Wespath
Investment Management

Consideration of Alignment of Interest in the Selection of Alternative Investment Managers

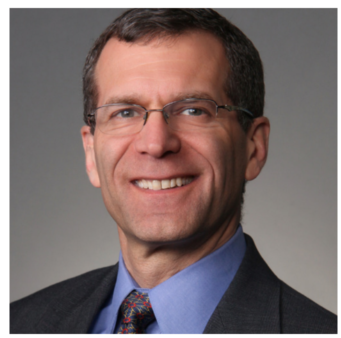
by Brian Boyer, CFA

This white paper will address the issue of why alignment of interest is crucial when considering placing capital with alternative investment asset managers. Alternative investments are investments that are not typically classified as stocks, bonds or cash. They are, for the most part, illiquid (i.e. investors cannot withdraw capital whenever they choose) because they do not trade on public markets. Investors generally access alternatives through specialized entities that are organized for legal purposes as limited partnership funds. Wespath invests primarily in two alternative asset fund types: private equity and private real estate. (See the Wespath white paper, "The Case for Alternative Investments in a Diversified Portfolio," for a broader discussion of alternatives in Wespath's funds.)

In addition, this white paper will summarize the due diligence "best practices" used by Wespath in its assessment of alternative managers' fiduciary standards. This review is not intended to be comprehensive nor should it be considered as a "fool-proof" guide for selecting the best fund managers from a fiduciary perspective. For clarity's sake, this paper will use the term "fund manager" to represent the universe of alternative asset or alternative investment managers with which Wespath invests.

As a manager of asset managers, Wespath's primary objective is straightforward: to identify and invest with top asset management firms. Ideally, these firms will succeed in delivering attractive investment returns that are minimally correlated with other managers, thereby lowering the overall risk of Wespath's funds. The implementation of this objective clearly falls into the category of things which are "easier-said-than-done." However, assuming one could select from a universe of managers that look promising from the standpoint of pure investment parameters—such as investment return, risk (volatility of investment return) and non-correlation—there is another consideration that is equally as important: that the manager is motivated to exercise the highest fiduciary standard by closely aligning its interests with the interests of investors.

"Wespath Investment Management, as a fiduciary, has a duty to operate in the best interest of its investors. Wespath expects that its asset managers will exercise a comparably high level of fiduciary care in managing Wespath's assets. However, like the Reagan-era slogan which applied to Soviet missile disarmament efforts: It is important to trust, but verify."



Brian Boyer

Brian Boyer joined the General Board in September 2003 as the director of equities in Investment Management. He is responsible for managing public equities and alternative investments, including asset classes of private equity and private real estate. Previously, he spent 15 years with First Analysis Corporation, a Chicago-based investment firm, where he was responsible for developing public equity research coverage and making venture capital investments in various technology sectors, including telecommunications products and services. He holds B.A. and B.E. degrees from Dartmouth College and an MBA from The Wharton School at the University of Pennsylvania. He also is a CFA Charterholder.

Examine Fund Terms

Interest alignment is critical for alternatives for several reasons. One significant reason is that investors remit capital directly to the manager (or the manager's bank) and not to an intermediate custodian bank where the flow of funds is controlled by the investor. Secondly, alternative investments are illiquid—the alternative manager controls fund cash flow by calling and distributing capital as needed. Thus, it is imperative that investors verify that an alternative manager has a strong system of internal controls with suitable checks and balances. This strong system of internal controls is an imperative requirement for all fiduciaries. Had investors done a better job of investigating the lack of internal controls in Bernard Madoff's hedge funds, the fraud might have been detected sooner or even prevented altogether.

The first step in conducting due diligence for an alternative fund is to examine the fund's terms and conditions as outlined in the private placement memorandum and the partnership documents. The fund terms describe the basic operating parameters of the fund, such as fund strategy, investment entity structure, target fund size, return objective, fee level and incentive formulas, fund life and investment period and maximum amount of assumable debt.

When contemplating participation in a fund, investors usually begin by examining fees. An investor considers the magnitude of the fees charged and how fees compare to similar funds in the market. However, a deeper dive into fee structure is more relevant when researching the alignment of interest between investor and manager.

Fees for alternative funds are generally split into two components: a management fee based on a percentage of assets (between 1% and 2%) and an incentive fee or "carried interest" which represents a share of the fund profits (typically 20%) above a certain minimum return or hurdle rate (usually 7% to 9% above cost.) Management fees are "guaranteed" in the sense that they are paid over the fund life, regardless of how the fund performs. The incentive fee is "success-based," i.e. only paid out if the fund return exceeds the hurdle rate. While a management fee is necessary to help cover a manager's internal expenses, a greater emphasis on fees generated through the fund's ultimate performance represents better alignment with investor goals.

Another fund term that can inform investors as to whether the fund's interests are aligned with its investors is "sponsor" capital—the amount of total fund capital contributed collectively by the fund manager and its employees. Sponsor capital ensures that the fund manager has its own capital working alongside that of its investors. Generally, fund managers pledge sponsor capital from 1% to 2% of total fund commitments. While the amount of capital committed by the fund manager is important, it is also important to note the source of that capital within the fund manager organization. Sponsor capital should originate from the employees directly managing the fund, not just the corporate entity that controls the fund manager. If this is the case, the interests of the fund's employees and corporate entity will align better with those of investors.

Alignment of Interest—Preferred Practice

Category	Stronger	Weaker
Ownership	100% employee-owned	100% corporate or public ownership
Employees	Dedicated to fund management	Shared among funds or other lines of business
Fees	Emphasis on carried interest	Emphasis on management fee
Sponsor capital	>2%	<1%
Source of sponsor capital	Fund employees	Corporate owner or third-party
Business lines	Fund management only	Multiple business lines
Fund strategies	Single	Multiple fund strategies
Multiple fund families	Unrelated strategies	Overlapping strategies/ separate accounts

Another key consideration in evaluating potential manager/ investor alignment relates to the ownership structure of the fund manager's firm. In general, Wespath favors fund managers with employees as the primary owners, as opposed to managers that are publicly traded or owned by some other entity not controlled by the fund employees. Employee-owned investment managers are preferable because the employees' success in managing the fund translates directly to enhanced value for the firm. Under this scenario, the benefits of the fund economics flow through to the personnel who are directly responsible for the success of the fund, which ultimately benefits investors.

Investors need to exercise caution when an employee-owned firm decides to sell a full or partial interest in the firm to a third party. While it is not always the case, transfer of ownership may indicate that employee owners/managers are intending to retire or leave the business and are using a sale to achieve personal liquidity. Publicly-owned fund manager businesses should also be evaluated carefully, as the duties and responsibilities of being a public company can lead to significant distractions from the core fund management operations.

Evaluate Competing Operations and Strategies

Another issue related to alternative investment firms is the number of other business units that compete with the primary fund management activities. Non-related business units and multiple fund strategies can distract from the management of the specific fund in which the investor participates. In addition, conflicts can arise between various business units. For example, real estate fund managers may publicize the value of being vertically-integrated if they own property management, tenant leasing or brokerage operations in addition to the fund investment business. In some cases, the fund management business may contract with its affiliated companies for these vertically integrated services.

Best practice dictates that the fund manager fully discloses on an annual basis all relationships between the fund and affiliated companies. This practice does not have to be a source of conflicts, as long as the fund manager has contracted for these services at a price and terms that are comparable with what is available from competitive bidders. In some cases, the fund may even receive a discount from the affiliated company.

A corollary to the situation described above includes an arrangement where a fund manager operates several funds that represent different strategies or offers separately managed accounts to large institutional clients, who typically commit capital in amounts greater than $100 million. While the investment strategy for these discrete pools of capital may be nominally different, they may be eligible to invest in similar transactions. A potential conflict can arise if a fund manager consistently rewards one fund with more desirable deals. The method by which the manager resolves potential conflicts can provide clues to the manager's commitment to fiduciary standards. (This potential conflict does not exist for single-fund managers or for managers who run a single family of funds in one strategy.)

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Best practice for a multi-fund manager is to maintain a deal allocation policy that fully describes the process by which the investment manager rotates transactions on an equitable basis among its funds and separately-managed accounts. Wespath prefers managers that are dedicated to a specific fund strategy. However, single-fund managers are a rarity in this growth-driven environment with multi-strategy managers far more common. Wespath does not exclude from consideration managers that operate multiple funds or offer separate accounts, but we do consider such arrangements as a potential red flag. Wespath's due diligence process involves a thorough investigation of how potential conflicts among funds and separate accounts are resolved through a clearly-articulated allocation policy.

The principal governing mechanism for investors to monitor interest alignment during the fund life is the limited partner advisory board. The largest investors of the fund typically comprise the advisory board, which meets at least once a year. The prudent fund manager relies on the advisory board to arbitrate potential conflicts, such as changes to fund structure and post-closing document amendments. While there is an inherent bias since the fund manager selects the advisory board candidates, the fund's largest investors are rarely denied membership on the board if they request it. As evidence of its commitment as a fiduciary, Wespath serves on the advisory board of a majority of its alternative funds.

A growing trend that is a very positive indicator of manager commitment to interest alignment is the practice of allowing advisory board managers to meet independently of the fund manager and its employees. In fact, managers who do not schedule "advisory board-only" executive sessions during their annual meetings are "leaning against the wind" in this age of increasing focus on good fiduciary practices in the alternative asset sector.

Evaluate Fund Life Cycle Conflicts

The typical life cycle for an alternative fund is: a one-year (or shorter) window in which the fund manager secures commitments from potential investors; a three- to five-year commitment period in which the manager identifies suitable investments; and then a four- to seven-year hold period in which the manager seeks to earn a return on the assets in the partnership. Wespath ensures that the fund's legal documents provide reasonable alignment between manager and investor interests during the entire fund life.

There are, however, two times in the fund life cycle when a managers' interest can diverge significantly from that of investors: the fund-raising period early on and the wind-down or liquidation phase at the fund's conclusion. During the capital-raising period fund managers are driven by powerful internal considerations to ensure that the fund gets raised. Without the future income stream from the fund, the manager will have difficulty supporting the expenses of its organization, primarily the personnel who are responsible for all elements of fund investment and administration. If the manager takes a long time, or even fails, to raise a subsequent fund, key employees may depart to work for another fund manager who has successfully raised capital.

Hence, the period of vulnerability during the fund-raising process may cause the manager to ignore external warning signs—such as macroeconomic or market-specific fundamentals—that would suggest that the environment is not suitable for raising a new fund. An investor who exercises due diligence may determine that the investment environment is not auspicious for the particular fund under consideration. In this situation, there arises a potential conflict between what is best for the investor and what is best for the fund manager.

A similar risk exists at the tail end of a fund's life. Recent newspaper articles have referred to "zombie" funds[1], which are alternative funds that have reached their wind-down phase but the managers are unable to liquidate the investments due to operating or ownership constraints. "Zombie" funds continue beyond the contracted end-of-life term, sometimes charging management fees that are unlikely to be recouped after all the underlying fund investments are finally liquidated. While an alternative fund's legal documentation generally includes end-of-life provisions—including approval procedures for extending a fund's life—there can be circumstances when the manager wishes to prolong the life of the fund against investors' wishes.

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For example, a fund manager may be deriving income from a fund that is deployed for day-to-day firm operating expenses, such as paying salaries or office rent. The manager may view the fund's fees as a "bridge" to support the company during the capital-raising period for its next fund offering. Investors on the other hand may already have a loss in the current fund and simply want to liquidate the remaining assets at the prevailing price and re-deploy the capital with another, more stable manager. Once again, a conflict arises between fund manager and investor interests. Today, most fund legal documents give investors or the representative investor advisory board the power to approve an extension of the fund's life. This represents an opportunity when investors can renegotiate terms, such as fee provisions, if they are dissatisfied with performance.

Wespath's Commitment to Due Diligence and Monitoring

Transparency in alternative asset fund governance has greatly improved over the last several years, partly because of the difficult fund-raising environment stemming from the Lehman crash of 2008. Fund managers have come to recognize that alignment of interest is an important consideration for institutional investors and that they must integrate it into all elements of their customer service platform. Despite this positive momentum toward investor-friendly terms in alternative investment funds, Wespath recognizes that the pendulum will likely swing back in favor of fund managers at some point in the future and that an unwavering commitment to monitoring investor/manager alignment of interest plays an ongoing and high-priority role in a prudently-run, diversified alternative investment program.

[1] The Wall Street Journal*, June 20, 2012, "Trying to Squeeze Life Out of 'Zombie' Funds"*

Wespath provides UMC-affiliated institutional investors with access to well-managed investment programs that historically have delivered competitive performance while honoring United Methodist Social Principles. Wespath is a division of the General Board of Pension and Health Benefits of The United Methodist Church, a century-old institution with a well-regarded reputation for delivering returns aligned with values.

Wespath is an established investment manager with approximately $17 billion in assets under management.

Our name honors John Wesley, the founder of Methodism and a leader in establishing social principles that outline the tenets of socially responsible business practices. Wespath reflects this heritage, along with he idea of putting clients on the right path to financial growth with a commitment to values-driven investing.

Wespath

Wespath Investment Management
1901 Chestnut Avenue
Glenview, IL 60025-1604
1-847-866-4100

wespath.com

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