INVESTMENT BRIEF

Q1 2016

Strategic Investment Group®

Common Pitfalls of Hiring and Firing Managers

Of the tools available to add value to institutional portfolios, identifying superior active investment managers is the most important. Yet the academic literature is unequivocal that the average institution does not add value through manager selection. Often the problem is traceable to poor hiring and firing decisions. Indeed, there are innumerable ways to go wrong when making such judgements, as manager selection is fraught with uncertainties about not only the managers themselves but also the market environments in which they compete. For institutional investors lacking the requisite skills, tools, experience, and temperament, manager replacement is a virtual minefield.

Many investors treat changing managers as if it were cost-free, but it can be very expensive. Failure to get manager decisions right hurts performance directly, of course, but the costs do not stop there. Manager turnover consumes management attention, staff time, and legal resources, and transitioning from one portfolio to another increases transaction costs. Then there are the opportunity costs of foregone added value from wrong manager choices. All of these costs compound themselves when investors fall into a self-defeating cycle of manager churning, habitually replacing poorly performing managers with others who also disappoint.

Given the centrality of judicious manager selection to successful portfolio management, we have undertaken a thorough review of the literature on manager hiring and firing decisions by institutional investors. We have extended the analysis of the academic studies by undertaking an in-depth look at Strategic's own track record of hiring and firing managers over the past 10 years. Happily, Strategic has fared better than the comparison institutions, adding significant value to client accounts through selection of managers.

Academic Research and Strategic's Results

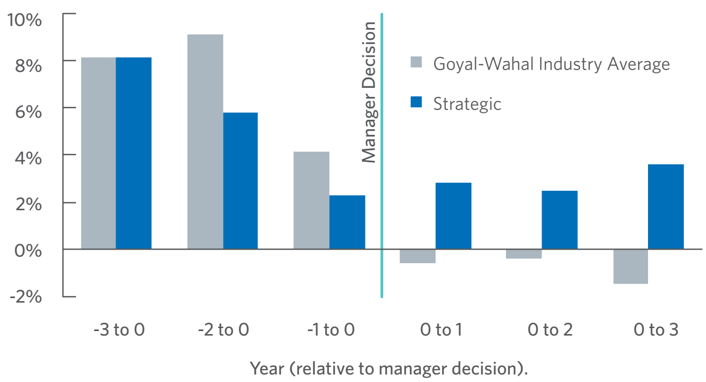
In their 2008 paper, Goyal and Wahal provide the most comprehensive direct analysis of institutional investors' manager decisions. They studied hiring and firing decisions as well as the combined performance of fired managers and their replacements. Their analysis found return-chasing behavior and concluded that "plan sponsors have no timing ability." Managers were hired after a period of outperformance, but failed overall to add value in the years after hiring. Managers terminated for poor performance typically rebounded to generate excess returns within three years after termination.

Combining the returns of fired managers with those hired to replace them, the study found that the average manager transition destroyed value. Goyal and Wahal demonstrated that the managers hired by institutional investors outperformed those fired in the years prior to the decision (as represented by the gray bars of the chart). In the years following the decision, however, terminated managers on average outperformed their replacements. This finding suggests that the institutional investors studied detracted from performance in their attempts to identify hot managers.

Strategic's experience stands in contrast to that of the average institution in the academic literature. Our hired managers continued to outperform the managers they replaced over the three years following our manager decisions (as illustrated by the blue bars). This performance has been a major contributor to Strategic's value added over the years.

Exhibit 1: Net Added Value from Manager Replacements

Sources: Goyal and Wahal (2008) and Strategic



Common Pitfalls

Of all the pitfalls in replacing managers, one of the most prevalent is a misplaced faith in timing ability, a form of hubris often confounded by unexpected manager or market behavior. Institutional investors tend to be impatient, overreacting to short term underperformance and contributing to a pattern of return chasing. Institutions also suffer from a related bias toward action, which prompts decision makers to replace underperforming managers too hastily, before they have a chance to recoup lost alpha. This bias is often compounded by episodic governance in which decisions are artificially constrained by the calendar of committee meetings. Rigid rules, intended to provide an objective framework by substituting mechanistic policies for fallible judgement, tend to reinforce a backward-looking approach and contribute to return-chasing.

Strategic tries to sidestep these hazards, not by avoiding judgement but by embracing and improving it. We maintain a focus on a manager's forward-looking prospects for value added, relying on our in-depth understanding of how the manager is likely to perform in different market environments. Difficult decisions about manager replacements are informed by careful due diligence, experience, and advanced analytical tools for identifying manager skill. We find that avoiding the pitfalls of manager selection and the costs of counterproductive manager turnover is essential to preserving manager selection as the most important means of adding value.

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