Strategic Investment Group®

Fiduciary Insights

COMMON PITFALLS OF HIRING AND FIRING INVESTMENT MANAGERS

INVESTORS, BOTH RETAIL AND INSTITUTIONAL, HAVE A POOR TRACK RECORD OF HIRING AND FIRING INVESTMENT MANAGERS. Consequently, they incur significant costs in terms of time, transaction fees, and missed opportunities. This edition of our Fiduciary Insights series considers the common difficulties of hiring and firing investment managers and contrasts our track record with the poor performance of many other investors.

Introduction

"It is the long-term investor, he who promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks. For it is in the essence of his behavior that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy."

-John Maynard Keynes, 1936

In addition to being a pioneer in economic theory and one of the main architects of the post-war global monetary system, John Maynard Keynes was also a successful investor who understood well the mistakes to which many institutional investors fall prey. As the above quotation suggests, the root of these mistakes is behavioral, involves poor governance, and includes the tendency of investors to herd together and chase returns. Those who take a long-term, counter-cyclical perspective, in contrast, should over time benefit from superior performance and contribute to the public interest by being a steadying influence during booms and busts. These investors should nevertheless be prepared to bear the opprobrium of the herd for breaking with convention.

Investors are forever seeking ways to beat the market, knowing that a steady stream of incremental value added, compounded over many years, can make all the difference in meeting their long-term investment objectives. Identifying superior active investment managers is the most important of the few available tools to add value to institutional portfolios. Yet the academic literature is unequivocal: the average institution does not add value through manager selection. A major contributor to this poor track record is the tendency of investors – both retail and institutional – to flock to managers following periods of strong performance while fleeing those that have recently underperformed.

Many investors treat these manager changes as if they were cost-free, but they 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 value added from wrong manager choices. All of these costs are compounded when investors fall into a self-defeating cycle of manager churning, habitually replacing poorly performing managers with others who also disappoint.

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 ten years. Happily, Strategic has fared better than the other comparison institutions, adding significant value to client accounts through manager selection.

Academic Findings Paint a Bleak Picture

The most comprehensive direct analysis of institutional investors' manager decisions is a Journal of Finance article by Amit Goyal and Sunil Wahal (2008). They studied hiring and firing decisions as well as the combined performance of fired managers and their replacements. Their data set encompassed thousands of hiring and firing decisions driving over $700 billion in flows among managers. The analysis tracks the performance of managers for three years before and after the decision to hire or fire. 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

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Other studies of institutional decision making support Goyal and Wahal's findings. Stewart et al. (2009) also find that plan sponsors' reallocation decisions detract from performance. Bad timing decisions related to style rotation and manager selection undercut returns, as newly funded investments subsequently underperformed those experiencing withdrawals. They conclude that, "much like individual investors who switch mutual funds at the wrong time, institutional investors do not appear to create value from their investment decisions." Taking a slightly different tack, Elton, Gruber, and Blake (2007) study plan sponsors' changes in the manager line-up of 401(k) plans. They too find evidence of return chasing as a motivation for manager changes. Their results suggest that those managers replaced subsequently outperformed those newly added.

Strategic's Comparative Record of Manager Selection

We have applied Goyal and Wahal's analytical methodology to Strategic's track record of hiring and firing active managers over the past ten years. Strategic's experience stands in contrast to that of the average institution in the academic literature. Three years after a manager change, the average institution had destroyed 1.4% in returns (gray line of below Exhibit). In contrast, the managers hired by Strategic outperformed the managers they replaced by 3.5% over the three years following our manager decisions (blue line of Exhibit).

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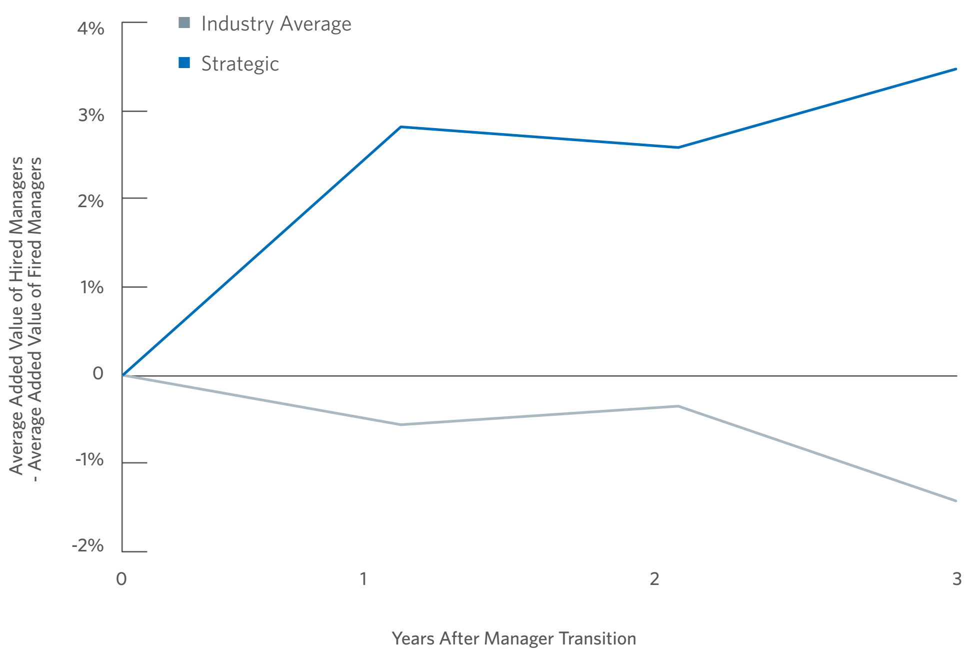
EXHIBIT:

Cumulative Benefit of Replacing a Manager

Sources : Goyal and Wahal (2009) and Strategic.



Past performance is not a guarantee of future results. Industry average analysis is sourced from Goyal, Amit, and Sunil Wahal, The selection and termination of investment management firms by plan sponsors, The Journal of Finance 63.4, p. 1805-1847 (2008). Strategic analysis is based on internally maintained data of third party active manager selection decisions made in discretionary client portfolios for the ten years ending December 31, 2015. Data is specific to liquid asset classes only for both the industry and Strategic averages. Excluded are certain legacy managers as part of new client onboarding and/or policy transitioning, as well as other terminations that were not deemed to be a "manager" decision because of their non-volitional nature. More information regarding the specific methodology applied to the analysis is available upon request.

We make manager selection a central pillar of our investment process because we believe it encompasses a broad and rich set of opportunities to add value. The value added from manager selection captures all of the security selection and other decisions taken by active managers. Other potential sources of value added offer fewer independent decisions and thus represent less fertile ground for achieving above-market returns. Tactical asset allocation decisions responding to valuation anomalies across asset classes, for example, are episodic in nature and provide a much narrower opportunity set. Decisions to favor attractive market segments within each asset class provide a somewhat richer opportunity set and are less episodic than tactical asset allocation, but still lack the full breadth afforded by manager selection. In addition, it is more likely possible to generate a superior information advantage, or "edge," in bottom-up micro decisions than top-down macro decisions.

We strongly prefer seeking to add value from a large and diversified set of sources over relying on relatively few, sweeping decisions. By selecting skilled active managers with complementary investment processes, we strive to tap into a broad set of highly informed, independent decisions, thus helping to dampen risk and boost the information ratio (the ratio of value added to active risk) of investment portfolios. Through our history, manager selection has been an important source of value added, while asset allocation decisions and asset class structuring have played a significant but supporting role.

Long-term Investing Boosts Returns and Global Financial Stability

Return chasing is not limited to manager selection, but is also evident in asset allocation decisions and style shifts, with equally deleterious effects on investment returns. Avoiding return chasing in all its guises can have a favorable impact on returns and contribute to broader social goals as well.

Economists at the International Monetary Fund (2015) have analyzed the widespread phenomenon of return-chasing behavior by asset owners through the prism of global financial stability. One recent analysis, Jones (2016), finds that the asset allocation decisions of the investors studied (global central banks, U.S. pension funds, life insurers, endowments and foundations) were pro-cyclical as a result of a failure to rebalance portfolios regularly as well as active return chasing over multi-year periods.

In addition to detracting from investment performance, such pro-cyclical behavior was found to undermine global financial stability. By chasing returns rather than heeding valuations, investors amplify market volatility, contribute to the creation of speculative bubbles, and compound the excessive and prolonged retrenchment from risky assets that follows the bust.

A more countercyclical approach to asset allocation driven by an assessment of long-term relative valuations, thus has a "double-bottom line" benefit of generating better investment outcomes for asset owners while also reducing an important source of financial instability. As Keynes observed, long-term, countercyclical investors contribute to the public interest.

Avoiding Pitfalls, Adding Value

One of the most common pitfalls of manager replacement 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 thus falling prey to a pattern of return chasing. They are especially prone to impatience if they feel that the herd is leaving them behind.

Impatience is also evident in the preference of many institutional investors for relying on a few large bets to try to add value. For these

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investors, a strategy that swings for the fences, even if the probability of a home run is low, is more satisfying than a sustained string of singles and doubles. Impatient investors forget that a steady, incremental approach that relies on a large set of largely uncorrelated sources of value added has much higher odds of success in the long run, while avoiding spikes in portfolio volatility.

Institutions also suffer from a related bias toward action, which impels 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 further contribute to return-chasing.

Strategic tries to sidestep these hazards. Rather than chasing returns, Strategic seeks value in the belief that price will ultimately follow. As Keynes and others have noted, a long-term approach to investing driven by relative valuations improves the chances of generating above market returns, while also dampening asset price boom/bust cycles created by return chasing and herd behavior.

Strategic also avoids swinging for the fences, preferring a steadier approach of consistently hitting singles and doubles. Just as assembling a roster comprising only batters who swing for the fences is not a winning strategy, skilled manager selection is in itself not sufficient for consistently adding value over time. It is equally important that the expected value added from each manager be uncorrelated with and complementary to the other managers in the portfolio. Structuring a portfolio's manager line-up so as to minimize the expected correlation of value added also helps manage portfolio risk. By focusing on a series of complementary, sensibly scaled decisions, this approach increases the likelihood of developing a steady and persistent track record of strong risk-adjusted performance.

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 replacement are informed by careful due diligence, deep 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 adding value consistently over time.

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Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

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