



POTENTIAL BENEFITS OF INVESTING WITH EMERGING MANAGERS

CAN ELEPHANTS DANCE?

Tenth Anniversary Study Reconfirms Emerging Managers Have Edge Over Larger Investment Firms

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Can elephants dance? Institutional investors should be asking themselves this question after the grueling market experience of the past five years. In terms of performance (not to mention the mutual fund scandals), the asset management industry's giants have not covered themselves with glory, yet they have continued to grow and gain market share. Moreover, there has been substantial consolidation in the industry during the past market cycle, driven by regulatory changes in the U.S. and the entry of foreign firms via acquisition. Economies of scale in distribution, compliance and technology, meanwhile, have given large firms a substantial cost advantage over small ones, which seems likely to perpetuate these trends.

Have these changes benefited clients? Having studied this question for more than 10 years now, we must conclude once again that they have not. For the five years ending September 2005:

- Roughly 40% of the core U.S. equity managers in the top performance quartile were with firms managing less than \$2 billion. This implies that the minimum firm size requirements typical of large plan sponsor searches immediately exclude a large proportion of the highest performing managers.
- These small firms outperformed the elephantine household names at the median, as well as at the top and bottom quartile levels. This result is consistent across all major style groups, and implies that manager selection skill may be better rewarded when applied to the small firm universe.
- Small firms delivered dramatically better performance in down markets, making suspect the idea that plan sponsors are protecting themselves by not investing with them.

Our quarter-century of experience as a manager of managers suggests that as investment firms grow, they find it more difficult to perform and are less motivated to take significant risk. This observation was first confirmed in our original study (Krum [1995]), and led us to create multi-manager investment programs focused specifically on emerging firms. This approach helps mitigate the incremental business risks, costs and capacity constraints of working with smaller managers within a style-diversified and risk controlled investment vehicle.

TEST SAMPLE

Despite these outcomes, clients have continued to award larger and larger shares of their assets to the underperforming industry behemoths. In October 2000, the beginning of our latest study period, our sample drawn from Nelson's Marketplace database encompassed 531 active core U.S. equity products managed by 287 firms¹. Of their total \$7.9 trillion under management (about 60% of U.S. market capitalization), more than 99% was controlled by firms managing greater than \$2 billion, compared to about 95% in 1988. Firms with less than \$2 billion under management made up 33% of the sample, but collectively held just 1% of the assets, down from about 5% in our earlier study. Most minority-owned firms fall into this category and, in fact, many



clients who come to us for emerging manager investment programs are interested in exploring the minority-owned universe.

Note the constraints this extreme market concentration places on large investors. Suppose, for example, that a large institutional investor sets its minimum allocation at \$200 million per manager, in order to limit the size of its roster and its fiduciary expenses. If policy prevents the investor from representing more than 10% of any single firm's business (a common constraint, in our experience), then the smallest firm it can hire will have \$2 billion under management. As mentioned above, for a mandate awarded in 2000, this one decision would have eliminated more than one-third of our sample, rejected over 40% of the subsequent top quartile performers, and increased the likelihood of sub-par performance during the subsequent market downturn.

MANAGER CATEGORIZATION AND GROWTH

In this series of studies, we have divided managers into "size classes" according to their relative market share of total assets under management at the beginning of the evaluation period. In Exhibit 1, for example, size class 1 includes the 84 largest firms, collectively holding 75% of the assets in 2000. When we measured assets in our initial 1988 study, it took roughly the same number of firms (91) to reach the same cumulative share, but the *largest* had \$70 billion under management. In 2000, the *smallest* class 1 firm had \$79 billion under management, and the largest had roughly 10 times as much. The assets under management (AUM) breakpoints for the other size classes, at 90%, 95% and 99% cumulative market share, also increased by an order of magnitude, reflecting both market appreciation of four and one-half times during the 13-year period, as well as the growing institutionalization of all equity investment.

EXHIBIT 1: BREAKDOWN OF FIRM SIZE IN OCTOBER 2000

SIZE CLASS	CUMULATIVE % OF ALL ASSETS	NUMBER OF MANAGERS	PERCENTAGE OF ALL MANAGERS	SMALLEST FIRM (\$M)	LARGEST FIRM (\$M)
5 (small)	100	175	33	16	1,908
4	99	121	23	1,909	9,413
3	95	70	13	9,601	19,334
2	90	81	15	20,092	77,036
1 (large)	75	84	16	79,825	724,510
Total		531	100		

Source: Nelson's Marketplace

The asset management industry has been turbulent during the past five years, even in a prosaic area like core U.S. equities. Exhibit 2 shows how the firms in our sample moved into higher or lower size classes during the 2000-2005 period, despite the lack of any real market advance.

EXHIBIT 2: FIRM SIZE CLASS STABILITY (10/1/00 - 9/30/05)

	5 (SMALL)	4	3	2	1 (LARGE)
5 (small)	74.6%	23.9%	1.5%	0.0%	0.0%
4	8.6%	61.4%	15.7%	14.3%	0.0%
3	0.0%	33.3%	30.0%	33.3%	3.3%
2	0.0%	7.1%	7.1%	50.0%	35.7%
1 (large)	0.0%	0.0%	0.0%	4.0%	96.0%

Source: Nelson's Marketplace

As one would suspect, this table shows that most small firms stayed small during this period, and nearly all of the largest firms stayed on top. However, of the 164 firms² in size class 5 (<\$1.9 billion AUM) in 2000, 23.9% grew into size class 4 by 2005, and a handful even made an order of magnitude leap into size class 3 (>\$9.6 billion AUM). Size class 1, the largest firms, showed the greatest stability, with only 4% (one firm out of 25) losing enough assets to fall into class 2. Size class 3, roughly the \$10-20 billion AUM range, was the least stable, with firms having roughly equal chances of holding steady or gaining or losing significant market share.

One explanation of this pattern is that during a period of flat markets and unrelenting cost and pricing pressures, the most obvious ways for large firms to grow have been to create new products or undertake mergers and acquisitions with significant mid-sized firms. Because nearly all large asset managers are now either publicly held or part of quoted financial conglomerates, management tends to feel compelled to pursue such growth strategies. Unfortunately, these initiatives are the very things that often worry us in our manager selection due diligence process, since they are very costly, distract management attention away from client portfolios, and frequently lead to staff turnover or other unwelcome organizational changes.

In all, 702 managers met our general selection criteria for inclusion in this study. 108 were excluded because they stopped reporting performance at some point during the 2000 - 2005 period, of which 44% were in the smallest size class. Since small managers make up 33% of our final sample, it's fair to say these managers have an above-average mortality rate, whether due to poor performance, acquisition or other restructuring. On the other hand, of the 63 products that were excluded because they were newly created during the period, 27% represented new small firms, indicating that entrepreneurship is alive and well in our industry despite growing structural cost disadvantages.

Clients searching for superior performance potential and defensive characteristics are more likely to find them in smaller firms.

PERFORMANCE BY SIZE CLASS

During our five-year study period, constraining manager searches to the multi-billion dollar firms in size classes 1 and 2 would have automatically eliminated more than 70% of the managers in the top performance quartile. Exhibit 3 shows the composition of each of the four performance quartiles and compares it with the composition of the total manager sample. The smallest managers make up 39.1% of the top quartile, even though they make up only 33% of the total sample. No other group is overrepresented in this way. Similarly, the smallest managers make up only 22% of the bottom quartile. Only the next-largest group is also underrepresented in this way, and only by a much smaller margin. These results suggest that while selecting a smaller firm cannot guarantee higher performance, clients searching for superior performance potential and defensive characteristics are more likely to find them in this category than any other.

EXHIBIT 3: COMPOSITION OF PERFORMANCE QUARTILES BY SIZE CLASS

	MANAGER SIZE BY CLASS					100.0%
	5 (SMALL)	4	3	2	1 (LARGE)	
Percentage of All Managers	33.0%	22.8%	13.2%	15.3%	15.8%	100.0%
Performance Quartile						
1	39.1%	21.1%	10.5%	14.3%	15.0%	100.0%
2	33.8%	23.3%	10.5%	19.5%	12.8%	100.0%
3	36.8%	24.8%	10.5%	10.5%	17.3%	100.0%
4	22.0%	22.0%	21.2%	16.7%	18.2%	100.0%

Source: Nelson's Marketplace

The great difference between the current test period and prior versions of this study has been the depth and duration of bear market action.

In general, results for smaller firms are more dispersed, showing a broader range of performance on both the upside and the downside. This result fits our intuition that as money management firms grow, they become more interested in growth than in performance, and the distribution of their returns tends to converge toward the median. In most time periods in which we have repeated this analysis, the broader dispersion of small manager returns has led them to be over-represented in both the top and bottom quartiles, highlighting the potential risks as well as the rewards of investing with them.

The great difference between the most recent test period and prior versions of this study has been the depth and duration of bear market action. We have always observed that small managers on the whole seem to deliver some of their best results in down market periods, and it so happened that they had a greater opportunity to show their talents recently than in other periods. The other side of the coin, however, is that large- and mid-sized firms have never done so badly. Clients who invested with them simply were the market, and could not get out of the way when the bears were charging.

Institutional investors can use this experience to adjust the breadth of their manager searches in the future. Investors (or their consultants) who have demonstrated a record of selecting median performers might be better off looking in the \$20-80 billion AUM range, since size class 2 had the highest median as shown in Exhibit 4. On the other hand, investors more skilled at manager selection may see a greater return from the cost of searching if they focus on smaller managers, since size class 5 has done almost as well at the median and much better at the first quartile mark. Similarly, if one is concerned about the market's overall return potential, smaller managers seem to be the place to be.

EXHIBIT 4: ANNUALIZED PERFORMANCE BY SIZE CLASS (10/1/00 - 9/30/05)

PERCENTILE	PERFORMANCE (%) BY SIZE CLASS					ALL MANAGERS
	5 (SMALL)	4	3	2	1 (LARGE)	
5 th	15.37	16.72	15.18	13.36	11.38	14.96
25 th	8.51	6.81	5.85	6.84	6.99	7.01
50 th	3.69	2.69	0.33	3.79	1.54	2.69
75 th	-0.36	-1.78	-6.48	-2.61	-2.88	-2.24
95 th	-6.50	-8.00	-11.61	-9.80	-8.30	-9.15
S&P 500						-1.49

Source: Nelson's Marketplace

COMPOSITE PERFORMANCE

As mentioned previously, there are clearly additional risks associated with investing with smaller firms. Chief among these are the business risk that the firm will fail to attract additional assets and go out of business and (at least in most periods we have studied) the "torpedo risk" of dramatic underperformance. For these reasons, our investment process stresses qualitative assessment of manager organizations, due diligence in depth, and the construction of diversified multi-manager programs.

To get some idea of how management firms of different sizes work together in multi-manager investment programs, we formed equally weighted composites of quarter-by-quarter performance for each size class. As shown in Exhibit 5, the smallest management firms, collectively including both the best and the worst performers, outperformed all other groups and outperformed the index by more than 5% per year on a gross basis.

EXHIBIT 5: ANNUALIZED PERFORMANCE FOR SIZE CLASS COMPOSITES (10/1/00 - 9/30/05)

	SIZE CLASS				
	5	4	3	2	1
Performance (%)	4.22	2.80	0.55	2.56	1.75
S&P 500	-1.49				

Source: Nelson's Marketplace

This wide margin of victory is the largest in the history of this study, and can be attributed to the down-market phenomenon mentioned above. In Exhibit 6, we break down the five-year period into 12 up-market quarters and eight down-market quarters.

EXHIBIT 6: RELATIVE COMPOSITE PERFORMANCE IN UP AND DOWN MARKETS VS. S&P 500 BY SIZE CLASS (10/1/00 - 9/30/05)

UP MARKETS				
SIZE CLASS	COMPOSITE AHEAD		COMPOSITE BEHIND	
	NUMBER OF QUARTERS	AVERAGE RELATIVE PERFORMANCE (%)	NUMBER OF QUARTERS	AVERAGE RELATIVE PERFORMANCE (%)
5 (small)	10	1.13	2	-1.04
4	10	1.15	2	-1.26
3	10	1.37	2	-1.22
2	11	1.22	1	-0.55
1 (large)	10	1.22	2	-0.43

DOWN MARKETS				
SIZE CLASS	COMPOSITE AHEAD		COMPOSITE BEHIND	
	NUMBER OF QUARTERS	AVERAGE RELATIVE PERFORMANCE (%)	NUMBER OF QUARTERS	AVERAGE RELATIVE PERFORMANCE (%)
5 (small)	8	2.22	0	NA
4	7	1.68	1	-0.03
3	5	0.49	3	-0.84
2	6	1.44	2	-0.55
1 (large)	6	1.06	2	-0.52

Source: Nelson's Marketplace

In up-market periods, small firms outperformed just as often as other firms, but by a smaller margin. In down-market periods, however, the small manager composite outperformed in every case, and by the widest margin by far of any group. These results are again consistent with our practical experience. Individually small firms tend to have less predictable performance, but when examined in groups, as in a diversified multi-manager program, the risk appears to be reduced.

OTHER EXPLANATIONS FOR PERFORMANCE

Why do the smallest asset managers frequently have such a strong performance advantage over large ones? In more than 25 years of working with smaller firms, we have arrived at our own largely qualitative answers.

- Greater appetite for risk among entrepreneurial owner-portfolio managers.
- Less bureaucratic working environment, allowing crisp decision making.

- Greater motivation and less complacency.
- Fewer liquidity problems.
- Greater organizational flexibility to deal with changing market environments.

Naturally, however, these are qualitative attributes that we look for, and are difficult to prove with data.

What we can do, however, is use data to show that common shortcomings of performance studies are not the source of the small firm advantage we observe. For example, we often hear the objection that small firms do better because they invest more in small cap stocks. In our sample, however, small cap bias³ does not appear to account for the small firm advantage in performance. All products identified as small cap or small-mid cap were deliberately excluded from this study to drive home this very point. Moreover, although mid caps as represented by the Russell Midcap Index outperformed the S&P 500 over the 4Q00-3Q05 period by a wide margin (6.2% vs. -1.5% on an annualized basis), the small firms in our sample were less likely (15% vs. 18%) to report a mid cap focus than the larger firms.

EXHIBIT 7: BREAKDOWN OF MANAGER SAMPLE BY CAP SIZE ORIENTATION AND STYLE

	COMPOSITION OF EACH SIZE CLASS					ALL MANAGERS
	5	4	3	2	1	
Large Cap	75.4%	70.2%	70.0%	74.1%	79.8%	74.0%
Mid Cap	15.4%	24.0%	25.7%	23.5%	17.9%	20.3%
Diversified	9.1%	5.8%	4.3%	2.5%	2.4%	5.6%
Value	34.3%	42.1%	35.7%	48.1%	39.3%	39.2%
Core	31.4%	19.8%	12.9%	22.2%	27.4%	24.3%
Growth	34.3%	38.0%	51.4%	29.6%	33.3%	36.5%

Source: Nelson's Marketplace

Further, while the past five years have clearly favored the value style over growth, Exhibit 8 shows that the same pattern of small manager outperformance at all quartile breakpoints held across all major style groups during that same time period.

In this analysis, we grouped products into value, growth or core categories based on firms' self-reported descriptions or benchmarks. Managers describing themselves as value, high yield, special situations or defensive value were assigned to the value category, while the growth category included self-reported labels of growth or aggressive growth. The core category includes those describing themselves as core or both growth and value. Index and enhanced index portfolios were excluded from the study, since we wanted to observe the impact of size on purely active investment decision processes.

The possibility of non-response bias raises additional questions. As mentioned earlier, we were forced to exclude 171 managers from our sample because they failed to report data for some portion of the five-year study period. An investor conducting a manager search in 2000 would have been able to select and hire these managers just as well as any of those included in our sample. As long as a portfolio existed at the end of 2000, he or she would not have known anything in advance that would have disqualified it.

EXHIBIT 8: ANNUALIZED PERFORMANCE BY SIZE CLASS AND STYLE (10/1/00-9/30/05)

VALUE MANAGERS						
PERCENTILE	PERFORMANCE (%) BY SIZE CLASS					ALL MANAGERS
	5	4	3	2	1	
5 th	18.37	18.34	18.70	14.07	12.84	16.99
25 th	13.27	9.49	13.13	11.76	9.54	11.19
50 th	8.79	6.79	6.95	6.66	6.99	7.01
75 th	5.86	3.53	4.65	5.20	4.05	4.68
95 th	2.32	1.25	-2.96	2.61	-1.16	1.35

GROWTH MANAGERS						
PERCENTILE	PERFORMANCE (%) BY SIZE CLASS					ALL MANAGERS
	5	4	3	2	1	
5 th	7.68	4.41	5.09	6.51	10.16	5.39
25 th	1.78	0.46	-1.04	-2.62	-2.30	0.46
50 th	-0.68	-2.74	-5.82	-5.59	-5.57	-3.61
75 th	-4.75	-6.44	-9.47	-8.24	-7.93	-7.72
95 th	-10.82	-8.95	-12.57	-18.08	-11.10	-11.21

CORE MANAGERS						
PERCENTILE	PERFORMANCE (%) BY SIZE CLASS					ALL MANAGERS
	5	4	3	2	1	
5 th	11.80	12.02	10.70	7.49	9.12	11.03
25 th	6.89	5.52	9.59	5.67	2.89	5.92
50 th	3.31	2.34	0.97	-0.37	0.18	1.85
75 th	0.29	-0.24	0.10	-1.39	-0.63	-0.58
95 th	-2.41	-4.13	-0.58	-3.21	-4.28	-2.68

Source: Nelson's Marketplace

If it turned out that these products as a group were more likely to be managed by small firms, and subsequently dropped out of Nelson's Marketplace database more frequently due to poor performance, their absence from our study sample would bias our results. The remaining small firms would look better on average as a result. In past versions of this study, however, we have used an analysis of partial time periods to estimate the impact of non-response bias at 20-35bp per annum, i.e., the performance of the smallest firms would look this much worse if all managers had reported results for the full period and had been included in the sample. While significant, this effect does not nearly account for the full magnitude of the small firm performance advantage we have observed.

CONCLUSIONS

One of the most frequent criticisms of performance studies is that they show results only for one specific period of time, when markets were dominated by one or another particular trend. This paper, however, marks the fourth time in the past 13 years that we have undertaken our analysis, during which time markets have been as varied as one could wish. Looking across these iterations, there are a few recurring conclusions that we feel we can state with great confidence.

- Small firm results are more widely dispersed, while large firms' returns cluster around the median. Consequently, investor skill in manager selection is more likely to be rewarded when applied to the small-firm universe. This often holds true even if selection skill is limited simply to eliminating the worst performing candidates.

Skill in manager selection is more likely to be rewarded when applied to the small firm universe.

- Small firms sometimes outperform large ones at the median, and sometimes underperform them, but they almost always seem to do better at the first quartile.
- Small firms often do much better in down markets.
- Investors who insist on only hiring large firms probably are not protecting themselves, and possibly are missing out on most of the best talent in the marketplace.
- These results do not depend on the exclusive use of small or mid cap stocks, nor on any particular investment style.

Unfortunately, however, there is no free lunch in investing. Working successfully with smaller firms frequently entails additional risks, due diligence, and administrative overhead. Investing via a manager of managers, with proven skills in research, operations and portfolio management addresses these concerns head-on, and has proven highly beneficial for our clients. Using a basket of managers relieves the capacity constraints of dealing with a single small firm, opening the door to investment by major institutional clients. While individual disappointments are probably inevitable over the long term, a multi-manager approach spreads business risk across several small firms. The fund structure itself, when properly designed and rebalanced, provides a style-diversified and risk controlled investment vehicle. If this vehicle allows for pooling, the incremental cost of specialized research, monitoring and administration can be shared with other investors.

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NOTES

- 1 The sample excludes hedge, index, and enhanced index funds, REIT and other sector funds, and balanced products, as well as all firms under \$10 million AUM. All data is drawn from Nelson's Marketplace, a product of Nelson Information, New York City. No attempt has been made to provide independent validation of this data.
- 2 Note that more than one manager/product from the same firm may be included in our sample. Size class 5 includes 175 products managed by 164 different firms, so there are only a few small multiproduct firms. In contrast, most of the largest firms in our study are represented in the sample by several products each.
- 3 Asset growth has been shown to degrade performance in small cap mutual funds. See for example Hurley & Kanner [1996].

REFERENCE

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