NEWPORT
retirement services

Newport Investment Manager Due Diligence Process

Newport believes that investment managers should be selected and monitored using a well-defined process. Our dedicated team of research analysts combines quantitative analysis and qualitative research to help identify investment managers we believe will provide superior long-term results. The process also incorporates a comprehensive and continuous review of all managers under research coverage.

Quantitative Screening

Proprietary quantitative screens are used as a starting point in the manager due diligence process to focus our research efforts on the most promising managers within a given asset class or investment style. We do not believe, however, that past performance should be the most relevant factor in the investment manager selection process. Research studies have found little evidence to support this theory. Reasons include the following:

- Top performing managers tend to experience significant asset growth, which may lead to declining flexibility, notably for managers who invest in less liquid securities
- Asset growth may result in increased team size, which could potentially reduce the responsibility of the key members who originally established the track record
- Investment success often leads to increased responsibilities for the investment professionals, including additional mandates to manage and more public appearances
- Successful managers are more likely to be recruited by hedge funds or other asset management firms
- Effective techniques may be copied or improved upon by other asset managers, which reduces the competitive advantage
- Successful managers may become overconfident, which could increase the likelihood of becoming complacent, taking shortcuts or making other hasty decisions

While past performance does not guarantee a manager's future success, it is a useful tool in screening for managers that may be worthy of further research. Our analysis is focused on discerning why the manager performed well, and whether we believe the portfolio management team has an identifiable advantage that can be maintained going forward.

Managers are classified based on both holdings-based and returns-based style analysis. Holdings-based analysis is predominately used, although the return patterns for managers are also considered. The classifications may be subjectively overridden by an analyst when further analysis deems that a manager was misclassified using a holdings-based methodology.

A proprietary manager evaluation model is utilized to narrow the investment universe and help prioritize research efforts. The model ranks managers in each asset class based on several variables. Managers are examined to determine if excess performance was attributable to manager skill or luck, and whether results were within a reasonable range of expected outcomes. We place a strong emphasis on managers that generate superior risk-adjusted returns versus their respective peer groups and best-fit benchmarks. The key screening criteria include:

- Style Consistency
- Risk-Adjusted Return
- Performance Consistency
- Excess Return
- Downside Risk
- Expense Ratio

Style Consistency – Tracking error and r-squared statistics are incorporated into the screening model to measure whether the manager's returns are representative of the intended market exposure. Tracking error is a measure of the volatility of a manager's excess returns relative to its benchmark. R-squared is a measure of the percentage of the manager's portfolio movements that can be explained by movements in its benchmark

Risk-Adjusted Return – The annualized return generated by the manager minus the annualized return of three-month U.S. Treasury bills, divided by the annualized standard deviation of the manager's returns.

Performance Consistency – Batting average and rolling performance statistics are incorporated into the screening model to measure the manager's ability to consistently outperform its benchmark. Batting average is calculated by dividing the number of months in which the manager outperformed or matched its benchmark by the total number of months in the evaluation period. Two-year rolling performance is also calculated in quarterly intervals to measure how a manager performs throughout different points along the market cycle

Excess Return – Measure of the manager's return in excess of its benchmark's return

Downside Risk – Downside deviation and down capture ratio statistics are incorporated into the screening model to assess the potential loss that a manager may incur during market declines. Downside deviation is a measure of volatility when a manager's returns are below those of its benchmark. Down capture ratio measures a manager's performance when its benchmark's return is less than zero

Expense Ratio – The percentage of fund assets, net of reimbursements, used to pay for operating expenses and management fees, including 12b-1 fees, administrative fees, and all other asset-based costs incurred by the fund, except brokerage costs. Managers with low fees compared to their peers receive higher rankings based on this measure

We place greater emphasis on long-term results in order to better distinguish investment skill from luck. Investment managers who rank in the top third of our evaluation model over the trailing five- or seven-year periods are candidates for further assessment.

We may consider an investment vehicle with a short track record (less than three years) if the manager has an institutional track record representative of the underlying investment strategy and investment guidelines, and if the vehicle(s) have comparable liquidity. We also favor investment vehicles with relatively low expense ratios, as the long-term compounding effect of higher expenses can be severely damaging to investor returns.

Qualitative Screening

We consider qualitative research to be the most critical component of the manager selection process. It further refines managers from the quantitative screen by focusing on attributes that are more likely to persist over time. The most appealing managers in our evaluation model are candidates for qualitative analysis by Newport's research analysts.

Our qualitative research efforts are primarily focused on the firm's organizational history, structure and stability; the depth and experience of the investment team and research group; the investment process and strategy; internal resource allocation; legitimacy of the track record and client servicing capabilities; among other characteristics.

Step 1 – Initial Review of Manager Evaluation Model Results

After reviewing the initial manager evaluation model results, the universe is further reduced by the research team based on preliminary qualitative assessments. Strategies that screen well, but have experienced material personnel turnover or changes in investment approach, are eliminated from consideration. In addition, the investment vehicle and underlying strategy composite must meet minimum asset thresholds. Vehicles with less than $100 million in assets and strategy composites with less than $300 million in assets are generally not recommended due to viability concerns. Finally, mandates that fail to provide dedicated asset class exposure or involve significant portfolio concentration risk are also eliminated from further consideration.

Step 2 – Information Request

A due diligence questionnaire is a means of obtaining more detailed information about each investment manager. Newport has developed manager questionnaires that cater to the specifics of each particular asset class. The questionnaires are focused on the key aspects of the firm and the investment strategy: organization, investment philosophy and process, and performance. A summary of each area is described below:

Organization – Organizational history; stability of firm; ownership structure; strategic focus; core competencies; integrity; depth, stability and experience of investment professionals; investment personnel turnover; retention tools; talent pool; succession planning; division of investment, and information security practices.

Investment Philosophy and Process – Universe of securities considered; idea generation; buy/sell discipline; decision-making process; valuation methodology; portfolio construction; risk management techniques; process enhancements; resources; and trading practices.

Performance – Performance objectives and expectations; internal benchmark; primary sources of alpha; structural biases; historical asset levels and plans for growth; available capacity and unrepeatable events that may have influenced the record.

Step 3 – Portfolio Manager Interview

After the research team reviews the questionnaire and analyzes historical performance, an interview will be scheduled with the investment manager. During the interview, the research team will evaluate the manager's ability to clearly articulate the process, discipline in executing the strategy, and specific examples that are in line with how the investment process was described. We also consider depth of research conducted to inform decisions, and whether the decisions have been consistent with the stated investment philosophy.

Recommended managers tend to possess considerable competitive advantages that may result in alpha generation going forward. These characteristics may include:

- Consistent outperformance versus benchmark and peers across various market cycles
- Seasoned professionals focused on long-term investment opportunities rather than market fads
- Conviction in investment decisions and a willingness to deviate from the benchmark
- A strong commitment to proprietary, in-depth research leading to sound, long-term investment decisions
- Access to information not readily available to competitors; this may be the result of strong networks and on-the-ground research capabilities
- Superior skill interpreting available data to estimate the future relative returns of securities due to insightful investment professionals and proprietary decision-making models
- Superior skill in portfolio construction and risk management that may produce favorable outcomes for clients

Alpha – The amount of return produced by a manager that is in excess of the best-fit benchmark's return after adjusting for risk

Step 4 – Manager Recommendation

Newport maintains a Focus List, which outlines the leading managers our research team has identified in each asset class. In the context of a client's investment lineup, where we seek complementary skill sets and diversification among investment managers, the Focus List forms the foundation of our manager recommendations.

If the research team believes that an investment manager is worthy of being added to the Focus List, the team will formally present the manager to Newport's Investment Committee. The presentation includes a detailed research report that compares the key quantitative and qualitative attributes of the manager under consideration to other leading managers within the asset class. Each research report is developed, with some flexibility based on the relevance of information for a specific strategy, to include qualitative-based observations on the following items.

Manager Analysis

- Firm stability and ownership structure
- Assets in strategy and capacity
- Management tenure and background
- Depth and breadth of resources
- Decision-making authority

Investment Strategy

- Investment objective and goals
- Philosophy and process
- Portfolio construction and risk management

Investment Recommendation

- Strategy opinion
- Competitive advantages
- Performance review
- Risk profile
- Performance expectations

The members of the investment committee will challenge the research team to support the recommendation. If any material issues arise, the research team will schedule a follow-up call with the manager and report back to the committee. Managers that receive committee approval to be added to our Focus List are actively monitored on an ongoing basis.

Step 5 – Ongoing Monitoring

The ongoing, systematic monitoring of the investments held by our consulting clients is an essential component of our manager due diligence process. The objective is to verify whether the investment retains the attributes that served as the basis for the initial recommendation. We regularly communicate with asset management firms to ensure that our decisions about manager retention and/or replacement are made in a timely and informed manner. The manager research team holds more than 250 investment manager meetings annually and research notes are shared internally through Newport's manager meeting database. The meeting database has been maintained internally by the research team since 2010 and tracks proprietary research gathered through the team's interactions with investment managers.

Our research team also conducts a thorough review of each recommended manager on at least a quarterly basis. The manager monitoring process includes a performance review, as well as a review of other variables that are often directly related to performance, including manager stability, style consistency, fund expenses, investment process changes and organizational developments. The information from our regular monitoring of investment managers is communicated to clients in our Quarterly Investment Manager Review.

As part of our quarterly review, a systematic Watchlist process is followed to formally address issues such as potential manager replacements on a recurring basis. A manager may warrant replacing due to factors such as the departure of the key member(s) of a portfolio management team, a change in style or investment strategy, or sustained underperformance with little confidence for future improvement. Certain organizational changes, such as an abrupt manager departure with no obvious successor in place, may require immediate action.

We consider it important for investors to be patient with managers who may be underperforming due to their style being temporarily out-of-favor. As such, managers who added to our Watchlist for failing our performance-monitoring criteria are given up to two years to remedy the deficiency, providing a four-year performance evaluation period. This assumes that the underperformance was driven by the consistent application of the manager's established process, in a manner where the results would be expected. We believe that establishing appropriate performance expectations through a disciplined manager research process is integral to achieving long-term returns in excess of the market's returns.

1350 TREAT BOULEVARD, SUITE 300, WALNUT CREEK, CA 94597

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