Multi-Asset Class Minority Manager Investing

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Giving Minority-Managers a Seat at the Table

Over the past several years, environmental, social and governance (ESG) investing has been an increasingly popular topic within the investment community. Recent events, including the nationwide effort to address racial inequality, have driven interest in the subject (particularly the social aspect of the equation) even further.

By extension, this has driven an increased awareness of and interest in minority-owned investment firms. Many investors now find themselves asking, "How do I find these firms?" and "Why aren't they in my portfolio or an integral part of my investment-making process already?"

In this InvestEd, we will discuss the common misconceptions when it comes to screening for and selecting minority-owned investment firms while providing truths and solutions to help overcome those misconceptions.

MISCONCEPTION: Smaller managers (many of which are minority-owned) underperform larger managers and are riskier.

TRUTH/SOLUTION: The investment industry is full of contradictions, and this statement has often been accepted as fact.

Put simply, in some asset classes, this may hold true. However, various research papers focused on the public markets have proven quite the opposite, and that in fact, smaller managers outperform larger ones. The original research on this topic goes back to 1995 when The Journal of Investing published an article entitled "The Performance Advantage of Small Portfolio Management Firms." Numerous research papers on this subject were also distributed in the early to mid-2000s, as many smaller boutique firms entered the market, which confirmed these same findings.

To see for ourselves if this continues to hold true, we ran a screen utilizing "eVestment" for firms with minority ownership of at least 51% within Domestic Large-Cap, Domestic Small-Cap and Developed International. We then compared the average returns for minority-owned firms against their peer universe. The results of our December 31, 2020 screens are located in the tables below. The tables are broken out by Domestic Large Cap Equity, Domestic Small Cap Equity, and International Equity universes, focusing on the three-, five-, and 10-year time periods. To provide a more thorough understanding of survivorship bias within each universe, we included the number of firms for each universe.

Domestic Large-Cap Equity	3 YR	5 YR	10 YR
Average Minority-Owned Return	13.63%	14.56%	13.28%
eVestment Median Return	12.32%	13.99%	13.15%
Total Number of products	1062	995	849
Minority-Owned Products	61	58	47
Initial Universe	Total Products 1127		Minority-Owned 66

Domestic Small-Cap Equity	3 YR	5 YR	10 YR
Average Minority-Owned Return	12.09%	14.30%	12.36%
eVestment Median Return	8.98%	12.75%	11.69%
Total Number of products	607	579	508
Minority-Owned Products	49	47	36
Initial Universe	Total Products 640		Minority-Owned 53

International Equity	3 YR	5 YR	10 YR
Average Minority-Owned Return	5.00%	8.90%	7.97%
eVestment Median Return	4.69%	8.28%	6.77%
Total Number of products	490	448	335
Minority-Owned Products	43	36	18
Initial Universe	Total Products 541		Minority-Owned 50

While we use eVestment data, we realize that the standard databases do not capture the whole universe of diverse managers. So, research teams need to be creative about sourcing them. More often, managers are reaching out or can be met through networking events or conferences. Allocators need to look past the standard databases to identify diverse managers and create their own custom database based on interactions and networking.

MISCONCEPTION: An Ivy League pedigree or employment at a bulge-bracket firm is a must!

TRUTH/SOLUTION: When searching for an investment manager, allocators often consider the university that the manager attended or the firms they have worked for in the past. For better or worse, preference has often been given to those that attended well-known universities or those that worked for large, prestigious firms within the financial sector. However, the fact is that these attributes do not always provide a solid correlation with performance and may lead to otherwise well-performing managers (including many minority-run firms) being overlooked. This apparent bias-based misconception is easy to self-correct.

One way to identify unintentional bias is by monitoring scorecards. Scorecards are templates used by research professionals to rate a given manager. The categories provided on the scorecard are a mix of the quantitative and qualitative information that an analyst inputs and scores based on their interpretation of the content or results. The rating or "score" of a strategy influences the ranking amongst peers on respective buy lists and funding opportunities. By tracking the scorecards of an analyst over time, trends and tendencies can become more apparent. This information can also be used to determine if behavioral biases are playing a significant part in analyst rankings. While on the quantitative portions of the scorecard, this might be harder to assess. Any biases should become more obvious within the qualitative aspects of the scorecard, such as the team experience and investment philosophy segments.

MISCONCEPTION: Screening and performing due diligence on smaller minority-owned managers is difficult.

TRUTH/SOLUTION: No, it's not.

When the FBI asked the infamous bank robber Willie Sutton why he robbed banks, he answered, "Because that's where the money is." Many research analysts often follow this same pattern of logic when they are running their initial screens for managers. They frequently begin their search by pinpointing organizations that have substantial assets under management (AUM). Perhaps unwittingly, this "follow the money" thinking leads them to ignore a host of smaller but well-run minority-owned firms, many of which have impressive track records of performance.

It should also be pointed out that research analysts are creatures of habit when it comes to the world of investment conferences. Year after year, analysts frequent the same investment conferences, where the attendee list is virtually the same as the previous year. This creates an unintended feedback loop as analysts tend to research, conduct business with and develop relationships with firms they are familiar with. This leads to many minority managers being overlooked, forcing allocators to look beyond the standard databases.

Rather than screening for firms by AUM, we posit that those interested in hiring a minority-run manager might be better served by first filtering for others and perhaps more telling performance criteria, including Alpha, Information Ratio, Sharpe, Capture and Skewness metrics. This would inherently lead to a bigger potential universe of minority managers for selection and help to wind down solid performers.

Regarding the due diligence aspect, most firms are already doing investment due diligence alongside operational due diligence. If the AUM for minority-owned firms is smaller, the research efforts should be more akin to the operational due diligence done on alternative assets. For smaller investment firms, the business and financial risk can be higher. The higher risk may mean more investigation and analysis, but the information that can be requested is typically readily accessible by the firm. The biggest question is: "Are analysts asking for the right information?"

We acknowledge that many perceive larger firms as being "better" or offering more stability and superior service. It is hard to forget that over the past two decades, we have seen several large, well-known financial institutions go out of business or be forced to sell to a larger organization. While these situations are clearly outliers, the lesson should be that business risk is relative. In fact, larger firms often have multiple business lines, which may exponentially increase their risk proposition.

Final Thoughts

Screening solely based on AUM, attending the same investment conferences year in and year out, and placing an overreliance on a given manager's educational background or previous employment can create certain biases. More importantly, these analysis methods or evaluations can cause reputable and well-performing minority managers to be overlooked, which by extension may have an adverse impact on the alpha generation of a portfolio. At PFM, we understand the aforementioned fallacies and misconceptions firsthand, because truth be told, we have fallen victim to them from time to time. However, we have also been proactive in our implementation of the solutions that we have advocated. In turn, this has allowed us to broaden our horizons and to discover managers that we might have otherwise overlooked. We believe that this thought process has helped us become a better and more inclusive investor, which will ultimately pay dividends for our most precious asset, our clients. By making only minor modifications to one's screening methods and adopting a more inclusive mindset, the investor opens themselves up to an array of potentially lucrative investment options.

For questions or more information, please reach out to your PFM representative.