BEACON POINTE ADVISORS

BEACON POINTE RESEARCH
WHITE PAPER

ASSETS UNDER MANAGEMENT-IS BIGGER BETTER?
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CONFIDENTIAL – PROPRIETARY

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Introduction

- Similar to the opposing sides of active versus passive management, the argument, whether more assets under management help or hurt an investment manager add value, has long been debated within the investment community.

- Proponents of investment managers with "greater" assets under management make the following arguments:

  - An investment management firm with a greater asset base generates more revenues, and therefore can spend more on investment research and analytics.

  - Firms with greater revenues are more apt to offer competitive compensation packages to key investment professionals, retaining intellectual capital.

  - "Larger" assets under management allow for larger volume trades, thus reducing transaction costs.

- Proponents of investment managers with "less" assets under management, on the other hand, make the following arguments:

  - A smaller asset base allows investment managers to have greater investment flexibility.

  - "Smaller" investment managers are generally employee-owned, resulting in greater key investment professional retention. Employee-ownership also allows for greater alignment of manager and client interests.

  - Investment managers that hold a smaller percentage of a company's float do not affect the company's stock price when trades are made.

  - Larger investment management firms focus more on "preserving" assets rather than adding value, and prefer not to deviate from the benchmark.

- Beacon Pointe believes that a key benefit for our clients is our belief that "smaller" investment managers generally provide greater alpha relative to larger investment management firms. Due to our mission to provide superior investment advice and client service to a select list of clients rather than simply building assets, Beacon Pointe's manager research team focuses much of our time searching for "smaller" investment management firms. More importantly, unlike many of the wirehouses and "larger" institutional consulting firms, our asset base does not force us to only utilize large investment management firms.

- Rather than simply making a broad generalization regarding "smaller" investment managers, Beacon Pointe recently completed a study on the relationship between an investment manager's assets under management and alpha.

The Analysis

- The following bullet points outline the steps for our study:

  - *Step 1* – Screen the investment manager database for investment products with the following characteristics:

    - Investment product is categorized as "U.S. Equity". This screen eliminated any real estate, balanced, commodities, and hedge fund investment products.

    - Investment product must have 5-years of performance as of March 31, 2004.

    - Investment product must have updated/submitted Total Product Assets as of March 31, 2004 to the database.

    - The screen resulted in 1,538 separate investment products. Investment products ranged from $.64 million to $153,613 million (as of March 31, 2004). As a note, these figures represent total investment product assets *and not* total firm assets.

  - *Step 2* – The investment products that passed the criteria outlined in Step 1 were then separated into quartiles, resulting in the following buckets (approximately 385 investment products per quartile):

    - 1st Quartile – Investment products with assets equal to or less than $168 million.

    - 2nd Quartile – Investment products with assets between $169 million to $580 million.

    - 3rd Quartile – Investment products with assets between $581 million to $1,718 million.

    - 4th Quartile – Investment products with assets equal to or greater than $1,719 million.

  - *Step 3* – 5-year alphas were calculated for each investment product within each quartile relative to the investment products' normal benchmark (derived from a returns-based multiple factor attribution/style analysis model).

    - The returns-based attribution model uses the historical returns of the investment products and style indices (style factors). The model uses a mean variance methodology and optimization technology to produce portfolio weights for each of the style factors. This methodology minimizes the residual risk of a portfolio of benchmark excess returns relative to the investment product. The resulting weights to the benchmarks are used to create a weighted benchmark return.

    - *Benchmark Return* – The benchmark return is the custom benchmark that is "optimal" to the investment product. The normal benchmark's annualized return is calculated by using the factor weights and the benchmark returns (style benchmarks). For example, in Exhibit 1, Manager ABC has the following factor weights: 6.97% Russell 1000 Growth, 74.61% Russell 1000 Value, 0.00% Russell 2000 Growth, 0.00% Russell 2000 Value, and 18.42% T-Bill. The benchmark return is calculated by multiplying the factor weights and the benchmark returns. Manager XYZ has the following factor weights: 11.01% Russell 1000 Growth, 28.92% Russell 1000 Value, 36.50% Russell 2000 Growth, 0.00% Russell 2000 Value, and 23.56% T-Bill. The calculation for the benchmark return is (11.01% x Russell 1000 Growth return) + (28.92% x Russell 1000 Value return) + (36.50% x Russell 2000 Growth return) + (0.00% x Russell 2000 Value return) + (23.56% x T-bill return).

For our analysis, the Russell 1000 Value, Russell 1000 Growth, Russell 2000 Value, Russell 2000 Growth, and T-bill were used as the style benchmarks to represent the "investable" equity market. We also used a 5-year time period (as of March 31, 2004) for this analysis.

Note that the R-squared for the regression is 0.90, suggesting that the variation of returns of the calculated "normal" benchmark explains 90% of the variation of returns of Manager ABC.

- *Alpha* – The alpha is calculated by subtracting the benchmark return from the investment product's annualized 5-year return. This value represents the excess return generated by the investment product over a normal or optimal benchmark.

Exhibit 1

Selected Managers	R1000 Growth Index	R1000 Value Index	R2000 Growth Index	R2000 Value Index	T-Bill
Manager ABC	6.97	74.61	0.00	0.00	18.42
Manager XYZ	11.01	28.92	36.50	0.00	23.56

Selected Managers	Benchmark Return	R2	Alpha	Residual Risk	Info Ratio
Manager ABC	3.46	0.90	4.48	5.26	0.85
Manager XYZ	3.15	0.83	6.90	9.18	0.75

The Results

- Rather than listing the calculated alphas for each of the 1,538 investment products, Exhibit 1 below lists the median and average investment product alpha for each of the quartiles.

Exhibit 1

	Average 5-Year Alpha	Median 5-Year Alpha
1st Quartile	2.91%	1.84%
2nd Quartile	3.89%	2.89%
3rd Quartile	3.68%	2.60%
4th Quartile	2.71%	1.46%

- The investment products within the 1st quartile, which consists of investment products with assets under management equal to or less than $168 million as of the 1st quarter 2004 end, had an average 5-year alpha of 2.91% and a median 5-year alpha of 1.84%.

- The investment products within the 2nd quartile, which consists of investment products with assets between $169 million to $580 million, had an average 5-year alpha of 3.89% and a median alpha of 2.89%. Both average and median alpha values are greater than those of the 1st quartile.

- The 5-year average and median alphas within the 3rd quartile were slightly lower than those of the 2nd quartile. The range of assets under management for this quartile was $581 million to $1,718 million.

- The 4th quartile's average and median 5-year alphas were the lowest relative to the other three quartiles.

- Beacon Pointe decided to further dissect the 4th quartile, which contained the investment products with the largest assets under management ($1,719 million to $153,613 million). Exhibit 2 identifies the average and median alphas for investment products with assets greater than $10 billion and $20 billion.

Exhibit 2

	Average 5-Year Alpha	Median 5-Year Alpha
> $10 billion	2.32%	0.79%
> $20 billion	1.34%	-0.16%

- Exhibit 2 above clearly indicates that on average, levels of alpha have dropped as investment products have continued to gather assets. The average 5-year alphas of 2.32% (>$10 billion) and 1.34% (>$20 billion) are lower than those posted by the 1st, 2nd, and 3rd quartiles. The median 5-year alphas are significantly lower relative to those of the 1st, 2nd, and 3rd quartiles.

- Exhibit 3 and 4 below are graphical representations of the calculated alphas relative to assets under management.

Exhibit 3

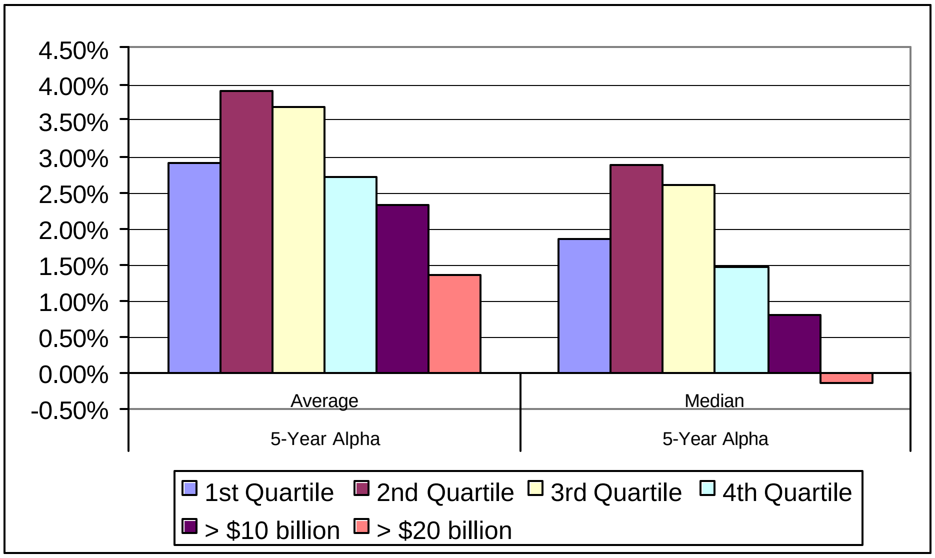
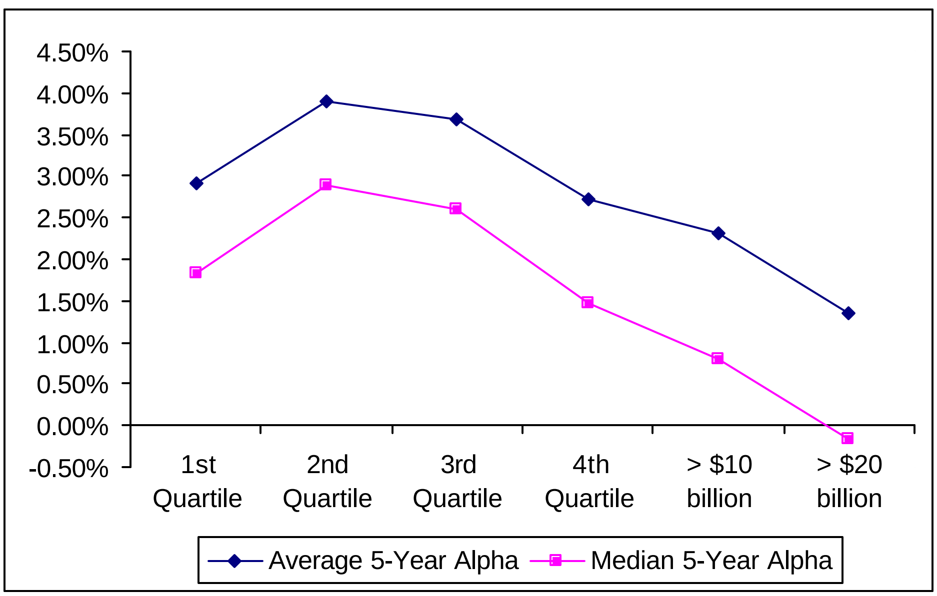


Exhibit 4



Conclusion

- Experts in the investment industry have long argued about the advantages and disadvantages of building a large asset base.

- Beacon Pointe believes that "smaller" investment management firms, in general, have greater flexibility within their investment process to generate excess returns over a benchmark. We also believe that "smaller" investment management firms generally tend to focus more on adding value rather than maintaining a business.

- Beacon Pointe, since its inception, has emphasized our ability to not only find, but also implement "smaller" investment managers into our clients' portfolios. We believe that our size and the make-up of our select client list afford us this advantage.

- Our initial study on U.S. Equity investment products suggests that our general belief holds true as the 4^{th} quartile had the lowest average and median alphas relative to the other 3 quartiles. This trend was further supported as our study broke out the average and median alphas for investment products with assets greater than $10 and $20 billion. Beacon Pointe intends to extend this study to the other asset classes, including Non-U.S. Equity and Fixed Income.

- We would, however, note that our analysis is not a hard-fast rule. Although the average and median alphas of "larger" investment products have been relatively lower than those of "smaller" investment products, there are large firms and products that have consistently generated excess return and alpha. For example, Dodge & Cox's Equity product has generated an alpha of 4.97% (versus a normal benchmark) over the past 5-years and has approximately $57,492 million in product assets (as of March 31, 2004). Dodge & Cox, a firm that has been on our focus list for over 10 years, is an example of a firm that has scored well in our proprietary manager evaluation/scoring process.

- 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.