BEST MANAGERS YOU NEVER HEARD OF

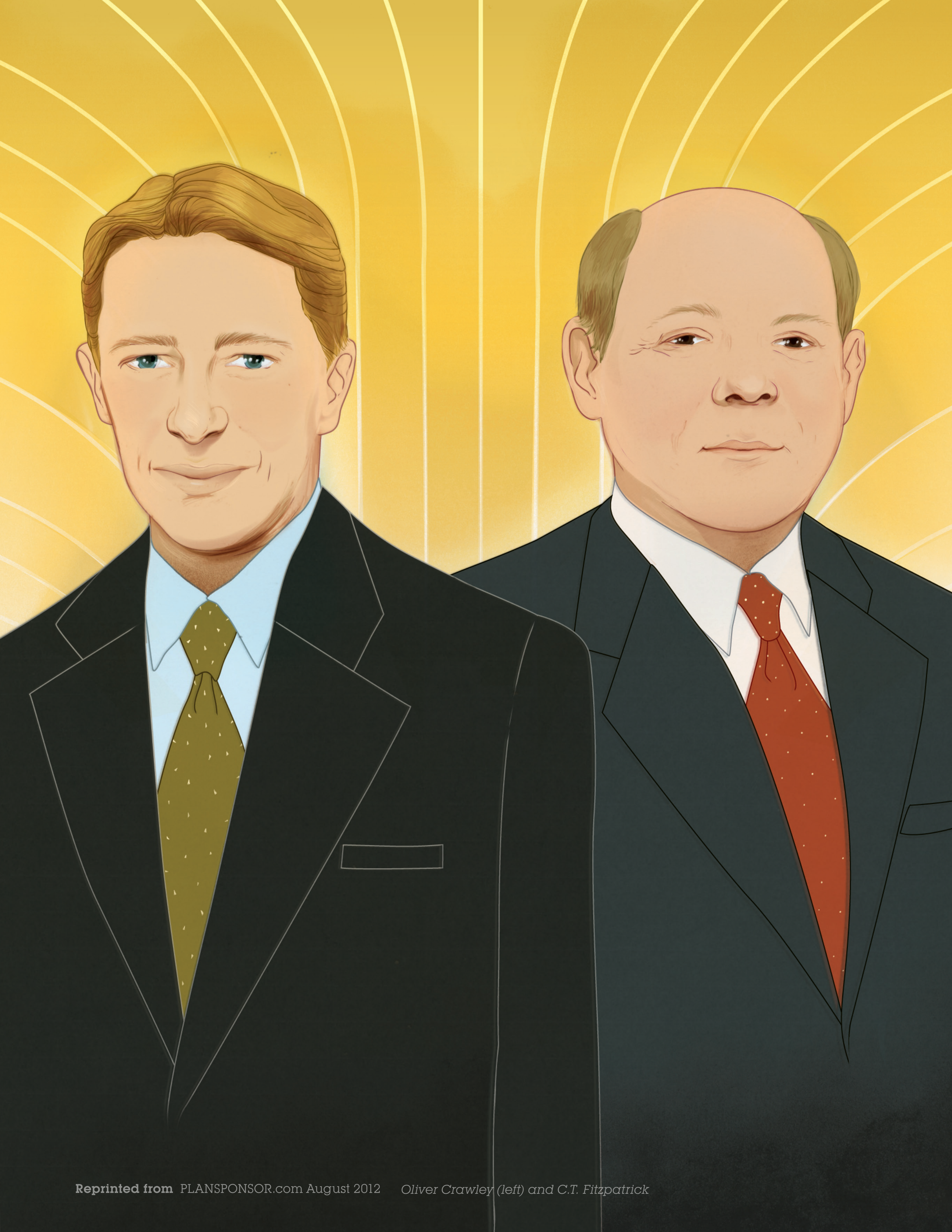
SMALLER STRATEGIES RULE—THOSE MANAGING THE LAST 1% HAVE BEATEN THOSE ADVISING THE TOP 99%

INVESTMENT management is an activity based on confidence, even arrogance—the belief of a firm's principals that they can consistently outwit the hundreds of professional managers in a given style. But, even in light of recent market outcomes, there is no shortage of confident, entrepreneurial people, and the industry grows every year—in early 2012, the Securities and Exchange Commission (SEC) reported 12,622 investment advisers registered in the U.S., an increase of 21% from 2008, and of 61% from 10 years earlier. Each year, PLANSPONSOR sorts through the new names, hoping to find a few that are ready for the rigors of the institutional market.

Investment consultants and researchers have long examined the relationship between firm size and results; most conclude that superior results come from smaller strategies. Ted Krum, an investment program manager at Northern Trust in Chicago, has posed the question every few years since 1995. His latest update, as of August 2010, again finds that for active large-cap core strategies, small firms—i.e., those managing the last 1% of assets—have beaten those advising the top 99%.*

For the five years ended June 2010, Krum reckons that the median small manager—a firm with less than $3.6 billion under management—delivered an annualized return 0.72% greater than the median large firm. He also notes that smaller firms outperformed in down markets but lagged in up markets. In his earlier research, small firms' performance advantage was even greater.

Illustration by Marcos Chin



 Oliver Crawley (left) and C.T. Fitzpatrick

There can be a downside, however, to organizations that are young and building. But because few newcomers are entirely *new*, most investment teams being seasoned and their strategies and track records established, the risks tend to be on the business side, says Lauren Etcheverry, equity investment consultant and vice president at Callan Associates in San Francisco and leader of Callan Connects, the firm's emerging manager initiative. "We take a closer look at firm structure and the business's break-even point. A firm might have just one strategy, but a diversified client base and a solid business plan are positive factors." She also prefers to see firm ownership distributed to the team, to increase the attraction of staying with the organization.

Both of PLANSPONSOR's 2012 Best Managers have experienced investment teams and solid track records established at larger organizations, and have built an institutional following in just a few years.~

**"No Contest: Emerging Managers Lap Investment Elephants"; www-ac.northerntrust.com/content//media/attachment/data/reports/1010/document/em_research_2010.pdf*

~All investment-return information in the two case studies comes from the manager database of eVestment Alliance in Marietta, Georgia.

Somerset Capital Management

London, England

"WE give our clients a different type of exposure to the emerging markets," observes Dominic Johnson, chief executive at Somerset Capital Management, which manages four global emerging markets equity strategies, all carried out through concentrated portfolios. "We dive deeper down the market-cap chain and go broader into newer and smaller markets, to find companies that are not followed by brokers and that other managers don't invest in. We offer real hypodermic access to the smaller markets and companies."

Somerset opened its doors in April 2007, with a team that had managed a successful emerging markets franchise at Lloyd George Management. In addition to its intellectual assets, Somerset had the benefit of $350 million in seed capital from two external shareholders that are also institutional clients. "That asset base made us profitable from the start, and every month since," notes Oliver Crawley, head of European marketing. Today, the firm has a staff of 20, including 12 active partners. Managed assets total about $1.5 billion across the menu of a global strategy, mid-cap, small-to-mid-cap and dividend growth fund, each delivered through a compact portfolio of about 40 stocks.

"We think a concentrated portfolio allows you to better manage risks, because you have a better knowledge of the holdings," says Johnson. "Forty positions are enough to give you diversification in a global mandate. We'd rather be taking fewer positions where we have real conviction than a lot of half-hearted positions that simply give us exposure to a sector or region.

"The emerging markets benchmarks often become skewed by the commodities and energy companies," he adds. "That can obscure the results of some periods, in terms of our ability as stockpickers. We want to be judged on our ability to select the right companies, rather than just be over- or underweight in the commodities sectors in an index—you can buy the commodities separately and make a lot of money doing it, but that's not what we are trying to do." Among small-cap emerging-markets managers, through March 2012, Somerset's Emerging Markets Small Cap Fund earned one- and three-year rankings in the 37th and 12th percentiles, respectively.

Not satisfied with admiring from afar, Somerset's managers get close to the companies they own. "You have to see evidence of the physical activity," Johnson explains. "And, culturally, there are different views of [an] outside shareholder—someone that exists to fund management's lifestyle rather than to be a partner in the business. The emerging markets are evolving, but there still are many added layers of risk." In Somerset's eyes, the most attractive candidates generate surplus cash flow, control the pricing of their products and command a position of strength from which they can expand.

"We are bottom-up stockpickers and focus on getting the right companies at the right valuation, but we don't ignore the macro," Johnson says. The currencies that companies operate in are of prime importance, particularly for borrowings. In the 1998 Asian currency crisis, many

Somerset Capital Management Global Emerging Markets Equities

Strategy assets: $530 million

	1 YEAR	3 YEARS	5 YEARS
Strategy return	-1.10%	27.54%	4%
Excess return	7.70%	2.47%	-0.67%
Information ratio	1.47	0.4	-0.11

Periods ended March 31, 2012
Excess returns calculated versus the MSCI Emerging Markets Equity Index – Net Dividends
Source: eVestment Alliance

good companies had dollar-denominated loans that ballooned when their native currencies were devalued. "We tend to use the macro concerns as a negative, and they serve as a risk control rather than set the direction of our investments," he says.

Liquidity is a crucial concern, as well. Many emerging market portfolios have good broad liquidity but poor "tail" liquidity when markets are stressed. Johnson notes, "We're very aware of the tails of our portfolios and try to keep them as liquid as possible." Somerset prefers companies with a preponderance of local ownership to insulate against capital flows driven by global trends instead of companies' merits.

Liquidity goes hand in hand with placing limits on strategy capacity—a founding principle of Somerset. With focused portfolios and a dedication to seeking out smaller-capitalization stocks in less busy markets, maneuvering room can be lost quickly. "We could leave our funds open and make marginally more profit," says Crawley, "but it would take longer to build or sell positions, and, at some point, that would hurt performance. As owners of the firm, we do not want to take that risk." Therefore, all Somerset's strategies have a capacity limit: Its small-cap fund, for example, was closed at $400 million assets, only three years and five months after first being offered to clients.

"Nothing goes in a straight line in the emerging markets," Johnson says. "There are a lot of great stories. About India, for instance—five years ago, you would have thought it was a one-way bet, but the reality is that India has not developed its economy very well, and it is woefully uncompetitive." Johnson has grown frustrated with India, where it actually has become more difficult to invest. "There's a vibrant culture of smaller enterprises, but investing there has become harder for us over the last two years—even getting a registration to be a foreign investor there has become more complicated. India has been a challenging place where investors have to watch everything, month to month. The emerging markets are still emerging, and investors need a capable steward for their capital."

Johnson sums it up: "That's why we have a role, and a business."

Vulcan Value Partners

Birmingham, Alabama

WITH its local deposits of iron ore, coal and limestone, Birmingham, Alabama, became a center of iron and steel production in the rebuilding that followed the American Civil War. "The Pittsburgh of the South" was thus represented in the 1904 St. Louis World's Fair by a 56-foot-tall cast-iron statue of Vulcan, the Roman god of fire and the forge, which, today, lights the evening sky atop Red Mountain, to Birmingham's southwest. "We liked the name because it ties us to the region, but it's a powerful symbol that is globally recognized, too," says Vulcan's chief executive and chief investment officer, C.T. Fitzpatrick, an Alabama native.

Fitzpatrick opened Vulcan in 2007, after a long and successful career at Southeastern Asset Management in Memphis, Tennessee. "I worked with them for 17 years, and we [had] a great track record. And I'm grateful to them," he says. "I hold them in high regard. After a while, though, my being 100% on board slipped to 80/20, and I thought I should leave rather than wait for things to become 60/40." In the years between the founding of the firm and opening it to outside investors this past February, Vulcan built a staff of 12 and an infrastructure to meet the future as an institutional manager.

Vulcan pursues a value style in the U.S. market through two concentrated portfolios of 20 to 30 positions—large cap and small cap—and two Partners Fund strategies restricted to just seven to 14 stocks. For the three years ended March 2012, the large-cap fund beat the Russell 1000 Value benchmark by 6.2% annualized; compared with the eVestment Alliance large-cap value universe, the strategy ranked in the 27th percentile for three years and the fourth percentile for five. Tracking error is modest, and the large-cap strategy's information ratio for three and five years came in at about 1.0. Vulcan's other strategies show similarly strong returns.

Fitzpatrick keeps the portfolio small, out of respect for market efficiency: "The markets are not so inefficient that you can have a diversified portfolio of really

Vulcan Value Partners Large Cap

Strategy assets: $268 million

	1 YEAR	3 YEARS	5 YEARS
Strategy return	17.60%	29.00%	7.55%
Excess return	12.81%	6.18%	8.36%
Information ratio	2.89	0.97	1.02

Periods ended March 31, 2012
Excess returns calculated versus the Russell 1000 Value Index
Source: eVestment Alliance

high-quality names at really large discounts, but they are inefficient enough that you can have an undiversified portfolio of really high-quality names at really large discounts. And that's our idea."

Total assets managed were about $500 million at the end of June. Eighty percent is institutional, and those clients are far-flung and varied. "Our largest client is outside the U.S., and we have significant clients in New York and on the West Coast. People have come from Australia and Switzerland to kick our tires, here in Birmingham. We are serious investors looking for other serious investors," Fitzpatrick says.

"Many value managers will buy what is statistically cheap at a point in time," he explains. "We do not. We look for businesses with the characteristics we want to own, and once we find them we will wait years, even decades, to buy them at the right price." The central objective is ample and sustainable cash flow, over a time horizon of five years, discounted at conservative rates.

Vulcan's research goes beyond the numbers, however. "You can quantify all sorts of metrics, but we have to get behind the numbers, to the qualitative aspects, and understand whether a company has an edge and can produce free cash flow," he says. "There are entire industries that we have no interest in, such as airlines. In fact, we look for the opposite of airlines—companies that don't require a lot of capital, and have pricing power, valuable brands and competitive advantages, and are loved by their customers.

"We don't ignore the macro environment, but we have a 90/10 split in the amount of research we do," he says. "That works out to looking at the big picture about one day every two weeks, which is plenty of time. We get insights on the macro world from the companies we talk to, and, when you put it all together, it either confirms—or doesn't—the conventional wisdom at the time and makes us cognizant of conditions and the impacts they can have on the businesses we own."

During the financial crisis, Vulcan avoided financial stocks, "even the statistically cheap ideas like Bear Stearns or Washington Mutual," Fitzpatrick recalls. "We had no interest, because the financials don't have inherent stable values. A bank might be selling at a discount to tangible book value, but, with 20 to one leverage, who can know what that value really is? We need to be highly confident that we are at least approximately right about the value of the company."

Vulcan's patient approach paid off in 2009. The large-cap strategy beat the Russell 1000 Value Index by 4.1% in 2008 (although was still off 32.7%) but returned 60.2% in 2009, surpassing the index by 40 percentage points. "Much earlier, we had done research on MasterCard, when it was not remotely cheap. When it hit our estimate of fair value, we were ready," Fitzpatrick says. "Before long, we started paying about 60 cents on the dollar. The earnings didn't decline; in fact, they went up by 20%, and in March 2009, it got to 40% of our estimate of value, and we increased the weight to 6% of the portfolio. You asked what happened in 2009? We had a bunch of MasterCards.

"We are highly productive on the research front and generate more ideas than we have capital for," he says. "Macro fears are dominating equity investing, so that capital is not flowing efficiently. There's a compression of valuation for quality companies, and the businesses that we are interested in are often trading at lower valuations than the lesser names we are not interested in. Finding things to buy is not the problem—it's finding things to sell that will allow us to pay for everything we would like to buy.

"Our time horizon is five years," Fitzpatrick says. "I can't tell you what is going to happen in six months. But we own businesses that have demonstrated their ability to compound their values in bad times and in good times, and their values are steadily accreting. It's a great time to be us." —*John Keefe*

BEST MANAGERS REUNION—CLASS OF 2011

IN THE SPIRIT of the eternal client question "What have you done for us lately?", we catch up with 2011's Best Managers and find that results for the 12 months ended March 2012 were mixed.

At F-Squared Investment Management, in Newton, Massachusetts, a setback in the most recent quarter led to a one-year shortfall of 4.28% from the S&P 500 for the F-Squared AlphaSector Premium strategy, dragging one- and three-year performance into negative territory. But, because the fund managed to surpass its benchmark every year from 2005 to 2010, it remains in the top percentile among large-cap core strategies for the latest five and 10 years.

The Ceredex Large Cap Value Equity Strategy of Ceredex Value Advisors in Orlando, Florida, came in 0.17% under its Russell 1000 Value benchmark for the year ended March 2012. Its small-cap counterpart made a better showing, however, and beat the Russell 2000 Value Index by 3.49%.

Last, the flagship Market Leaders Value fund at O'Shaughnessy Asset Management, in Stamford, Connecticut, landed 2.8% ahead of the Russell 1000 Value Index for the year ended March 2012, earning respective ranks for one, three and five years in the 30th, first and sixth percentiles. —*JK*

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Vulcan Value Partners buys concentrated positions for our portfolios, averaging 5% in our model portfolios, which may make our performance more volatile than that of our benchmark indices and our performance may diverge from an index, positively or negatively, as a result. Our focus is on long term capital appreciation, so our clients should consider at least a five year time horizon for an investment with Vulcan. **Past performance is no guarantee of future results and we may not achieve our return goal.**

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The S&P 500 Index is an unmanaged index of 500 common stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index. The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. Index figures do not reflect deductions for any fees, expenses, or taxes. Investors cannot invest directly in an index.

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