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INVESTMENT COMPANIES

Emerging Manager Programs: A Best Practices Overview
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Emerging Manager Programs: A Best Practices Overview

OBJECTIVE

Investments in private equity have become an important asset class for large pension funds looking for long-term, attractive returns and diversification. A growing number of pension funds are interested in developing emerging manager programs, but most are not sure where to start, or how best to structure such a program.

The objective of this white paper is to provide an overview of best practices from some of the nation's leading pension funds that have pioneered private equity investment with emerging managers. This report does not provide an extensive and exhaustive review of best practices, but rather analyzes and compares a few of the more successful emerging manager programs in order to identify those factors that appear critical to their success. We intend for the paper to stimulate further thought and discussion about emerging manager programs, and invite the insight and feedback of others in the field. We also hope the models discussed in this paper will serve as an inspiration and a guide to other institutional investors.

After extensive research, several interviews with key decision makers at three selected pension funds, and a number of discussions with successful emerging managers, we have concluded that seven critical success factors are needed to build sustainable emerging manager private equity investment capabilities. Emerging manager programs can yield myriad benefits. However, the primary goal for each of the emerging manager programs that are discussed in this paper is to generate attractive investment returns that are on par with, or superior to, industry norms.

EMERGING MANAGER PROGRAMS

Over the past few decades, an increasing number of state, county and city pension funds have included emerging managers as components of their strategy to invest in alternative assets. Generally, the industry definition of an "emerging manager" is a money manager that manages assets below a given threshold—for example, no more than \$2 billion of assets—but investors can apply their own criteria to what should be considered "emerging."

For the purposes of this white paper, "emerging managers" are defined as any private equity/alternative asset class investment firms/funds that are majority owned or managed by people who have traditionally been underserved or excluded from the industry, namely people of color and women. Historically, the terms "emerging manager" and MWBE (minority- and women-owned business enterprises) were interchangeable because MWBE asset managers fell below

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investor thresholds within mainstream investment consultant manager universe databases. In many instances today, the vast majority of MWBE firms are still considered emerging managers. However, some MWBE operators may not classify as emerging managers either because they have garnered increasing assets under management built on both a successful track record alongside sustainable business models or they have reached a more mature stage of their business life cycle.

Initially, many practitioners in the private equity field, and even some on pension fund boards and their investment consultants, questioned the wisdom and prudence of allocating scarce assets to individuals and private equity investment firms that they perceived as having limited knowledge and relationships. To many, it appeared as if the pension funds' decision makers were capitulating to pressure from minority voters and/or vocal civil rights organizations. This initial reaction upset experienced minority and some non-minority professionals, who had observed that the number of qualified emerging managers had increased dramatically across the country. Indeed, many of these professionals had graduated from top business schools and honed their investment expertise by working in top-tier private equity firms.

Despite this skepticism, progressive leaders and institutions worked to provide opportunities for these new emerging managers. Three of the largest pension funds stood out above all others: California Public Employee Retirement System (CalPERS), California State Teachers' Retirement System (CalSTRS) and New York State Common Retirement Fund (NY Common). These three large pension funds set the stage and became the model for supporting emerging managers through bold leadership, comprehensive planning and development of innovative programs that accelerated the use of emerging managers. In the case of each pension fund, the primary reason for the increased use of emerging managers was to achieve the highest rate of total return reasonably possible with prudent levels of risk and liquidity. Most emerging managers are small investment firms, measured by Assets Under Management (AUM), so they tend to invest in small to medium-sized companies. Given their size and strategies, emerging managers are a great source of uncorrelated alpha to any diversified portfolio of alternative assets.

In addition to the goal of achieving the highest return on investment (ROI), each of the pension funds discussed in this paper had their own ancillary goals to achieve social and economic impact and change. Many of these goals will be discussed later in this white paper.

Furthermore, CalPERS, CalSTRS and NY Common each had their own reasons to believe in the concept of investing with emerging managers. For example, CalSTRS' rationale included capturing the opportunity presented by the nation's dramatic demographic shift, particularly in California. It aimed to build an investment portfolio that tapped into those changing demographics, and mined the undiscovered talent of emerging managers, both within the state and throughout the nation. The three institutional funds also challenged their leadership teams to

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initiate the design and management of procedures equal in quality to other programs and provide assurances that the emerging managers selected would perform at the highest levels within the industry while generating returns commensurate with those typically generated by mainstream private equity funds. While outside the scope of this current research effort, early indicators of results among strategic partners selected by these pension funds to implement programs vary in performance due to differences in vintage year timing for program implementation, strategic approach and manager selection process. However, the emerging manager programs appear to be performing in line with the broader industry norms. Performance assessment undertaken once programs are more mature will more accurately gauge how well they have done.

More and more, institutional investors are coming to understand the benefits of a carefully constructed portfolio that includes emerging managers, which can supplement their core private equity portfolio. This promising new emerging manager group presents the opportunity to obtain additional alpha not offered by programs investing only in traditional funds.

Studies have demonstrated the high achievement of emerging managers over an extended period. “Minorities and Venture Capital: A New Wave in American Business”¹ and “Venture Capital Investment in Minority Business,”² both by Timothy Bates and William Bradford, are among those illustrating that minority private equity funds collectively earn yields on their realized investments that are higher than those in the broader private equity industry. By illuminating the high returns generated by mature, minority-oriented private equity firms, these studies dispel the mistaken assumption that these firms are low-return, social investors.

For more than four decades, the National Association of Investment Companies (NAIC) has been the strongest advocate for the greater involvement of emerging managers. NAIC has articulated the case for emerging managers through persuasive arguments and outstanding advocacy. The organization has presented the clear and indisputable argument that if emerging managers were given the opportunity, they would be able to provide superior returns because of their ability to leverage their skills and expertise in concert with their deep industry knowledge of the emerging domestic market to successfully execute private equity investments.

The three pension funds discussed in this paper should be commended for their pioneering efforts to create emerging manager program models for other funds to follow. Now, other pension funds, regardless of size, should embrace the utilization of emerging managers.

¹ Timothy Bates and William Bradford, “Minorities and Venture Capital: A New Wave in American Business, The Kauffman Foundation, 2003.

² William Bradford and Timothy Bates, “Venture Capital Funds Investing in Minority-Owned Businesses: Evaluating Performance and Strategy,” The Kauffman Foundation, September 2008.

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THE CRITICAL SUCCESS FACTORS

In this brief white paper, we outline innovative approaches CalPERS, CalSTRS and NY Common have initiated and used to identify, evaluate, select, include and support emerging managers. These approaches are summarized in the following seven key factors:

1. Top management commitment and support;
2. Clearly stated goals and objectives;
3. Well-structured and clear definitions of “emerging manager”;
4. Strong, knowledgeable leadership of overall program;
5. Innovative and well-conceived program;
6. Experienced strategic partners with proven track records; and
7. Broad outreach to the emerging manager community.

Each fund has taken a unique approach to incorporating these factors into their program.

1. Top management commitment and support

All of the funds included in this study had key, powerful decision makers who believed in and strongly advocated the use of emerging managers.

In the case of CalPERS and CalSTRS, trustees appointed to their boards include elected officials such as the Treasurer of the State of California. Leaders in this position, like Phil Angelides before and Bill Lockyer currently, readily saw the parallel with their offices’ longstanding efforts to identify, select and include underrepresented firms among the pool of underwriters for state agency bond issuance.

Among the earliest of these programs is the California Initiative. Implemented in 2001 with a capital investment of \$475 million, it was sponsored by Angelides when he was the state treasurer and member of the CalPERS board.

“Our investments have already demonstrated that many places that have been overlooked, have promise for economic return ...,”³ he said at the California Initiative’s inception. “We [Americans] are richer and stronger if more people have an opportunity to participate in financial markets.”⁴ The California Initiative has since directed more than \$14

³ Phil Angelides, Treasurer State of California, “The Double Bottom Line: Investing in California’s Emerging Markets,” (May 2000).

⁴ Boston Consulting Group, “Equity Capital in the Emerging Domestic Market and its Critical Role in Driving Growth in the Broader U.S. Economy,” NAIC, (July 2009).

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billion in investment capital to spur economic progress in California's underserved communities.⁵

As the emerging manager concept was beginning to take off, other strong leaders around the country were well aware of the lack of capital flowing into low-income communities. That awareness accelerated the drive to increase the numbers of emerging managers, particularly professionals of color. Among these were New York City Comptroller Bill Thompson,⁶ who led that city's public pension plans into the emerging manager space, and Connecticut Treasurer Denise L. Nappier, who helped pave the way for the Connecticut Retirement Plans to work with emerging managers.⁷

As CalPERS, CALSTRS and NY Common became models for the nation, they also became models for the next cadre of peers in the U.S. pension community. Building on their initial platforms, these funds have been able to advance the emerging manager concept and allocations to emerging managers. It has not been an easy task; often these pension funds have had to face a declining tax base, hostile political opposition and volatile global economics. They prevailed by retaining the support of their boards, developing highly capable professional staffs, and constantly reaching out to the community at large. Most importantly, these funds maintained a long-term perspective on the value emerging managers could provide to their programs and our society.

2. Clearly stated goals and objectives

For fiscal and political reasons, clearly defined goals and objectives are very important for each pension fund. With respect to fiscal reasons, each fund stated that, above all else, their primary goal was to achieve the highest return for each dollar invested.

While return on investment was the primary goal, each institution also had ancillary programmatic goals that included increasing participation by women and minority managers, impacting their respective communities, and fostering minority and MWBE. In the case of CalPERS, these ancillary goals were explicitly stated when the California Initiative was created.

The California Initiative seeks to invest in portfolio companies in traditionally underserved markets. While its primary focus is on California-based investments, it has flexibility to consider investments in other regions. The Initiative seeks to discover and invest in opportunities that may have been bypassed or not reviewed by other sources of investment capital. The primary objective is to generate

⁵ Ibid.

⁶ Matt Edelson, "Why We Invest in EDM," *Journal of EDM Finance* (Summer 2005).

⁷ Kimberly Campbell, "An All-Around Strategy," *Journal of EDM Finance*, (Spring/Summer 2007): pp. 48-52.

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attractive financial returns, meeting or exceeding private equity benchmarks. As an ancillary goal, the initiative was destined to have a meaningful impact on the economic infrastructure of California's underserved markets and invest in portfolio companies that:

- Have historically had limited access to institutional equity capital;
- Employ workers who reside in economically disadvantaged areas; and
- Provide employment opportunities to women and minority entrepreneurs and managers.⁸

For CalSTRS, these objectives were captured in their Policy on California Investments and the mandates given to their fund of funds.

Article 1, Section 31 of the California Constitution prohibits state government entities from granting preferential treatment to any individual or group on the basis of race, sex, color, ethnicity, or national origin in the operation of public employment, public education, or public contracting. The highly controversial Proposition 209, which created this prohibition, was seen by proponents as a sign that California was a state where diversity was so pronounced that the playing field had been leveled. Opponents of the measure were not convinced. Nevertheless, Proposition 209 passed in 1996, thus amending the California Constitution. As a result, neither CalPERS nor CalSTRS are permitted to use diversity percentage goals as their key criteria for investment or contracting decisions. However, both funds have maintained a strong commitment to diversity. When CalSTRS created BAML Capital Access Funds (BAML CAF), a fund of funds, it stated:

“By investing in talented professionals and well run firms, BAML Capital Access Fund strives to facilitate linkages between private equity capital and the underserved communities that will facilitate the greatest growth in this country.”

To serve as a financial catalyst, BAML CAF invests in private equity funds that:

- Invest in companies located in or employing residents of low-to-moderate income (LMI) geography;
- Invest in companies owned or managed by ethnic minorities;
- Invest in companies owned or managed by women;
- Invest in companies focused on delivering products or services to any ethnically diverse customer base; and
- Invest in companies located in urban or rural areas with limited access to investment capital.

⁸ CalPERS, 2007 Annual Report .

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NY Common has historically fostered the growth of emerging managers with a focus on minority- and women-owned funds. In 2008, State Comptroller Thomas P. DiNapoli created the Empire State's new emerging manager program with a goal of investing \$1 billion with emerging managers.⁹

3. Well-structured and clear definition of emerging manager

With many of the emerging manager programs this report examined, the focus was on increasing the opportunities for inclusion of women- and minority-owned managers. Many of the first wave of managers gained valuable experience running minority small business investment companies (MESBICs). Over the years, however, the emerging manager definition has evolved to focus less on race and gender and more on the size of the fund and the fund's track record.

CalPERS — Depending on CalPERS asset classes, with respect to private equity, the Alternative Investment Management Program (AIMP) considers general partners raising a first or second institutional fund as new and emerging investment management firms.

CalSTRS — Defines emerging manager as a general partner raising their first, second or third institutional fund. CalSTRS' fund of funds partner BAML Capital Access Fund uses similar criteria to CalPERS Alternative Investment Management Program. In addition, BAML Capital Access Funds have a mandate of rural and urban underserved emerging space, and Invesco Private Capital focuses only on emerging managers.

NY Common — Compliant with recently enacted NY State law, emerging managers are defined—depending on asset class—by AUM thresholds, with a special emphasis on identifying women and minority funds.

By utilizing the above definitions for “emerging manager,” the three pension funds were able to design programs with clear mandates.

4. Strong, knowledgeable day-to-day leadership

Laws can be drafted and goals can be established, but without strong, dedicated, day-to-day managerial leadership, any program will fail. CalPERS, CalSTRS and NY Common eventually incorporated dedicated resources by recruiting experienced professionals from the emerging manager space to further resource the portfolio management function of their emerging manager programs.

CalPERS — Tim Legesse, investment officer, Diversity Programs, has more than 19 years of financial services work experience, 16 of which were spent

⁹ “Stepping Up to the Plate,” *Journal of EDM Finance*, (Spring 2008).

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managing institutional investment portfolios in alternative strategies broadly (commercial real estate, private equity, venture capital, and hedge funds). In the past decade, he has been more focused on private equity and venture capital asset management.

CalSTRS — Solange Brooks, portfolio manager, Investment Executive Unit, reports directly to the CIO and brings years of experience as a high-level administrator in various positions in the State of California. She has received numerous awards for her outstanding and bold leadership, and is considered one of the superstar role models in the emerging manager profession.

NY Common — Tyson Pratcher, assistant comptroller, NY State Office of the Comptroller, previously worked as a lawyer and a key advisor to former New York Senator Hillary Clinton. He brings knowledge of the field, tough analytical skills and keen political acumen to this high-stakes, high-profile job.

With the support of their fiduciaries and senior level staff, leaders like these are driving the emerging manager concept toward progress integration into the overall investment process and enterprise culture. Equally essential are those key business partners who manage asset class departments, contribute to the investment decision process, and partner to support emerging managers to achieve maximum return.

The key decision makers interviewed for this white paper all took pride in what they had accomplished with respect to emerging managers, but reiterated that the common overarching requirement for emerging managers was consistent with that required of mainstream fund managers, which was to produce competitive returns in order to qualify to re-compete for future allocations.

5. Innovative and well-conceived program

Beyond just allocating funds to emerging managers, each of the pension funds participating in this white paper took care to create innovative and well-conceived programs to enhance the likelihood that their investment goals would be achieved. For example:

CalPERS:

California Initiative (2001)

- \$1 billion allocated/fully committed.
- Strategic relationship with Bank of America and Hamilton Lane Partners.
- Focused on underserved markets in urban and rural areas.

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Capital Link - Emerging Private Equity Manager Program (2007)

- \$1 billion allocated/fully committed.
- Strategic relationship with Centinela Capital Partners, a minority-owned private equity fund of funds.
- Direct investment in new and emerging private equity funds, including women- and minority-owned funds.

CalSTRS:

Urban and Rural Investment Program (2002)

- Funded the Milken Institute to conduct a study to explore the feasibility and potential benefits of private equity investment in underserved rural and urban communities.
- *First Phase: Initial Commitment.* It began with a total of \$350 million in commitments including an initial allocation of \$75 million to the CalSTRS/Bank of America Capital Access Fund (which is managed by BAML CAF), and \$100 million to the New and Next Generation Manager Fund (managed by Invesco Private Capital).
- *Second Phase: Growth & Renewal.* It followed additional allocations of \$200 million and \$100 million to BAML CAF funds, and an allocation of \$200 million to the New and Next General Manager Fund II (managed by Invesco Private Capital).
- In 2006, CalSTRS created the Proactive Portfolio to invest directly in emerging funds from the pool created by the fund of funds. The total commitment in private equity for the first and second phase stands at \$1.135 billion.
- *Third Phase: Ongoing Stability.* CalSTRS developed a five-year strategic plan to continue to support the emerging manager space, not only in private equity, but throughout the investment portfolio.

NY Common:

Emerging Private Equity Manager Program (2008)

- \$1 billion emerging manager program.
- Strategic relationship with Parish Capital and BAML CAF.
- Parish allocated \$350 million: \$250 million for co-investment opportunities and \$100 million for fund investments.
- BAML CAF would manage \$200 million to be directed to fund investing.

From all indications these are just the beginning of many other programs to come.¹⁰

¹⁰ CalPERS and CalSTRS teamed up with Altura Capital to create a comprehensive database of emerging managers and financial service providers.

6. Experienced strategic partners with proven track records

Once capital had been allocated and committed, many of the described programs would have failed if the emerging managers had been poor investors. From the very beginning when these programs were institutionalized, CalPERS, CalSTRS and NY Common went to great lengths to ensure they only partnered with the best firms capable of achieving high investment goals. In many ways, these initial partners truly were emerging manager pioneers.

Because these and other private equity companies succeeded at performing at a high level, initial efforts were expanded to develop a larger and more significant pool of emerging managers.

CalPERS has been investing in private equity for many years. It has established relationships with fund of fund advisors such as Grove Street, BAML CAF and Centinela Capital Partners, through which it has indirectly invested in emerging managers. The pension fund has also invested directly in a number of emerging managers who have demonstrated success.

Under the leadership of Solange Brooks, CalSTRS has been at the forefront of utilizing emerging managers. In the private equity space, specifically in proactive portfolios, \$460 million has been focused toward direct side-by-side commitments to nine funds and seven direct funds. Another \$675 million has been allocated to two fund of funds: Invesco's New and Next Generation Manager Program, and CalSTRS/BAML CAF.¹¹ The CalSTRS investment culture embraces diversity throughout the portfolio. Under the leadership of its Chief Investment Officer Christopher J. Ailman, all managers in the various asset classes are held responsible for including diversity in their everyday decisions.

NY Common has invested in emerging managers both through fund of funds and through direct investment. It has engaged BAML and Parish Capital Advisors to manage its fund of funds relationships and also to manage a co-invest program with emerging managers. The pension fund also has successfully invested directly in a number of emerging manager funds. NY Common is a strong advocate of emerging manager programs and in institutional investors capturing best practices and exchanging lessons learned. They believe doing so serves as a valuable source for providing discussion among the institutional investor community.

By highlighting the development process of the various programs at the three largest pension funds, the discussions can evolve and potentially impact behavior of large investors towards new and increased investment in the emerging manager space. NY Common applauds the investment that NAIC has made in propelling the story of the Emerging Manager.

¹¹ CalPERS, 2009 Annual Report.

7. Broad outreach to the emerging manager community

All three pension funds have been effective at reaching out to existing and potential emerging managers. To ensure they cast as wide a net as possible in their searches for the best qualified emerging managers, CalSTRS and CalPERS jointly funded Altura Capital. Altura's mission is to develop a comprehensive directory of emerging and under-capitalized managers, fund of funds, partnerships, consultants, researchers and broker-dealers in 11 asset classes.

Other forms of outreach have included:

- Regularly participating in NAIC's institutional investor and fund manager activities, research initiatives and NAIC's EDM periodical, the *Journal of EDM Finance*.
- Working with the Association of Asian American Investment Managers (AAAIM).
- Actively supporting the Toigo Foundation, whose mission is to encourage greater minority presence at the senior level across all areas of finance.
- Working with the National Association of Securities Professionals (NASP).
- CalSTRS' joint venture with Dr. Michael Porter's Inner City Economic Forum to create a venue where inner-city-based corporations can be introduced to private equity providers.
- CalPERS employing diversity investment consultants such as Mosaic Investment Advisors to assist in gaining insight on emerging managers and creative design of new models to expand inclusion.

Because of these relationships, seminars, sponsorships and programs, all three funds are widely known and respected in the community.

CONCLUSIONS AND RECOMMENDATIONS

Our country is undergoing a profound demographic change. Within the next few decades, groups that have historically been identified "minorities" are expected to comprise a majority of the population. Yet, people of color and women are significantly underrepresented as owners and managers of investment firms, particularly in the management of alternative assets and private equity funds.

Public pension plans of every size will continue to be scrutinized and pressured by their constituents, many of whom are people of color or women, to invest a portion of their capital with private equity funds managed by women and people of color.

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Two or three decades ago, institutional investors that were looking to deploy meaningful amounts of capital with investment firms owned by people of color and women had few options. Today, the landscape is different. Over 40 emerging manager firms collectively manage more than \$14 billion in private equity from limited partners across the globe. These firms are active in almost every strategy, with a heavy focus on investing in small to mid-sized companies, and in underserved communities.

Public pension plans interested in investing part of their capital in emerging managers are advised to take into account the lessons learned by their pioneering peers before setting out to structure and execute their own emerging manager programs. The two fundamental ways of investing are: directly in emerging manager funds and through fund of fund relationships. The three funds interviewed for this white paper employed both strategies in order to build a diversified portfolio of managers, manage relationships with those managers effectively, and continue to invest in the top performers.

Those interested in learning more about the emerging manager space will find an abundance of information readily available through numerous resources. The National Association of Investment Companies (NAIC) is a good place to start. www.naicvc.com.