AdvisorOne

A Class Apart: The 2011 SMA Managers of the Year

Extraordinary due diligence and a history of success set 2011's best SMA managers of the year apart from the crowd

Investment Advisor | April 1, 2011 | By John Sullivan, AdvisorOne   Share |

"All of the firms have a focus on investment quality and their alpha thesis," says J. Gibson Watson III, president of **Prima Capital Holdings**. "Post credit-crisis, due diligence is more than just stringing together a set of historical returns; now, it's all about the culture of the companies and the quality of their management."

That, according to Watson, is the theme common to the 2011 Separately Managed Account Managers of the Year, and largely responsible for the recognition and award.

This is the seventh year that *Investment Advisor* and Prima Capital, the Denver-based firm that conducts due diligence on SMA managers, have joined together to choose the best SMA managers in multiple categories.

"We started the program as a joint venture with Standard and Poor's," Watson explains when asked about the awards' genesis. "The idea was to develop an SMA ranking and rating platform to be housed in S&P's Advisor Insight. We felt with the increasing popularity of SMAs as a product, it would be of value."

The initial criteria for inclusion are at least $200 million in assets; tenured management (at least three years); superior ratings in five Prima Guide categories (all data in the following profiles come from Prima's Prima Guide online tool, with data as of Dec. 31, 2010). If an attractive prospect for an award is below average in one category, or has an N/A in one category, the analyst will manually evaluate the merit of the manager in relation to the category in question. Lastly, the product should be widely available through retail SMA programs.

The committee starts with a quant approach, making sure each portfolio scores high marks in firm strength, resources devoted to the particular strategy, tax efficiency and performance, compared to their benchmarks and their peers. The quant analysis goes on for some time, but the discussion on the candidates—chosen by Prima's analysts—ends with a quality discussion on the manager (or, usually, team), including their tenure and the ownership of the firm, whether they have skin in their own games, and what makes them unique in their process of stock or bond picking through different business and market cycles. As Investment Advisor and AdvisorOne Group Editor in Chief Jamie Green wrote when announcing last years' winners, "they are not flashes in the pan who've been able to scrape together a good year or two: their processes and their human capital allow them to perform well, and consistently, year after year."

"Our comprehensive historical analysis encompasses a rolling period of time," says Watson, who blogs for AdvisorOne.com. "We can therefore see how the managers perform over different, extended periods of time."

Which, he says, allows Prima analysts to evaluate not only their alpha thesis, but specifically how they **exploit market inefficiencies**.

"We have more qualitative questions for managers when performing our due diligence," he adds. "And this tracks with the industry as a whole. Advisors and investors have a deeper appreciation for due diligence. It is incumbent upon advisors to go beyond historical performance. In a post-Madoff world, they absolutely must verify the independent auditors and the clearing and custodial firms and perform all the necessary operational due diligence."

Whether it's a UMA, UMH, traditional or model-based SMA, they should be used as part of a broader, diversified portfolio, one that include ETFs, mutual funds and other effective products.

"We don't feel it's appropriate to look at any product of this type in isolation," Watson says. "What's relevant is how they work with other products they're teamed with in the portfolio."

In the profiles of the top managers that follow, you'll learn how these SMA Managers of the Year set themselves apart. Look for additional coverage on these managers and their portfolio building strategies on AdvisorOne.com.

Large-Cap Core Award
Cornerstone Investment Partners
Concentrated Equity Portfolio

Information is a commodity," says portfolio manager **Rick van Nostrand**, when asked about the investment philosophy of **Cornerstone Investment Partners**. "We don't try to out-research the market. Rather, we adjust for investor behavior and exploit price/intrinsic value ratios with 30 solid stocks in our portfolio. When the behavioral gap 'snaps back,' we're rewarded."

Of course, not "out-researching" the market doesn't mean they don't perform proper company due diligence, something for which the Atlanta-based company is particularly proud. It's that they believe the market to be efficient, and would rather rely on the predictable irrationality of their fellow investors.

The employee-owned make-up of the firm gives each member a vested interest in doing right by the client, with the majority of ownership in the hands of the eight member investment team, in order to ensure they're properly incentivized.
The team, whose members average 28 years of portfolio management expertise, conducts fundamental research to identify characteristics that enable a company to achieve long-term profitability and to ensure those qualities are repeatable. They include quality of management, patents, products, distribution, culture and brand value.

"We keep the portfolio limited to 30 stocks to ensure each has a direct impact on portfolio performance," van Nostrand says. "Some of our competitors have 50 or 60 stocks in their portfolio; that completely dilutes their performance. It doesn't make sense to us."

The firm also looks to include those names with the greatest margin of safety and the greatest chance of achieving fair value. Industry and sector weightings are strictly an outgrowth of the firm's **bottom-up stock selection process**.

In choosing Cornerstone as this year's winner, Prima noted the firm uses a **fair value model** that screens a universe of approximately 800 large-cap stocks to find which stocks are trading at a discount to Cornerstone's fair value estimate. Cornerstone then looks at which stocks are trading at the deepest discount to their fair value and conducts fundamental research on those names. The firm spends all of its time researching these stocks and works to understand why the stock is cheap since the fundamentals are strong. When researching a name the team focuses its time on understanding the current operating environment, dissecting the company's business model and financial statements, assessing its competition, and studying the management team.

Cornerstone then builds a portfolio with its **highest conviction names** and will trim or sell a position once it meets its fair value, or if the manager finds a better opportunity.

Overall, Prima believed Cornerstone was a strong candidate for the large-cap core SMA award due to its clearly defined and repeatable investment process, strong risk-adjusted returns and consistent exposure to the large-cap asset class.

The investment team consists of John Campbell, chief investment officer; Edward Mitchell, Jr., managing partner, portfolio manager; Fred Wetzel, Jr., portfolio manager; Neilson Brown, portfolio manager; Rick van Nostrand, portfolio manager; Dean Morris, portfolio manager; and Cameron Clement, portfolio manager.

Large-Cap Growth Award

Wedgewood Partners Inc.
Large-Cap Focused Growth Strategy

Ask David Rolfe for the firm's **elevator pitch** and he has it at the ready.

"We're big subscribers to the arguments put forth by Charles D. Ellis, author of '**The Loser's Game**'," begins Rolfe, chief investment officer of St. Louis-based **Wedgewood Partners**. "Instead of trying to time the markets and getting sucked into short-term volatility, we take a long-term view and let the markets work for us. Too many of our competitors try to do otherwise, and we refuse to play that loser's game. That, quite simply, is our investing philosophy. "

This longer-term view naturally leads to a big belief in—and heavy reliance on—**index investing** which, as Rolfe notes, by definition is buy-and-hold investing. This means the firm has a history of minimum turnover in the portfolio. As a corollary, Rolfe notes, this approach also affects the firm's stock selection.

"If we expect to invest in companies for many years, we focus on those select companies with the brightest multi-year prospects for growth," he says. "Additionally, our view on risk is contrary to the typical manager as well. We don't view risk via individual security price volatility, rather all of our risk analysis is centered on the individual business."

The second time's the charm for the 22-year-old firm, as Prima has previously recommended Wedgewood for an SMA award. In recommending the firm this year, Prima said it was "pleased the manager is looking to **grow its business through the SMA channel** and is solely focused on the large-cap growth strategy."

With $875 million currently in assets under management, Wedgewood believes consistent execution of their fundamental, long-term-focused research process coupled with disciplined valuation can produce excellent long-term returns, according to Prima. The strategy has delivered, producing top quartile performance on an absolute and risk-adjusted basis over the last three, five and 10 years. Wedgewood builds a concentrated portfolio of 18 to 22 stocks trading at a deep discount to their estimated intrinsic value that are typically driven by two factors: overly conservative consensus estimates and compressed valuation multiples.

Confirming Rolfe's long-term views, Prima says Wedgewood is a very **patient investor** focused on a three- to five-year outlook which typically results in low turnover. Over the past five years, portfolio turnover has ranged between 30% and 53%, which contributes to its tax efficiency. Additionally, Wedgewood is able to **accommodate tax loss harvesting at client request**, further improving potential tax efficiency. The firm was a strong candidate for the large-cap growth SMA award due to its ownership structure, talented and tenured investment team and consistency of alpha generation.

The investment team includes Anthony Guerrerio, president and founder; David Rolfe, chief investment officer; Dana Webb, senior portfolio manager; and Michael Quigley, portfolio manager.

Mid-Cap Equity Award
Denver Investment Advisors
Concentrated Mid-Cap Growth Strategy

Denver Investment Advisors has a process that works, and they're sticking with it.

The (surprise) Denver-based firm was founded in 1958, with the separately managed account team put in place in 1998.

The firm has a long history of **real dedication to investment research** and to being early with new opportunities," says Mitch Begun, partner and co-director of mid-cap growth research. "The Concentrated Mid-Cap Growth strategy was designed as a best-ideas, high-conviction product."

Begun says the mid-cap asset class is extremely attractive, and the firm's **sweet spot** is companies with between $1 billion and $10 billion in market cap. They are a little more developed than their small-cap brethren, he says, but still more flexible and with more opportunity for growth than large-cap stocks.

“We **generate alpha from our stock selection**,” Begun explains. “We look for a nice balance of growth, value and quality characteristics. We also look for companies that are either market leaders or can gain market share. From a secular standpoint, we look for **dynamic growth in an industry**; from the more cyclical industries, we look for an inflection point in which to enter. Overall, we have company-specific drivers, rather than top-down drivers.”

A key differentiator for the firm, he says, is that it **focuses on risk management and a strict sell discipline**. The latter is something not enough managers focus on, according to Begun.

“Our risk screen helps us identify characteristics that lead to underperformance. And we don’t want to overpay for our stocks. We sell when the market recognizes what we recognize. We have to be very disciplined about this because when you make **mistakes in the growth space**, they tend to be more violent, so we focus on delta.”

When looking to buy, the team looks to **see if the overall industry is growing**, if the company is gaining market share, if margins are expanding and if the valuation if attractive. When looking to sell, naturally the signals are the opposite: a slowing industry, losing market share, compressed margins and valuations that are simply too expensive.

The firm names health care company Varian Medical Systems by way of example of a company they like. The x-ray and diagnostic provider is a leader in its space and recently released a new product, TrueBeam. The new product is gaining market share in radiation oncology and diagnostics, and is expanding, in particular, in economies where wages and quality of life are increasing.

Begun notes that the firm is structured as to **avoid the echo chamber** by assigning managers to sectors rather than entire industries.

“For instance, we have one manager dedicated to technology hardware,” he says, “and another to technology software. In this way it helps in the collaborative process.”

Small-Cap Equity Award
The London Company
Small-Cap Core Strategy

“We don’t think we’re better than anyone else, we just take a rational approach to investing,” says Stephen Goddard, when asked to brag on himself and his firm.

Goddard, managing director and founder of **The London Company**, based in Richmond, Va., then gets down to basics. The firm takes positions in low beta, conservative companies that are large enough to make an impact to portfolio performance, but with a primary focus on downside protection.

“It’s far easier to determine downside risk than it is to determine the next winner,” Goddard says. “What really hurts the portfolio are the names you’re wrong about.”

The firm was founded as “a very small shop” in 1994, but soon got the attention of industry consultants and today has roughly **$2 billion in assets under management**.

Jonathan Moody, a principal and portfolio manager with the firm, says he distills the investment process into four pieces. The first is that they go into a new investment with a long-term approach and **don’t key in on short-term fluctuations**.

“We don’t want to try to outguess the other 1,000 analysts on what the earnings will be for this quarter,” he says.

The second is buying in at attractive valuations, or building the portfolio “on the backs of the companies’ balance sheet.” They look at valuations in the same manner as an owner or private equity investor, and assume zero to little growth because they **don’t trust the analysis coming from Wall Street**.

“We’re private equity wannabes,” says Goddard. “We look to control what we can. We can’t predict the future, but the balance sheet is something real; something that’s in the here and now.”

The third piece, Moody says, is to find the appropriate investments and then weight them accordingly.

“We hate positions of 1% or less,” he says.
The last piece is ensuring tax efficiency on the part of the portfolio. Moody claims turnover is currently

less than 25%.

It all sounds pretty staid and conservative. Is there anything that really sets their philosophy apart?

Yes, according to Prima. The London Company takes a somewhat unusual approach in that it seeks to determine a company's optimal cost of capital, which it then uses to discount future cash flows. A discount of 40% or greater to the firm's determination of intrinsic value is sought in potential "buy" candidates, thus, the product's value bias. The firm conducts intensive research on each company which includes knowing management's capital allocation strategies. The methodology is similar to evaluations by private buyers (Goddard's "wannabes" comment), which can benefit returns in an environment in which private equity buyers, and mergers and acquisitions are prevalent.

According to Prima, "The small-cap strategy has been an exceptionally consistent performer on an absolute and risk-adjusted basis since its inception."

Specialty Manager Award
Forward Uniplan Advisors
Uniplan REIT Portfolio

As we said; second time's the charm, even more so for Forward Uniplan Advisors, as this is the firm's second win in as many years.

"The team started out in the balanced portfolio space," says president and portfolio manager Richard "Rick" Imperiale. "Our REIT portfolio came out of that."

It's a good thing, since REITs are what won them this year's award. REITs, according to Imperiale, raise portfolio returns while lowering volatility, something any introductory 101-investor should like, but getting the message out still takes a concentrated effort.

"Our first order of business is educating advisors to the benefits of REITs in the portfolio," he says. "Real estate is always local. New York always seems to never have enough office space. Chicago, on the other hand, always seems to have too much. It would be nice to simply transfer that capacity from New York to Chicago but as we all know, it doesn't work that way."

Understanding those supply and demand fundamentals are critical, he says, as are the products to best address those fundamentals.

Once the firm solves for location and geography issues, it moves to more qualitative issues; meaning the quality of the management team and how they'll take advantage of the relatively good real estate outlook in their local market.
"Just as advisors evaluate us when looking for help in managing the REIT portion of their portfolio, we too evaluate REIT managers to ensure the right fit," Imperiale says. "That qualitative analysis is something, I feel, that's a bit different from how other managers evaluate the opportunities in the space."

Prima would seem to agree, and notes Forward Uniplan has one of the longest and most consistent track records in the SMA REIT peer group, and has outperformed the Wilshire REIT Index 18 times in the last 22 years. The boutique firm manages roughly $500 million in assets, with $288 million in the REIT portfolio.

Prima considers Imperiale to be a pioneer in REIT investing and his extensive experience, willingness to move to cash in turbulent market environments such as 2008, and consistent sell discipline are the chief value-adds for the strategy. Imperiale and his team of six blend macro/microeconomic, quantitative and qualitative analysis to construct a concentrated (25 to 35 holdings), benchmark-aware portfolio with low turnover. The REIT strategy has had tremendous success throughout its history, with top quartile annualized alpha over all trailing time periods in the last 10 years.

Fixed Income Award
Sage Advisory Services
Intermediate Fixed Income Portfolio

When Bob Smith, (right), decides on a course of action, he doesn't mess around. After meeting Mark MacQueen, (left), at the wedding of a mutual friend, the two opened the door of Sage Advisory Services three weeks later.

Smith and MacQueen, both Merrill Lynch alums, decided on a fixed income focus, not a popular message in the tech bubble build-up of 1996.

"It was all equities at that time, so we knew we needed a specific strategy to get people interested," Smith recalls. "I also knew that in order to keep them engaged, we'd have to have complete transparency about what it was we were doing. It's their money; they should have access to it whenever they want and I had no problem with them looking over my shoulder about the moves I was making. That holds true today."

It's that strategy that brought the firm from nothing to their current $10 billion asset level, Smith says.

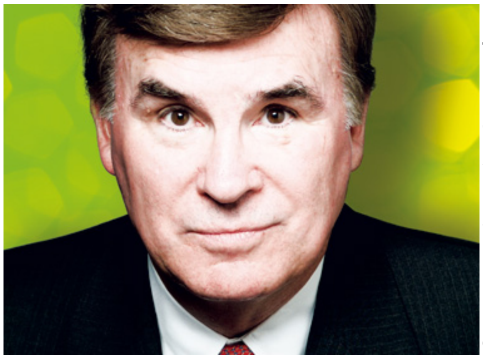
According to Prima, the intermediate fixed income portfolio ended 2010 with $3.7 billion in total assets. The investment team is reasonably staffed with 14 investment professionals. Like many taxable fixed income processes, Sage begins with its six member investment committee setting specific duration, yield curve and sector positioning for each portfolio. For the intermediate portfolio, maturities range from one to 10 years, and include all of the sectors of the taxable market, though the MBS sector is consistently underweighted relative to the Barclays Intermediate Aggregate. Sage leverages several street research sources in addition to its own internal research.

The approach in security selection is different from most managers in that Sage isn't looking for the "hidden gems" in the corporate credit space (typically 30% to 40% of the portfolio), but rather focuses on liquidity and relative value comparisons, looking to capture the broad beta of the preferred industry segment. Given this approach, the average corporate holding is just 1% to 1.5% and the typical account will hold more than 25 corporate issues. Treasuries, agencies and, to a lesser extent, the MBS holdings in the account are used to modify duration and provide liquidity.

As Prima notes, the performance of the intermediate strategy has been exceptionally consistent over the past 14 years. The composite has outperformed the Barclays Intermediate Government Credit Index in 12 of the 14 years, underperforming by a total of just over 1% in 2002 and 2003 combined. The outperformance has always been relatively small (only in 2009 was the outperformance more than 1% in a calendar year). On a risk-adjusted basis, the rolling two-year alpha on the product has been positive 96% of the time.

But Smith notes another area where the firm is finding alpha: the efficiency with which the firm executes its trades, keeping transaction costs low that it can then pass along to clients.

"It's an area where we find considerable alpha," Smith says. "We make the street compete against itself for the benefit of our clients."



International Award
Thomas White International
International ADR Strategy

"We really consider ourselves a research firm," says Tom White, a man who needs little introduction in the separately managed account space, but we'll do so anyway. The chairman and president of Thomas White International, White has over 40 years of investment experience, beginning in 1966 at Goldman Sachs. Stints as an officer of Lehman Brothers and managing director at Morgan Stanley soon followed, and White founded the firm that bears his name in 1992.

The firm's international ADR strategy is something that sets it apart, White says. Its research driven approach translates to "people on the ground," so to speak, most notably with the opening of its office in Bangalore, India.

"We have the capability not only to buy ADRs in many countries, but we often can actually trade securities on their exchanges, which gives our clients a distinct advantage," White says.

Prima notes that Thomas White was their primary candidate for the 2011 International SMA Award from the beginning, as the firm has the highest aggregate ranking (i.e. sum of the four category scores) of the five finalists. Additionally, the organization has been very stable over the years, has gradually built out retail SMA relationships and continues to execute their well-designed investment process. This was especially the case in 2010, when the portfolio was underweight emerging markets and overweight Japan (i.e. this was non-consensus positioning) and yet still managed to outperform the Index.

“The international ADR strategy is a derivative of the firm’s ordinary share strategy; however, no apologies are necessary as it has performed equally well,” Prima writes. “Our overall opinion of the firm is quite high, particularly in regard to the investment process, the pedigree of the investment team, and the consistency of performance.”

Thomas White International employs a consistent, repeatable process that relies heavily on a quantitative system to rank stocks in deciles among over 100 valuation groups that are based on industries, sectors, regions, countries and combinations thereof, according to Prima. There are qualitative aspects to the process whereby team members analyze each company in terms of its management team, products and accounting quality, thus making the process more balanced than a purely quantitative approach.

Douglas Jackman, executive vice president and chief operations officer, runs the firm on a day-to-day basis. It is employee-owned, a business model Prima favors in its deliberations, and repeatedly White took pains to point to the expertise and performance of the entire team during our interview. The investment team consists of Wei Li, Ph.D.; David Sullivan II; Douglas Jackman; John Wu, Ph.D.; Jinwen Zhang, Ph.D.; and Marc Ma, Ph.D.

About the Author »

John Sullivan, AdvisorOne

John Sullivan is the editor of *Investment Advisor* magazine and the editor of the Retirement Channel for AdvisorOne.com. Sullivan is the former editor of *Boomer Market Advisor* and *Bank Advisor* magazines, and has a background in the insurance and investment industries in addition to his journalism roots.