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# Senior Consultant

The Voice of the Investment Management Consultant

## The Politics of "Minority" or "Emerging" Manager Programs

*Ted Siedle, President, The Benchmark Companies*

In March of 2004, we were invited by a consultant to a large Midwest pension fund to be one of six finalists to manage a $100 million investment in an "emerging" or "minority" manager-of-managers program. This assignment would involve our firm selecting and monitoring a stable of "emerging" or "minority" managers. Generally to qualify as "emerging," firms must have shorter track records and assets under management than traditionally required by pension funds. For example, a firm may have $50 million under management and a two-year track record, as opposed to greater assets and a three-year record required by most pensions. To qualify as "minority," firms must be majority-owned by minorities or women. Qualified minorities may include African American, Eskimo, American Indian, Asian/Indian, Hispanic and even Portuguese or Cape Verdean in some localities. Every pension that adopts such a program in furtherance of the laudable goal of increasing participation in asset management by individuals and firms that have typically been shut out of the pension management industry may have different requirements.

We have never managed money but were included in this search because of our expertise in vetting and monitoring managers, including investigating some of the other finalists. We had spent a considerable amount of time researching the development of an emerging or minority manager-of-managers product, including the review of registrations and compliance histories of approximately 100 emerging and minority money managers. We had also examined the operations and track records of the few existing emerging and minority managers-of-managers and established a due diligence system specifically designed for use in connection with emerging managers. However, as a result of this research, we realized there were significant challenges to offering such a manager-of-managers product that was competitive in terms of fees and performance and still met the specific political agendas of each prospective client. We observed that the actual performances of the existing products net of fees were not encouraging; however, the performances quoted by these managers-of-managers often were far more impressive than could be documented. Further, certain of the existing managers-of-managers had unfortunately encouraged a significant percentage of the limited number of firms that qualify for these programs to engage in improper practices. Thus, we recognized we might have to exclude these firms from consideration, if we were to avoid scandals related to some of the other managers-of-managers.

In a letter prior to the finals presentation, we indicated we would welcome the opportunity to provide a manager-of-managers product to the Fund, however we wanted to be certain that the Fund fully understood the challenges related to the product they envisioned and "the likelihood that performance net of fees would not meet the assigned benchmark." Why would we tell a pension that proposed to hire us that the product they wanted us to manage for them would likely not have competitive performance? Even if it were true that the product would not perform well, would it not be better to give them what they wanted and finesse the performance issue? We were confident that none of the other finalists would candidly address the performance issues or detail the risks involved.

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The initial problem we had related to this search concerned the *definition* of "emerging" manager that the Fund proposed. The rush to place assets with emerging managers that gave rise to the search had been prompted by certain local elected politicians who, though not pension fiduciaries themselves, felt qualified to tell the fiduciaries of pensions within the state how to select money managers. These politicians wanted to see African American and Hispanic managers hired, particularly such firms located within the state. We were even advised as to certain firms which were to be included within the program we would be responsible for managing.

While "emerging" manager has elsewhere been broadly defined to include any manager with assets under $1 billion, including women-owned firms and even firms owned by White males, these latter firms were not of primary interest here. Our competitors had assured the Fund they could meet the guidelines regarding ethnicity and locality, and still deliver competitive performance. Indeed, they even submitted lists of the managers they proposed to hire for approval by the Board of the Fund. We did not.

In our presentation to the Fund's Board, we took the opportunity to further explain our concerns about emerging and minority manager-of-managers programs. Below is a discussion of the matters we brought to the specific attention of the Board.

**Money management is a complex, highly regulated business. If the manager-of-managers doesn't set the example for the underlying managers, if he isn't a resource they can go to for guidance, then the whole team of managers is heading down the wrong road**

As a result of multiple layers of managers, the fees related to manager-of-manager programs are higher than hiring the underlying managers directly. The upstream manager or the "manager of managers" receives approximately half the fee; the underlying managers, the managers who are actually managing the money, receive approximately half, or even less in some cases. In other words, on a $100 million investment, if the effective fee were 80 basis points, the manager-of-managers would receive approximately half or $400,000, and the underlying managers would receive approximately $400,000 divided among them. This is a very high fee for managing a $100 million domestic equity account. If the Fund hired the managers directly, it could save $400,000. So the question we felt the Board should ask was: *What is the manager-of-managers doing to earn his fee?*

Marketing? Hopefully more than simply marketing the program. Marketing plus performance monitoring? Funds pay consultants substantially less than $400,000 to monitor the performance of a $10 billion portfolio. The manager-of-managers had better be performing important tasks to justify earning its substantial fee.

If the manager of managers didn't have the professional training and skills to effectively select, monitor and "manage" the underlying managers, then he was being paid primarily for marketing, i.e., for hustling business for the underlying managers. If that's what the Fund wanted to do with its money ... fine ... as long as it understood what it was getting.

We indicated that we believed a manager-of-managers must contribute more than marketing and performance monitoring. If plan sponsors agree that the goal is to encourage the development of successful minority-owned asset management businesses, then they should look for a manager-of-managers who could not only assist these firms in gathering assets but also in negotiating their way through the treacherous waters of the institutional asset management marketplace. Unfortunately, we frequently found that the managers-of-managers encouraged wrongdoings by the underlying managers, rather than set an example.

We made the following prediction to the Board: "Make no mistake about it: there will be public revelations regarding some of these programs in the future. If the emerging or minority managers and manager-of-managers are playing games, they too will be taken to task."

We listed some of the criticisms that have surfaced regarding emerging and minority manager-of-manager programs.

1. **Solicitation of political contributions by managers-of-managers from emerging and minority managers participating in their programs**

Minority managers have told us they have been instructed to contribute substantially, i.e., $50,000 or more, to politicians to participate in certain programs. According to news reports, some emerging managers have contributed over $1 million to "play."

Extensive political contributions could be disastrous to the effort to increase minority participation in asset management. For example, when minority municipal underwriting firms gave political contributions in exchange for municipal bond underwriting business in the early 1990s, they were prosecuted. It's not that the minority firms were doing something the other mainstream municipal underwriting firms hadn't been doing all along, but they got caught when the rules changed. Today the rules governing managing money and pensions are changing dramatically. They are being rewritten almost daily. What was acceptable in the past will not be acceptable in the future. "Pay-to-play" of all sorts is coming under scrutiny.

2. **Misrepresentations regarding performance, assets under management and fees are being investigated and minority managers of managers are being terminated for being less than truthful**. We have participated in such investigations and have been contacted regarding additional investigations that may be undertaken in the future.

3. **Allegations of fee splitting and other compensation arrangements between minority managers-of-managers and their underlying managers are circulating**. Conflicts of interest are being alleged. Again, the whole country has recently awakened to discover the many games being played with their mutual fund and retirement savings. Minority managers and managers-of-managers must especially be prepared to defend their practices or be exposed as political hires, lacking on the merits.

Obviously we did not expect to be hired by the Fund, given the message we delivered. Frankly, it was business we didn't want. Our goal was to nudge the Fund to reconsider the merits of their approach to increasing participation by minority managers. Rather than heed any warnings, the Fund boldly increased its allocation to emerging and minority manager-of-managers programs that day and awarded $300 million to be divided equally among three manager-of-managers firms.





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We believe that it is more likely than not that these allocations will underperform over time. How great the underperformance will be remains to be seen. How aware the participants in the pension fund are of these highly politicized awards is unclear. When the cost of this decision is finally revealed, we wonder whether the participants will feel it was justified.

Interest in emerging or minority manager-of-managers programs is growing once again, following a period of waning interest related to the elimination of affirmative action. We would encourage pensions that venture into these waters to structure their programs carefully and not follow the example of others given the known shortcomings of many of the existing programs. ■

## About the Author

President of The Benchmark Companies, Edward Ahmed Hamilton ("Ted") Siedle is a federal securities attorney, investment banker, brokerage entrepreneur and writer, who has been named by the Press as the "Sam Spade of money management" and "the nation's most vocal critic of abuses in the money management industry." Ted began his career in law with the SEC's Division of Investment Management, which regulates money managers and mutual funds. After several years of government service in Washington, D.C., Siedle served as Legal Counsel and Director of Compliance to one of the largest international money management firms. Over the past decade, he has founded and managed investment banking and brokerage firms offering specialized services to municipalities, pension funds and money managers. Ted is a nationally recognized authority on investment management and securities matters. To learn more about consulting to the pension funds, visit The Benchmark Companies' web site (http://www.benchmarkalert.com/index.html) or contact Ted at info@benchmarkalert.com.

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