Manager Selection

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Cornell University
Show of Hands

Do you think that institutional investors add value from their manager selection decisions?

Yes, No or I Don’t Know
Today’s Discussion
1. Business people rewarded once assets arrive, and stick
2. Portfolio managers rewarded once they outperform their benchmarks
What is Reward for Clients?

Wouldn’t it be interesting…

to collect all the hirings and firings of investment managers, determine why these decisions were made, and whether or not they added value?

And use the results to improve the industry…
Today’s Topics for Discussion

1. Scott’s research (2007 on)
2. Key book observations (2013/14)
3. Key takeaways
Scott’s Three Research Studies

1. Institutional manager selection process (1985-2000)
3. Survey of institutional investor decision process (2004...)
First Two Studies—Research Design

Examine flows between managers

1. Explain flow activity
2. Test subsequent performance

Informa database: Returns & Characteristics on over 7000 Inst'l Products
Informa Database—Asset Levels

**Assets in Billions**

Total grew to exceed $10 trillion by 2007

FYI: Asset Flows represent 10% per year on average
Results of First Study: Drivers of flows

Asset and Account Flows:


Institutional investors

1. rely on benchmark-relative performance, not simply total return
2. are not overly focused on short term results
3. pay attention to style, but do not necessarily adjust for style extremeness
4. rely on return pattern more than simply cumulative returns
5. require more evidence before terminating an account
Basic Question: Do institutional investors add value from changing manager allocations?

Statistical results suggest…

Managers who receive contributions tend to under-perform managers who experience withdrawals

Based on over 80,000 annual observations between 1985-2006
Subsequent Performance—WEIGHTED Results

% Difference in Performance:
FLOW Weighted and ACCOUNT Weighted Portfolios of Managers
(1985-2006)

<table>
<thead>
<tr>
<th>Difference in Annualized Returns</th>
<th>1-year</th>
<th>5-years</th>
<th>1-year</th>
<th>5-years</th>
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<tbody>
<tr>
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FLOW-WEIGHTED

ACCOUNT-WEIGHTED

NOTE: Collectively, plan sponsors are losing billions of dollars a year through their manager allocation decisions!
Part Two of Second Study: Sources

Key Question: Which decisions lose value?

• Are they good at setting asset allocation but not at manager selection?

• Do they add value at the category or style level but destroy value once it is implemented?

Statistical results suggest…

Investors lose value at the style and mostly manager selection decision levels, and a little in the short term from asset allocation decisions.
Sources of Loss of Value—One-Year Periods, 1986-2006

Brinson Analysis: Category versus Product Selection

Category | Product | Interaction
---|---|---

-0.8 | -0.7 | -0.6
-0.5 | -0.4 | -0.3
-0.2 | -0.1 | 0

Legend: Category, Product, Interaction
Current Study: Survey of Plan Sponsors

1. Confirms many research results
2. Identifies non-performance criteria
   - Communication skills
   - Reputation
   - Consultant input
3. Mixed perceptions of investment performance
Summary of Other Survey Results

- Plans with consultants and higher education levels turn plans over to a greater extent.
- More “functional” plans evaluate decisions to a greater extent, have fewer asset classes and higher turnover.
- Tainted managers are terminated to a greater extent by public plans, yet only if performance is poor.
Book’s Key Observations
Other Research Studies’ Results

1. Using institutional data
   - Confirm Scott’s results
   - Identify evidence of statistically significant manager skill and persistence in consistency

2. Using mutual fund data
   - Limited evidence of statistically significant manager skill (table 2.7)
   - Limited evidence of persistence (table 2.9)
   - Some evidence of short-term manager selection skill

\[ rp = \alpha_p + \beta_p R_f + \beta_p (R_M - R_f) + \epsilon_p. \]
What did Scott learn from Manager Selection?

1. Active manager skill does exist.
2. It is very difficult to identify skillful managers (after fees) in advance, especially in public markets.
3. In some cases, the effort may be worthwhile.
4. There are things we can do to improve results.
In addition to information on the record of active management and manager selection…

- The arithmetic of active management
- Index fund selection
- Mixing fund managers
- Lists of guidelines and key recommendations
- Excel tools
- Bibliography
Cool Summary of Research on Qualitative Factors

Exhibit 2.2. Correlation between Manager Characteristics and Subsequent Performance Based on Investment Performance or Company Financial Performance

<table>
<thead>
<tr>
<th>Factor</th>
<th>Relationship</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Intelligence</td>
<td>Positive</td>
</tr>
<tr>
<td>2 Knowledge</td>
<td>Neutral to positive</td>
</tr>
<tr>
<td>3 Focus</td>
<td>Neutral</td>
</tr>
<tr>
<td>4 Long-term thinking</td>
<td>Positive</td>
</tr>
<tr>
<td>5 Independent thinking</td>
<td>Positive</td>
</tr>
<tr>
<td>6 Alignment of interests</td>
<td>Positive</td>
</tr>
</tbody>
</table>
### Cool Summary of Research on Manager Success

#### Exhibit 9.2. Evidence of Alternative Investment Alphas Based on Results from Four Research Studies

<table>
<thead>
<tr>
<th>Evidence</th>
<th>US Equity Mutual Funds</th>
<th>Fund-of-Funds Hedge Funds</th>
<th>Venture Capital</th>
<th>Private Equity</th>
<th>Real Estate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Evidence of positive average net alpha</td>
<td>Zero</td>
<td>Marginal</td>
<td>Mixed</td>
<td>Mixed</td>
<td>Marginal</td>
</tr>
<tr>
<td>Evidence of superior managers</td>
<td>Limited</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Limited</td>
</tr>
<tr>
<td>Evidence of alpha persistence</td>
<td>Limited</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Limited</td>
</tr>
<tr>
<td>Evidence of flows to positive-alpha managers</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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</tbody>
</table>
Book’s Key Recommendations
Recommendations for Plan Sponsors

1. Don’t follow fashion…seek valuation
2. Know difference between deep value and relative value
3. If everyone wants you to fire manager, ask yourself if you’re selling at the bottom
4. Evaluate your process, not just your current managers
5. Look at managers’ portfolio construction
Observations for Managers

- Your clients may select you simply because your track record (style may not be adjusted for fully) looks good
- They may give up on you when short term performance is poor
- There’s a good chance this decision is a mistake
- Keys: know your client and develop good communication
Recommendations Regarding Communication

- Communicate frequently, begin by managing expectations
- Communicate more if performance weakens
- Demonstrate, and then explain
  - Why performance weak
  - Portfolio characteristics & performance consistent with process
  - Performance tends to reverse
    - Good followed by weak
    - Really good followed by weaker
Business Recommendations

Pick an attractive asset class

Hire skillful managers
  – *Bright & knowledgeable*
  – *Focused*

Structure appropriate incentives
  – *Long term view*
  – *Independent decision making*
  – *Alignment of interests*

Understand portfolio construction
Final Recommendation

NEW RESEARCH RESULTS:
- Survey of Plan Sponsors
- Perceptions on confidence, importance to study process performance and control variables
- t-stat on “importance to study process performance” = 0.089

KEY RECOMMENDATION: **Evaluate your process,** not just your current managers
Manager Selection

Thank you
Scott’s Contact Information

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Appendix
More on Drivers of flows

1. Most assets flow to managers with good one, three and five-year numbers
2. Poor one-year number not a big problem
3. A really bad one-year number is
4. A poor 5-year number not a big problem if one and three-year numbers good
FAJ Study: DATA

- 1985-2006, over 80,000 annual observations
- Equity, fixed, international & global
- Industry assets grew from $320 B to $13.5 T
- Includes mutual fund data in later years
- Tested for survivorship bias
Initial Analysis: Subsequent Performance—QUINTILE Results

% Difference in Performance:

These results are statistically significant.
Collectively, plan sponsors are losing billions of dollars a year through their manager allocation decisions!
Third, Survey Study test for perception on investment performance

Results suggest apparent inconsistency between perception and reality.

<table>
<thead>
<tr>
<th>Topic</th>
<th>t-stat</th>
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<tbody>
<tr>
<td>Disagree Performance Deteriorates</td>
<td>4</td>
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<tr>
<td>Believe Manager Performance Good</td>
<td>10</td>
</tr>
<tr>
<td>Disagree Performance Improves</td>
<td>4</td>
</tr>
</tbody>
</table>
So…What’s Going On?

• Respondents agree they evaluate subsequent performance of decisions and believe their decisions are appropriate and effective

• *Yet the More Experienced See It*
  Some respondents seem to appreciate performance reversals to a greater extent
Performance Chasing May be a Problem

1. 98% believe returns are important
2. 85% require minimum of 3-yr record
3. Anticipated changes in asset class allocations correlated with trailing returns
Average Manager Turnover

High Level of Performance Chasing: 6.4%
Low Level of Performance Chasing: 4.8%

Percentage Disappointed with Supplier Performance

High Level of Performance Chasing: 12.0%
Low Level of Performance Chasing: 10.0%

$t = 2.4$ Not statistically significant
Sample References

Presentation based upon:


References:


