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# THE MEASURE OF A MANAGER

*Alternative investments demand a different tack to manager selection.*

A major hurdle in implementing alternative investments such as hedge funds or private equity is deciding which manager to hire, since many aspects are vastly different from the familiar “long-only” world.

Developing criteria to screen candidates can be daunting when a plan sponsor has no personal experience with the asset class. For a fast—and free—education, ask several potential managers, “What criteria should I use to screen for the finalists?” and “When should a manager be fired?”

Many talented providers of alternative investments started by serving private wealth clients and are naturally intimidated by the contract terms and reporting that institutions require. For example, fund-of-fund managers can be surprisingly hesitant to report, even on a quarterly basis, such key variables as leverage, liquidity, and gains or losses in assets under management. However, you’ll probably find managers can become very flexible if a small reporting or contract term stands between them and a large investment, so address these issues early in the process.

Compared to the long-only space, contracts in the alternatives area often have unique terms and conditions, and providers may operate in offshore jurisdictions. Consult with your custodian and inquire about contract terms in preliminary meetings with managers. Have the contracts reviewed by a legal expert, but minimize the expense by waiting until the field has narrowed to a few semi-finalists. However, do the review before recommending finalists to a committee.

Like most hiring decisions, choosing an investment manager requires lots of professional judgement. Plan sponsors often use one or more outside consultants to assist in this subjective process. If a sponsor relies on a single consultant’s judgement, then the range of good outcomes is constrained by the biases and experience of one person or firm. The other option—challenging the consultant’s selection process—is often time-consuming and expensive: the

consultant must organize their data and decisions into neat, colorful tables, charts and decision trees, while the diligent plan sponsor must review it (and pay for it).

An excellent way to get a broad view while quickly narrowing down your list is to ask several consultants to provide their top three to five picks, then follow up by asking why they didn’t recommend the same names the other consultants did. This way you’ll get a variety of thoughtful opinions, often for no more than the cost of paying one consultant for a more in-depth report.

In dealing with multiple consultants, you must give assurances that their intellectual capital will be protected. Don’t share documents or reveal which firm recommended whom, don’t invite them to debate their choices face-to-face, and pay a fee that fairly represents their intellectual capital. Don’t expect consultants to recommend or even like this approach, but the ones you currently do business with won’t walk away, and the ones you don’t do business with won’t pass up the chance to show you what they’ve got.

Unfortunately, in the alternatives arena, most consultants monitor only a few managers, so even several advisors may have gaps in their knowledge. To obtain more information on the suitability of managers, ask the opinion of other plan sponsors with larger, in-house research staffs as well as managers in areas related to the asset class you are exploring, such as individual hedge funds or fund-of-funds, and managers just outside your selection criteria. Also, a low-cost way to investigate managers is to retain recently retired or unemployed industry participants to network with their contacts.

To summarize, in selecting a manager for a new alternative investment, plan sponsors need additional advisors to develop tailored selection criteria and perform proper due diligence of people, processes and performance. Investors should also devote more time up front to the negotiation of contractual issues, especially related to reporting requirements. ■