PACIFIC CURRENT GROUP

# MANAGER EVALUATION: CUTTING THROUGH THE NOISE

**A new framework for investment manager evaluation decoupled from past performance.**

## By Paul Greenwood, CFA

Since the dawn of investment manager evaluation, investment managers have been subjected to all manner of scrutiny in an effort to discern which of them are likely to deliver strong results. The effectiveness of manager evaluators varies considerably, although many employ processes that, at a high level, are quite similar.

The typical process begins with someone running screens to identify firms with strong historical performance and a minimum amount of assets under management in order to narrow the universe of managers to a manageable number to subject to additional scrutiny. Sometimes this scrutiny is truly rigorous; however, all too often little such analysis is performed, and past performance plays an excessively prominent role in the selection process.

### Manager Evaluation = Manager Forecasting

Regardless of how one approaches manager evaluation, one thing is clear: the selection of an active manager is inherently an exercise in forecasting. Implicitly or explicitly, one's willingness to pay active managers' fees suggests that they expect a better outcome than using an inexpensive passive alternative.

So, if manager evaluation is actually an exercise in manager forecasting, then the question becomes, "what can we observe today that will give us insights into this manager's ability to meet or exceed our risk/return objectives over the long haul?" If there is nothing that sheds light on the future, then active management is hopeless. If there are predictive attributes we can identify, then what are they and how can we evaluate them?

We believe that successful investment managers share a variety of different investment, organizational, and personality characteristics that can be identified on an ex ante basis, thereby tilting the odds of success in your favor.

### Why is past performance of such little value?

Most people start their quest for talented managers by screening past performance. They do this because 1) it is readily available, and 2) try as we might, it is hard to divorce ourselves from the feeling that past performance must be highly predictive, even though the empirical evidence tells a different story.

A brief discussion as to why past performance isn't a good predictor of future results is in order. We start with the contention that active management is inherently a low signal-to-noise ratio business. In other words, a manager's active risk (i.e., the extent to which performance differs from the benchmark) is composed of two parts, "signal" and "noise." Think of the signal as the unique insight or skill a manager possesses and noise being all the rest of the performance unrelated to skill. Generally, noise reflects systematic exposures to certain factors or portfolio attributes as well as just sheer randomness (i.e., luck). This noise tends to drown out the signal over short to intermediate periods. Moreover, the noise component has a tendency to be mean reverting, which means that if you are using past performance to identify investment managers, you are more likely to be sorting managers based on which ones have been the biggest beneficiaries of noise rather than which ones possess the most skill.

To illustrate, imagine two large cap core managers. Within the broad large cap universe, Manager A emphasizes quality (i.e., low debt and high return on equity) and earnings stability. As a result, its portfolios tend to gravitate to certain economic industries like consumer staples and drug stocks. Manager B attempts to identify inexpensive companies likely to experience meaningful improvements in their earnings, which naturally leads it to invest in more cyclical areas like technology or materials and processing. Given that both managers are quite committed to their respective philosophies, the "habitats" in which their portfolios are concentrated tend to be quite predictable.

Now imagine we have had a market environment that strongly favors Manager A for two or three years, and as a result, its short- to intermediate-term performance now looks much better than Manager B's. Those looking to hire a large cap core manager will be more impressed with Manager A's results, even though it is likely that its habitat within the large cap core universe has become relatively expensive compared to Manager B's habitat. The all too common result is that Manager A is hired, just in time to experience the relative underperformance that occurs not due to an absence of skill but rather its habitat within the broader large cap core universe.

The following table provides a real-life example of the impact that habitat can have on manager performance. We use two sub-indices of the Russell 1000® Index and look at their performance for different annualized periods ending September 30, 2017. These sub-indices are meant to proxy two common habitats in which large cap core managers focus. While the long-term results of these indices are similar, which type of manager was more likely to shine over the last year? Also, how well do you think evaluators, clients, and prospects adjust for the noise associated with these different habitats?

| | 1 Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|
| **Russell 1000 Defensive Index®** | 15.0 | 10.2 | 13.3 | 7.7 |
| **Russell 1000 Dynamic Index®** | 22.0 | 10.9 | 15.2 | 7.1 |

Source: Russell Investment Group. Data as of 9/30/2017.
Performance figures for periods greater than one year are annualized.

By not fully understanding the extent of noise in a manager's habitat, investment manager clients leave themselves susceptible to buying high, selling low, and then feeling like luck has abandoned them.

Another very simple explanation for the lack of predictivity in past performance is that the conditions that produced prior results may have changed. Unless the evaluator has a strong sense for what has driven performance over time, there is great risk of assuming that the conditions that produced previous results are still present. For instance, many times a firm's strong track record may largely be attributable to the skills of one key person, such as an analyst, who has left the organization. It is entirely possible that people reviewing the team's strong performance will attribute the stellar results to the existing team, and thus assume comparably impressive results are to be expected in the future.

## What makes a good manager?

In our view, capital markets are highly, but not perfectly, efficient. To succeed over the long-term, investment managers must possess sustainable competitive advantages. Many active managers simply don't have any such advantages and would thus be expected to produce market-like returns over time, before considering their fees and transaction costs. We contend that there are plenty of investment firms with sufficiently strong competitive advantages to allow them to outperform over time and more than justify the fees they charge. We lump these advantages into three broad families:

1. *Information* – This is perhaps the most obvious source of advantage. If a person or investment process can consistently identify proprietary information that provides insights into a company's future, it can be a powerful source of excess returns. That said, in our Full Disclosure world, systematically uncovering such impactful new information isn't easy or cheap.

2. *Interpretation* – For the most part, investors investing in developed markets all have access to the same staggering amounts of information. How one filters through this information, identifies what is relevant, analyzes financial data, and assesses what forecasts are implied in current market prices is ultimately the most likely source of competitive advantage.

3. *Implementation* – Considerable value can be gained or lost based on how a firm captures the insights it generates. The most obvious example would be through efficient trading practices, though the manner in which investment managers make decisions also falls within the realm of implementation and can be even more impactful on results.

These "Three I's" sound like independent and distinct types of advantages. In reality, these categories are inexorably linked and difficult to disentangle. For example, many firms focus on trying to uncover relevant pieces of *information* before others learn of them, yet because the value of such information may be short lived, the ability to quickly and accurately *interpret* and then *implement* this insight is crucial to success.

To address this challenge, we apply the following simple conceptual framework to the managers we evaluate:

1. **What does the manager believe and what is its investment process?** – An essential prerequisite to evaluating an investment manager is developing a thorough understanding of its investment philosophy and process. Understanding the origin of the philosophy and process and how they have evolved over time provides context for the evaluator's analysis.

2. **What must they do right/well to be successful?** – Once investment philosophy and process have been explained, our next question becomes, "Given their philosophy and process, what do they need to do right to be successful?" In other words, what "Success Factors" are likely needed to excel with this investment strategy? This is the point in the process where we are essentially determining the relative emphasis that should be placed on the different organizational and investment process elements that give rise to and perpetuate a manager's competitive advantages.

   Answering this question well requires the evaluator to have an understanding of how capital markets work, knowledge of relevant academic literature, sound economic intuition, and experience gleaning the common threads among successful/unsuccessful firms and strategies.

   For example, imagine an investment manager that employs a process focused on identifying companies undergoing significant, positive fundamental change that will result in rapidly accelerating earnings. This is a reasonable strategy and most elements of it are well supported by considerable academic research.

   With such processes, prolific idea generation is necessary because the average holding period is short (typically 6 to 12 months); the need for new ideas is great. Research timeliness is relatively more important than research depth because the type of developments that will drive earnings acceleration tend to get impounded in stock prices rapidly. A strict and emotionless sell decision is imperative because the more rapid growth of these companies results in higher expectations and higher valuations, thus greater downside risk. Given the higher portfolio turnover that accompanies such a strategy, a streamlined decision making process is critical and probably is best facilitated by people working in an open environment (i.e., not in separate offices).

Imagine another manager on the opposite end of the style continuum, a deep value manager. This manager employs a process trying to invest companies selling at very low valuations, which have most likely delivered disappointing earnings for a lengthy period of time. Over time, the manager expects earnings to revert to “normal” levels. This very classic approach to value investing has been employed by many successful firms and the academic research supporting it is voluminous.

Finding stocks selling at low valuations is a simple exercise, but determining if a company is undervalued is another thing altogether. Companies that fall into the universe of deep value stocks are typically ones that have stumbled. Investment managers must determine what has led to the stumble, what company management plans to do about it, and how likely they are to succeed in improving results. Because deep value managers are so valuation driven, they have a tendency to invest too early (while fundamentals are still eroding) and sell too early (when stocks hit their estimate of “fair value”), which makes the management of these timing risks a critical success factor.

The undervaluation of deep value companies tends to be recognized gradually, which leads to longer holding periods (24 to 60 months). Accordingly, with more research-intensive, lower portfolio turnover strategies, research depth plays a greater role and implementation efficiency generally plays a lesser role.

One advantage of clearly considering each manager’s success factors is that it reduces the risk of defaulting to broad generalizations of what makes a good manager. A few examples of such generalizations include: more investment professionals are better than fewer, extensive research is better than more expeditious research, and concentration is better than broad diversification. We would argue that none of these are inherently virtuous attributes, but rather could be positive, negative, or neutral depending on the manager in question.

3. **Are the Success Factors present/strong enough to provide an edge?** – This is where the real work comes in. Having already made a determination as to what the key success factors are likely to be, one must then attempt to determine if a manager consistently exhibits these traits in enough measure to give them a sustainable edge. This is typically done through multiple conversations with key members of the investment team, ideally supported by objective data (generally, portfolio and performance information). Appraising the relative strength of each manager’s Success Factors is greatly facilitated by broad exposure to managers employing generally similar strategies.

4. **Can all “perspectives” be reconciled?** – The manager evaluation process requires a constant reconciliation of the multiple perspectives on a specific manager. In other words, a manager’s investment philosophy must be reconciled with its investment process, which should be reconciled with the portfolios the manager produces and the resulting performance. The inability to reconcile one of these perspectives with all the others is problematic. At a minimum, it means there is a deficit in the evaluator’s understanding of the manager. At most, it may indicate a lack of candor on behalf of the manager. This reconciliation process is often overlooked, particularly when performance is seductive. We believe an explicit discussion to reconcile discrepancies is a critical part of an evaluation process.

5. **Are we being objective?** – All judgmental investment decisions are subject to the myriad of behavioral biases to which humans are so vulnerable. These biases encourage us to find causal links between good and bad performance and specific investment process and organizational attributes, even when none exist. If one isn't careful, this can easily result in a high probability of falling prey to chronic performance chasing and disappointing results.

   There are numerous ways to mitigate these behavioral traps, all of them imperfect. We attempt to tackle this by 1) having multiple people evaluate each manager; 2) disaggregating our view of each manager into granular subcomponents, assigning quantitative ranks and weights to each component and then aggregating them to produce a composite score; 3) not making decisions under stress; and 4) facilitating a decision-making dynamic where people are comfortable expressing their opinions, challenging the views of others, and changing their minds when appropriate.

## Summary

Undoubtedly, there are many ways to be successful in manager selection. We have been sufficiently humbled through the years to know that in the absence of an appropriate conceptual framework for evaluating managers, manager selection can easily become an arbitrary exercise, acutely vulnerable to the siren song of past performance.

The framework discussed here is based on the idea that successful investment managers have identifiable advantages that give them an edge with information, interpretation, and/or implementation. These advantages are not the same for all managers and should be evaluated in the context of each manager's investment philosophy, process, and organization. With adequate experience and a decision-making structure that encourages objectivity, manager selection is a game that can be won.

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As Managing Director, Global Chief Investment Officer and President, North America of Pacific Current Group, Paul provides overall leadership and strategic vision, as he spearheads the growth efforts of the firm and guides our global sourcing, investment and portfolio management teams. Paul was a co-founder Northern Lights Capital Group (now Pacific Current Group). Prior to Northern Lights, Paul served as director of US Equity for Russell Investment Group ("Russell"), where he managed a team of more than 20 investment professionals who were responsible for all of Russell's U.S. equity oriented portfolio management and research activities. He also served as a Russell spokesperson and authored many articles and research commentaries related to investment manager evaluation. Paul graduated from Washington State University and is a Chartered Financial Analyst.

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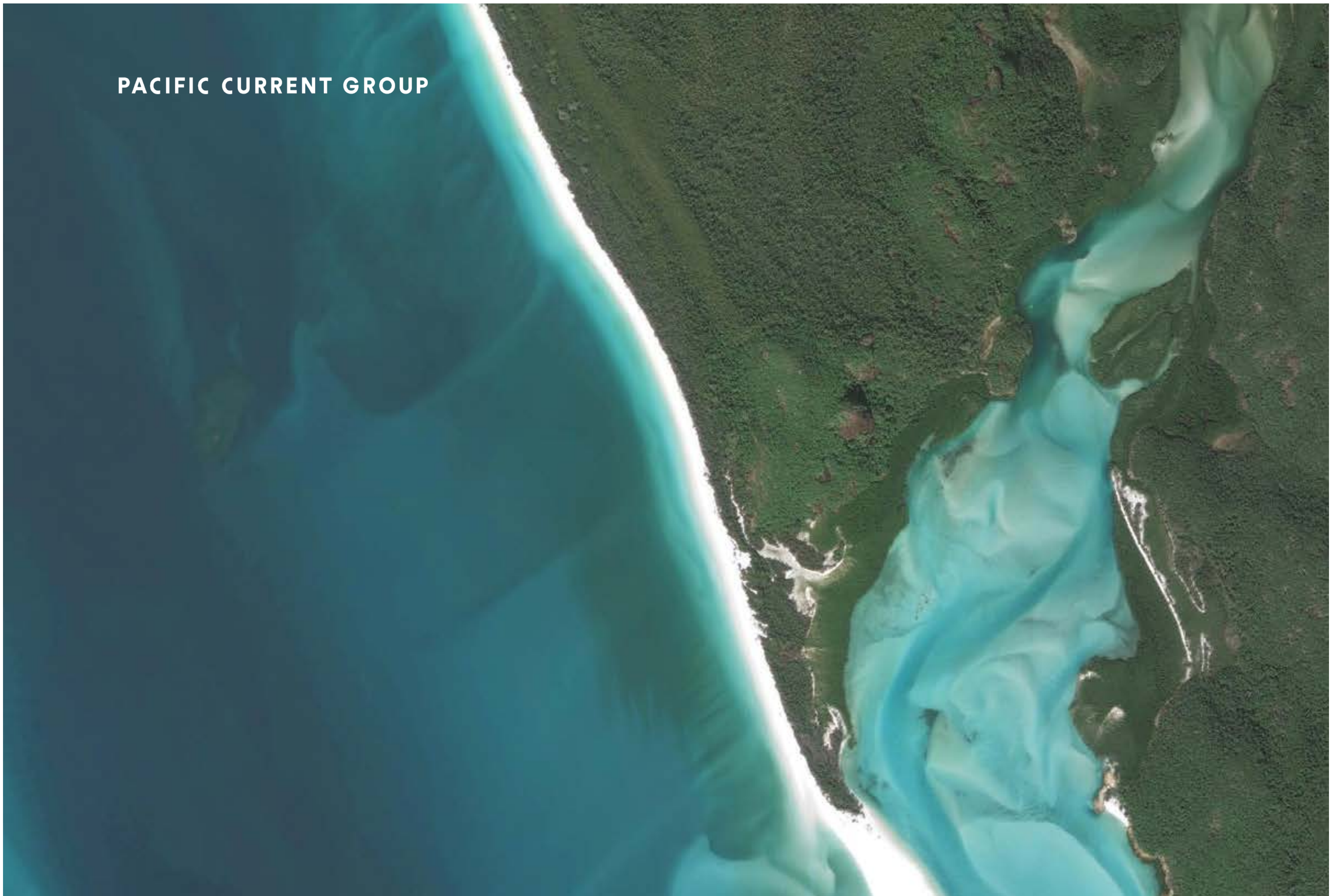

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