"Investing in the Future: Minority Opportunities and the Federal Retirement Thrift Savings Plan (TSP)"

TESTIMONY OF THURMAN V. WHITE, JR.
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Before the

SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND DISTRICT OF COLUMBIA
HON. DANNY K. DAVIS, CHAIRMAN

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
U. S. HOUSE OF REPRESENTATIVES

JULY 10, 2008

Mr. Chairman and Members: First, I would like to thank you for the opportunity to appear before you today, and also thank you for convening this hearing on such an important topic to our industry.

My name is Thurman V. White, Jr. President and CEO of Progress Investment Management Company, LLC (hereafter "Progress"), an employee-owned certified minority business enterprise and registered investment adviser. Progress has an 18-year track record of excellence in asset management. Today we manage almost $7 billion in assets for many of the nation's premier public and corporate institutional investors. Progress has been a pioneer in the area of managing "emerging managers", which includes minority and women-owned investment firms. Progress serves institutional clients as a manager of managers developing diversified emerging manager investment portfolios in various asset classes – equity, fixed income and private equity strategies. We execute our investment strategy by identifying and using new investment talent -- "emerging" investment managers -- that may often be overlooked and/or underutilized by traditional pension fund consultants and large pension plans. We then use these firms to create diversified, risk-controlled multiple manager investment strategies to deliver competitive investment returns.

In my testimony today, I'd like to make three brief points on why emerging managers are indeed an appropriate investment for the future, and should be an integral part of the asset allocation for the Federal Retirement Thrift Savings Plan (TSP) and other federal plans

With investment firms, size does matter – but not as traditionally perceived. There is a growing body of academic research that supports the fact that small, entrepreneurial investment firms, i. e., emerging managers, can and often do outperform their larger counterparts. See Footnote 1. In addition to this research, the investment returns of firms like Progress and others in this industry represent solid proof that there's no loss of investment performance or undue risk when using emerging, minority and women-owned investment firms. In fact, one can consistently achieve market-competitive returns through emerging manager investment strategies.

Another reason to hire emerging managers is the diversification they bring to institutional portfolios. The investment management industry is conservative by nature, and slow to change. Despite actual portfolio results and research to the contrary, many institutional investors still perceive bigger as better and, therefore, prefer the large investment firm names that we're all too familiar with instead of seizing the opportunity to hire less well-known small entrepreneurial firms including those asset managers runs by talented minorities and women (many of whom got their initial experiences with larger firms then left to start their own firms). Ironically, the fact is there may well be more unintended risk in those portfolios managed by large firms than investors realize. The huge non-transparent mortgage derivative losses and write-downs suffered by large investment banks, and the recent demise of Bear Stearns, illustrates the many unknown and unexpected risks in large investment firms.

Hiring emerging managers can mitigate the large firm concentration risk that may be generally evident in many retirement plan portfolios, and specifically in the portfolios run by the Federal Thrift Savings Plans. Having such a large pool of assets managed by a single manger is very risky. Such single manager concentration runs contrary to prudent investment policy that typically looks to asset class as well as manager diversification as an efficient means to diversify risk and enhance returns in today's volatile market. In fact, we can question whether the TSP and its Advisory Council are upholding their fiduciary responsibilities to the Plan's beneficiaries by failing to adequately diversify manager as well as asset class risk (discussed below) within the TSP.

Finally, hiring emerging managers is a means to not only provide opportunities to new investment talent but also a means to foster new ideas and investment innovation.

Industry "Best Practices" and How Other Large U. S. Pension Plans Use Targeted Emerging Manager Investment Strategies

Exhibit 2 provides a partial list of all of the U. S. pension plans that have utilized targeted emerging manager investment strategies to enhance overall investment returns, diversify their portfolios and reduce manager concentration risk, and provide opportunities for entrepreneurial firms to incubate and deliver new ideas and innovation to the industry – all to benefit the beneficiaries of these plans. That the Federal Retirement Thrift Savings Plan is not listed among these plans is shameful, and frankly puzzling.

And our national pastime, and the many baseball fans, are the beneficiaries of this more inclusive brand of Major League Baseball as we know it today.

I believe that the same "win/win" phenomena can happen with the Federal Retirement Thrift Savings Plan, The National Railroad Trust, the Pension Benefit Guaranty Corporation and other federal plans. However, this win/win will only happen if the Federal plans become more inclusive, use emerging managers including minority investment firms and allow us to provide the benefits of alpha, diversification and diversity for their portfolios.

Thank you for the opportunity to appear before you today. I will be happy to answer any questions you may have.

Footnote:

1. Research Papers on Emerging Managers

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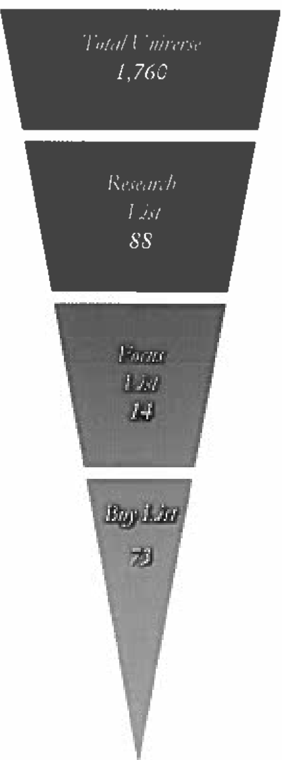
EXHIBIT 1 — THE PROGRESS DATABASE

Manager Research and Focus List (Strategies)



By Style

	All	African-American	Asian-American	Disabled	Emerging	Latino-American	Native American	Minority Unclassified	Woman-Owned	Women + Minority
Fixed Income - Cash Mgmt	30	9	2		13	1			5	
Fixed Income - Core	168	40	8		91	7			22	
Fixed Income - Core Plus	12	2	1		5	1			3	
Fixed Income - High Yield	27	1			17	1			8	
Fixed Income - Int. Rate Forecasting	68	5	2		51	2			8	
Fixed Income - Other	126	12	7		85	3			18	1
International Fixed Income	23	1			11	1			9	1
International Equity	110	4	7		83			1	12	3
Large Core or All Cap	402	22	12		319	3			46	
Large Growth	215	23	7	1	156	2			26	
Large Value	135	15	2		100	2	1	2	13	
Mid Core	31	5	1		21				3	1
Mid Growth	54	5	2		41	1			4	1
Mid Value	43	7			31	2			3	
Small Core	57	3	3		46				4	1
Small Growth	96	4	2		80	5			2	3
Small Value	77	8	3		58	1			7	
SMID Core	11				10				1	
SMID Growth	21	1	1		16				2	1
SMID Value	13	1	1		10				1	
Other	28	4						7	17	
Other - Equity Specialty	13	1		2	7				3	
Totals:	1,760	173	61	3	1,251	32	1	10	217	12

By Size & Ownership

	All	1-50	50-100	100-500	500-1000	1000-2000	> 2000
African-American	173	16	5	40	21	32	59
Asian-American	61	8		25	6	1	21
Disabled	3						3
Emerging	1251	161	110	435	254	265	26
Latino-American	32	6		8	8	7	3
Native American	1				1		
Minority Unclassified	10	7		1			2
Woman	217	44	29	38	45	27	34
Woman/Minority Owned	12				4	8	
Totals:	1,760	242	144	547	339	340	148

Specifications:

1,760 Strategies

All developing managers with less than $2B

All woman- and minority-owned managers

At least 51% independently-owned

Registered Investment Advisors only

PROGRESS INVESTMENT MANAGEMENT COMPANY

EXHIBIT 2

PARTIAL LIST OF U.S. PLANS USING EMERGING MANAGERS

The following is a representative list of known U.S. Pension Plans that have committed assets to emerging manager strategies:

- **1199SEIU Employees Benefit and Pension Funds**
- **Alameda County Employees' Retirement Association**
- **Arkansas Teacher Retirement System**
- **Bank of America Corporation**
- **Boeing Company**
- **Boulé Foundation**
- **California Public Employees' Retirement System**
- **California State Teachers' Retirement System**
- **Chicago Policemen's Annuity & Benefit Fund**
- **City of Kansas City Employees' Retirement System**
- **City of Philadelphia Board of Pensions and Retirement**
- **Coca Cola Master Retirement Trust**
- **Contra Costa County Employees' Retirement Association**
- **Detroit General Retirement System**
- **District of Columbia Retirement Board**
- **Exelon Corporation**
- **GE Asset Management**
- **Illinois Municipal Retirement Fund**
- **Illinois State Board of Investment**
- **Indiana Public Employees' Retirement Fund**
- **Liberty Mutual Retirement Benefit Plan**
- **Los Angeles City Employees' Retirement System**
- **Los Angeles County Employees Retirement Association**
- **Maryland State Retirement & Pension System**
- **Massachusetts Bay Transportation Authority Retirement Fund**

Successful Emerging Manager Strategies for the 21st Century

Thurman V. White, Jr.

About the Author

Thurman V. White, Jr. is President and Chief Executive Officer of Progress Investment Management Company, LLC, a pioneering specialist in developing emerging manager investment portfolios. For the past 16 years, Mr. White has served in a variety of leadership roles at Progress. In 2004, he and a team of senior executives led the firm's management buyback, resulting in Progress becoming an independent, employee- and minority-owned investment company. Founded in 1990 and with $7 billion in assets under management today, Progress is recognized as the industry's largest and most experienced manager of emerging managers. Currently, Progress works with 60 emerging firms, managing 25 multi-manager investment portfolios for some of the world's largest, most sophisticated institutional investors.

In a previous article, I pose a straightforward question: "Given the evolution and growing popularity of emerging investment managers, why aren't these entrepreneurial firms more broadly represented in institutional investor portfolios?" The purpose of this article is twofold: (1) to attempt to answer that question, and (2) to promote increasing investment in emerging managers by sharing portfolio allocation strategies and best practices.

Definitions of "emerging manager" vary depending on the goals of the investor. In 2008, "emerging manager" most often means "small" in terms of assets under management ($2 to $3 billion or less), independent (at least 51% employee-owned) and sometimes, but not always, firms owned by women or minorities.

Often, these are smaller companies created by an exodus of talent from larger investment firms. "Emerging Managers," says Joseph J. Haslip, Assistant Deputy Comptroller for Pensions for the New York City Retirement Systems, "have the same talent, educational background and acumen as the people at the larger firms, but they have opted to be more entrepreneurial." The City of New York, through its five different pension funds, has invested approximately $7 billion, or 6% of assets totaling $114 billion, with emerging managers through diverse investment strategies.* *(For more on New York City's innovative, diversified approach to pursuing emerging manager returns, see separate box on Page 5.)*

More Possibilities For Alpha

U.S. plan sponsors invest with emerging managers to capture their alpha potential, to provide more opportunities for newer and smaller firms, and to access new talent and future manager capacity.

Many studies over time have shown that small, employee-owned investment companies outperform their larger competitors.[1] It has almost become a truism in our industry that the greater the assets under management (AUM), the less the likelihood of outperformance. The inverse relationship between assets and alpha (assets up, alpha down) is part of the reason that many global investment firms position themselves as a group of small "boutiques" operating under the umbrella of their parent company.[2]

Says a public-fund investment officer and longtime Progress client, "When managers reach a certain level of assets under management, their risk becomes losing assets under management as opposed to market risk." Consistent with this perspective, this public plan's domestic-equity portfolio is almost totally indexed—except for two strategic allocations to active managers: Progress and another firm. Through strong performance and additional asset awards of $270 million, the Progress portfolio has grown from $100 million to more than $1 billion during the past 10+ years.

* As background for this article and a companion article, we conducted interviews with selected Progress clients. We share their views here, with permission, on a for-attribution and, in some cases, not-for- attribution basis.

Strategies for Investing in Emerging Managers

Investment Vehicles

EXHIBIT 1 - The following is a representative list of known U.S. Pension Plans that have committed assets to emerging manager strategies:

U.S. Pension Plans	
1199 SEIU Employees Benefit and Pension Funds	New York City Fire Department Pension Fund
Alameda County Employees' Retirement Association	New York City Police Pension Fund
Arkansas Teacher Retirement System	New York State Common Retirement Fund
Bank of America Corporation	New York State Teachers' Retirement System
Boeing Company, The	Ohio Public Employees Retirement System
Boulé Foundation	Oregon Public Employees Retirement Fund
California Public Employees' Retirement System	Pennsylvania Public School Employees' Retirement System
California State Teachers' Retirement System	Pennsylvania Treasury Department, The
Chicago Policemen's Annuity & Benefit Fund	PG&E Corporation
City of Kansas City Employees' Retirement System	PPL Services Corporation
City of Philadelphia Board of Pensions and Retirement	Public School Teachers' Pension & Retirement Fund of Chicago
Coca Cola Master Retirement Trust	San Antonio Fire & Police Pension Fund
Contra Costa County Employees' Retirement Association	San Francisco City & County Employees' Retirement System
Detroit General Retirement System	San Joaquin County Employees' Retirement Association
District of Columbia Retirement Board	Seattle City Employees' Retirement System
Exelon Corporation	Shell Oil Company
GE Asset Management	State of Connecticut Retirement Plans & Trust Funds
Illinois Municipal Retirement Fund	State Universities Retirement System of Illinois
Illinois State Board of Investment	Teacher Retirement System of Texas
Indiana Public Employees' Retirement Fund	Teachers' Retirement System of the City of New York
Liberty Mutual Retirement Benefit Plan	Teachers' Retirement System of the State of Illinois
Los Angeles City Employees' Retirement System	Verizon Communications, Inc.
Los Angeles County Employees Retirement Association	
Maryland State Retirement & Pension System	
Massachusetts Bay Transportation Authority Retirement Fund	
Michigan Department of Treasury	
Minnesota State Board of Investment	
Municipal Employees' Annuity & Benefit Fund of Chicago	
New York City Board of Education Retirement System	
New York City Employees' Retirement System	

As emerging managers clear barriers to entry by providing competitive performance, they have grown significantly in number. Not only have their numbers increased, but today there also are many different ways to invest in emerging firms:

Manager-of-Managers (MoM)

Investing in emerging firms through a manager-of-managers has become popular for many reasons. The manager-of-managers approach allows a plan sponsor to invest in a portfolio of emerging managers through a

A Nuanced, Thoughtful Approach to Capturing Emerging Manager Alpha

"Because domestic equity isn't what it used to be"

As part of its strategy to pursue alpha in non-traditional ways, New York City's pension plans have invested in emerging managers across asset classes and through diverse investment vehicles, including multiple manager-of-managers and direct relationships.

Not content to accept industry definitions by rote, New York City has created two emerging manager classifications for investing in the public markets: "emerging managers", with zero to $1 billion under management and "developing managers", with $1 billion to $5 billion. "We want to have more exposure to smaller managers in the public marketplace because domestic equity just isn't what it used to be," says Deputy Comptroller for Pensions, Joseph Haslip.

In private equity, New York City defines "emerging" as zero to $400 million under management in first- and second-time funds; in real estate, emerging is defined as zero to $300 million in first- and second-time funds. New York City also is in the process of evaluating a seeding program to make direct private-equity investments in emerging managers.

Providing seed money to emerging managers adds business risk to investment risk, and therefore must be weighed carefully, says Mr. Haslip. He nonetheless views seeding as "an integral component to keep a stable of top-performing talent in the market."

The California Public Employees' Retirement System (CalPERS) has championed this form of emerging manager investment strategy through its first-of-a-kind Manager Development Program (MDP). Since 2000, Progress has had the privilege of working in partnership with CalPERS, along with another service provider, in implementing the CalPERS MDP strategy. One of the most successful MDP graduates from the Progress portfolio to the CalPERS mainstream lineup is Arrowstreet Capital, a Boston-based, quantitative, international equity manager.

Strategies for Investing in Emerging Managers

Asset Allocation Considerations

Once the plan sponsor has decided upon the investment vehicle or vehicles, the next key decision is, "Where will our emerging manager allocation fit within our total portfolio?"

There are many different approaches to answering this question, depending upon the structure of the plan, the proposed allocation to emerging managers and the plan's philosophy of managing assets.

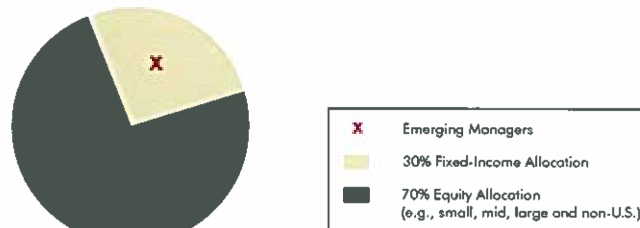
The exhibit below provides a simplified representation of different ways to allocate assets to emerging managers within the portfolio as a whole.

EXHIBIT 2 - Emerging Managers Asset Allocation Models

Part of the Total Allocation

Model 1

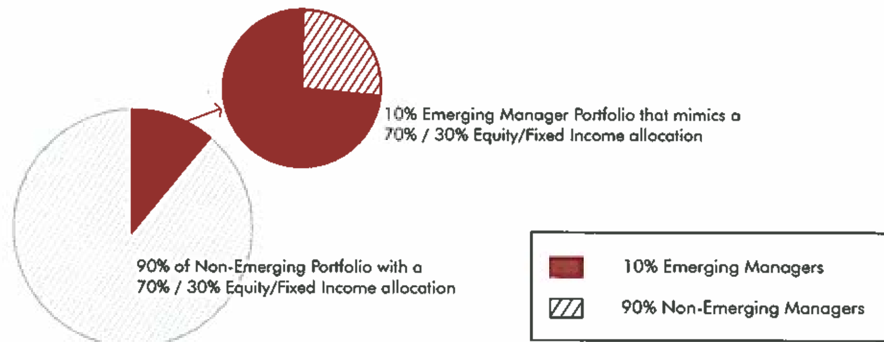
An equity/fixed-income allocation including emerging managers as part of the overall portfolio.



A Separate Allocation

Model 2

A separate emerging manager portfolio mimics the asset allocation of the overall portfolio.



5. **Be dynamic about the size definition of "emerging manager."** In an earlier article,[7] I discussed how a key definition of "emerging"—size of AUM—has evolved with the growth of the asset management industry. In 1990, when Progress began investing in emerging managers, we defined "emerging manager" as $500 million or less. Today, we define it as $2 billion or less, and some of our corporate clients have raised their emerging manager ceilings to $3 billion and even to $5 billion, depending upon the asset class (e.g., higher for fixed-income managers due to different scale considerations). It is important to not let the definition that guides your program remain static when the world around you is changing. When the largest asset managers have grown to more than $1 trillion in AUM, for example, you may need to ask, "Is $2 to $3 billion still an appropriate ceiling for an emerging firm?" By raising this ceiling with the growth of industry AUM, institutional investors broaden opportunities for smaller companies while broadening their own universe of alpha possibilities.

6. **Clarify how the definition of "emerging" should operate.** Another implementation issue that raises compliance concerns is how to treat firms that grow beyond the size definitions written into program guidelines. Many plan sponsors have chosen to define emerging managers as those with less than $2 billion in AUM. But what happens when a firm grows successfully beyond that $2 billion ceiling? Is that firm still an "emerging manager"?

   Our experience at Progress suggests that the firm should still be considered emerging. If such a firm does not maintain its emerging status, then it may fall into a no-man's land too large for the emerging program but too small to be considered for direct-hire or stand-alone mandates. This results in a program anomaly that doesn't create a "win/win" for clients or emerging firms. The key here is whether the emerging firm is below the AUM ceiling at the time of funding the manager for the program. An emerging firm that outperforms and demonstrates the capacity to gather and manage additional assets should be awarded additional assets—not penalized. As long as that firm fits the asset size definition at time of funding and continues to outperform, our preference is to allow that firm to remain in our programs regardless of subsequent AUM size—or to graduate the firm to direct-hire assignments with our clients. (Also see Best Practice #10 on the merits of establishing a clear graduation policy at the start of an emerging manager investment strategy.)

7. **Stimulate product innovation through program flexibility—fund emerging products as well as emerging firms.** As the emerging manager universe has matured, emerging firms have become adept at developing new investment products. A Progress study shows that, although many of these firms are new and/or smaller in size, most are led by veteran investment industry professionals (see sidebar opposite). Not-withstanding their professional experience and relative success in performing and gathering assets, many firms nonetheless still face significant barriers to entry when introducing new products. This holds true even for companies with total firm AUM far in excess of the typical $2 billion to $3 billion ceiling. We, therefore, believe that the next generation of emerging manager program design should allow more flexibility to:

   (1) seed new products of funded emerging firms (subject to the new product successfully meeting the investor's due diligence criteria)

   (2) seed and include emerging products from firms larger than the program's AUM ceiling, where such products are otherwise competitive and suitable for a client portfolio

   (3) fund other innovative investment strategies in an "opportunistic" portfolio component

   In no event should this opportunistic component of an emerging manager strategy represent more than 10% to 15% of total emerging manager program assets.

   Progress has had positive experiences funding the second generation of products from existing funded firms with proven alpha engines, personnel and processes. We also have had positive experiences funding the second

Experienced Emerging Manager Professionals

- More than 50% of founders or portfolio managers have 11 to 25 years of industry experience before founding their firms
- 76% of key portfolio managers have 16 to 25 years of experience
- 62% of key portfolio managers have more than 25 years of experience

Based on a 2006 study of the Progress funded-manager universe of 62 emerging firms.

The Opportunity To Compete = An Opportunity For Everyone To Win

Emerging managers do not want special favors. They want an opportunity to compete. But the biggest barriers to true competition are still fear of change and comfort with the status quo. If pension plans continue to invest primarily in household names based on this comfort factor—and our research shows that they do—they are doing an immense disservice to their beneficiaries. Despite the proven performance track record of these talented, entrepreneurial firms, institutional investment portfolios on average have invested only a small percentage—typically 1% to 3% of their assets—in emerging investment strategies.

At Progress, our mission is to change this practice by crafting innovative alpha strategies that deliver value for investors. In partnership with our clients, our vision is "to become the company most known for changing the face of the investment management industry." By removing unneeded barriers and granting emerging managers the opportunity to compete, institutional investors democratize capital, thereby making the investment industry as a whole more robust and competitive—a better future for all.

Based upon investment performance and sound fiduciary policies, our hope is that more institutional investors will embrace these proven investment strategies. As a result, when we build successful emerging manager investment programs, we create "win/win/win" synergies—for clients and their beneficiaries, for emerging managers, and for our industry.

This is the second in a series of publications by Progress designed to share the firm's experience in creating emerging manager investment programs. We want to help the investment industry better understand the issues, strategy options and best practices associated with developing emerging manager programs. For more information, please contact Mona Williams, Executive Vice President, Marketing & Client Service (mwilliams@progressinvestment.com).

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Footnotes

1. For a complete bibliography of studies documenting the performance advantage of investing with emerging managers, please visit www.progressinvestment.com.
2. White, Thurman, "Small Isn't What It Used to Be: The Changing Face of Smaller Investment Firms," June 2003, the Institute for Fiduciary Education.
3. Ibid.
4. "What the Research Tells Us About Emerging Managers," panel discussion at the 2004 Progress Plan Sponsor and Emerging Manager Conference, Scottsdale, AZ. Note: This panelist has co-authored one of the most comprehensive, authoritative studies on emerging managers: "A Review of Developing Managers and Developing Manager Programs," April 2003, by Allan Emkin, Neil A Rue, CFA, Jeremy Thiessen and Sandra Parker. This paper is available under "Research" at www.pensionconsulting.com.
5. Progress Investment Management Company, LLC - Investment Committee Report, p. 1, May 2008.
6. White, Thurman, "From Diversity to Diversification—The Evolution of the Term 'Emerging Manager,'" July 2008.
7. Ibid.