared to 2006, in today's environment, structuring a portfolio to achieve that same 7.5% long-term rate of return would require a reduction of core fixed income exposure and a smaller allocation to U.S. large cap equity. Commensurate with the decline in core fixed income and U.S. large cap allocations, allocations to non-U.S. large cap and emerging markets equities would naturally increase, which translates to higher expected volatility. For plan sponsors that are highly sensitive to this material increase in expected portfolio volatility, we would likely see the substitution of equity beta with real estate and alternatives such as private equity.

Exhibit 5: How The Times Have Changed



2006 Avg. Annualized 10 Year	
Return	7.5%
Volatility	8.9%

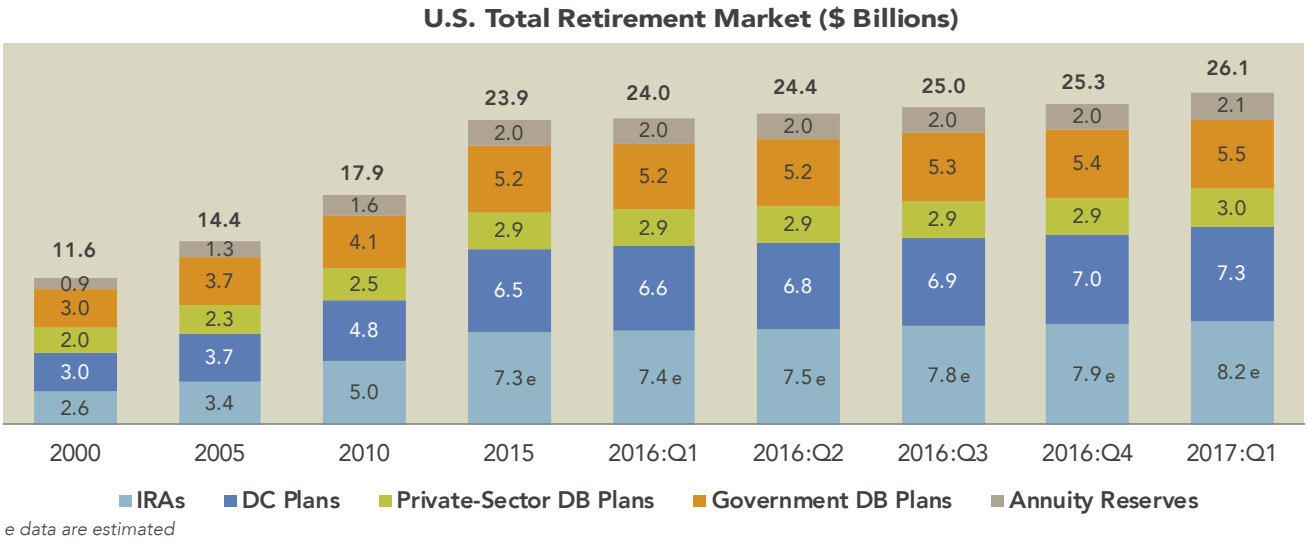
2016 Avg. Annualized 10 Year	
Return	7.5%
Volatility	13.3%

2016 Avg. Annualized 10 Year (+Alts)	
Return	7.7%
Volatility	12.8%

In summary, the growing demand for low-cost index products and a low projected return environment has meant that a significant number of plan sponsors are more than willing to increase their allocations to return seeking and diversifying asset classes such as international equity and alternative investment options. Critically, these high demand strategies are managed by a relatively small number of diverse firms.

Another structural change that cannot be ignored is the seismic shift in assets from defined benefit (DB) pensions to DC savings plans. As shown by Exhibit 6, total assets in DC plans have eclipsed those held by DB plans. Generally speaking, DC plans account for a significant portion of mutual fund assets, and diverse firms have not traditionally seen a significant portion of their AUM derived from the mutual fund channel. This redistribution of assets from DB to DC plans has also been a key driver of the supply and demand imbalance between the products that are typically offered by diverse firms and the asset classes that have seen the most significant growth in asset flows.

Exhibit 6: Retirement Assets



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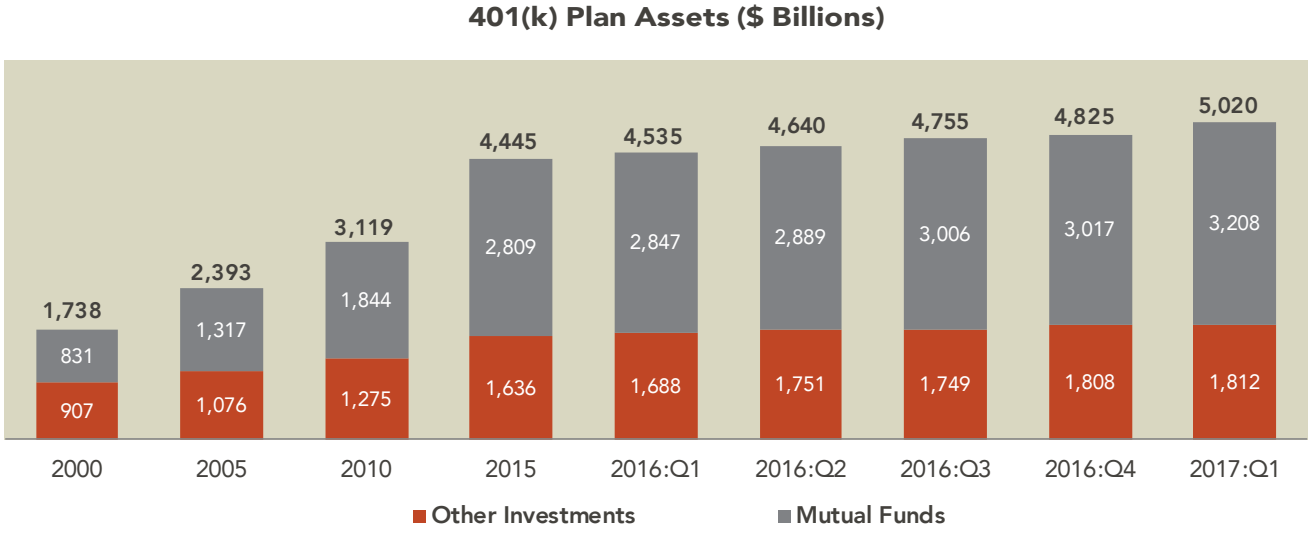

Source: Investment Company Institute, Federal Reserve Board, and Department of Labor

Conclusion and Next Steps

While it is important that plan sponsors, diverse managers and consultants continue to discuss and provide practical solutions that address the diversity hurdles that exist within the investment industry, it is equally critical that all of the aforementioned parties concurrently address and explore thoughtful solutions to overcome the structural challenges that have been highlighted in this newsletter. For example, it is a realistic expectation that target date funds utilized by DC plans will continue to grow at a healthy clip beyond the $1 trillion plus that they currently hold in mutual funds and collective trusts.[4] Thus, it is essential that plan sponsors, diverse managers and consultants identify practical avenues for MWBE firms to enter this key market; potential methods include sub-advisory relationships, collaborative and strategic relationships across multiple diverse investment managers or potentially, a revival of manager of manager firms, entities with the skillset and track record of building custom portfolios.

Similarly, when addressing the imbalance between the supply of certain strategies and the demand for asset classes that are managed by just a few - if any - diverse managers, it is perhaps practical for plan sponsors, consultants and diverse managers to push for greater diversity on investment teams at non-MWBE firms. Without nurturing a new generation of diverse talent at mainstream firms and within highly underrepresented – from a diverse investment professional standpoint - strategies such as core real estate and private equity, the investment industry runs the real risk of making the supply-demand balance between diverse managers' product offerings - and the demand for certain strategies - even greater in the future. It is worth noting that many of the well-known investors at diverse firms started their careers at bulge bracket firms prior to starting their own firms. Therefore, it is important that practical solutions that seek to address the supply-demand imbalance can further the tradition of molding experienced investors from the fertile training grounds of larger firms. Ironically, larger firms - particularly those with multiple product lines across traditional and alternative asset classes - can ultimately be one of the bigger catalysts for positive long-term change in the diverse manager landscape.

While the diverse manager community remains at a cross roads and the process of adapting and evolving is far from straightforward, the diverse firms that do navigate through the headwinds described in this paper will arguably be tomorrow's winners. Similarly, if some of the points that have been raised in this paper can spur a discussion and action that leads to a growing pipeline of talented, skilled and experienced female and minority professionals at larger or "mainstream" firms, this would be a desirable outcome from Marquette's perspective. Undoubtedly, the investment industry would likely benefit from the "normalization" of diversity while at the same time, addressing the lack of female or minority participation within certain asset classes or strategies by building a steady pipeline of thought-leaders and investors in these segments of the market.

The Marquette team looks forward to further dialogue with the diverse manager and plan sponsor communities on the points raised in this newsletter. For the plan sponsors reading this paper, we look forward to continuing our discussions with you at our upcoming meetings, our special topic luncheons or one of our regional roundtables. For the diverse managers that have reviewed this piece, we continue to welcome your thoughts and feedback. Marquette continues to maintain an open door policy to the investment manager community and, additionally, our team looks forward to seeing you at our next round of diverse manager luncheons and roundtables.

[4] Sources: Morningstar, Barrons

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