A Framework for Manager Selection

Mr. Stone, Mr. Bansal and Ms. Carder, oversee the University of Chicago’s Public Markets and Absolute Return, or “PMAR”, team. Together, they oversee over $4 billion of investments in Global Equities, Fixed Income, Credit, Absolute Return, and Private Debt. Mr. Stone, as Managing Director of the team, has been with the University for 13 years and has a total of 28 years of experience. Mr. Bansal, Senior Portfolio Manager of Equity Oriented Strategies, has been with the University 10 years and has 18 years of experience. Ms. Carder, Senior Portfolio Manager of Credit Oriented Strategies, has been with the University for 3 years and has 16 years of experience. Mr. Bansal is assisted by analyst Matt Hill, and Ms. Carder is assisted by analyst Chris Ridenour. The PMAR team is charged with selecting the best managers they can find while operating within the overall constraints and mandates of the University’s strategic policy and Total Enterprise Asset Management approach. The PMAR team’s goal is long-term (three to five year) outperformance versus appropriate benchmarks. Their manager selection process has been successful over a range of market cycles. The most recent three year periods saw excess returns in their asset classes ranging from 130-740 basis points annualized. The five year period ending June 2012 saw annualized excess returns from 290-360 basis points.

Introduction
“A Total Enterprise Approach to Endowment Management”, presented by Mark Schmid and Que Nguyen in the January 2012 NMS Exchange, introduced the University of Chicago’s integrated approach to investment strategy. Total Enterprise Asset Management (TEAM) seeks to frame the investment strategy of the endowment in the context of the long-term operating goals and risks of the University, rather than as a stand-alone, total return fund. In this companion piece, we detail an overarching investment philosophy and manager selection process employed in our Public Markets and Absolute Return portfolios, which we believe supports the TEAM approach and ultimately the University’s academic mission.

Two Types of Managers
We begin by presenting an oversimplified view of the investing world as containing two distinct investment styles: “Short-Term” or Trading-oriented and “Long-Term” or Intrinsic Value-oriented. A similar categorization can be found in Value: The Four Cornerstones of Corporate Finance, by Tim Koller, Richard Dobbs and Bill Huyett, wherein the authors describe four classifications of institutional investors: Intrinsic Investors, Traders, Mechanical Investors and Closet Indexers.

Short-Term investment managers are plentiful. Generally speaking, they are near sighted by choice; they can see only as far as the next earnings season. This doesn’t bother them, as they believe anything that can happen beyond three to six months is unknowable. They are often interested in technical analysis and momentum; they trade actively and exhibit high portfolio turnover. Earnings revisions and near-term corporate events are viewed as opportunities. When they encounter a stock they believe has a terminal value of zero, but that might experience a positive earnings surprise before that, they enthusiastically invest and trust their market-timing skills for their exit. Put less hyperbolically, they readily invest even when they believe the intrinsic value of the company is far below the current market price, e.g. Internet stocks in the late 1990’s.

This investing style is driven by the usual compensation schemes for managers, which unduly reward short-term outperformance. Koller et. al. suggest nearly 80% of all investors, especially in the public equity space, invest with this kind of short-term trading, mechanical or index-oriented approach. Our base assumption is that this style of investing leads to average results. While we believe it is possible to find great managers in this space, it is extremely difficult to do so. This is not our preferred style.

Long-Term investment managers are focused on the intrinsic value of the business and typically are very farsighted, with the professed ability to see three to five years into the future. They are willing to hold positions for extended periods of time. Free cash flow and fundamental business and balance sheet analysis are paramount. When they encounter a stock they believe has a terminal value of zero, but which might experience a positive earnings surprise before that, they politely decline to invest. In the equity space some call this Buffett or Graham & Dodd investing, while in the credit space some would call it a focus on old fashioned credit underwriting. We prefer to think of it as common sense.

While there are fewer managers investing with a long-term approach, our belief is that, as a group, they will outperform the short-term investors. Thus, we believe that by focusing on managers with long-term perspectives, we are “fishing” in waters where there is a higher probability of delivering strong alpha.

The D’s and the P’s
The D’s
As noted above, our overarching philosophy is that most of the investing world has a very short-term focus, and that by training our attention on managers with a longer-term orientation, we increase our chances for success. Over the course of time, we have come to realize that our manager selection process is greatly aided by having a discipline to follow in manager evaluation. This realization has led us to the development of “The D’s and P’s”.

The D’s are our attempt to anchor our philosophical interest in long-term thinkers with concrete descriptions of what kind of investing leads to outperformance. If a manager does not engage in at least one of the four D’s, there is virtually no chance we will be interested in that manager for an investment. Whenever we review managers’ materials, we are initially checking to see which D’s they practice or represent.

[Continued on Page 15]
The first D is **Discount to Intrinsic Value.** We believe the best way for managers to generate alpha is to identify assets that trade at a significant discount to intrinsic value. This strategy does not lead to style bias in equities, as it includes both value and growth managers. What it does lead to are managers who invest in companies with high free-cash flow, defensible brands, wide economic moats, low capital expenditure needs, and reasonable leverage — companies that are trading at a substantial discount to the manager’s estimate of intrinsic value, usually due to a perceived short-term challenge in the business. Companies, in short, that tend not to be very interesting to short-term investors. On the credit side, this strategy leads to a focus on covenants, cash flow, balance-sheet strength, recovery value and liquidation value. To assess a manager’s commitment to Discount to Intrinsic Value, we look for a long track record and an investment philosophy clearly articulated through years of investor commentaries. We ensure that the manager has created a systematic way of assessing the discount level and tracking it over time. Furthermore, we need to have the ability to go back in time to understand what they were thinking in the past when positions were initiated or passed over. We like to see and discuss specific examples of successful and failed investments to further assess manager skill.

The second D is **Deep Research.** This often means that we have a focus on managers who perform their own fundamental bottom-up analysis. This is true across our asset classes. In Global Equities, for example, we tend to prefer portfolio managers who still function as company analysts. We are often led to managers with concentrated holdings and constrained assets under management. Of our 15 Global Equities managers, seven own 10-20 stocks, three own 30-50 stocks, three own 100-200 stocks and two (the more macro or index like) own more than 450 stocks. Our managers use sell-side research sparingly, if at all. We are looking for managers who will happily make 100 phone calls, and consider 30 resulting conversations a victory. Crucially, we are always asking this type of manager what he sees in a stock that the market doesn’t see; i.e. what makes his point of view different than the market consensus? Deep research on the credit side means managers who do not rely on rating agencies but do their own intensive in-house credit analysis. However, deep research does not always mean a concentrated portfolio or a sense that the manager knows the company better than anyone else. It can include managers who have superior quantitative systems to analyze large numbers of equities (or credit or derivatives). Even here, though, we prefer fundamentally based systems to technical systems. You are unlikely to ever see us being impressed by the “years of research” that have led to a moving average crossover commodity trading system.
The third D is Driving Outcomes. Here we are looking for managers on the equity side who practice activism or constructivism, managers on the distressed-debt side who control the bankruptcy process and managers on the direct-lending side who can structure and define terms of the loans they make. These managers tend to be on the larger AUM side, with enough capital and reputation to force situations to their advantage. In this area we will hire both operationally and financially focused managers. As with our other D’s, this is a strategy best executed with a long holding period in mind.

The final D is Dislocated Markets. We firmly believe that specific market segments can occasionally exhibit unfair pricing. Sometimes this is caused by a preponderance of non-economically motivated transactions. Sometimes there is a behavioral element at play, driven by investors’ misunderstandings and fear. Sometimes there is something structural going on — witness the withdrawal of banks from middle-market lending in both the U.S. and Europe and how that has created an opportunity for non-bank lenders to swoop in and make high interest rate, over-collateralized loans to strong borrowers. Most of the managers we like in this area tend to have very specific areas of expertise. Interestingly, the actual securities purchased — or loans made — in this area are often quite illiquid, even though the resolution of the dislocation may occur rapidly. Thus, this area, more than any other, is best executed via a locked-up investment vehicle. Most endowments have been seeking to reduce their level of illiquid investments, which makes it difficult for many of them to build up a large position in dislocated market opportunities.

The P’s

Once we have assessed a manager’s suitability for our portfolio based on her D’s, we move on to analyzing how well she scores on our P’s. The P’s are our mnemonic for making sure we cover a variety of important questions whenever we are conducting due diligence on a potential investment manager. Each P has a large subset of related questions and measurements, some quantitative and others more qualitative. (Figure 1)

Our first P is Process. When evaluating investment managers, process is not only key, but refers to everything from investment decision-making to trading to risk management to operations. We believe that a strong focus on process leads to repeatable success in idea generation, investment analysis and portfolio construction. As a result, we want to understand the day-to-day details of all the manager’s processes. Where do people sit? How many screens are in front of them? What are they looking at on those screens? How do personnel in different offices communicate with each other? How does money move between accounts? Who has signing authority? Who can initiate positions? Who can terminate them? Is lunch brought in? How about dinner? What kind of fire suppression system do they have in their computer room? Does the door lock? Who has the key? Who can physically make changes to computer models? Questions like these are only a fraction of what we want to know in our quest to understand a manager’s process.

Our second P, arguably just as important as the first, is People. We are looking for teams with experience, preferably through more than one market cycle. We expect relevant education and training. We want appropriate staffing, in both front and back office, given the manager’s strategy and assets under management. We try to gain insight into the manager’s motivations and ethical code, as we demand integrity of the highest order. We prefer low turnover in investment personnel and we want to be able to have an expectation that the management team will be in place for at least the next five years. We require that significant senior level attention be paid to the portfolio, but we are also cognizant of key man risk. It is vitally important to us that we feel like we understand our managers’ motivations, so we spend a lot of time talking about non-investment issues. We care about what books they are reading, what their hobbies are, what kind of cars they drive and houses they live in. We want to know what led them to start their own firms and why and how they left their prior firms. We want to understand why, if they are among the managers who are already monetarily successful, they are still managing outside money and whether we can count on them to continue doing so.

Our third P is Partnership. We expect to have long-term relationships with our managers, so we want to ensure that we agree with how they are running their firm today as well as with their growth plans. We look for a significant commitment of the manager’s personal assets to the strategy. Alignment of interest should also extend to the compensation structure for all employees. We prefer compensation based on total long-term fund performance, not employee- or group-specific annual returns. The manager should have assets under management that are appropriate for the strategy (e.g., small cap investing is done best with a small asset base). Focus should be on one or a few related products, and AUM growth should be controlled. It is essential that redemption terms be in line with the liquidity of underlying securities. We also seek out evidence that the manager will continue to be solicitous and attentive to us once we are a client.
Our fourth P is **Portfolio**. This is the most objective and quantitative of our P’s. We factor-map the manager’s holding to a set of indices so we can determine the theoretical beta to global equity markets, as this is one of our key metrics across the endowment. We then run an analysis to make sure we won’t be over-concentrated in specific trades or names across the endowment. We also seek to ensure that managers are actually doing what they tell us they are doing. If they are active, we need to make sure they are not closet indexers. We prefer consistency in strategy over time; managers can shift asset allocations as opportunities arise but should not exhibit strategy drift. We look for adequate transparency so that aggregation of our risk metrics across all funds can be accomplished. We avoid excessive leverage in those cases that leverage is employed. We discourage the use of recourse, short-term, mark-to-market leverage at the fund level or the asset level. We expect the fund to have adequate liquidity to pay for redemptions but also to take advantage of opportunities. We want to invest in managers who have rigorously monitored risk across portfolio positions, including currency, political, valuation, liquidity and correlation risks.

Our fifth P is **Performance**. With respect to performance, we look for a long-term track record relative to appropriate strategy benchmarks. We want to understand what, if anything, has changed with respect to the manager’s strategy or personnel. But the reality is that no matter how well a manager fits our D’s, and no matter how much we like our assessment of them with respect to Process and People and Partnership and Portfolio, historical performance does matter. We certainly recognize that past performance is not necessarily an indication of future performance, but demonstrated success as an investment manager generally is required. That does not mean that the manager can’t have hit some bumps along the way, but a three-year losing streak is much more palatable as part of a ten-year track record than as the only record they have.

Our sixth and final P is **Price**. By price we mean management and incentive fees. In general, our preference is to hire the best managers we can at the best fees. In a perfect world, for example, the best long-only equity managers would charge only management fees, as is often the case for UK-based equity managers. Barring that, we desire that the management fee alone not be a source of significant profits for the manager, especially if incentive fees are charged as well. When there is an incentive fee, we prefer a hurdle rate or preferred rate of return. Lastly, there should be a claw back of incentive fees over the look up time frame, i.e. a three-year lockup should charge incentive fees only on the three-year return, not annually.

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**FIG. 2**

**Investment Q&A Checklist**

<table>
<thead>
<tr>
<th>Due Diligence Step</th>
<th>Completion</th>
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<tbody>
<tr>
<td>Receive investment manager marketing presentation</td>
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<td>Conduct initial meeting with investment manager</td>
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<td>Place initial reference calls</td>
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<tr>
<td>Review PPM and LPA, prepare due diligence questions</td>
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<tr>
<td>Prepare and distribute deal summary to Investments Staff</td>
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<tr>
<td>Review investment opportunity with CIO and receive feedback</td>
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<tr>
<td>Place investment opportunity on PUC report and review Investment Committee feedback</td>
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<tr>
<td>Visit manager on-site for full due diligence meeting</td>
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<tr>
<td>Investment manager meets with CIO</td>
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<tr>
<td>Place in-depth reference calls</td>
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<tr>
<td>Have legal documents reviewed by outside counsel</td>
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<tr>
<td>Prepare and distribute an updated and more extensive deal summary</td>
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<tr>
<td>Engage investigator to conduct background check on new investment managers</td>
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<tr>
<td>Distribute internal recommendation to Investment Staff and solicit feedback</td>
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<tr>
<td>Present internal recommendation to Asset Allocation Committee for approval</td>
<td></td>
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<tr>
<td>Negotiate legal docs and side letter</td>
<td></td>
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<tr>
<td>Complete internal operations process</td>
<td></td>
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<tr>
<td>Deliver signed documents to manager</td>
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The Approval Process and Ongoing Monitoring

A clear process for manager selection and monitoring is crucial to our internal success at the endowment. We need to be able to clearly articulate and document why an investment is appropriate for our portfolio. Internally, a strong process gives us a checklist by which to proceed, to ensure that we don’t accidentally skip any steps in our due diligence. The approval process we are about to describe applies to each of our internal groups when making manager selection decisions.

In the first step of our internal approval process, we prepare a “Partnerships Under Consideration” document that lists basic, salient features about every new fund that we might be considering. This document is sent to all members of our Investment Committee, which is comprised of University Trustees. The Investment Committee members do not actively weigh in on manager selection, but this process allows them to know what we are evaluating and to alert us if they have any relevant knowledge about a manager we are considering.

As the second step in our process, we create a one-pager describing the manager’s strategy, firm, and funds. We use this as a talking sheet during our weekly Investment Staff morning meeting.

If a manager passes through our previously described due diligence hurdles (the D’s and the P’s), we prepare a longer PowerPoint document, usually 15-30 pages. We present this PowerPoint document at an “Investment Q&A meeting” which is open to all investment staff. Detailed questioning is welcomed. In this document we describe the manager’s strategy in greater detail, discuss the terms and conditions, evaluate the investment strengths and weaknesses, summarize our assessments of the D’s and P’s, show performance, and go through some investment examples. We also include a checklist so everyone can see where we are in the process. (Figure 2, Page 17)

After the optional-attendance investment team meeting described above, we either decide to continue with more due diligence or we decide not to pursue the manager. If we continue, and eventually decide to make a recommendation, we prepare a formal investment recommendation write-up of 40-50 pages. The write-up includes sections on the firm, the management team, investment philosophy, process and portfolio. It concludes with a section containing outside counsel’s legal review of the fund documents. The write-up is presented to our internal Asset Allocation Committee, co-chaired by our Chief Investment Officer and our Managing Director of Strategy, whose voting members include our CIO and our six Managing Directors. The appropriate asset group presents the write-up to the Asset Allocation Committee, after which a formal vote is taken, with the CIO having final approval and veto power.

As part of our due diligence and ongoing monitoring process we construct a risk matrix, which outlines our perceived exposures to different forms of risk for each investment. A sample matrix can be seen below. For each of our P’s we rate the manager’s riskiness on a 1-9 scale, with 9 being the least risky. We present this information to our internal Asset Allocation Committee when we bring a manager forward for investment approval. Then, on a quarterly basis, we present the risk matrix for every one of our investments.

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**Risk Matrix**

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<tr>
<th>P's Overall</th>
<th>Process</th>
<th>People</th>
<th>Partnership</th>
<th>Portfolio</th>
<th>Performance</th>
<th>Price</th>
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</thead>
<tbody>
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<td>Manager 1</td>
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<td>Manager 2</td>
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<td>Manager 6</td>
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- **Double Cross**: No significant concerns, Top Third, Best Practices, A- to A+
- **Single Cross**: Some concerns, Middle third, Under watch, B-to B+
- **Triple Cross**: Serious Concerns, Bottom third, Close watch, C+ and lower
to our internal Risk Management Committee, co-chaired by our Chief Risk Officer and Chief Operating Officer, with whom we discuss any upgrades, downgrades, flagged concerns, or other changes that might have occurred in our thinking. Here is a sample, colorized on our 1-9 scale, of what we present. (Figure 3, Page 18)

**Conclusion**

When it comes to selecting managers for the Public Markets and Absolute Return portfolios at the University of Chicago endowment, we try to apply a consistent philosophy and approach. We seek long-term oriented managers who invest with an eye towards at least one of our D’s. We evaluate managers on how well they satisfy our P’s. We factor map each manager to some combination of the over 150 indices we track to get an idea of how the manager’s current portfolio would have performed in the past and how it might perform in the future. We gather our thoughts and impressions and rate the managers in a risk matrix on an initial and ongoing basis.

With more than 80 managers in our PMAR portfolio, and with 300-500 meetings per year with potential managers, it is vitally important that we have a solid process in place with which to make our evaluations. It is worth noting that one of the reasons we are able to do this is the resources that the University has made available to our office. The PMAR group has five people, and the most senior three have a combined 55 years of experience. We think this gives us the ability to question managers in a probing manner that might not be accepted from less experienced allocators. In addition, we have the means to take multiple international trips each year, exposing ourselves to investment thinking from around the globe in an effort to identify the most promising themes and managers. The same is true of our very experienced Private Equity and Real Assets teams.

It is important to point out that one of the chief reasons we can focus on manager selection (the focus of this article) and thematic investment opportunity identification is because of the overall strength of our office. Roles are well defined, but collaboration is the order of the day. We never have to worry whether an operational issue is going to divert our attention, we have a team dedicated to operations and operational due diligence led by our Chief Operating Officer. We don’t have to build our own computer models to measure the calculable risk of our managers — we have a risk team headed by our Chief Risk Officer with more programming and mathematical firepower than most hedge funds. We don’t have to concern ourselves on a day to day basis about our overall levels of manager driven market exposure —, we have a strategy team led by our Managing Director of Strategy to tactically reallocate among global equity and fixed income markets based on our office’s market views. We are fortunate to have the support and leadership of a Chief Investment Officer who has built a well-conceived organization and new processes in the last three years that allow us to concentrate on what matters to our team and the University’s endowment. Finally, the University’s Investment Committee includes very experienced and knowledgeable business and investment leaders who effectively empower and collaborate with the Investment Office.

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**FEATURED GUEST SPEAKER**

Gillian Tett  
*U.S. Managing Editor & Assistant Editor*  
*Financial Times*

*For more information please contact*

Diana@nmsmanagement.com