Strategic Investment Group®

Fiduciary Insights

BEYOND MANAGER BEAUTY CONTESTS

AT THE END OF THE MANAGER SELECTION PROCESS, MANY INVESTMENT COMMITTEES CONDUCT A FINAL ROUND OF INTERVIEWS, THE SO-CALLED "BEAUTY CONTEST," DISLIKED BY MANY MANAGERS BECAUSE OF ITS SUPERFICIALITY. This method of selection can be dissatisfactory for sponsors, as well. It misdirects fiduciary oversight, relieves consultants of accountability, and is symptomatic of incomplete and ineffective delegation of fiduciary responsibility.

The Master of Ceremonies

At many pensions, endowments, foundations, and other such organizations, the search for a new investment manager often ends with a round of brief interviews in which the finalist managers are brought before a panel of fiduciaries for final selection. The format of the interviews has been compared to that of a beauty contest, often by managers who must run such gauntlets routinely in their efforts to win new business. Although these reviews are standard practice in the investment management industry, few fiduciaries openly question their effectiveness in identifying the best managers.

The master of ceremonies of a typical manager beauty contest is the fiduciary's consultant, who controls each of the three critical phases of the manager selection process. In the first phase, the consultant defines the mandate, usually by drafting a request for proposal that focuses the search and limits its scope to a certain style or type of investment strategy. In the second segment, the consultant screens the universe of eligible managers to arrive at a short list of qualified candidates. In the third stage, the consultant conducts a review of the finalists by a committee of fiduciaries who authorize the selection.

A skillful consultant makes sure that all of the finalists presented to the committee are acceptable, conforming to the published guidelines of the search. No embarrassing discoveries should be made by the fiduciaries at this stage. Since all of the managers are qualified and vetted, the only task remaining for the fiduciaries is discerning amongst moderate differences between the contestants. If the fiduciaries follow the consultant's lead, those differences will be just about their only basis for decision. The interviews are usually brief, sometimes just 15 to 20 minutes, squeezed on the agenda and constrained by time.

The beauty contest approach to manager selection has several implications. One obvious feature is that it puts the lion's share of control into the hands of the consultant, at the expense of the fiduciary committee, but leaves ultimate accountability at the committee level. The consultant's central role is evident throughout the selection process — in defining the mandate, screening the candidates, and directing the beauty contest.

In a candidate elimination process, the decisions that most severely limit the field of candidates are made early on, in defining the mandate and screening candidates. The most options exist and are discarded at the earliest stage — usually by the consultant or his firm. The power to exclude many candidates and strategies at the beginning of the process can be more determinative than the power to select from a few, similar survivors at the end.

The ostensible involvement of the committee at the final interview does not diminish the dominant influence that the consultant exercises early in the process. Once eliminated, the strategies and investment managers dismissed by the consultant are not normally reintroduced for consideration. Despite having this dominant influence, the consultant does not have full accountability for the result of the manager selection. The committee transfers the burden of accountability from the consultant back to the committee.

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Conflicts of Interest

Given this concentration of control in the hands of the consultant, the beauty contest approach to manager selection presents opportunities for agents to abuse their delegated power. "Pay to play" arrangements between consultants and managers are an example of the conflicts of interest that can compromise unsupervised gatekeepers operating in a lucrative business - especially when the business-seekers are paid better than the gate-keepers.

The pecuniary temptations increase when consultants double as vendors, offering products and services to the very managers they screen. Managers who "purchase" these products and services may get preferred status from the consultant, when they should be automatically excluded from consideration for mandates.

Good Polish Versus Good Process

The format of beauty contests creates a natural bias toward presentation skills at the expense of the investment process. Moreover, the vetting done by the consultant gives the fiduciaries the feeling that the risk of making a mistake has been removed. Since every manager is acceptable and qualified, the only thing left for the committee to decide is how well each manager presents. Visible presentation skills tend to overshadow unseen investment skills. In a beauty contest, good polish is at least as important as good investment process.

The beauty contest format does not allow the committee members the time to explore many details. The short interviews do not offer the opportunity to delve deeply into the manager's experience, investment process, organization, philosophy, product development capabilities, compensation arrangements, trading procedures, and many other details of due diligence. The fiduciaries often do not take the opportunity to visit the manager's place of business and meet members of the staff other than those presenting to them at the finals.

The losers of the beauty contest are not just the finalist managers who failed to impress the committee, but also those managers who were screened out before the finals. Emerging firms with short track records or low assets under management often do not even make it to the finals, nor do promising but unconventional strategies that do not fit into consultant style boxes. The biggest losers of all are the fiduciaries, who do not get a chance to consider managers and investment options that might add substantial value, but that the consultant did not think would show well.

Keeping Control of the Wrong Things

In effect, a beauty contest represents the last chance for an investment committee to supervise the work of the consultant, who has been delegated the meaningful details of the manager selection process. This delegation is necessary and proper. Committees running beauty contests should surrender control of these details, so that they can focus on more important areas of their fiduciary responsibility, such as asset allocation policy. But beauty contests keep fiduciaries improperly and ineffectively involved in manager selection, and their involvement diverts energy and attention away from high-level issues and dilutes accountability.

An Alternative to the Beauty Contest

Manager beauty contests are symptomatic of a larger and more important problem — the incomplete delegation of fiduciary responsibility by an investment committee. Rather than maintaining the false appearance of being in control at the manager level, fiduciaries would do better to focus on policy while completely outsourcing manager selection. Explicit and complete delegation of the entire function of manager selection is better than partial delegation and restores clarity of accountability.

The trust that the fiduciaries place in the advisor is the key issue. Certainly, full delegation of manager selection requires more trust in the third-party advisor, not less. Therefore, the task should not be de-linked from accountability for investment performance, as is frequently the case when consultants act as agents rather than fiduciaries themselves. Moreover, the client's fiduciary committee should focus its own due diligence on the selection criteria and process and the investment insight offered by the firm to whom they delegate this responsibility. The committee's attention at an earlier stage and higher level of oversight will ultimately be much more critical than reviewing the fine variations between a set of pre-screened finalists.

In the end, an organization ready to exercise full selection authority, with long experience in handling this responsibility and with full accountability, should select managers. This arrangement frees fiduciaries to concentrate on the higher level policy decisions that they need to make and relieves them of a time-consuming, but ultimately unproductive, responsibility. In sum, the fiduciaries can improve the manager selection process — by delegating it fully and getting out of show business.

Strategic Investment Group

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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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