EMERGING MANAGERS

EMERGING MANAGERS HOLD THEIR EDGE VERSUS ELEPHANTS

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In six studies of emerging investment manager performance spanning 16 years of stock market history, Northern Trust has demonstrated that the smallest firms, collectively accounting for only 1% of institutional market share, enjoy a consistent advantage over industry leaders. Since this edge is most dramatic in bear markets, we have raced to update our results for the epic five-year period ending 2008. With the Standard & Poor's (S&P) 500 Index down –2.19% per annum, and –22% in the last quarter alone, did small, entrepreneurial firms provide the downside protection that we have come to expect from them?

SMALL FIRM RESULTS

As in past studies, we found that for core U.S. equity institutional mandates, small firms' results were more broadly dispersed than those of large firms, on both the upside and the downside. These results imply that manager selection skills can be applied more profitably to turning over rocks in the small firm universe than in filing me-too reports on the household names. While little is certain in investing, the following findings suggest that investors in emerging firms stack the odds in their favor:

- One-third of firms in the top quartile had less than $2.6 billion in assets under management[1], as shown in Figure 2.
- Even if we make no assumption at all about manager selection skill, small firms in aggregate outperformed the S&P 500 six times out of eight in down market quarters. They outperformed the index by 0.51% per down-market period, the best of any of the groups studied.
- The median small manager outperformed the median large firm by 41 basis points per annum, for savings of more than $4 million on a typical $200 million institutional allocation over the five years studied. The advantage was similar at the top and bottom quartile marks, and across value, growth, and core investment styles. The margin of victory, however, was narrower than we have observed in past studies.
- Small firms delivered these results while taking less risk, as shown in Figure 1. On an equally weighted composite basis, small firms lost –0.74% per annum versus –1.23% for large firms, with an annualized standard deviation of 13.9% (matching the S&P 500) versus 14.7% for the largest firms.

We hear over and over again that institutional clients hire the largest firms because they view them as safer than emerging firms. In reality, this decision is just another over-crowded trade that may expose clients to excess volatility and nasty surprises, without adequate compensation in terms of full-cycle performance.

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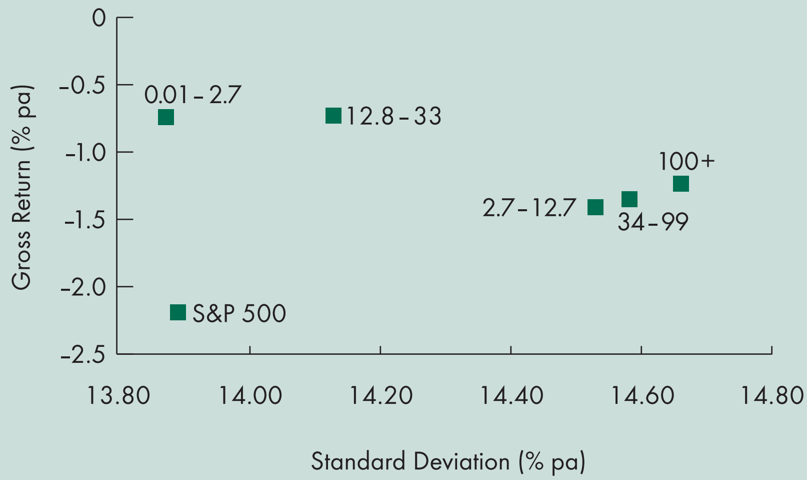
FIGURE 1: **COMPOSITE PERFORMANCE BY FIRM AUM ($B)**

5 Years Ending 12/2008

Through the recent market turmoil, smaller firms have produced average annual returns exceeding those of larger firms and the S&P 500, with lower volatility.

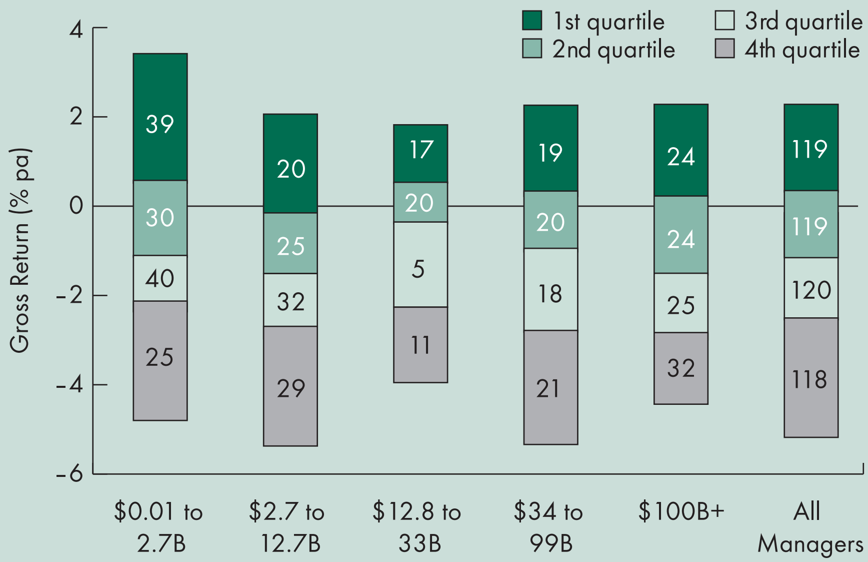


Data Source: eVestment Alliance, Marietta, GA.

FIGURE 2: **LARGE CAP PERFORMANCE BY FIRM (AUM)**

5 Years to 12/2008, 5th to 95th Percentile (Number of products per quartile indicated inside bars.)

Small firms outperformed large firms at similar percentile levels, so skill in manager selection was better rewarded when used to research smaller firms.



Data Source: eVestment Alliance, Marietta, GA.

DUE DILIGENCE REQUIRED

Unfortunately, there is no free lunch in investing. Working successfully with smaller firms frequently involves additional due diligence, business risks, and administrative overhead. Investing via a manager of managers, with skills in research, operations, and risk management, addresses these concerns head-on. Using a basket of emerging managers relieves the capacity constraints of dealing with a single small firm, and opens the door to major institutional clients.

While individual disappointments inevitably occur, the multi-manager approach spreads business risk across several firms. A properly designed fund structure tends to emphasize style diversification and add value through rebalancing. If the investment vehicle allows for pooling, the incremental costs of specialized research, monitoring, and administration can be shared with other investors.

FIGURE 3: **UNDERLYING MANAGERS (LARGE CAP CORE)**

Investors who limit their large cap exposure to just the large and mega managers (AUM > $33b) are missing out on 78% of the manager opportunities and 61% of the products on the market.

FIRM AUM ($B)	# OF FIRMS	# OF PRODUCTS	SHARE OF TOTAL AUM	CUMULATIVE SHARE
100+	30	105	75	75
34 to 99	30	78	15	90
12.8 to 33	28	53	5	95
2.7 to 12.7	76	106	4	99
0.01 to 2.7	118	134	1	100

Data Source: eVestment Alliance, Marietta, GA.

Notes:

1 While the term "emerging manager" has often been defined as a firm with less than $2 billion in assets under management, this has been a moving target. In our research, we have consistently defined the group as the smallest firms that collectively hold 1% market share of all assets managed by the firms in the total study sample. Details on this and other methodological questions can be found in our published research, "Potential Benefits of Investing with Emerging Managers: Can Elephants Dance?" *Journal of Investing* (Spring 2007).

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