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EPISODE 50:

Breaking Down Hedge Fund Investments

with Crewcial Partners

Robert Morier: Welcome to the Dakota Live! Podcast. I'm your host, Robert Morier. The goal of this podcast is to help you better know the people behind investment decisions. We introduce you to chief investment officers, manager research professionals, consultants, and other important players in the industry who will help you sell in between the lines and better understand the investment sales ecosystem. If you're not familiar with Dakota and their Dakota Live content, please check out dakota.com to learn more about their services. Before we get started, I need to read a brief disclosure. This content is provided for informational purposes and should not be relied upon as recommendations or advice about investing in securities. All investments involve risk and may lose money. Dakota does not guarantee the accuracy of any of the information provided by the speaker who is not affiliated with Dakota, not a solicitation, testimonial, or an endorsement by Dakota or its affiliates. Nothing herein is intended to indicate approval, support, or recommendation of the investment advisor or its supervised persons by Dakota. Today's episode is brought to you by Dakota Marketplace. Are you tired of constantly jumping between multiple databases and channels to find the right investment opportunities? Introducing Dakota Marketplace, the comprehensive, institutional, and intermediary database built by fundraisers for fundraisers. With Dakota Marketplace, you'll have access to all channels and asset classes in one place, saving you time and streamlining your fundraising process. Say goodbye to the frustration of searching through multiple databases and say hello to a seamless and efficient fundraising experience. Sign up now and see the difference Dakota Marketplace can make for you. Visit dakotamarketplace.com today. Well, I am very happy to introduce our audience today to James Bell consultant and Director of Hedge Fund Research with Crucial Partners. James, welcome to Philadelphia.

James Bell: Great, well, I'm really happy to be here. I actually, my dad went to Drexel for his masters, so the opportunity to sit down with a professor from Drexel is really exciting for me.

Robert Morier: Oh, good, well, I hope I live up to your dad's expectations or at least his memories of Drexel University. That's really nice to hear. Yeah, I teach in the School of Entrepreneurship. So, it's interdisciplinary, so we get masters students as well as undergraduates. So, I'm very proud to hear that your father went there. Thanks for sharing that. How was the train ride in from New York to Philadelphia?

James Bell: It was great. I'm always struck by how quick it happens. It's weird because you take the subway to get around New York sometimes, and you forget that you can get to another city within an hour, so.

Robert Morier: I know. It's an amazing thing. The I-95 corridor, when it works it works great. When it doesn't, it's a different story, but I'm glad it worked for you this morning. Well, before we get started, I'm going to read a little bit about Crucial

Partners. I'm going to read your biography for our audience, and then we're very excited to ask you questions. So, thanks again for being here. Previously Colonial Consulting, Crucial Partners is an independent investment advisory and OCIO firm focused on providing customized investment advice to nonprofit institutions. Founded in 1980, the firm's evolution over the past 40 years includes expanding their scope of research from exclusively US to International, building out a robust private assets team, developing a comprehensive diverse manager discovery process, and anticipating and developing solutions to the ever-expanding requirements and concerns of their endowment, foundation, and other institutional clients from investment policy statements to critical administrative responsibilities. Our guest, James Bell, is a consultant and Director of Hedge Fund Research for Crucial Partners. James joined the firm in 2008 and provides investment advisory services tailored to non-profit clients, which has helped them allocate over $1 billion to leading hedge fund and fund of hedge funds. James meets regularly with hedge fund, fund of hedge funds, long only, and private equity asset managers to evaluate their investment strategies. He is also responsible for carrying out manager searches to satisfy the unique client specific mandates in both alternative investment and long-only strategies. Prior to joining Crucial, James was an analyst at Muirfield Capital Management, where he conducted due diligence on hedge fund and alternative investment strategies. James began his career as an analyst at Plus Fund Group and IMM respectively. James is a CFA charter holder and maintains a variety of certifications from cybersecurity at work to several leadership credentials he has accumulated over the years. Finally, James graduated from the University of Chicago with a degree in economics. He lives in New York City with his wife and two children, and we are very happy you're here with us in Philadelphia today. Congratulations on all your success.

James Bell: Oh, thank you, thanks.

Robert Morier: Well, thank you for being here. You live in New York City now, but where are you from originally.

James Bell: So originally, I grew up in upstate New York. And it's interesting how I've ended up in… I didn't actually spend a lot of time in New York as a kid because we were so far upstate. But now that I've spent more and more time there, just the energy, the dynamism of the city, just I really enjoy that.
I've come to really appreciate that it's a walking city. So, you go to a lot of other parts of this country, it's great. It's very, very fun, but I like that I can walk places. I love each neighborhood is really distinctive. And you can be at a… go visit some sort of art installation gallery, but then you can also walk and quickly be in another area where you have a hole-in-the-wall restaurant where there's some grandma or grandpa that's like the best at making this dumpling dish or this noodle dish or something like that. So, I love that aspect about New York.

Robert Morier: That's great. Yeah, I lived on and off, mostly on, in New York for about 18 years. And I know you're in Queens now, so those restaurants have definitely accumulated over the last several years in Queens. But it never ceased to amaze me, that in the course of a day, that you could clock somewhere between 6 to 10 miles just walking through the city. So, I couldn't agree more. It's a great place to live and a great place to walk. So how did you end up choosing the University of Chicago then? You grew up in upstate New York, obviously, New York City now, but you went out to the Midwest, a wonderful school. But how did you come to choose it?

James Bell: So, I was actually born outside of Chicago. So, I always had this… Chicago definitely loomed large in my mind as this cool interesting city on a lake. When I was at that point in my life where you're a student or you're thinking about what you want to do for college, certainly the academics of the University of Chicago were amazing, and that rigor was really interesting for me. But I also really liked that they had a common core curriculum, and you had this emphasis on critical thinking. I really thought that you wanted to be… that college was to help you become a very well-rounded person. And so that was an attraction, at least during that application process. And then after you come to that spring, and you're going through this decision-making process internally in your head. And what I really liked, at that moment when I went to see the school, was everybody you met just was so wildly into what they were doing. And it was like to a level where you just never saw that. You could tell that these people just geeked out very deeply and were very passionate about whatever they were studying, whatever they were working on, and I wanted to be at a place where I was surrounded by those people. And that's what brought me to the University of Chicago.

Robert Morier: So where did that passion fall for you? What was that feeling as you were coming out of school? You started and worked as an analyst for the first two jobs, but how did that… I'm always curious. Teaching a lot of undergraduates, I see the same thing. These students are amazing. They know exactly what they want to do or at least the spirit of what they want to do. But to tie it to a job is a different exercise. So how did you end up kind of finding that passion?

James Bell: I really liked that connecting economics and investing and was interested in that when I was in an under… when I got deeper into my undergrad education, I had the opportunity to have some Nobel Prize winning professors. The connecting it to work part aspect, actually, it came kind of in a roundabout way. So, I graduated in a year where it was difficult to recruit. And one of the things I ended up doing is working for a firm that actually put together investment conferences. So, we developed content that was designed to be attractive to all the stakeholders. So, you have the investor, you have the fund manager, you have the service providers. Our goal is to bring them all together in a room. At this point in time in the hedge fund industry, there wasn't a lot of information about hedge funds out there. Really did have these private capital introduction events, and that was the way they raised capital. The attraction there was that opportunity to just get in the door, get to learn an industry, and then from there, a lot of what I ended up doing is spending time just talking to people. And I got to people at different family offices. I got to know other alumni from my school. And I knew, pretty early on, after putting together and being part of the team that put together some of those events, that I really wanted to be at the event, not just attending the event and organizing it. And so, and to get there. I really had to move more to an investment manager. And so, through contacting a number of alumni, I found an opportunity more on the operational side, so the operational and reporting aspect, at a leading hedge fund index provider. And from there, I then built up my skills at that very, little bit dry, but Excel and focusing in on making sure all the data is correct. One of the things we did on a daily basis, is we were reporting for a wide variety of hedge fund products. And we were reporting on how they matched relative to a benchmark. So, you get to learn a little bit about the securities. You learned a bit more about how to think about what moves stocks and what actually is the technical aspect of what's in these funds. But at the same time, we're not investment decision makers. And so wanted to get more to that investment decision making side. I continued to look for opportunities and found this great opportunity with Muirfield, where it was fund to funds that had a long-short-focused product and more of an absolute return focused product, opportunity to work with a group of what had essentially been the senior management at DLJ and learn from them about what it's like to invest as a principal investing your own capital. And that was the next step in my journey. So unintentionally, I managed to work around a lot of different sides of the asset management industry and the investment management industry to get to a place of being more of a decision maker research person. And then from there, moving to Crucial was really about that opportunity to get to focus more on working with non-for-profits where you could see very directly the impact of your work to help them generate performance and how that helps to really fund what they're doing to build better communities, to nurture their neighborhoods around where they exist.

Robert Morier: It's funny. Probably felt like it was a very circuitous path. But actually, when you hear it, it sounds very Intuitive.

James Bell: Yeah, it seems much more intentional now, in retrospect, than it did at the time.

Robert Morier: It always does, doesn't it?

James Bell: It felt a bit of a roundabout way to get to the answer.

Robert Morier: No, but it makes sense. It's really interesting too. Coming out of school at that time thinking about what people were thinking about, what did they want to talk about? I can imagine that one of the topics was, what just happened? What's going on now? What should we be doing in terms of managing risk, particularly in hedge fund portfolios? Which is also interesting because at that time, coming out of the crisis, a lot of the long-short managers were starting to pivot into long only. So, you had this kind of new Paradigm of alternative managers dabbling into the traditional institutional world where previously, it was more of the usual route of the alternatives hedge fund structure. So no, it makes a lot of sense. I appreciate you sharing all that. It's a great insight for us as to how you came to Crucial. So, it's been over 15 years, congratulations. I know you've probably seen a lot over those 15 years, but maybe for our audience's benefit, if you could give us just a broader sense of Crucial, formerly Colonial Consulting for the folks who have been in the industry for a number of years, like myself. Tell us about Crucial. What's the mission, and specifically, what's your role with the firm?

James Bell: Sure, so we partner with non-for-profits to invest their capital in a way that can accelerate their impact. We are both an OCIO and also a non-discretionary consultant. So, we have 114 clients with $26 billion in assets under advisement. We view ourselves as our clients' partner. And part of that name change to Crucial was to really signify the crew as a sport, when you think about crew as a sport, there's no one person that can't be there for you to succeed. And so, we wanted that to be part of who we are. We wanted to be front and center that we view ourselves as a partner with our client. And that we are going to be closely working with them but also internally, viewing it as a crew. We have a research team. We have a reporting team. We have a investment coordination team. And all those groups also come together so that we can implement a client portfolio. And so, we wanted to really codify that into the name. We work with our clients. We work with them across the board. So, we spent a lot of time really trying to understand what's their goal with this capital. Where are they on their investment journey? What's their history with investing with different asset classes? And then we incorporate that when we sit down with them and build what we call an Investment Policy Statement, the IPS. And that becomes really the guiding document for how we work with them on a day-to-day basis. We then create an asset allocation framework for them. And then we look to really identify best-in-class managers to build into their portfolios to meet the needs and objectives that they have overall. In terms of things that really are critical to us, research is at the core of our firm. Everything we do is around research, as is diversity. We are really proud of the fact that we have won awards for our work in diversity, and really, that is core to who we are and our DNA.

Robert Morier: In terms of the research process, that was very helpful, particularly in framing the philosophy of how you think about manager research and selection. So, as it relates to your role and then the team, how is the team structured? And how do you sit within that as hedge fund consulting?

James Bell: Sure, so we have a 20-person integrated research team. So, we have a generalist model. We encourage cross-asset class collaboration. So, a person could be doing work on a boutique long-only manager, but they could also be doing work on a growth equity, private equity fund and doing support work on a hedge fund. There's a lot of interesting synergies that occur when you're going for from asset class to asset class. That said, you do need to make sure the trains go where they're supposed to go, things get done. So, we do have some hierarchy. We try to limit it. We do have a CIO who really sets… Michael Miller, who really sets our overall framework. We have a director of research. We have an investment committee. And we have asset class heads, and they're there to make sure the process is completed. When you have an open framework, there is a little bit of a risk that people just work on what they want to work on, and you have to counterbalance that with some structure. Internally, when we're working to approve a manager, it takes two people in the team, senior people, to sign off to say I support this manager for it to move through our process. Additionally, separate from the research team, we have an ODD review that's done of the manager. And that really is to ensure that all that is up to par. You do have a level of understanding of ODD, and you do know who service providers are and things, but this gives you that additional person in set of work really done to dig in on the manager.

Robert Morier: With Michael Miller and the investment committee, is the policy being set or directed by the client, or is there an in-house view that then gets permeated throughout the client portfolios?

James Bell: We certainly have a view of what's the optimal way to build a long-term endowment-oriented portfolio. So, one of the great things about Crucial, is that 95%-plus of our clients are non-for-profits. So that generally means that we have a similar time horizon across our client base. It generally means that we have a similar need in terms of capital. Now, some of our clients don't necessarily have to have a draw on their portfolio. Some do have a draw. Some particularly on the educational side right now, have been taking bigger draws because it's been difficult around the COVID period for them. But generally speaking, long-term capital across the board that helps really set things. It's more about knowing how to navigate some of the things at the edges for us, making sure we're all kind of rowing in the same direction when an opportunity potentially occurs. We're not macro traders, by any stretch, but there are ebbs and flows. There's a bit of psychology to the market, which sometimes creates an opportunity. And it's really helpful to have a CIO and a director of research and a group that can kind raise their hand and say, hey, this area has underperformed for a while. There's a structural opportunity here. We should be making our clients aware of this and working with them to layer in some of this into their portfolio. Again, it's not about trading, but it's about really trying to line up for long-term success. And a portfolio. So, it's somewhere between… it's a little bit Swenseny, but it's not entirely a Swensen-type model because certainly we can't take on that illiquidity that some of those educational institutions can take on with how they've structured their portfolios. But also, it's helpful with, as we're working with newer and managers, that where there is a bit more of a risk with that manager. And having other people on the team that have a lot more experience sit down with that PM, talk to them and understand them is really helpful to ensure that we really have thought through every aspect of that manager and that fund.

Robert Morier: Yeah, that makes sense. I was going to ask how you define and integrate risk management strategies within the investment research process. So, thank you for leading me into that question.

James Bell: For us, risk is really a permanent impairment, a permanent loss of capital. There's no overlays. There's no option strategies inside of our portfolios. Instead, it's really proactively… first and foremost, it's about knowing the manager, knowing their temperament. And then when we understand their strategy, we understand their temperament, we then think about how to use them in the portfolio. So, risk management will come in the form of sizing. It would come in the form of counterbalancing them with other managers in the portfolio. If they're a deep-value manager that might have a long duration on some of their investments, you might need to counterbalance that with a manager that is less super deep value in terms of their approach. And so, we're looking to create that balance, but we're certainly not trying to risk manage to a certain vol target. And we're not using any sort of product to do that in our portfolios.

Robert Morier: That makes sense. Thanks for sharing. I appreciate it. So, putting all of this together, you touched on the research process, at least how many people it takes to move a manager forward. But would you mind maybe thinking about it, I guess one way to think about it, as you mentioned, you've got this analogy of the boat, right? You've got eight people, so we know who the parts are. You've got the coxswain, maybe that's Mike who's directing the boat. You've got the investment committee in the skiff making sure that we're all doing it together. So, once you're kind of going in the direction you generally know what you need to do, what's the process look like in terms of sourcing the manager, starting the research, digging into the research, making the recommendation, and then ultimately, making an allocation. If you would, take us through that.

James Bell: Why don't I just take a step back and just kind give you a sense of the overall philosophy before going more to the direction of what we do to dive into the managers. Excellence is rare. If you think about the market, and you think about the S&P 500, that is essentially a summation of the median of all the managers that are investing in any time period is going to give you what the index is. And if you apply fees to managers, you end up below the median. So, it is very, very hard to end up in this upper quartile, upper half of the market. So, we really start with that premise. Generally speaking, we emphasize fundamentally driven managers that are price sensitive that have a focused portfolio that is highly researched. And ultimately, we're looking at these managers to really identify what's their variant perception. We think that the only way to really outperform is to have a point of view that's different than consensus, it's different than the market. And to do that, you really have to have something about you, your experience, how you view the world, how you analyze data, something that helps you get to that point of view. It kind of goes hand in hand with diversity too, to a certain extent, because ultimately, if everyone goes to Harvard, everyone has the same finance professor, everyone takes the same accounting class, it's funny how when you screen, you all screen for the same thing. And so having managers that have a different background that come from different walks of life really helps layer in and ensure that you are getting that variant perception. And then ultimately, having a defendable variant perception. But in terms of what we look for when we're diligencing a manager, I'd say that we're humble about what we really can know and not know. And so that humbleness comes out in the sense of there are certain strategies we're just we're like, we're not going to get an edge here. This is not for us. If it's getting beyond the capabilities of what we can do, we'll admit that. Secondly, we're humble in also admitting that we don't know what the day to day is ultimately at a manager's office. We meet with them. We do a lot of work to get to know them. We do a lot of reference checks. But ultimately, we do not know what that day to day is. So, we approach the whole process with that level of humbleness and open mindedness to test what we believe in our thesis. People, process, performance, philosophy are all the things we really key in on. We're trying to build a mosaic. And we're looking at how these all interconnect together and come together to form the firm itself and how that firm is going to react and grow and change over time. But people is the most critical part. So, and if I could put that in flashing lights, bold, triple font size versus the rest, I would say people, people, people. Particularly with boutique investment firms, they are essentially the physical manifestation of this manager's investment philosophy, this is how they think, this is how they view the world, brought into the real world. So really, the people part is front and center and very, very critical. We think that it's each investor, because investing is so personal, really has a type of investment personality that you want to get to know and understand. And if this is disconnected from how they're investing, typically, that's where you run into problems. A manager is not comfortable with the position sizing and having a very risk-on portfolio. And then they trim at the wrong moment and miss the opportunity that they actually could have had with their portfolio or vice versa the manager just is very, very risk controlled and is trying to manage a risk-controlled strategy but actually wants to be more aggressive. And that too, that conflict, we think, can create a lot of issues for the fund that ends up impacting the performance. So, people is front and center.

Ideally, as we're digging in on the manager, what we're trying to figure out is their temperament and style. I do want to see a manager that has really thought about who they are as an investor. You spend a bunch of time reading books, spend a bunch of time writing out what it means to invest the way they want to invest, and also understands the pros and cons and weaknesses of their way of approaching investing. And so that's why I say the people part is really, really critical. Do you want to see some competitiveness, some way that the manager has a competitive nature? This industry can be brutal. You can have a period of multiple years of underperformance. But usually, those are also the times they're setting up for this amazing, multiyear run of great performance for a manager. The other thing is a deep passion for the investment art. And it can come in different ways. So, a credit manager, particularly with the opportunistic credit type funds that are investing in stressed credit, it could be that they just love understanding the capital structure of a company and the interconnectedness of the 50 different entities and where this debt sits and what its attachment point is. And that gets them so excited because they're like… and you see their eyes light up when they talk about it, and they get all bright eyed. Or like with an equity long-short manager, it could be that they love the accounting. And they love rebuilding the balance sheet of a company and being able to figure out that this company is a very good short, and no one understands it because they haven't done this work. And they know it's unsustainable because they've done all the work on the accounting side. And that gets them so excited. I want to see that, ideally, from a manager. And so, we spend a lot of time. When we meet with the managers, we're doing multiple meetings. We're reading all the materials they send us. And that helps us really try to triangulate in on that aspect. The other thing that we're thinking about throughout this process is how does this manager… what is this manager telling us when they're talking about their people, process and their philosophy about risk management? But then also, what do they say about risk management and what do they say about what risk means to them? And we want them to tell us. We want to hear how they think about it. We want to make sure that aligns with us. From our perspective, we certainly have a view of what risk management should be for a manager to succeed, but we want them to tell us what their view is. And we want to understand how it matches to what we believe is the way our clients want to have their money invested. It takes us multiple meetings, as I mentioned, throughout the process too. The other underlying current is alignment, and there's many different layers of alignment. There's, as I mentioned, the risk aspect. We just want that to align with us.

But there's also an alignment in terms of the manager being incentivized to manage to generate high performance. And we want that to align with us. We want to see it the team is aligned. We want to see all these different layers throughout the firm. Particularly on the team alignment, it's really easy when a fund is relatively new. But it does get harder over time. This industry generates a lot of wealth for people. And in those first couple of years at a fund, it's a start-up culture. But then, eventually, things can change over time. And so, we're always trying to understand how managers thinking about that. How they're really trying to build for that multi-year 20, 30 years of successful performance.

Robert Morier: It sounds like you're really looking for that congruity between words and actions.

James Bell: Yeah.

Robert Morier: So, it's like almost like a forensic due diligence in terms of the character, the type of actions the portfolio manager is taking in order to get their business off the ground, the type of team that they build. But I am always curious, how do you get through the marketing veneer? Because a lot of these portfolio managers and particularly founders of these businesses, they're not always great salespeople, but sometimes they're quite well trained.

James Bell: No, they're usually the most interesting and dynamic and fun people to meet. A lot of it is getting them talking. And so, if you have an hour meeting with somebody, and you came in, and they're building their portfolio, and mostly what they talked about was not specific stocks, that could be a bit of a red flag, or a bit of like maybe they're not as deep into the passion on the investment side. The other thing is really asking to speak to some other people on the team and get that triangulation from them, like, what is their version of the story without the main person here. How similar is it, how congruent is it with that version of the story? But it is really hard. A lot of times it is also looking at their portfolio and their performance over time. You will meet with a manager pretty early on. And then you might not revisit that manager for six months. And the great thing about that is you have this perspective from when you met with that manager about what your expectation is. You have this period of performance, almost this experiment in a way. You know what the market did over the last six months. You know what their investment style performance should be. And then you can read about how they did in that time period. And then you can go back and ask them questions. A lot of times, the really telling thing too is, talking to managers about lessons learned and how frank they are during their lessons learned. We've had some managers that are just very, very frank about, they're like, you should never hire us. We make these kinds of mistakes all the time. And that honesty is really, really eye opening. And it's something we really appreciate. And we like when managers have that. And it also goes back to that insight of being true to themselves. This is who I am as an investor. This is what I'm trying to work on. This is how I'm trying to iterate myself. And I'm so passionate about investing, that I'm going to keep on iterating on this, until I can't iterate anymore.

Robert Morier: Yeah, great advice for managers calling you. It's funny. It just reminded me of a story. When I started, many moons ago, at a firm, we were selling international equity. And our co-portfolio manager was asked who his competitors were. And in that conversation, he essentially admitted that he actually liked his competitors so much they should consider the competitor instead of us during the final pitch. So, it was a little backtracking we had to do. But in the end, we did get hired. But I think to your point, which is a good one, you do forget that that humility is so important and really critical, especially when you're responsible for other people's assets, that fiduciary responsibility. Well, you touched on a few things in your answer. So, if you don't mind, just kind of going back. You mentioned focused portfolios. So, what does a focused portfolio mean to you in terms of concentration or sector industry concentration, whatever it is as it relates to that focus relative to the more diversified approach?

James Bell: So, a more diversified approach would be more like a portfolio that is a 50, 100-stock portfolio, where max position size is 150 basis points. And you are managing the portfolio to some sort of tracking error. So, you're very aware of what are the sectors in the benchmark, and you will probably own every sector in the benchmark. And you will also own a company, may not even be your best idea, but you own a company within each of those sectors to ensure that you have some exposure. That is not what we try to do. We want managers that have a focused portfolio, essentially, where there's probably 5 to 10 ideas in their portfolio that are scaled up in size. And whether they have only 15 stocks or whether they have 30 stocks, even up to 40 or so, but where there's really that focus, and they really show that conviction in those ideas, in part, because of that variant perception. If you just own the market, it's very, very hard to outperform the market. But if you own well-researched companies with a fundamental understanding of what can drive their performance, we do think there's a real opportunity to outperform over time. And it's similar on the credit strategies. We do want to see them focused towards where the opportunities lie. And it might be that there's a big opportunity in mortgage-backed securities. And those became a big piece of their portfolio. Or there might be a big restructuring, or there might be an opportunity in a couple of different middle-market companies that are going through stress. We want to see that concentrated effort. And so for us, we used focused because we feel that that's a better word than saying concentrated. Because I think it gives you a sense that the portfolio can have a bigger tail, but ultimately, performance comes from this piece of the portfolio.

Robert Morier: Interesting, thanks, well, you also mentioned performance. So, what are the most critical performance metrics to consider when analyzing hedge funds? And how do you balance the historic performance with the future potential?

James Bell: Historic performance with future potential is always so dangerous. It's very easy to like a manager that's on a run and had two to three years of great performance. And so, we always are trying to check ourselves when we see managers that have had a great couple of years of performance and think, is the reason we're looking at it because it has done so well in this time period. And the first analysis is, really, what is the alpha they've generated on the long side, what is the alpha they've generated on the short side? For credit managers, what's the structuring alpha they've generated relative to that overall asset class and thinking about that. And then, what do we think over a three-year period? And so, we do like to look at a longer window of performance, like a three to five-year window of performance. And but often, I would say that when we see a period of underperformance, particularly if we can do the work on a manager and understand why. So, if you look across the market right now, one of the things you're seeing is that a lot of very focused health care strategies are underperforming and have really underperformed for the last three years relative to other hedge fund strategies. That, in our view, is an opportunity because we can understand that there's really been a multiple contraction across the industry. And that we can also see that, potentially on the other side of it, there's a lot of interesting secular tailwinds setting up to create opportunities for these funds going forward. Something similar on the long side, we had a couple of year period we invest with some activist strategies. But those managers underperformed for a number of years because Japan was so out of favor. But if you look at our clients right now, those are our best performing funds over the last three years because we held them through. We understood that the underperformance was in part because of the work they were doing to facilitate the change in those companies. And now we're able to reap the benefit of that. And so, we're always trying to think about it in the context of what's the market you're in, how has it performed, and how much alpha have you generated relative to it? And then try to be very careful not to fall in love with the current darlings of outperformance and also not to… at the same time, you don't just run into managers that have underperformed. You have to understand why. And certainly, if everything is OK with the manager and the team, it can be a real opportunity.

Robert Morier: Well, you've gone through this very thoughtful manager research process. So, one of the questions I was thinking, is how does it all come together? So, do you have a buy list, is there a recommended list? And I ask for a couple of reasons. One is that you have a traditional advisory business, but you also have the OCIO business, the discretionary business, which arguably, can move a little bit faster. So, as you think about your recommended managers, the folks that you're deploying capital to, how does that ultimately come together, and are you maintaining a list?

James Bell: We do have a list of approved managers internally. The process takes time with us. We do generally think about things in terms of a quarterly rotation with our clients. And so, if you think about any new manager that starts to work with us, there's probably a certain number of slots available in any given quarter that come up just because of the natural cadence of what you're doing in meeting cycles, what you're covering with the clients, also what changes might be happening. We generally are very long-term oriented. And as you can tell, probably, from the way, I've answered a number of these questions, we do like to give our managers a chance. Even if they do lag for a period of time, we want to see them outperform. And our point of view is they're very smart people. They've been successful. In all likelihood, they're going to continue to be successful. So, we do try to give them that chance. When new managers come into our portfolio, it usually starts with a handful of clients investing somewhere in the order of probably like a $15 to $20 million starting investment, and then builds from there over time, typically, getting into the 80 to 100 million or even more, depending on how core of a strategy it can be in the part of the portfolio. So certainly, for like a core US large cap value or a core US small cap value manager, you could see pretty sizable assets go into that manager over time. Hedge funds, there's a little bit more idiosyncraticness to hedge funds, and there's a little bit more of making sure it kind of matches with the rest of a client portfolio. So, the overall assets probably end up peaking out in that $80 to $100 million type range when we have a fully built-out manager in the portfolio.

Robert Morier: When you think about the hedge fund mix, so what does the allocation look like within the hedge fund space itself? So, you mentioned long short on the macro.

James Bell: Yeah, so about 75% of our approved managers, our equity-oriented strategies, about 25% are absolute return strategies. About half of those are more on the credit side. And then the other half are that platform type, absolute-return oriented manager that are multi-strat-ish. On the long-short equity side, we do like the asymmetry of how they can generate performance. And so, we've always liked that they do get to capture a bit of that equity markets. We do think over the long term, equities are one of the best performing asset class for long-term capital to own, and we want to take advantage of that. Currently, one of the things that's really interesting setting up is that now that we do have interest rates so much higher than they were, there's a nice positive carry now on shorting. Shorting actually can generate a little bit of income. And that creates a nice little tailwind. It's not huge. It doesn't offset a mistake on a short that goes against you. But it is a nice tailwind of a couple hundred basis points. And we do think that's a nice setup. The other thing is the fact that now capital costs money. It's very, very different for companies. That becomes almost a hard catalyst, potentially, for a lot of businesses, where they have to think about what's going on their debt. That also creates an opportunity for equity long-short managers because in the process of having to fix something that's a debt issue for a company, it could be positive trajectory, or it could be a negative trajectory from there. And the work that they're able to do can really help understand the company, and they can take a position on a company based on that.

Robert Morier: Last week, I was in a meeting, and I heard someone say, fund of funds are back, hedge fund of funds are back. So, are fund of funds back? And if so, how are you thinking about the space.

James Bell: Fund of funds have evolved a lot over the years. So, you go back to when I joined Crucial. At that point in time, a lot of the benefit of fund of funds was that they were an access game. That it was you as an institutional investor, had no idea who these funds were. You couldn't get in front of them, couldn't understand them. Now for the most part, the top-20 hedge fund managers are generally household names. You can find the names of them. It is harder to go outside of that. So, what you have seen is fund of funds have evolved. And you've seen funds that kind of pop up with a focus more towards the seating side of things, a focus towards co-investments, or maybe it's a focus towards just new managers, managers with less than a three-year track record, and we're going to work with those. And so, it has evolved for us. We certainly use fund of funds. But we're not really shifting how much extra we add there. We do like the benefit of going direct, particularly, because it helps us to be able to counterbalance other things in a portfolio. You could, for example, we're talking about health care. Well, maybe a client doesn't have as much health care exposure as you want. And the traditional part of their portfolio, you could look to add it in the hedge fund part of their portfolio. Or maybe they're overweight health care in the traditional part of their portfolio, and maybe you're going to want to counterbalance that with a manager that has more business services or cyclicals exposure inside of the hedge fund part of the portfolio. And so, we like having that level of control.

Robert Morier: You also give up transparency. Well, you used to, maybe not as much before.

James Bell: Yeah, it's gotten better. You definitely get the list from the fund of funds about what they own. But the challenge with the fund of funds, is you are… now, some of them have come up with creative ways solutions around how they have to take cash out of a fund or take cash out of a fund and hold cash on their balance sheet. Some have developed ways to deal with that. But that was a drag on fund of funds. And that impacts returns and the extra layer of fees.

Robert Morier: Now that we have a sense of how this portfolio is constructed, one of the questions that our audience really likes to at least hear the answers to is, what are you working on today? So, what are the areas of the portfolio that clients are interested in, that you're interested in, and you're spending time on, at least as you think about maybe the next 6 to 12 months?

James Bell: We're always spending time on long-short equity.

Robert Morier: It sounds like it.

James Bell: It's just it is really interesting. There's always a lot of opportunities there. We are spending more time on credit managers. With rates much higher, where the potential for there to be a default cycle we do think there could be a nice opportunity there going forward. We continue to layer. We do focus a lot on trying to identify diverse manager talent. That continues to be a really big effort on our part. It's just abysmal how few assets in the industry, it's something on the order of like less than 2% of assets, are with managers from a diverse background. We measure diversity in terms of ownership as being 51%. We want them to be the owner. We think that's the only way to really be in control. And we do think that there is a lot of great talent there. It gets overlooked because maybe they didn't go through the traditional process. They're not a 2 plus 2. By 2 plus 2, I mean that they did I-banking, and then they went and worked in private equity for two years, and then they went to another hedge fund, and then they're a 26-year-old launching with Blackstone and all these other places on their resume. Maybe they don't have that background, but it doesn't mean they're any less of an investor. And in fact, if anything, what we found is that the transparency and access we get by identifying these under-followed managers, gives us a lot more information. And it really aids our decision making.

Robert Morier: I'm always curious because this is a question, actually, you mentioned it, and a question that's often asked of asset managers, which is what happens when a position doesn't work? From your perspective, what happens when a manager doesn't work? What does that process look like in terms of the exit?

James Bell: It takes time. As I said before, we want to see managers succeed. We generally believe that they are smart. They have a team. Now, if there is a team issue, and that's the reason that the fund is in trouble, or if there's a certain level of turnover where we really do worry about the manager itself, like the structure of the manager, the pool, things like that we would look to exit very, very quickly. But if it's an issue of the manager has lost their way a little bit, we oftentimes will give them a little bit of room to find it. Now, it's not a forever time period. There's a period of time where you can give patience. But then there's a period where you start to ask a lot more questions. Things that have really pushed us to leave a manager would be the team turnover, particularly for a manager where we're seeing the number two or number three people leave pretty regularly and not feeling like there's people that are stepping in of the same caliber as what was there in the past. Sometimes you do see that turnover because ultimately, the PM doesn't want to have 10 different products, and they want to keep a focused team, you do see some turnover. But you want to understand who's stepping in and feel that they can do what the person that left can do. The other thing that has led to turnover sometimes is risk. We see a manager… interestingly, it oftentimes happens with a really successful manager.

They get very, very successful. They have a period of performance where they lost more money than they realized. And I think part of this is just a natural psychology of, they probably never thought they were going to accumulate this level of wealth. Now they've lost more than they ever thought they would accumulate, and now they want to protect what they have left. And you see them going through this period and then becoming more risk averse, when really, it could be an opportunity. Because whatever the flywheel, the coiled spring that's working against them becomes a coiled spring, it could actually propel them to higher performance. But their response is to actually lose conviction and adjust their strategy down. That usually is something that, as we pick up on that, we would look to exit a manager. We do try to give the manager transparency about what we're concerned about as we're going through the process. We obviously don't always see eye to eye when those things happen, but we try to be as transparent as we can with them about what our concern has been and why we are moving on from that manager.

Robert Morier: So how does your team maintain its competitive edge? How do you stay competitive relative to your peers?

James Bell: I think first and foremost, it's partly by having just a really open team. That there's not a firewall that an idea has to come from this person from this way who's vetted it with these four people. It's like, hey, this is a really interesting idea. I think we should take a look at it. And that constant like, ideas coming percolating at you, that really kind of helps keep us on our toes. Internally, as a group, we're very focused on just constantly thinking about what we can improve and how we can do things better. We integrate as much as we can with technology. We have become big believers in using Teams. We use that to communicate together, and that has really helped us improve our communication make it easier.
Because there's things that you obviously have to reply to right away, but then there's also information sharing that can occur on a platform like that that can be really useful and iterative over time for you.

Robert Morier: So, is the Slack channel up and running yet?

James Bell: No Slack teams, we use Teams for… but we have channels for everything in Teams.

Robert Morier: Well, you've touched on emerging managers, early-stage managers, a few times in the conversation. But we would be very interested to learn more about that program. How formal is that program? What does it look like in terms of the qualifying aspects of an emerging manager? How do you define an emerging manager?

James Bell: Sure, so we don't like the term emerging managers too much, just because it feels a little bit, and I'm going to use another term that we don't also like a lot too, it feels a little bit like the Rooney Rule. Like a little bit like, hey, we have this over here. We don't need to think about it anymore. And you know, it doesn't get you… It doesn't always get the manager into the mix as much because you're putting it in a bucket, and you're putting it in a corner versus keeping it in the portfolio as part of your main portfolio where it should be. We are very active in looking at new launch managers and certainly managers that can have smaller assets, particularly on the private side but also within the traditional equity side and within the hedge fund side. And our goal here is just to get to know the manager early and see if there is an alignment, focus on who they are as an investor, how they're thinking about risk, how they're going to have an edge in a differentiate view? And if we can see all those things coming together very early on, we are very comfortable with starting to work with a manager that has less than $50 million in assets. That's not an issue for us. And we can help them actually kind of grow by being a reference for them helping others see who they are. We work with a lot of different groups out there IDAC, and NASP, and we also help put together events. And so, we can certainly help that manager get a little bit more light shone in their direction than maybe they're seeing otherwise and be that first institutional capital that comes into their portfolio. Our ODD team can talk to them about what they're doing great, but then also point out, here's things that we'd want you to do down the road.

Robert Morier: Will you or your clients consider taking equity stakes in those managers or revenue share?

James Bell: We don't do that because it just complicates the decision-making process a lot because you have to always ask, how can you redeem from a manager if you get a piece of their business?

Robert Morier: That's a good point. To close up this part of the conversation, one of the questions I usually ask if there is an emerging manager program, is what does the graduation process look like? Because you had mentioned in the beginning, sometimes emerging manager programs and emerging managers can be sidelined, and then they stay over there for a long time.

James Bell: Yeah.

Robert Morier: But when they do graduate, or as they work towards a graduation process, what does that look like from Crucial's perspective, as a manager researcher?

James Bell: So, as a manager, as I said, typically a manager will start with a few investments from a few clients, and then it just kind of accelerates over time across our client base. We all see the performance of all the different clients, and we see all the performance. We see all the performance of the managers that are on our approved list. So, people will notice when a manager is outperforming and look at their list of managers that they have in their portfolio and talk, potentially, to the person that sponsored that manager, hey, how are they outperforming? What do you think of them relative to what I own in my portfolio? And so, it's really organic. There's not a kind of a meeting that says like, you graduated, or a—

Robert Morier: Ceremony.

James Bell: …a ceremony for a fund. But if they end up with that higher level of capital, that means that they've probably graduated up across our firm.

Robert Morier: Well, in your latest quarterly commentary called One-Man Shovel, you note investing in companies that prioritize diversity and inclusion can potentially increase portfolio returns in a few ways. It goes on to say that it aims to mitigate the impact of ingrained systemic paradigms of thought by educating ourselves on behaviors that lead to social injustices and limit the visibility of diverse talent. So, if you could bring all of this together into how you think about diversity and diverse investing as it relates to Crucial's mission.

James Bell: Sure, so diverse investing is really core to our DNA. We as a firm, really are of the belief that it takes diverse talent to know diverse talent. So, at the firm itself, I have colleagues that are from all backgrounds or from all over the world. One of the colleagues I work with in research, he was early on working at Wall Street, then he had a band that toured, then he had a time period where he owned his own business. And now he's back to doing manager research and portfolio management. And you have that mixed with a person that was born in Morocco, a person who was born in China, people that have grown up all over the world. So, we really do believe it takes diverse talent to know diverse talent. 75% of our C-suite is of a diverse background, and we think that's very, very different relative to our peers and also really shows how we are unique in that aspect. We cast a really wide net. We have a team member, Angela, who goes out to a number of conferences and just lets people know, hey, we're here. We're interested in this. You don't have to have $100 million in assets and five-year track record and all these check-the-box items to come meet with us, just come meet with us, have a conversation, let us know what you're doing. We'll be able to tell pretty early on. As I said, if that alignment is happening, and we start to see those stars lining up, we're going to start talking to you a lot and see what we can do to help accelerate that process. And so, we have an open-door policy, and we also provide feedback. So, one of the things we do is that either we would do it directly, the individuals that met with the manager, or Angela would have a conversation with them afterwards. So, they get feedback from us about why we are excited about you, what we're looking to see from you in the future, or what just doesn't match what we're trying to build for our clients. And so, we think that that feedback part is really, really critical. The other thing we do is a lot of advocacy work. We work with NASP, with IDAC, and a lot of other organizations just to get the word out about how there's this opportunity with diverse managers. Our CIO, Mike Miller has given testimony before the SEC working committees on this issue. And so, we really try to push that conversation forward. In the client side, we're telling the clients about the diverse managers in their portfolio. And we're tracking it, and we're reporting it. And if you're reporting something, people have conversations about it. They ask you about it, and it becomes a natural extension of that. We are also working with clients to codify if they, as an organization, want to take that next step helping them be able to put language into their IPS or Investment Policy Statement to include what they're going to be doing on promoting diverse managers, promoting ESG.

Robert Morier: Wonderful, thank you for sharing all that. Well, we talked a little bit about the opportunities that you're seeing, but what are some of the main challenges that you foresee coming up? I mean, it's a little bit of a crystal ball, but you've been in the alternative space for a long time now. So, as you think about the current market environment, you're looking and talking to all of these different managers, what are some of the main challenges that you foresee in the hedge fund space over the next couple of years?

James Bell: So, assets have gotten pretty big in some of these firms. It can be a challenge because… and some of these firms have been successful. They've had great performance. Obviously, they're providing investors with something they want to raise this capital. But the complexity around is different. And the opportunities that those funds can invest in is different. When you're putting to work $40 billion, it's very, very different than when you're putting to work two or three or one or $500 million. And so, I think that is something that, because we've seen this growth of mega firms in the hedge fund industry that is puts the industry at risk, leverage is complicated. It just speeds things up very, very quickly. If you have a portfolio that's levered 5x, so 2.5x on the shorts, 2.5x on the longs, off 5% on each side, down 10% on a kind of gross level basis, you're down 50% on your capital. 5% portfolio going 5% against you should not be considered to be an impossibility. And so, we do worry about some of the leverage that's embedded in the system and how managers are using leverage to generate returns, particularly some of the bigger multi-strat managers. And we also do worry about that the industry has kind of bifurcated into big multi-strat trading shops and smaller boutiques and wonder how that aspect will play out over time. We continue to think that, ultimately, it's very, very hard to consistently trade a position and make money on it. And then really, the way to make money is to have a differentiated view, take advantage of the fact that you have a longer time window, and then use that with your work understanding the fundamentals to generate outperformance.

Robert Morier: Well, you've given us a lot to think about. Thank you so much for all of these insightful answers. We appreciate it. We appreciate you being here in Philadelphia. Before we say goodbye, we always like to ask our guests the people that have influenced their careers, so the mentors who helped you along. If you could share any, we would appreciate it.

James Bell: I've been at Crucial for a very long time and had a great opportunity to work with Mike Miller, our CIO. And so, I would say he's been very, very influential for me as a mentor, but then also, some of my peers at Crucial have really turned into mentors. I've learned a lot from one of my colleagues, Anthony Hagen, about private equity investing. He really taught me how to think about it. How to think about how that works with other asset classes, and what it means when your diligence managers that you're investing with for 10 years versus what we do in the more liquid part of the market, which is a very, very different investment horizon.

Robert Morier: That's great. Thank you for sharing that. Thank you again for being here. It was really a pleasure. We look forward to more continued success for you and the folks at Crucial. We appreciate your time and look forward to nothing but the best.

James Bell: Oh, thanks.

Robert Morier: If you want to learn more about James and Crucial, please visit their website at www.crucialpartners.com. You can find this episode and past episodes on Spotify, Apple, Google, or your favorite podcast platform. We are also available on YouTube if you prefer to watch while you listen. If you'd like to catch up on past episodes, check out our website at dakota.com. Finally, if you like what you were hearing and seeing, please be sure to like, follow, and share these episodes. We welcome your feedback, as well. James, thank you again for being here. And to our audience, thank you for investing your time with Dakota.