

Picking The Right Manager, A 3PM Critique

Steve Rubenstein of third party marketing firm Arrow Partners provides insight into how 3PMs evaluate investment managers

During a recent meeting of third party marketers in Chicago, Arrow Partners participated in a panel discussion on what to look for when selecting money managers to represent.

The purpose of the session was to help 3PM firms better identify and evaluate potential manager-clients. We began our comments with the observation that after 15 years in third party marketing, it is clear to us that the most important component of building a successful 3PM business is choosing the right manager to represent.

Within a few seconds, a few hands were raised in the audience. The question everyone wanted an answer to was: "How do we source or identify managers?" For us, the reality is that no two situations are the same. In fact, our most successful client engagements have been referrals from a range of sources including other 3PM firms, consultants, investors and personal relationships, not from screening industry databases or through proactive marketing.

I tried to discourage the session's attendees from attempting to find some magic formula to uncover the "perfect manager." Instead, I suggested they focus their attention on avoiding the wrong manager. Let me explain.

One of the benefits of being a veteran third party marketer is the wide range of experiences we have had, both positive and negative. The good news, I explained, was that these experiences have greatly impacted our ongoing manager selection

A 4 Part Series



process. In fact, we have had enough mistakes that documenting them to be sure we'd avoid them in the future became an important initiative at Arrow. Over time that documentation has evolved into an internal scorecard. Today, we are much more confident in our choices and sleep better at night with the roster of firms with which we are partnering.

The purpose of our scorecard, I explained, is to help us evaluate managers more quantitatively with greater consistency and to identify potential "red flags" and warning signs about a manager's profile. This checklist, while designed for 3PM's, can also assist managers in garnering a better understanding of their strengths and weaknesses.

During the next four months, we will present and discuss the four main components of our 28-factor scorecard. The four parts are:

- Part I - People & Organization
- Part II - Product & Strategy
- Part III - Investment Process
- Part IV - Terms & Conditions

We have tried to create a disciplined process for evaluating the "soft issues" of manager due diligence. This scorecard is our attempt at developing a 360 degree view of a manager.

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Scorecard: How to Evaluate People & Organization

Part I - People & Organization

Goal: Evaluate the "talent" component of the firm.

Often, I receive phone calls from other 3PM firms that are having problems with one of the managers they represent. Frequently, after a short conversation, I observe that there were early warning signals that the 3PM may have ignored. Perhaps then, the conflict or issue could have been anticipated and maybe avoided. People are creatures of habit, and tend to act consistently and similarly over time.

Some 3PM firms make the mistake, in our view, of focusing too much on performance numbers and quantitative "risk" metrics and not enough on the qualitative elements of the firm such as culture, chemistry and the integrity of the firm's key employees.

Other organizational topics are now at the forefront of due diligence including compliance, infrastructure and transparency, to name a few. Recent events have proven that the financial strength of the manager is more important than ever.

There are, of course, certain criteria that are more heavily-weighted than others; some issues are "deal killers" while others could be considered nit-picky.

Think about the following eight items.

Ownership: independent firm with widely distributed equity ownership, is the team going to stay?

- 3 = 100% owned by key decision makers
- 2 = substantial ownership by professionals (> 50%)
- 1 = insignificant ownership by professionals or 75% by one person

Number of investment professionals: more is better, consider plans/ability to hire down the road.

- 3 = 3 or more investment professionals
- 2 = 2 professionals or 1 with plans to hire more
- 1 = one man show

Culture of firm: strong values, able to retain talent, solid brand, defined succession plan

- 3 = leaders set positive examples, promote from within, high trust factor

2 = open-ended mission statements, speak in cliches, over confident

1 = high employee turnover, business of "silos", finger pointing, fear-based, blame game, reactive

Portfolio manager presentation skills: looking for polished, sincere, articulate, and persuasive.

- 3 = comfortable, persuasive, passionate, professional
- 2 = lesser presence, knows what they are talking about, with confidence
- 1 = boring, drone, mumbles, inarticulate, rambling style, needs help

Reputation and integrity: are there any "skeletons in the closet"?

- 3 = no legal actions, clean ADV, good gut feeling
- 2 = "story" appears to check out fine regarding past employers or SEC audits
- 1 = checkered past, much explaining to do, legal actions, fined or censured

Financial strength: are they in a position to invest in the marketing effort?

- 3 = lots of cash on balance sheet, pays bills on time, profitable firm
- 2 = "breaking even", performance significantly impacts P&L,
- 1 = living paycheck to paycheck, late on paying bills, high burn rate

Manager location: geographically desirable is preferred.

- 3 = major city, lots of daily flights, possible airline hub
- 2 = limited flight availability, 1-2 hour drive from major city
- 1 = no direct flights, remote location

Portfolio manager "pedigree": prefer high caliber people with great references from first class organizations

- 3 = Blue chip background, well recognized, long history of repeated success
- 2 = solid background and credentials, but unknown
- 1 = "I can confirm that they worked here...that's all," not distinguishable



Scorecard: How to Evaluate Product and Strategy

After evaluating the people and organization, the next step to identifying good managers is product and strategy.

One of the common questions our managers are asked during a meeting with a pension consultant is "How does a small firm like yours efficiently narrow down the entire universe of stocks to a manageable list?" Good question!

For years, consulting firms have used quantitative scoring systems to evaluate and monitor the growing universe of investment managers.

So, we decided to create a similar discipline for our manager selection process.

While we don't have any secret formulas to find the right manager, we do have many ways to avoid the wrong manager. Here are the seven factors we consider.

Part II - Product & Strategy

Goal: Evaluate the "product profile" and investment decisions.

Asset class activity: Capacity constrained is preferable. With hot asset classes, consultants and plan sponsors are more likely to overlook issues that may be deal-killers in other styles.

- 3 = high demand with limited supply of quality managers
- 2 = consistent current demand or increasing demand
- 1 = occasional interest or tactical demand

Performance: Above median for 3 and 5 years. Consistency on a year to year basis is important.

- 3 = top quartile with consistency, 5 years (or close), low dispersion, with critical assets
- 2 = top quartile with volatility or 2nd quartile with consistency, less than three-year track record, dispersion of returns
- 1 = below second quartile over long term or too short a track record

Assets under management: Critical mass makes life easier but it's hard to find.

- 3 = \$100 million small-cap, \$750 million large-cap, \$400 million hedge fund, \$2 billion fund-of-funds
- 2 = less than the above, but something to work with
- 1 = nothing to work with

Available capacity: Must be enough to make it worthwhile.

- 3 = potential annual recurring revenue of \$1+ million
- 2 = projected annual recurring revenue of several hundred thousand dollars max
- 1 = limited capacity, targeted campaign, short life

Institutional clientele: Makes things easier, the more the better.

- 3 = several institutional clients, enough for a composite
- 2 = one or two unknown institutional clients
- 1 = no institutional clients

Portability of performance: Only relevant if team lift-out

- 3 = fully portable, GIPS verified, able to link
- 2 = reference to prospectus, gaps in time
- 1 = none to cite, starting over, "I was part of a team"

Investment vehicles: Can they take clients of all size, type and location?

- 3 = separate accounts, commingled vehicles, mutual funds, SMA/wrap, LPs
- 2 = primarily separate accounts, experience with commingled funds, willing to invest
- 1 = lots of small separate accounts only

For anyone analyzing managers, including managers themselves, we hope you find this evaluation tool to be useful. Part III will be discussed in the next issue.



Scorecard: How to Evaluate Investment Process

After evaluating the people and organization and product and strategy, the third step to identifying a good manager is investment process.

Recently, we ran a domestic equity large cap growth screen of a leading industry database and found more than 200 firms possessed a 10-year record. So we did some easy math and concluded that there are approximately 50 firms that have a top quartile 10-year record. Wow! So the question we were faced with was whether or not we wanted to represent a large cap growth firm knowing the headwinds we faced trying to "differentiate" this firm vs. 50+ other managers...each of which has top quartile 10 year records. Obviously, the answer was no.

Developing the ability to quickly say "no" is probably the most difficult lesson to learn. We have to be decisive and efficient with our time management skills.

Here are six topics to consider.

Part III - Investment Process

Goal: Determine the "uniqueness" of the process

Disciplined process: Consultants love process that appears to be disciplined, especially with buy and sell rules, because it's repeatable and it gives them confidence in managers future actions.

- 3 = process is clear and easy to put down on paper
- 2 = process exists but with a lot of subjectivity, needs to be developed
- 1 = not well articulated, convoluted story

Competitive advantage: looking for repeatable sustainable advantages.

- 3 = clearly identifiable anomaly to exploit
- 2 = some elements of uniqueness, must be "drawn out" from manager
- 1 = been there, done that, cliché, commodity sounding

Identifiable style: manager must have a style that can be defined or categorized to fit in a consultant box.

- 3 = fits easily into an existing style/cap box
- 2 = good fit with some exceptions
- 1 = grey area, difficult to identify logical buyers

Attribution analysis: holdings & returns based, peer group rankings.

- 3 = consistent value added across all categories, numbers con firm story well
- 2 = conclusions fairly positive, time-sensitive, invites data mining
- 1 = "Houston, we have a problem" or too short a record

Distinctive "story": a unique "story" and/or process makes for an easier sale.

- 3 = easy to distinguish from competitors
- 2 = unique parts of the process that we have emphasize
- 1 = story is hard to distinguish from the crowd

Backoffice systems and service providers: Institutional quality and support & administration.

- 3 = well recognized, national firms, superior infrastructure and "large company" systems
- 2 = would probably barely pass most due diligence inspections



Scorecard: How to Evaluate Terms and Conditions

As a third party marketer that represents smaller emerging managers, we are often asked "Why doesn't the manager have more money?" Sometimes the answer is that manager has not marketed before and preferred to build a meaningful track record before trying to grow. That is fine...as long as it is true.

Unfortunately, there is often another reason. Many investment managers have long track records, great performance numbers but only a small amount of assets. The reason, we have frequently observed, is that many of these folks don't respect the distribution side of the investment management business. They feel that the buyers will "find them as long as they continue to put up good numbers." They will repeat a story they heard, or overheard, about one manager that opened doors to new business and raised a few billion dollars by word of mouth and reputation. One of my favorite excuses is the comment that they once had a salesperson at the firm, but "it did not work out." This is not a Field of Dreams business.

Some firms will state they are too busy for marketing and only have enough time to manage the portfolio. They will tempt or challenge a 3PM with a higher commission payout if they can raise the money, but the "red flag" warning is clear. They won't make a commitment to the marketing side of the firm. Stay away!

Part Four - Terms & Conditions

Goal: Determine the "fairness" of the relationship and view of the sales & marketing function.

View of 3PM business: ideal situation is referral from manager with successful 3PM relationship

- 3 = firmly committed to 3PM model, no internal salesforce, "drank the kool-aid"
- 2 = salesperson left, seems to possess open mind, may internalize in future
- 1 = skeptical, micromanaging, compete with internal people, list-centric

Contractual terms and conditions: look for proper combination of exclusive relationship, retainer, expenses, commissions, trailers

- 3 = all of the above
- 2 = combination of retainer with reasonable protection, fair commissions
- 1 = limited target, short term, no/little retainer, short trailer

Commitment and accessibility of the professionals to market: perhaps the most important issue over the long term. Refers primarily to the willingness to travel and supply us with data we know to be necessary to do our job professionally.

- 3 = will gladly do everything we tell them to do, willing to speak at conferences
- 2 = willing to travel, but reluctant with some information
- 1 = their most favorite thing to do is say "NO" to us

Marketing history: prefer undiscovered manager, not in databases, no protected list

- 3 = "Why don't they have more money?" limited institutional presence, truly unrecognized
- 2 = mild recognition in marketplace, neutral/positive reception
- 1 = overmarketed firm with history of ineffective sales effort, broken story

Marketing materials and information requests: must be able to answer questions and turnaround replies to inquiries promptly

- 3 = manager "pushes a button" and correct answers arrive within 1-2 days
- 2 = takes a week for turnaround, often needs editing, but getting better
- 1 = disaster, must pull files from archives, piece-meal solutions, no process

Chemistry: do we enjoy their company? How do we feel when they call?

- 3 = can finish each others sentence, definitely on the same page
- 2 = over time, relationship improves, normal amount of initial two-way skepticism
- 1 = oil & water, don't respect marketing function, roomservice instead of restaurants

Website: are they technologically current?

- 3 = nice site, lots of material, professional brand
- 2 = outdated site, limited web presence
- 1 = no web site, no plans to launch, no interest

For anyone analyzing managers, including managers themselves, we hope you found this four-part evaluation tool to be useful.

