momentum

The art and science of manager research

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global investment management

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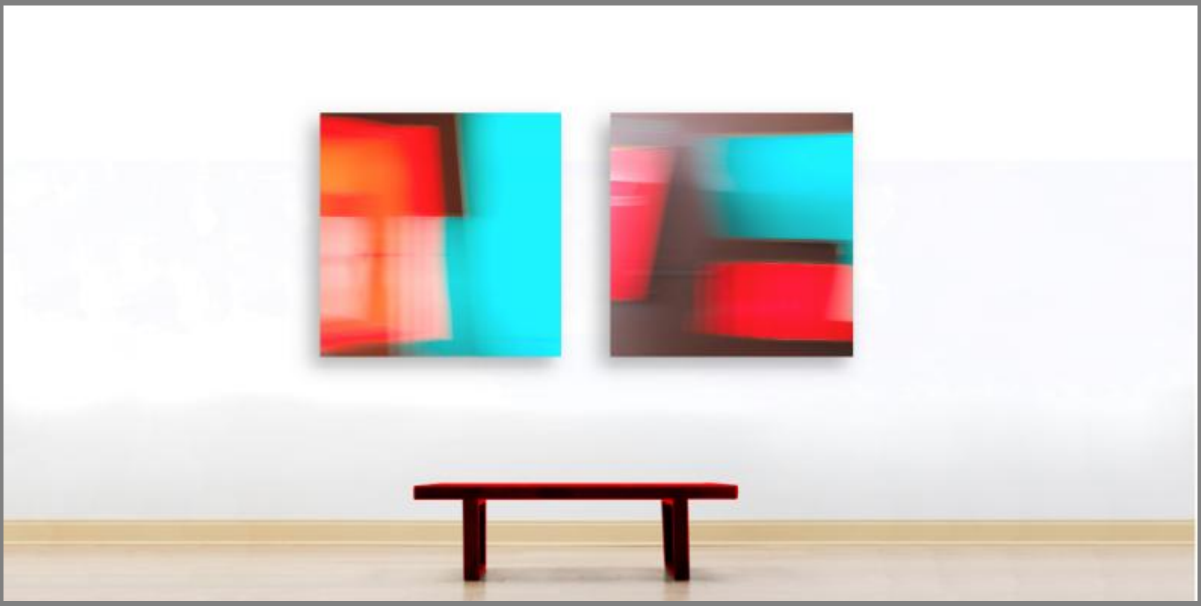


1. Introduction

Manager research is a core capability at Momentum Global Investment Management. It sits at the heart of our investment process and allows us to implement our asset allocation and investment style views as well as active / passive management biases.

We believe that a strong manager selection process can add significant value over time to a client's portfolio coupled with the enhanced due diligence and corporate governance that an experienced and rigorous manager selection team can provide. We also believe that it is a much more efficient way to manage portfolios and facilitates the implementation of dynamic investment decisions without emotional attachment to an in-house investment capability.

Key to this philosophy are a number of core beliefs:

- No single investment management firm has a monopoly on talent or good ideas. Consequently We see no rationale for restricting stock selection expertise to an in-house team
- No single manager can excel at all times. An active 'buy / sell' discipline is essential
- Picking single managers requires extensive research, good timing and expertise. Manager selection is time consuming, labour intensive and requires skill and experience

2. The importance of a well-resourced, experienced manager selection capability

As a core component of our process, we use third party managers to perform very specific investment roles within our asset allocation process. These can take the form of geographical, style and currency allocations and enable us to focus on very specific areas of the market where we see valuation opportunities. This philosophy is consistent across portfolios.

Manager selection allows us to implement these particular views on a best of breed basis meaning that each asset allocation decision is implemented by the team that we believe to be the best placed in the world to do it. It also allows us to use active and passive management where appropriate, which can have significant impact on fees.

The likelihood that the best fund manager (for any given asset class) has conveniently set up shop just round the corner from your office is very small at best. Unconstrained idea generation and research effort is therefore a key skill and at the heart of any research process.

Good managers come in all shapes and sizes but all share common attributes:

- a strong, supportive ownership structure
- a clearly defined and disciplined investment philosophy and process
- an experienced team that can demonstrate consistent implementation of their process through good and bad times

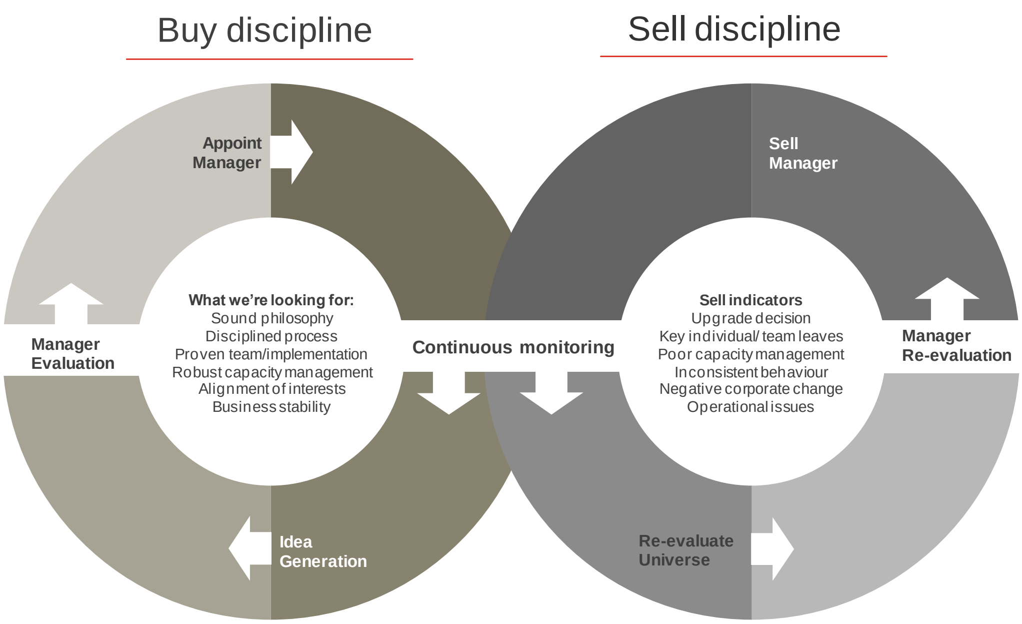
3. Characteristics of a great investment manager

The starting place for all of our manager research is our framework for what we believe makes an excellent investment manager. With any investment process, it is vital to know what you are looking for. This is true regardless of asset class. We do not attempt to see all managers; that would be an inefficient use of finite resources. Instead, we focus our research on specific manager 'styles' (for example, in equity markets, value, momentum and quality) which, in combination, offer the best risk/reward characteristics over time.

At Momentum Global Investment Management, we look for the following criteria in all our potential manager ideas: disciplined implementation of a sound investment philosophy; experienced individuals motivated to produce consistent outperformance and a firm that is structured to create an environment conducive to generating superior long-term investment results.

We aim to find all of these characteristics in our selected managers. When we weigh up the pros and cons of a manager. we will not compromise on the quality of a manager's philosophy and process.

Notwithstanding this, the firm and people criteria are very important, and with a very concentrated line up of managers selected from an unconstrained universe we are able to be selective on these factors.



4. Idea generation

Good manager ideas can come from anywhere and to this end we encourage our analysts to have a multifaceted approach to manager searches.

One key source of investment manager ideas comes from our long learnt and almost innate understanding of who does what well and an ability to look beyond the obvious.

Aside from this relatively indefinable side to our idea generation, Momentum GIM typically generates ideas via two methods:

Firstly using our proprietary databases, we undertake ongoing rigorous Screening for performance traits which we use as an effective means to identify ideas.

In our proprietary tools, we utilise data from numerous sources. We search for managers who have performance profiles which are similar to those we seek. For example, deep value managers would most likely have had strong outperformance in the 12 months ended March 2010, so we would screen for top performers during this time, since they are likely to have a deep value bias.

We also screen for managers with short performance track records so that we can analyse these managers' qualitative information to determine if they might fit our investment criteria. This helps to ensure that we don't miss 'emerging managers', for example when a team are implementing the same process at a new firm

In addition to our screening methodology, we also, on occasion, generate ideas thanks to the unique nature of our Professional Network – which includes:

When you have been analysing managers as long as we have and you have a history as a sound and long term minded investor, many investment managers seek us out to promote their work. On a very selective basis, this can yield results.

Manager research meetings can lead to knowledge of peers and key professionals who have left the firm to set up on their own;

Our research team has interacted with a large number of sales contacts in Europe, Asia and the US. When they move firm or their existing firm has a new strategy they will typically contact us since they know what we are looking for;

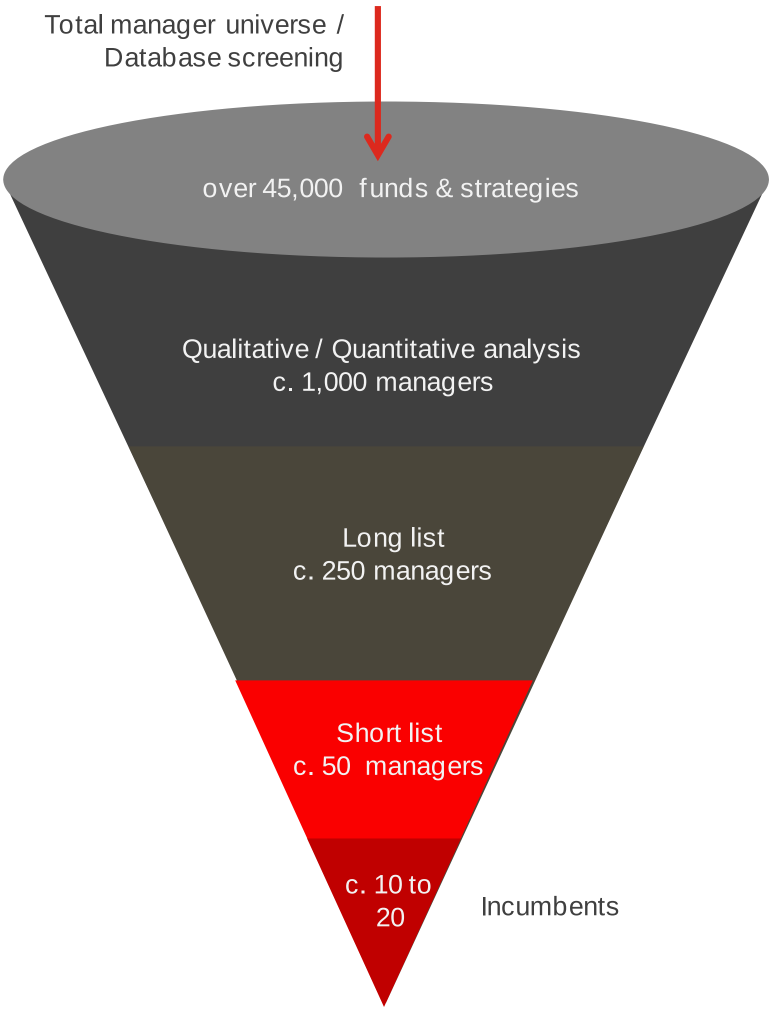
The team will attend industry conferences where discussions with other attendees on investment strategy can lead to new ideas;

Other members of the Momentum GIM team will alert the relevant desk when they find a firm or manager whom their contacts or own research have uncovered;

Finally, Momentum GIM will discuss with managers who offer strategies similar to those we seek whether they would consider running a different version that would be more suitable for our needs. For example, we have approached US focussed managers to discuss different versions of their proposition to cover global mandates as opposed to International.

5. Filtering process

Once we have generated a new idea, we begin our filtering process. This involves detailed performance and holdings analysis, and assessing the manager's investment philosophy and process. We will analyse holdings in our proprietary software to see if they display the stylistic traits we seek, and we will analyse their performance to verify if this is consistent with their style exposures. Reading a manager's description of their own process (whether from a database, the manager's website, or a presentation they send us) provides us with a first pass on their stock selection criteria and portfolio construction methodology. If our initial review of a manager suggests they will not be suitable for our portfolios we will conduct no further research. Typical reasons that they may not be suitable would be: that they are not a manager with a clear alpha source (such as a consistent exposure to a style tailwind); the level of assets under management in the strategy is too high given their style and the asset class; significant recent changes to investment team which mean that the performance track record is invalid; or the portfolio construction methodology is inappropriate.



6. Qualitative analysis / manager research meetings

Once we have identified a new manager we will undertake detailed quantitative and qualitative analysis to determine whether they are worthy of increased levels of research or ultimately suitable for inclusion within our portfolios. We will meet with as many of the relevant people within the firm as we can.

As well as having detailed face-to-face meetings with the portfolio manager we will try and meet relevant analysts to check for consistency of message. When we hire a manager we expect that the people we meet will be managing our clients' money for a number of years. Therefore, it is essential that we have a detailed understanding of how the key decision makers implement their philosophy and how the team interacts.

We will spend as much time as is necessary to become comfortable with an investment team before including them in our portfolios. We believe that this detailed understanding allows us to stick with good managers even when they are underperforming. The key is in understanding the reasons for any underperformance and whether this is consistent with their style and market conditions. We need our managers to stay consistent to their style as this is crucial for the 'blend' within the portfolio: all managers are retained to carry out a specific role and any deviation from this will lead to immediate review and potential de-selection.

In addition to our meetings with investment professionals, we aim to meet with the key business leaders to understand the stability of the firm and establish whether the motivations are to generate performance or just grow assets under management.

7. Quantitative analysis

We make widespread use of quantitative tools which are combined with our qualitative judgment to determine the suitability of a manager for our fund. Quantitative tools allow us to gain deeper understanding of a manager and therefore verify or challenge our qualitative insights. In some instances, our quantitative tools highlight inconsistencies such as significant changes to the strategy in the past which can invalidate a manager's historical track record. Where appropriate, these will be followed up with further research meetings.

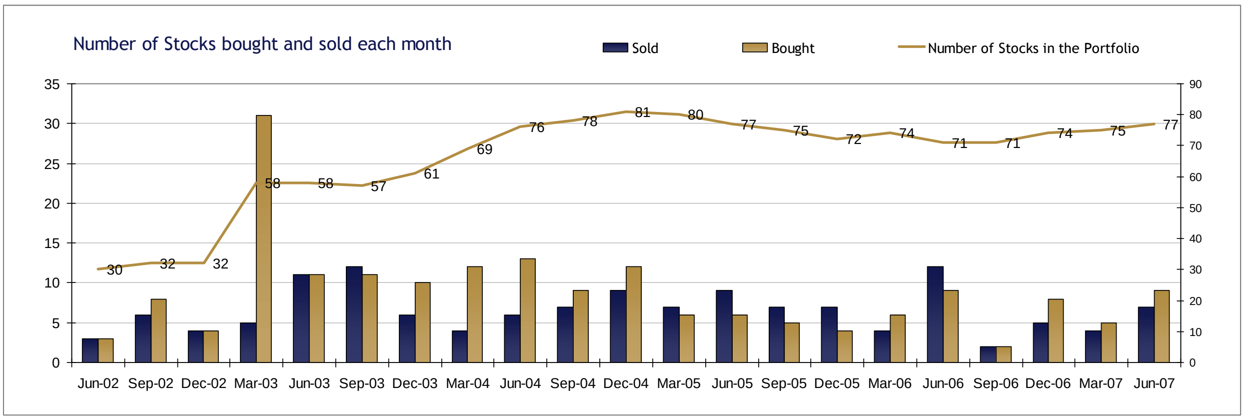
In addition to Momentum's proprietary manager software, we subscribe to a range of external quantitative tools, but have typically adapted these to suit our specific requirements. Our tools allow us to undertake a broad range of analysis on managers including: evaluating historical portfolio holdings to determine whether a manager has a disciplined investment process; evaluating performance characteristics to determine if they match the manager's stated style; analysing the impact of asset growth on a manager's ability to replicate past performance; and analysing the variation in a manager's geographical, sector or size allocations to determine whether they possess any biases.

Miport is a proprietary database that allows us to conduct performance analysis and evaluate peer groups.

Other software allows us to conduct holdings-based analysis and analyse the performance of different investment styles.

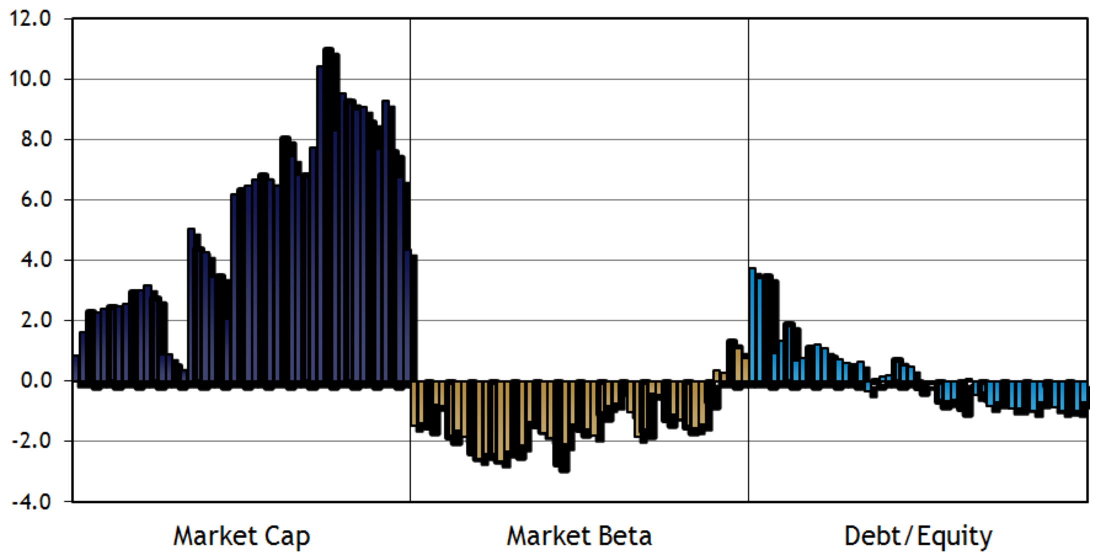
Style drift example:

- Significant increase in stocks
- Material change to process impacts reliability of track record



Market cap drift: US small cap

- Significant move up the ‘market cap’ scale as AuM grew
- Inability to follow investment process as originally designed



Source: Momentum / Style Research 2008

8. The 'sell' discipline

This is a crucial component of the process and is equally as important as the 'buy' decision It is essential that when 'buying' into a manager we have a full understanding of the investment philosophy and process, the team, and the business and ownership structure. We also need to identify at the outset what changes to these three components could instigate a review and potential 'sell'. By clearly defining what these triggers are prior to an investment, it makes the ongoing monitoring and due diligence extremely honest as well as removing the emotional attachment that can often arise during a relationship with any third party supplier.

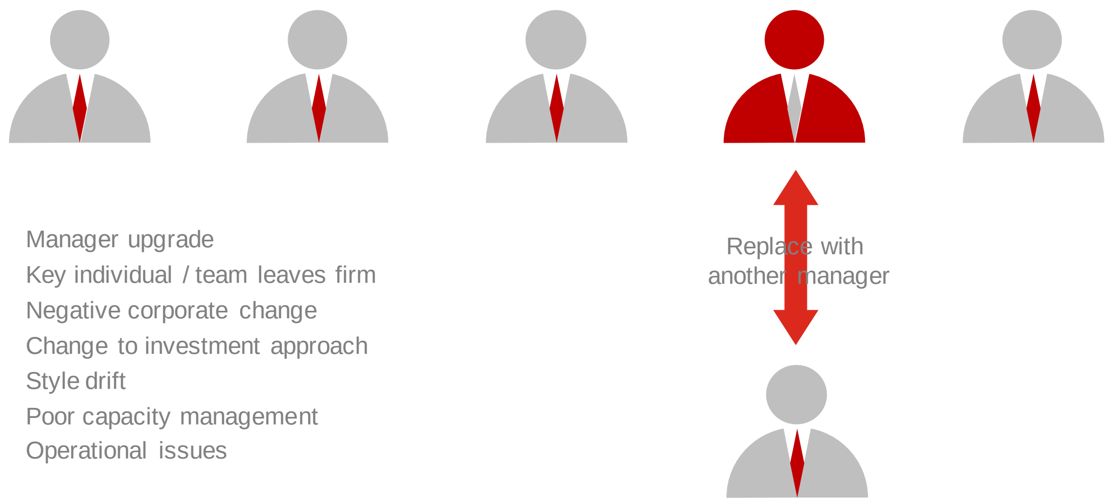
We will replace a manager if they no longer fulfil our investment criteria or if we find a better alternative. Some of the reasons that we may replace a manager include:

- key personnel departures
- negative corporate developments
- poor management of capacity.

We would also replace a manager if we identified that they were no longer implementing the investment style for which we had hired them. However, since we have spent significant amounts of time with managers before we hire them, we have not had to replace a manager for this reason to date.

Should we wish to make a manager change, we will typically implement this via a specialist transition manager to reduce the risks to a client.

Potential triggers for manager changes



9. Capacity analysis: it's not rocket science...

There are two key questions to answer:

1. Why is capacity critical?
2. Why is capacity difficult to determine?

Why is capacity critical?

Having the freedom to implement your investment philosophy as a manager thinks best is a critical ingredient to generating strong performance. A greater universe of potential investments to select from should enable better performance. Consequently, with lower assets under management in any given strategy, managers are more likely to be able to implement their best ideas at the appropriate weighting in their portfolios. Having the liquidity to build up positions in investments without affecting the price is clearly an advantage of having smaller assets.

The ability to sell out of winners is another advantage of a nimble smaller manager. It doesn't serve clients well if a manager selects a great investment but is unable to sell the position at the price they would wish to, since in their attempts to sell large quantities of a security in a short space of time, the manager's own actions negatively impact the security's price. Having the ability to trade out of winners or losers and move on is important. For example, if an equity manager owns 10% of a company (which is more than possible for larger strategies with small cap holdings) and they decide that they no longer want to own the stock, i they may find it difficult to sell at a price they're comfortable with, especially given the reasons they want to unwind the position may be simultaneously reducing the enthusiasm of other investors. Thus the sale of a large position can take time.

Such positions can end up taking up a disproportionate amount of an investment team's time, and they may have to employ new methods in an attempt to realise value, such as taking a seat on the Board or engaging with other strategic investors. Clearly this can add value, and is an important aspect of some investment managers' processes; but the key is to understand the difference between teams who expect to take this approach ex ante, and teams who are forced into doing so as a result of their oversized stake in the business being unsaleable via normal markets.

Clearly some managers will claim advantages of having enormous assets in their strategy. The most common is management access. However, we meet with a lot of investment management firms from around the world, some large and some very small managers. Many of the smaller managers once worked within a big firm, and it is extremely rare to find a manager who is not surprised by the level of management access that they receive, even with significantly smaller firm or strategy assets.

Why is capacity difficult to determine?

Due to the liquidity of the underlying investments, capacity varies significantly across asset classes. For example, Global Bonds and UK small caps have differing levels of liquidity, so managers operating in these asset classes will have different levels of capacity.

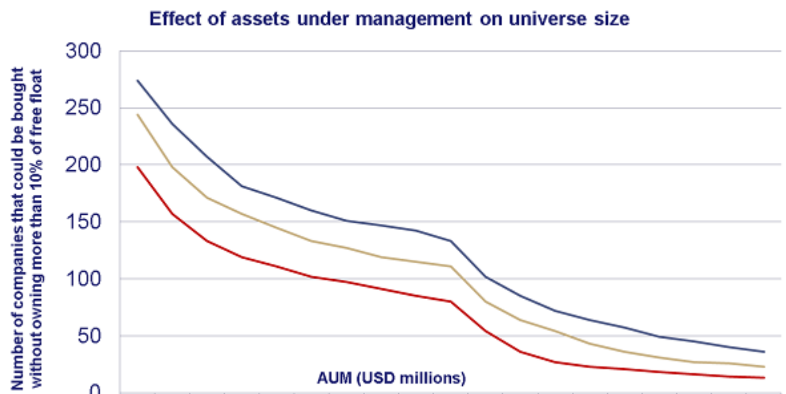
It depends on each manager's individual strategy. For example, a high turnover growth strategy operating within the same universe as a buy-and-hold value strategy is likely to have a lower capacity, due to the extra liquidity required by the manager to implement their philosophy. Furthermore, each manager's level of concentration impacts their capacity. Put simply, a manager who has a more diversified portfolio can generally manage more assets.

As a result of the above, there is no easy way out on this topic; no magic formula or number exists. Therefore, we believe that the most effective way to assess capacity is to understand a manager's asset class and their individual style of investment as best we can before we invest. Combining this with our experience we can establish what we believe is an appropriate capacity for each individual strategy, and then seek to divest from managers as they approach this level. Our strong preference, however, is to invest with managers who have a pre-defined strategy regarding capacity that broadly agrees with our own analysis.

Many successful managers who have build up a high level of assets under management will argue that capacity is not a problem for them, at least “not yet”. They could even evidence this by pointing out that, for example, they don’t own more than 5% of the free float of any of their existing holdings and could sell any holding within a week. However, this belies the fact that they may have (intentionally or unintentionally) migrated up the market cap spectrum as assets in their strategy have increased. From our research point of view the key question we ask is: could they replicate their portfolios from years ago (when they started building their track record and had lower assets under management) with today’s level of assets? The answer is often a resounding ‘no’ since it would result in them owning excessively large stakes in certain smaller companies. Where this is the case we need to take this into account since it implies they would be unable to replicate past performance with current assets, and therefore the performance track record is less relevant.

Capacity management:

- The chart below illustrates how effective universe size is reduced as assets under management increase



	25	50	75	100	125	150	175	200	225	250	500	750	1,000	1,250	1,500	1,750	2,000	2,250	2,500
3% position sizes	274	236	207	181	171	160	151	147	142	133	102	85	72	64	57	49	45	40	36
5% position sizes	244	198	171	157	145	133	127	119	115	111	80	64	54	43	36	31	27	26	23
10% position sizes	198	157	133	119	111	102	97	91	85	80	54	36	27	23	21	18	16	14	13

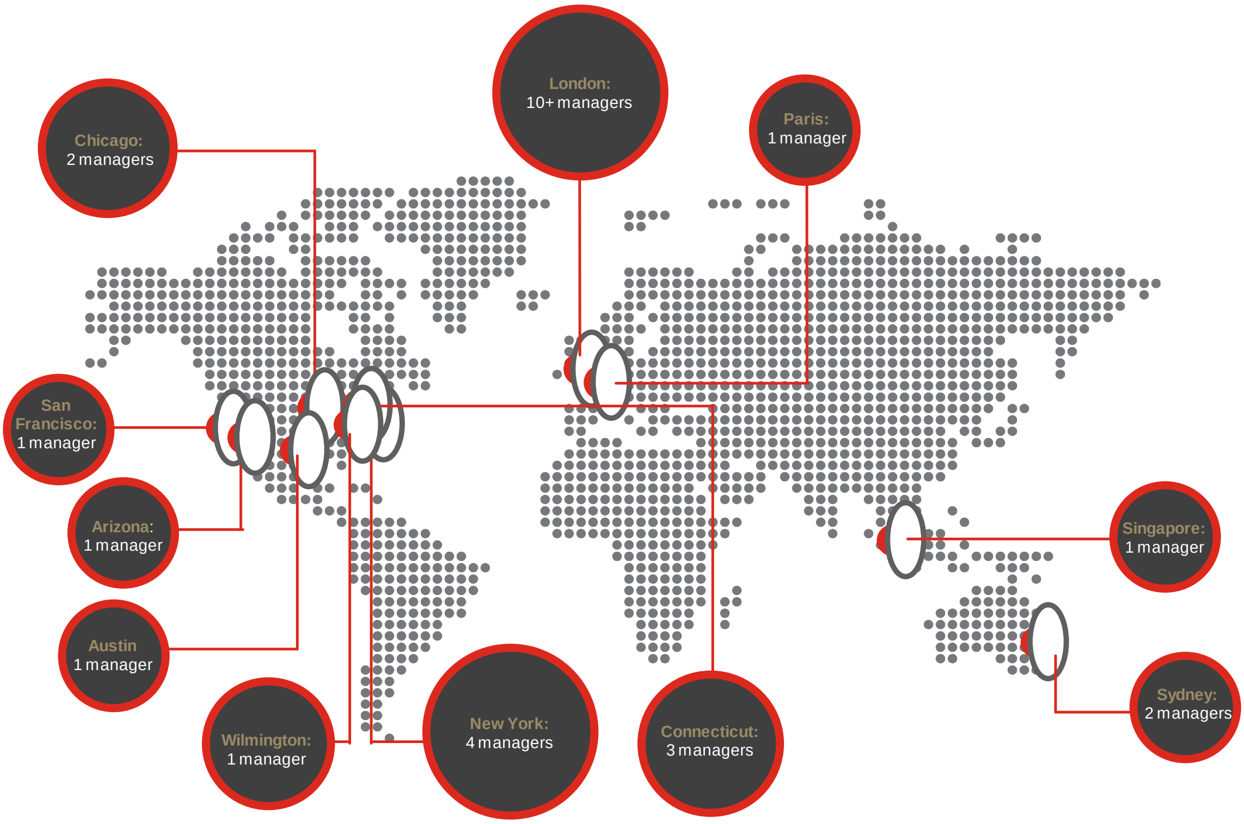
Source: Momentum / Bloomberg May 2011

10. Summary

All good managers share core characteristics - this is what drives our research and decision-making. We do not need to know every manager in the universe or have a view on their process – what we focus our time and effort on is finding the very best managers (wherever they are based) to fulfil a specific role within our portfolios. It is also essential that we have an excellent backup / substitutes list in case an event occurs that reduces our belief in a manager's ability to deliver on their mandate.

The decision-making process to 'buy' or 'sell' a fund / manager should be driven by a clearly defined and disciplined process that results in a true understanding of the product and highlights the risks. It also needs to provide a framework that enables the team to make hard decisions as and when appropriate based on judgement and experience rather than emotions or relationships.

Good managers come in all shapes, sizes and locations – knowing when to buy and sell is a specific skill set that can over time add value to a client's portfolio. And key to the whole process: if you don't understand the product, don't invest.



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