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The Challenges of Managing a Student-Managed Fund

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The 360 Huntington Fund at Northeastern University was inaugurated in 2007. Initial funding came from a combination of donations from alumni and a small grant from the Dean's office. All told, donations equal approximately $250,000. At the midpoint of 2017, the Fund has approximately $850,000. During most of the period, the Fund has outperformed its benchmark.

This article will showcase the achievements of the 360 Huntington Fund and provide a roadmap for schools contemplating introducing their own student-managed funds.

FORMATIVE DECISIONS

Basics

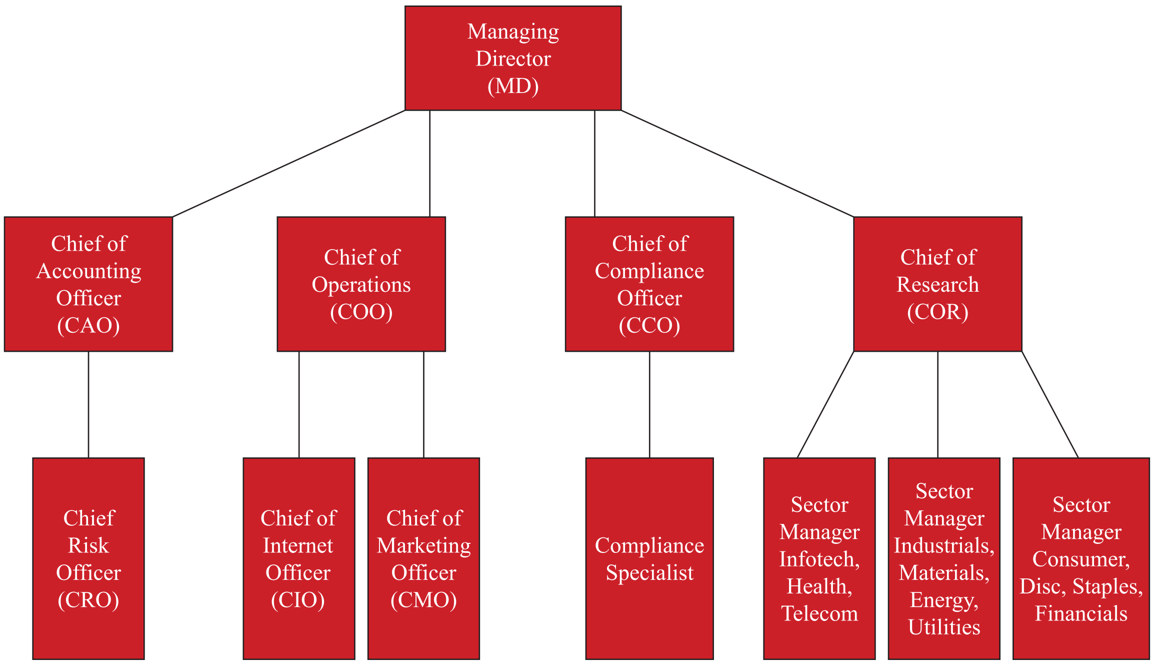
Having decided to create a student-managed fund, the next question is what type of fund that will be. Although we originally contemplated a long–short fund format to push students to be more critical of companies and their outlooks, our donors advised and we agreed that novice investors are ill suited to the task of identifying companies to short. The next issue was whether to permit students to attempt to time the market (go to cash or some cash at times) or to focus on portfolio selection. We chose portfolio selection because our investments and portfolio classes already provide students with a non-experiential overview of those topics and nothing we teach (other than possibly Managerial Economics) is geared to market timing. Finally, we asked about allowing students to buy options, derivatives, or exchange-traded funds (ETFs). The first two security types were rejected due to their higher risk; ETFs were allowed as either place holders to balance the portfolio or to park cash when donations are first received or securities are sold.

Student's Role

From the many possible models for student involvement, we opted for a fully student run design. This design is depicted in Exhibit 1, which shows how students are responsible for all operational aspects of the fund. The only exceptions to this rule are that the faculty 1) request that trades be made and 2) have final authority over decisions. The reason for this decision is simple: We want to teach students how a mutual fund is operated and managed and not how back-office work is conducted.

The most critical student role, as seen in Exhibit 1, is that of the managing director (MD). Since inception, we have had seven MDs. He/she is responsible for virtually every decision made by the Fund. Supporting the MD are the C-level officers, the most

EXHIBIT 1
Organizational Chart of the 360 Huntington Fund



important of whom is the chief of research (CR). The CR manages the sector managers (SMs), who are responsible for training and overseeing the numerous student analysts. The entire hierarchy is designed to move students upward to ever greater levels of responsibility. Our MDs start as analysts, become SMs, and then reach the MD level possibly having served as the CR as well.

Investment decisions always begin with a pitch made by an analyst(s). There are few constraints on the analyst other than to choose a company from a U.S. stock exchange. Many of these analysts are total novices to stock selection and yet the 360 Huntington Fund has a remarkable track record versus both other schools (and our benchmark—see later discussion). We credit this success to the intense vetting process that every stock pick is subjected to. A time-constrained analyst's stock pitch is followed by a far longer and very penetrating review and criticism period by the entire fund cohort. The ordeal is managed primarily by the MD but with the assistance of the CR and the appropriate SM. Analysts are warned that the discussion is not personal and to expect intense review. After experiencing one such debate, an analyst's future stock pitches are improved. We schedule returning student analysts' pitches first to give new analysts an opportunity to observe what to expect and what is expected of them.

We have supported student participation in national competitions between student managed mutual funds for several reasons. The primary one is that students look forward to comparing themselves with other similar teams at different schools and this visit is treated as a reward for their hard efforts. In addition, the interaction with other student teams provides a learning and networking resource. On occasion, the 360 Huntington Fund has revised its operating procedures after learning about another school's methods.

Operational Issues

The most critical issues confronting the 360 Huntington Fund is managing the transition between MDs as the current one graduates and a search must be conducted for the replacement. If the process is managed well, one of the C-level students, such as the CR, moves into the empty position. This process works well, provided that the transition takes place in the fall semester. The reason for this is that the number of students participating in the Fund is seasonal with the highest number being in the fall semester and the lowest number being in the summer. An additional problem is that most graduate students at Northeastern participate in a corporate residency program. Some employers do not permit our students to engage in trading activity, thereby reducing the supply of eligible student candidates for the MD position. This problem affects other management positions held by students as well. Although the 360 Huntington Fund has never had a time when it lacked a MD, on occasion there has been much scrambling to fill the various positions.

A good MD not only drives the research intensity of the security selection process, but he/she also has an important human resource role in cultivating new active participants wanting to accept the mantle of fund management. These two concerns, investment selection and encouragement of new and younger participants, drive the MD selection process.

Security Selection Process

The 360 Fund intends to be fully invested in U.S. equities with temporary cash holdings resulting only from sales and new cash inflows. We hold approximately 30–35 positions at any time. Our benchmark is the broad-based Russell 3000. We occasionally hold an ETF, such as IWV, to provide exposure to the overall market or a sector where we are otherwise underweighted versus the benchmark.

Student analysts are required to make at least one stock pitch to the Fund's management team during a semester. Analysts frequently work with a partner, and additional guidance is provided by one of three SMs. A stock pitch requires both qualitative and quantitative analysis. The qualitative analysis is in the form of a catalyst that motivates the likelihood that a security is undervalued (or overvalued). The quantitative analysis is captured on a standardized Excel template that provides a variety of DCF (discounted cash flow) and multiple-based valuations. Students must decide which of the valuation models are most appropriate for their particular stock. Ultimately, the analysts create a target price and a risk-adjusted alpha that should be substantially positive for a "buy" recommendation.

Analysts have 10–15 minutes to make their pitch. The pitch is followed by a Q&A session that typically lasts another 15–20 minutes. The Q&A session is generally where the most valuable information is revealed. All students have access to the pitch and valuation materials prior to the class session. This means they had time to review the catalysts and valuation assumptions and to do some of their own research on the stock. After sufficient discussion, the managing director will call for a vote of the management team. There are typically five voting managers, and a simple majority is sufficient to accept or reject the analyst's recommendation.

Not surprisingly, most analysts present "buy" recommendations. Over the past few years, approximately 40% of these recommendations were accepted. As the Fund holds very little cash, this means a "buy" must wait for a "sell." Sell recommendations come from two sources. First, analysts can identify a current holding and revalue it. If the new valuation suggests a sell, then the analyst's pitch will be evaluated and voted on. Alternatively, managers can vote among themselves on a sell decision. This commonly occurs when a stock has exceeded its target price or when there has been a fundamental change in the outlook for a stock. There is no mechanical buy or sell trigger.

Once a decision to buy or sell is voted on, the MD will email the specifics of the market order to one of the faculty advisors. At this time, all market orders to buy are standardized at $25,000 total cost. Given the Fund's current size of approximately $850,000, an opening trade represents about 3% of total AUM. The advisor will forward the trades to the University's Treasurer's Office, where the trade will be submitted to the Fund's brokerage account. Why the complex process? At Northeastern, all security transactions must be executed by the Treasurer's Office. Over time, we have refined this process so that recommendations made during an evening class will be executed during the morning of the following day. Faculty advisors have "view only" access to the Fund's brokerage account and can confirm the trade.

Trading for the Fund is relatively expensive: $35 per trade. In the 12 months ending August 8, 2017, the Fund made 23 purchases and 28 sales. The imbalance indicates recent efforts to harvest positions that have reached their valuation targets and to have sufficient funds for buy recommendations during the upcoming academic year.

Portfolio Level Issues

The Fund uses the Russell 3000 as its benchmark. This is a very broad U.S. equity index that was selected to allow analysts to obtain candidate securities from any sector or market-capitalization strata. We measure tracking error versus the benchmark and encourage analysts to identify potential buys from sectors where we are underweighted. For example, at the end of 2016, the Fund was underweighted in health care and financials by 6.2% and 4.7%, respectively. During the first half of 2017, the Fund purchased two new health care stocks and two new financials. This was partly financed by the sale of industrial stocks, where the Fund was overweight by 9.0%.

Trades such as these reduce tracking error and move the portfolio's beta toward 1. However, the Fund's average holding has a smaller market cap than the average of the Russell 3000. This is the primary source of tracking error for the Fund.

PERFORMANCE

Over the 60 months ending in June 2017, the Fund generated a geometric average annual return of 17.97%. This exceeds the 14.59% average for our benchmark, the Russell 3000 Total Return Index. Further analysis indicates that we have low systematic risk. Our beta versus the index was 0.81. The risk-adjusted return, or alpha, was 5.60% annually. This is a good result, but it is clear that we have substantial tracking error versus our benchmark as the R-squared for the 60 month regression is 0.62. Tracking error is 1.77% per month or 6.13% annualized. The resulting IR, or information ratio, is 0.26, suggesting that the Fund is adding value based on relative return to relative risk. Year-by-year results are presented in Exhibit 2.

In sum, the Fund has a strong track record over the five-year period ending in June 2017. While the Fund's analysts have done an excellent job over that period, it is clear that the Fund has substantial tracking error versus its benchmark. A Fama–French three-factor model indicates that the Fund has significant exposure to small-cap equities but no significant bias toward value or growth.

EXHIBIT 2
Year-by-Year Performance Results

Year	Fund Return	Russell 3000 TR Return
2012–2013	28.12%	21.46%
2013–2014	29.24%	25.22%
2014–2015	15.35%	7.29%
2015–2016	–1.38%	2.14%
2016–2017	21.29%	18.51%
Geometric Avg.	17.97%	14.59%
Std. Dev.	10.01%	9.71%
Beta	0.81	
Alpha	5.60%	

Notes: Each annual period ends in June. All statistics are annualized.

ONGOING CHALLENGES

The primary challenge that persists for the Fund is continuity of management. This is a challenge for every student-managed fund. The median term for the managing director is one year. The median analyst stays for about the same period. This means the Fund must emphasize training, particularly for analysts. We budget one class session at the beginning of each semester to review the Fund's valuation models and sources of data to support equity analysis. New analysts are mentored by continuing analysts.

Our initial goal was to give students the opportunity to acquire experimental knowledge to supplement their course work knowledge and thereby acquire better jobs and coop opportunities. Over the time the Fund has operated, we would conclude that the goal has been met. Students have been welcomed by many investment companies.