BEACON POINTE
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BEACON POINTE RESEARCH WHITE PAPER

WHY SPEND TIME ON INVESTMENT MANAGER SELECTION?
TOTAL FUND ANALYSIS AND ATTRIBUTION
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CONFIDENTIAL – PROPRIETARY

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How Important is Investment Manager Selection?

- Studies show that over 90% of a fund's performance and variability is attributable to a fund's asset allocation decisions.
- The remaining 10% of a fund's performance and variability is derived from investment manager structure and selection.
- Why then should investors spend so much time researching and monitoring investment managers?

Exhibit 1

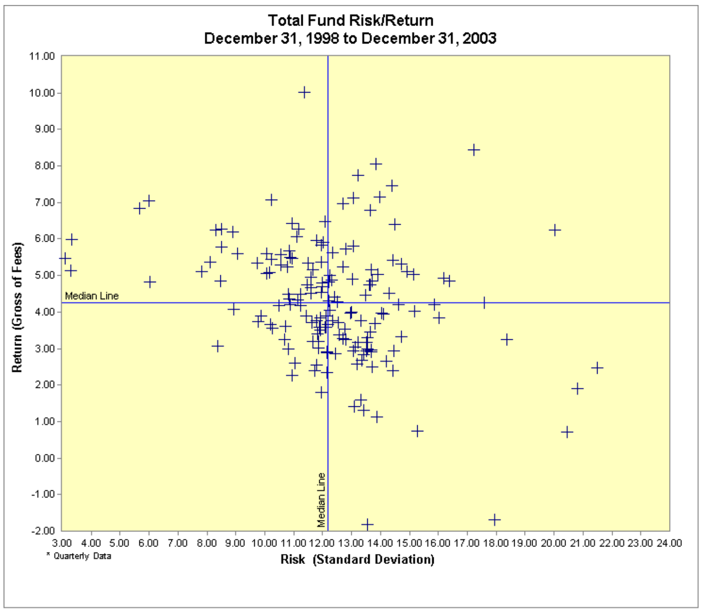
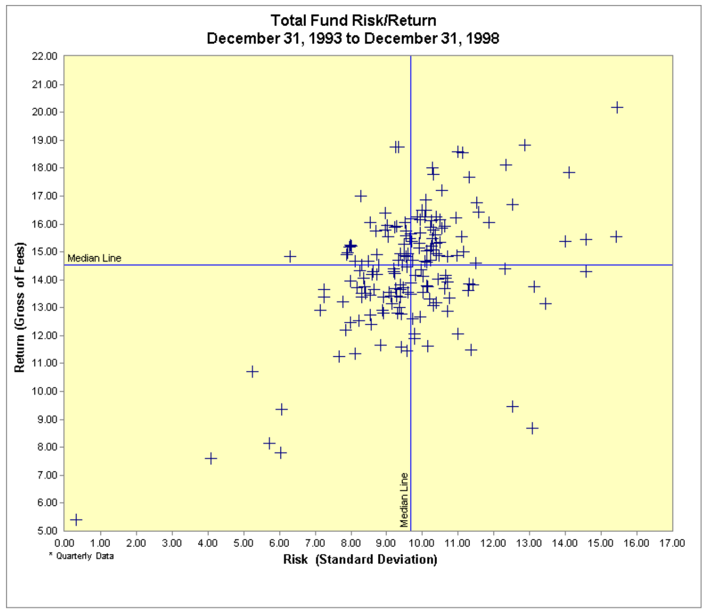


Exhibit 2



- Exhibit 1 above presents a 5-year total fund risk and return graph as of December 31, 2003. The total fund universe consists of corporate defined benefit funds, public defined benefit funds, insurance, and endowment and foundations.
- Logic tells us that there should be a "linear" relationship between risk and return—investors should be compensated with more return if they assume more risk. *Exhibit 1, however, identifies <u>no such relationship</u> as some funds have taken more risk and have not achieved "more return".*
- Exhibit 2 does show a slightly higher relationship between risk and return. As of December 31, 1998 there is a trend that identifies more return for more assumed risk taken by each of the funds in the universe. *Yet still, from a total fund perspective, there are some funds that are not on the efficient frontier.*

Why Spend Time on Investment Manager Selection?

- In order to understand why some funds have achieved higher returns for similar or even lower levels of risk, investors must separate out a fund's policy return and implementation return from the fund's overall total return.

- *Policy Risk and Return* is calculated from a fund's asset allocation policy mix (% U.S. stocks, % bonds, % non-U.S. stocks, and cash)—in other words, the risk and return levels if the fund was invested passively or in index funds. For example, if a fund's target asset allocation was 55% U.S. equities, 15% non-U.S. equities, 25% fixed income, and 5% cash, the policy return is a weighted average calculation of 55% S&P500, 15% MSCI EAFE, 25% Lehman Aggregate, and 5% T-bill. This would be the return (and risk) if the fund has *passively* invested in index funds.

- *Implementation Risk and Return* include investment structure and investment manager selection decisions. Implementation risk and return can also be defined as the result of active management decisions. The goal of active management is to outperform the Policy Benchmark.

Policy Risk and Return

- Exhibit 3 below plots the 5-year *policy risk and return* values for the funds within the universe as of December 31, 2003. It is evident from the analysis that a *strong linear relationship* exists between risk and return during this time period. Funds that assumed less risk over the past five years achieved higher returns. Funds that assumed greater risk over the past five years, underperformed funds with lower risk levels. *We can conclude from this chart that policy (passive/index) risk and return are relatively efficient.*

- Exhibit 4 below plots the 5-*year policy risk and return* values as of December 31, 1998 for the same funds within the universe. Again, similar to the conclusion arrived from Exhibit 3, a *strong linear relationship* exists between risk and return during this time period. Over this 5-year period, however, funds that assumed higher risk levels achieved higher returns. *We can again conclude, based on this analysis, that policy (passive/index) risk and return are relatively efficient.*

Exhibit 3

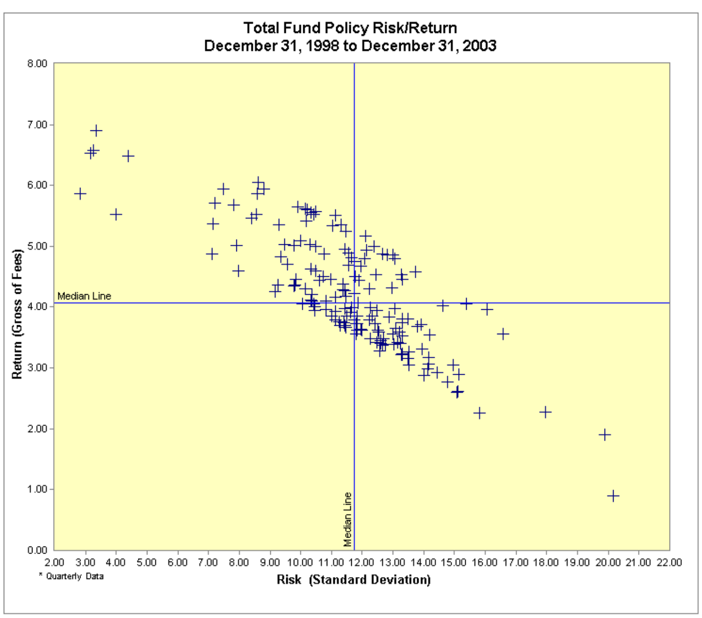
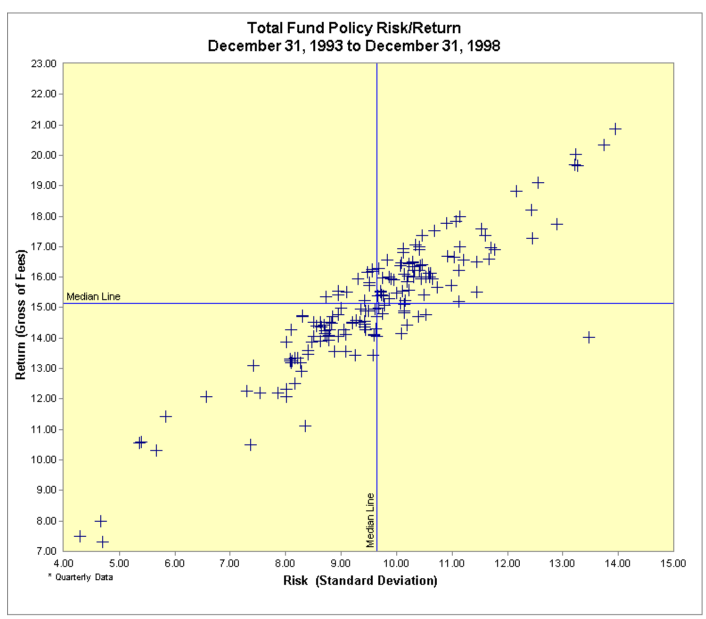


Exhibit 4



Implementation Risk and Return

- If total fund policy returns are on the efficient frontier (as represented in Exhibit 3 and 4 on the previous page), then from where does total fund return variability come? Why do some funds assume more risk and yet achieve lower returns?

- Fund total returns can be broken into two separate components—policy return and implementation return (Fund total return – Fund policy return = Fund implementation return). As stated earlier, implementation return includes active management decisions.

Exhibit 5

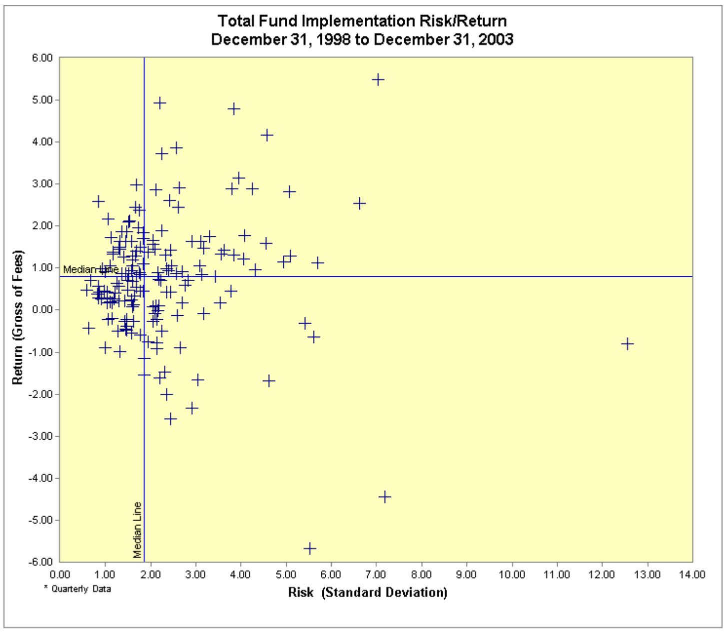
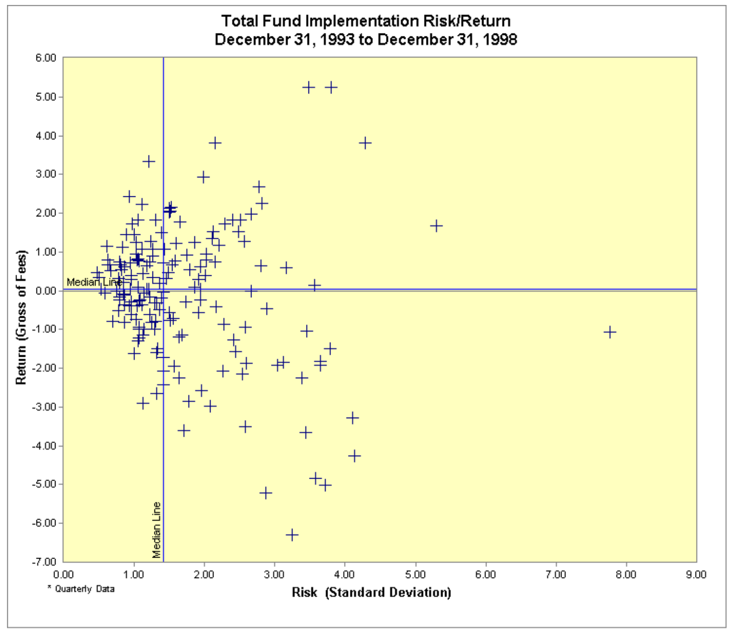


Exhibit 6



- Exhibit 5 above plots 5-year *total fund implementation risks and returns* for each of the funds within the universe as of December 31, 2003. As is evident in the analysis, *there does not seem to be a linear relationship between active risk and return.* Funds that have taken greater implementation risk have not all achieved higher implementation return or active management return.

- Exhibit 6 identifies a similar conclusion as—*there is no relationship between active risk and active return across the funds.*

- As seen from the past four exhibits, implementation risk and return across the funds within the universe have greater variance than policy risk and return and tend not to lie on the efficient frontier. "Why Spend Time on Investment Manager Selection?" - *Active management decisions explain the variability of total fund risk and return and explain why some funds may assume similar risk levels relative to other funds, yet achieve a much lower return.*

Active Management Decision

Exhibit 7

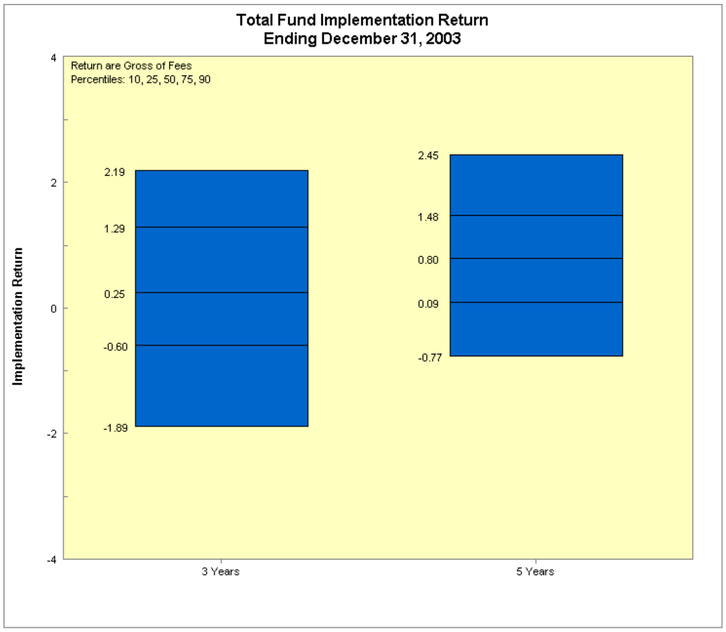
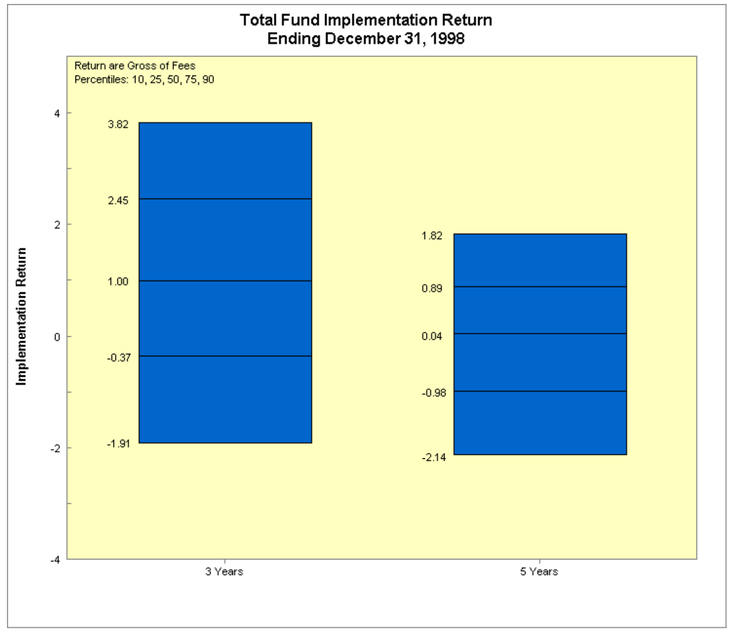


Exhibit 8



- How important is managing a fund's implementation return? According to Exhibit 7, as of December 31, 2003, active management returns ranged from –1.89% to +2.19% over a three-year period.

- Over the five-year period, implementation returns ranged from –0.77% to +2.45%. Again, implementation return is the result of a fund's active management decisions such as investment manager selection, investment manager structure (style tilts), and rebalancing.

- Exhibit 8, which presents the universe of total fund implementation returns as of December 31, 1998, shows a wide disparity between the 5^{th} percentile and 95^{th} percentile.

- Over the three-year period, implementation returns ranged from –1.91% to +3.82%.

- Over the five-year period, active management decision returns ranged from –2.14% to +1.82%.

Conclusion

- A fund's total return consists of two distinct components—policy return and implementation return. The policy return is the passive return that can be achieved by investing in vehicles such as index funds. The implementation return is the active management return, which is a result of active management decisions such as style, regional, or sector tilts.

- Total fund risk and returns across funds have varied greatly over different time periods. Total fund risk and returns do not consistently fall on an efficient frontier. Policy risk and returns across funds, however, do lie on an efficient frontier. *Thus, active management decisions explain why some funds are not on the efficient frontier from a total fund risk and return perspective.*

- Beacon Pointe believes that it is important to manage implementation risk and return and thus believes that the core competency of any investment-advisory firm should be its investment manager research.

- Beacon Pointe has implemented a stringent process for the investment manager research and evaluation process. The purpose of this process is to cover a large universe of investment managers, but *more importantly, to have a thorough and in-depth analysis of each firm's investment capabilities*. This process gives Beacon Pointe professionals extensive information on each investment manager and also allows our consultants to focus specifically on the most qualified investment managers. We believe that our clients receive an unparalleled level of investment manager research and evaluation.

- Although most consulting firms rely solely on quantitative analysis to recommend or monitor investment managers, quantitative analysis is "backward-looking" and shows how the investment managers have performed in the past. Studies show that past performance is not a good indicator of future performance, yet many consulting firms continue to rely solely or heavily on quantitative analysis. *It is great to see that a manager has performed well in the past, but what Beacon Pointe research professionals are interested in is how well the investment managers will do for our clients in the future.*

- Qualitative factors that Beacon Pointe's research team has incorporated into the manager research process fall within the categories of People/Organization, Investment Philosophy/Process, and Firm/Product Resources. Beacon Pointe is interested in whether the firm has a strong culture, whether the employees all have the same conviction, if the employees are motivated and have ownership in the company, what is unique to the manager's philosophy and process, how a manager will add value in the future, whether a manager knows what types of risks he is taking and if those risks are being managed, and what types of research and resources are available to the manager. *Beacon Pointe, discusses these factors with each investment manager and subsequently rank these factors, assigning a value to each factor.* Answers to these questions give Beacon Pointe consultants the ability to select managers with the highest probability of meeting future objectives and of adding future value or "alpha". These factors give the clients a deeper insight into how well a firm will do *going forward*. Beacon Pointe strongly believes that a combination of quantitative and qualitative analysis maximizes value to our clients.

- Please contact your Beacon Pointe consultant should you have any questions.