Emerging Managers
In the Institutional Investment World

A PREA Roundtable

Moderator

Ted Leary, President, Crosswater Realty Advisors

Participants

Diego Carrillo, Investment Officer, CalPERS

Claudia Loewe Faust, Founder and Managing Partner, Hawkeye Partners, LP

Marjorie Tsang, Director of Strategic Research & Solutions, New York State Common Retirement Fund

Marc Weidner, Managing Director, Franklin Templeton Real Estate Advisors

Now that the real estate investment world is back to a somewhat more healthy, normalized environment, the idea of investing in and through emerging managers has been resurrected. Just who are these emerging managers and why the renewed interest? **PREA** gathered a Roundtable of leaders to discuss the many aspects of this topic.

Leary: I'd like to start by getting from each of you a concise definition of *emerging manager*. I have found that definitions vary from firm to firm and fund to fund, so much of what follows in my questions is based on what people think an emerging manager is. Let's start with Diego: What is an emerging manager at CalPERS?

Carrillo: CalPERS Real Estate defines an emerging manager as an investment management firm with less than $1 billion of assets under management, and it is limited to first, second, or third commingled funds and/or separate account investment strategy.

Leary: Does that mean you have different definitions for emerging managers in different asset classes?

Carrillo: Yes, each asset class has its own definition of an emerging manager.

Leary: Claudia, you are next.

Faust: Hawkeye defines an emerging manager as a firm that does not manage institutional capital on a direct and perhaps discretionary basis. This could be a lift out from an opportunity fund or a financial services firm or an operator/developer that traditionally invests capital from investment advisors to pension funds.

Leary: Marjorie?

Tsang: Emerging managers for the real estate commingled fund program would be managers that are raising funds under $750 million and have not invested beyond Fund III. For our vehicle for real estate joint venture operators, the definition is managers or operators who have less than $1 billion in equity capital under management, have been in the business of real estate investing for 12 years or less, and have not raised more than three institutional funds.

Leary: Marc?

Weidner: Franklin Templeton typically defines emerging managers as those that have limited institutional experience and a strong desire to provide institutional quality. The best definition, as Marjorie suggested, is first, second, or third institutional fund-raise and a small size; typically, $750 million is a good starting point.

Leary: Emerging managers seem to be getting renewed focus, the topic of a lot of conversation in the past couple of years. Is there evidence that emerging managers produce better results?

Tsang: I wouldn't say that it is necessarily a renewed focus; this has been discussed for a great number of years. It has just been implemented of late. Maybe four plus years ago, PREA supported the formation of a working group to discuss emerging managers. But to get to your point, Ted, obviously the goal is to get good returns and to find the managers that will be able to produce the profits that the pension funds seek in an era when there is a lot of competition. That is getting a lot of attention right now.

Leary: Marc, you sponsored a paper that showed that first-time managers tend to do better than more established funds. What was interesting was that by the time those managers got to their second, third, and fourth funds, they started to tail off.

Weidner: That is correct. First-time funds tend to outperform number two, and number two typically outperforms number three, so that is the negative

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correlation. There is very strong, consistent anecdotal evidence. I don't think we can write the last chapter on this, with all the caveats about survivor bias and data issues that the industry has to deal with, but there is an increasing body of evidence that shows this trend. There is also a positive correlation between small size and return. Small size brings focus to a particular established strategy or targeted strategy. That doesn't necessarily mean it will always outperform the broader strategies, but in many cases, it has. These are attributes that emerging managers tend to exhibit.

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Leary: If you accept the logic—call it the young-and-hungry-produce-better-results-but-over-time fade—should we have an affinity group for "demerging" or disappearing managers? Time and size are enemies of returns, but the big dogs keep getting bigger. So can investors have it both ways? Can they keep giving money to large, multigenerational real estate managers and at the same time invest in emerging managers because theoretically they produce better returns?

Weidner: Our view is that they should probably do both. But to Marjorie's point, I think "emerging managers" is really just a new term for an old concept; these are the new entrants to the market. The new entrants might have new ideas, a new level of commitment and determination, a drive that you don't always see elsewhere, but at the same time, they capture only a certain type of exposure. We certainly are not arguing that investors should disregard the larger, established, "emerged" managers. Some of them are producing extremely good results. Others are disappearing as well. I think we are just in a manager cycle in today's environment, which makes it so interesting.

Leary: What is it about these emerging managers? Is it youth, energy, new ideas that produce better returns? What triggers their ability to outperform?

Tsang: There is a focus, a very strong focus in what they have experience in, what they are going to target and accomplish. They have a great deal of skin in the game in many different aspects. They are incented to do very, very well because their future is riding on it. It is an investment strategy that they probably know well, and they can execute smaller transactions better than established managers. So you have a quite a number of factors that are to emerging managers' advantage. They have challenges also. That is what we as investors have to take into account as we evaluate them.

Faust: Marjorie, I think you said that very well. We look for certain attributes in a manager. Honestly, new or old, certain characteristics tell you which ones are going to do better. Specialists tend to do better than nonspecialists as well as platforms that are focused versus nonfocused. We look for firms where every piece of business counts. They might be new firms, or they might be firms that have an equity-based model where they make money only if the deals do well over the long term. We want to do business with firms that have a natural alignment of interest with our capital. For example, a publicly traded investment management firm is motivated to grow AUM; that is how its stock benefits. However, a private firm that makes money when the deals make money is motivated to produce better results in terms of the overall performance at the asset level. These things exist regardless of whether a firm is new or has been around for a while.

Carrillo: CalPERS has been investing with emerging managers directly and through funds of funds for more than 20 years. Based on our experience investing in this space and on our lessons learned throughout the years, CalPERS Real Estate has a renewed approach toward investing in emerging manager strategies. In August 2011, the CalPERS Investment Committee approved a new formal $200 million real estate emerging manager program. The objectives of this program are to achieve risk-adjusted returns at or above the benchmark, to access investment opportunities that may not otherwise be pursued and to source and mentor talented emerging investment managers located in California with the potential to grow and become successful

institutional investment managers. Claudia just touched on specialist versus nonspecialist and focused versus unfocused, which factored into our thinking when developing this new program. Our goal was to develop a clearly defined, focused, and smaller program with the hope of expanding upon it in the future.

Leary: That is a good segue into my next question. What are the risks to an investor, and how do you vet an emerging manager? When the new team of Joe and Jane and Jack and Jill tells you what its returns were, what its track record was, what its experience base is, how do you know that information is the new team's and not their old firm's?

Faust: That is a very good question. The kind of firms we look for have professionals who have been around a long time; they are cycle-tested. You can look at what they have been involved in over many years to better understand what their history has been. We go through a lot of their past deal flow in detail. We want to understand how they think. It is just as much their track record as how they think about deals, how they approach deals, where you see their weaknesses, and separately, how they run their businesses. In addition, if they leave a firm and are on their own, can they transfer their access to deal flow?

Leary: If they are cycle-tested, by definition, they've survived one or two cycles, so they can't be too young.

Faust: Right. If the professionals have been around for less than a cycle, I think you have quite a bit of risk.

Leary: Anybody else want to jump in? I think the vetting issue is a tough one.

Carrillo: One of the risks that CalPERS identified with regard to this strategy is that it is very time- and resource-intensive. Claudia just outlined how intensive sourcing and overseeing emerging managers can be. In contrast to the more traditional fund-to-fund structure, the program will have a separate account structure with one of our existing, external managers. This "mentoring manager" will be responsible for sourcing, overseeing, and mentoring emerging managers selected for this program. The downstream structures between the "mentoring manager" and emerging managers will be separate accounts as well. Once sufficient data is available to evaluate investment performance—cost and other relevant factors—CalPERS will assess whether to up the allocation.

Tsang: Perhaps Marc could describe some of the due diligence process. On behalf of the Common Retirement Fund, there was due diligence in connection with a new team that had come out of an investment bank. That posed the question you did, Ted: How do you know that it is the team's track record? How do you know it was not the efforts of some other individual or some other team or that it was organic to these individuals as opposed to the product of the larger institution?

Weidner: Sure, Marjorie. You need to do all the due diligence for an established manager, but you also need to work a little bit harder in this more difficult environment to get the facts. Attribution of track record is a big issue. It is complicated enough to assess the track record, but now you need to deconstruct the track record and assign it to a particular individual. You do that with a grain of salt, of course, because success has many factors. And everybody would claim the good results. But then I think it is about cross-referencing the data. This is the most time-consuming aspect of due diligence. You need to ask the same questions over and over again among the largest possible number of people who participated in a transaction. That is just for the track record, but you should probably do the same for every step of the due diligence process.

We assume that most institutional investors have a similar investment process; it is step-by-step, quantitative, and qualitative. When it comes to emerging managers, however, the information is not always readily available. When it is readily available, you probably need to unpack it and look behind it. So the due diligence is more resource-

intensive; Diego noted that. It is more time-consuming and probably a little bit more intellectually challenging because at some points you need to find ways to get access to the information.

I want to go back to Claudia's comment about what a good manager is. Our view on this is really that the investment capability is always first and up front; everybody sees it. We look at the deals and the deal sourcing, the pipeline, the track record, the reputation. But we also spend a lot of time on the middle and back office. The operational systems go beyond asset management; there is the reporting: how much does the manager know about the portfolio at any point in time? Does the manager have the capacity and willingness to service institutional investors that are entitled to receive customized information reliably and on very short notice? By the way, this is conditioned to scalability; at the beginning of their business lives, people probably know everything about the deals they are doing, but as they grow, they need to put together systems and operations. This is critical, especially when there is turnover, which inevitably happens.

The last piece is understanding the fiduciary obligation, or having the appetite to be an institutional manager. That is much more complicated to assess; it is a very qualitative judgment, but it is key. I would summarize it this way: Will a manager be willing to forfeit short-term interest for the long-term benefit of the investors? In other words, when this alignment of interest breaks—which happens from time to time; we have evidence of that in recent history—what will the manager do? Will the manager look at the short-term interest, or will the manager look at the big picture and understand the need for different action required for the portfolio? For us, this is really the golden rule that we are trying to establish and find when we underwrite managers.

Leary: Marjorie, there was a number involved in the definitions we heard, a billion or $750 million, no more than that; if you are over that, you are not an emerging manager. But is there a minimum emerging managers have to have under management or otherwise they are on an economic suicide mission because they just can't make it?

Tsang: I wouldn't assign a minimum number to it because there are so many other criteria that should be used to evaluate whether a very, very early-stage manager has the ability to take on the responsibility established under a program. Some of the managers we have worked with may be very, very young and have had very little under management, but they have other attributes and experiences that demonstrate the maturity and experience to be able to, in our evaluation, be successful. So we don't establish a minimum number.

Leary: Does anybody give the same level of attention to whether an emerging manager gets too big and has been around too long? The natural flow of things is that the performance numbers start going down. I don't see how an investor can be excited about emerging managers as a strategy to improve returns when big managers that have been around awhile keep getting money. I am missing something there.

Carrillo: For CalPERS, scale is something staff is always mindful of. The Real Estate Unit has a target of 10% of the total fund. If the total fund is approximately $240 billion and real estate is approximately $21.5 billion and at 9% of the total fund, then generating economies of scale becomes critical. Real Estate's strategic plan includes reducing the number of investment managers we do business with and allocating more capital to a smaller number of managers. That is our business model going forward. Additionally, the strategic plan carves out a portion of its portfolio to tactical investments, including an emerging manager strategy. So getting back to your question earlier about whether investors can do both, the answer is yes for CalPERS. We have identified managers—typically larger, more established managers that have done well by us—to receive annual allocations. In addition to continuing these larger relationships, CalPERS Real Estate will also invest in emerging manager strategies.

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Tsang: It is not a zero-sum game that if managers have gotten older, they are not performing. Look at the managers that have received commitments even above their targets; they have performed. The literature has supported that. Their returns have been solidly on-target, not middling. As investors, that is our job. We are looking for managers that are going to deliver the returns we are seeking. I don't know any investors that are going to say they are going to cut anyone any slack just because they have gotten larger. First and foremost, the criterion has to be performance. Not all funds take a single path. All these funds have emerged. The existing leadership is often not always there from beginning to end. A fund brings other people on, brings in new blood, people retire, so it is an evolution. It is not a one-size-fits-all.

Leary: It is expensive to be in the business initially. Are you willing to pay more to an emerging manager in terms of basis points or something to make sure the manager gets started? A number of the people I have dealt with had some very good ideas, but they really didn't understand the fundamental economics of the institutional business, particularly what I'd call the burden of reporting to large pension funds and consultants. In the last cycle, they got stretched because they didn't have enough AUM; they had more costs than they anticipated because they kept getting requests for information from clients. Is there some point at which you have to give your emerging manager X dollars to help ensure that the manager doesn't flounder financially, no matter how creative or how good the strategies are? Are you willing to subsidize an emerging manager to make sure the manager is focused on the strategy, not so much on paying the rent every month?

Faust: We are focused on firms that can be standalone managers after they come through our program. We don't invest in funds. Instead, we create a separate account-like structure and then allocate significant capital to it on a discretion in-the-box basis. We can give emerging managers some seed and growth capital, but at least in Fund I, we did not need to do that. We can lower the cost of entry tremendously because the firms can start investing immediately. We will also support some of the fund administrative aspects of their operations if needed until they can get the staff on board themselves. But the reality is, depending on the strategy of an organization, to run an investment management business and raise a fund, an emerging manager is going to have to have $4 to $6 million in overhead covered annually. Basically, most funds are too small to pay that overhead. That limits the field quickly.

When institutional investors develop emerging manager programs, they have to have a clear view of what they are trying to accomplish and tailor the path to get there. Are the investors trying to find firms they can work with over time, who will become part of their stable? Or are the investors trying to spread some capital around the industry as a more general sign of support of emerging managers? The willingness of the investor community to support new entrants over time is the most critical element of an emerging manager program.

Investors need to know what it costs a manager to run their business. Emerging managers should be willing to give investors a sense of what the budget is for running their business, their sources of income, the net worth of the principals, what capital is available to them. I think investors make a mistake sometimes when they think emerging managers are hungry, so let's just slash their fees and promotes. The problem is investors need to realize the fees may be the only source of income for the platform, and they shouldn't cut emerging managers' income beyond the place where they can survive. Likewise, asking for a higher preferred return can also be problematic because it can encourage firms to take on riskier kinds of investments than their sweet spot or prohibit them from competing for deals in the market. The promotes are also what attracts talent. Investors should understand how managers are financing their businesses. Make sure the financing is sound and managers have a realistic budget to support themselves and business plan for their develop-

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ment because if you are in a fund, it is an eight- to ten-year relationship.

Leary: Have you all found that most people understand the issue Claudia just described—the time and cost side of being an institutional manager versus an entrepreneur who finds capital periodically when he or she needs it? Or are they naïve about that?

Weidner: I think it is part of the mentoring aspect that Diego referred to. Underwriting an emerging manager requires a different type of interaction with the manager. Claudia described it very well. There is a conversation going on, and the conversation is not an exchange of information and requests; it is a conversation about the business, about the plan, about the growth, about what is appropriate and what is not. It is a very different type of conversation than you would have with Fund V of a multibillion-dollar fund, where you would pull out the information that is relevant for your process as opposed to telling the manager what best practices you see with other fund managers globally. I don't think those managers are interested in having that conversation very often. Maybe they will listen if they are fund-raising, but I think emerging managers are truly interested in understanding what the requirements are. And there is a learning curve on both ends.

Leary: Marc, are you also doing what Claudia described earlier, underwriting the "business model" and "profitability model"?

Weidner: Sure. I think we take a comprehensive approach to the fee. I totally agree with Claudia. You have to start with the P&L; you can't start with the sort of "magic" base fee number, because it doesn't mean anything. You want to make sure you don't only negotiate a price, because if you do, you might be sorry with the results and end up with bigger problems. The base fee should cover the cost of doing business, and you want to make sure you understand that cost and that the manager needs to be funded and funded properly. If you don't do that, you are going to run into trouble quickly. On the performance fee, what we tend to see with a lot of the emerging managers is that the people who benefit from the performance fee are often actively involved in the fund that you are investing in as opposed to being in a family of funds, in a family of products, or in a family of asset classes. That creates a focus and an alignment of interest and, frankly, a reward profile for the managers that will get you there at an overall cost that we believe is not more expensive than what you would pay for an established manager. But don't negotiate the fees too hard because you may regret it.

Leary: Anybody else want to comment on that?

Carrillo: I think getting a small incremental amount over what you might pay a manager that has a much larger allocation is appropriate. We presented it to our investment committee last year when we recommended this program. We disclosed and were very transparent about the fact that this would be a more expensive program; we have two layers of fees that are associated with this space. And we want these emerging managers to focus on sourcing their investments, not necessarily being distracted by source capital. We really think the process going forward is that the mentoring manager will be in the vetting process more so than in the sourcing process. We fully expect the mentoring manager to be in the trenches in that due diligence process and that sourcing process—everything that everybody has talked about today. All of this is going to cost.

Leary: Is there an optimal model or several good models for going about finding emerging managers and investing in them and/or through them?

Tsang: This gets back to the fact that every organization, every pension fund has its own personality. Look at all the programs that have been discussed over the past two to three years; they all reflect what the pension fund needs and wants. And that is the way it should be. For example, we have two different programs. One is directed toward funds;

another is directed toward something the Common Retirement Fund has done a lot of and well historically, which is in joint ventures. Organically, we felt that that was an opportunity we wanted very much to pursue. In our eyes, it was a unique strategy, and therefore we had to be very open-minded about how to structure the program, find that mentoring manager, and design the program. It is unique to us. I would say that every single emerging manager program we've seen over the last few years is geared toward the needs of that particular pension fund. I also analogize it to what Diego said at the beginning, which is that every asset class may have a different definition and therefore every pension fund for real estate has a certain goal to meet, and therefore each program is reflective of it.

Leary: Marc, you're doing more traditional funds to funds, is that right? Or do you have some separate accounts doing this?

Weidner: The way we address the issue of sourcing is an open-door policy with a 360-degree approach. Funds or investment ideas come to us in all shapes or forms. Whether the pitch is a one-page list of bullet points or a full-fledged presentation, it doesn't matter. What is important is that we see the makings of a potential manager, and we start a conversation. So it goes back to the resource issue we discussed earlier. It is important that we have sufficient resources available to reach out and be available. This open-door policy starts at the beginning of the process, to take an initial pulse, and for the managers we see potential in, we start a conversation. If it is successful, that conversation goes all the way through to a plan formation and an investment.

I would like to say a word on the MBE/WBE space—the minority and women business owners space—which is part of the emerging manager space. We see a lot of interest in this segment. All the same attributes we are talking about today are present in the MBE/WBE space, but the MBE/WBE space is underrepresented in the capital market. It is obvious when you go to conferences and events and when you look at the profile of the industry, that we are missing out on diversity. Some of these managers have a commitment to or an understanding of a certain product or asset class or community that we think might be harder to reproduce in other types of funds. The MBE/WBE space is just another way for investors to diversify their exposure to real estate and not get everything the same but with different names in their portfolios.

Carrillo: Piggybacking off your comment, Marc, and as I stated earlier, our objectives for investing in emerging manager programs include generating risk-adjusted returns by identifying early-stage funds with strong potential for success, accessing unique investment opportunities that may otherwise be overlooked, and cultivating the next generation of external portfolio management talent. But we believe that women and minority-owned investment management firms are more likely to be emerging managers, and as a result, an ancillary benefit of our emerging manager program may be the increased diversity of CalPERS Real Estate external fund managers.

Leary: What few words of advice would you give potential emerging managers?

Tsang: It would be the same advice I would give any manager: slow and steady wins the race.

Weidner: I would add to that: understand the investor and the investor's needs and spend time doing so. Many managers are more introspective or focused on their operations. I think it is a good investment of their time to really understand the final beneficiaries.

Carrillo: Stay disciplined and "stick to your knitting."

Faust: There isn't much more for me to say. I agree, keep disciplined. I think what Marjorie said about slow and steady wins the race really speaks to why the space has opened up for new managers.

Leary: I think we have covered all we had planned in a great conversation. Thank you all for participating. ■

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