PACIFIC CURRENT GROUP

COMMENTARY

How to Tell Substance From Style When Evaluating Investment Managers

By Curtis Yasutake, CFA

Try to recall the last time an investment manager really "wowed" you in a meeting. Do you remember what was so impressive? Was it the substance of your discussion with the manager? Or were you influenced, instead, by their presentation skill, appearance, or personality? In this paper, I suggest three potential lines of questioning that could help you focus on substance and minimize the influence of distracting factors in your manager due diligence.

Introduction

Manager[1] due diligence is largely a people-assessment game. Allocators[2] must determine whether the person sitting across from them can be trusted and whether that person is among the most skilled investors within his or her respective asset class. Since it is impossible to look directly into the mind of another person, we often rely on external indicators to signal credibility. Studies indicate, for instance, that people who are taller,[3] wear glasses,[4] speak with a British accent (in the United States),[5] or simply speak more frequently,[6] are perceived to be more intelligent and credible. So, was the person who blew you away a skilled investor or was it the glasses?

While sharp glasses would be an extreme example, irrelevant external factors can indeed have an insidious impact on one's impression of an investment manager. In this paper, I suggest three lines of questioning for investment manager due diligence that aim to minimize the influence of such factors and instead emphasize tangible, factual aspects of a manager's organization and investment process. These questions should help allocators to identify the most skilled investors, rather than the most polished presenters. Of course, the most objective forms of analysis can be performed prior to the meeting using investment data and analytics. Here, I intentionally focus on broadly applicable qualitative questions that can supplement insights from analytics, since the appropriate tools vary by asset class.

LINE OF QUESTIONING 1

Investigate a firm's hiring process for new investment professionals.

Asking about an investment team's hiring process can provide indirect insight into investment capability and process. The rigor of a team's hiring process and the lead investor's involvement are indicative of their motivation and passion for investing. The most engaged investors tend to have extreme attention to detail and high standards for new hires. Additionally, the characteristics the team seeks in investment professionals provide insight into the firm's culture and investment process.

"The rigor of a team's hiring process and the lead investor's involvement are indicative of their motivation and passion for investing."

Another benefit of asking about recruiting and hiring is that responses tend to be more candid, since fewer allocators ask detailed questions about those topics.

When asking about the hiring process, it's wise to push the manager to provide specific examples. To illustrate, let's compare two actual responses from managers where I asked about the hiring process for a new research analyst. Both managers are small boutiques that follow a fundamental investment approach and claim to have a competitive advantage from their team's depth of research.

> **Manager A** identified three to five candidates using personal references. The lead investors performed one round of phone interviews and one round of in-person behavioral interviews. The key traits sought were 1) relevant experience and 2) culture fit.

> **Manager B** performed a broad search using recruiters and received around 1,000 resumes. The lead investors personally interviewed 75 candidates and contacted multiple independent references (beyond those provided by the candidates) to vet finalists. The desired traits were: 1) unique contact network, 2) research intensity, and 3) sell discipline. The manager assigned the finalists a three-week research project to assess these traits.

The lead investors at Manager B clearly dedicated significant time to the hiring process and carefully considered the desired criteria, while Manager A did the bare minimum. This is one indication that Manager B has greater commitment and motivation, which are difficult traits to assess but can be a key differentiator between good and great investors.

1 Note that throughout the paper, the term "manager" may represent either an individual lead investor or a firm's investment team.
2 Note that we use the term "allocator" broadly to include anyone involved in investment manager due diligence and selection.
3 Blaker, N. M., Rompa, I., Dessing, I. H., Vriend, A. F., Herschberg, C., & van Vugt, M. (2013). The height leadership advantage in men and women: Testing evolutionary psychology predictions about the perceptions of tall leaders. *Group Processes & Intergroup Relations*, 16(1), 17–27. https://doi.org/10.1177/1368430212437211
4 Hellström, Å., & Tekle, J. (1994). Person perception through facial photographs: Effects of glasses, hair, and beard on judgments of occupation and personal qualities. *European Journal of Social Psychology,* 24(6), 693–705. https://doi.org/10.1002/ejsp.2420240606
5 Stewart, M. A., Ryan, E. B., & Giles, H. (1985). Accent and Social Class Effects on Status and Solidarity Evaluations. *Personality and Social Psychology Bulletin*, 11(1), 98–105. https://doi.org/10.1177/0146167285111009
6 Anderson, Cameron & Brion, Sebastien & Moore, Don & Kennedy, Jessica. (2012). A Status-Enhancement Account of Overconfidence. *Journal of personality and social psychology.* 103. 718-35. 10.1037/a0029395.

Additionally, Manager B's thorough interview process likely translates directly to the rigor of its investment research. Given that Manager B identified and interviewed its own references for the final group of candidates, it wouldn't be a stretch to assume that the firm is more active in leveraging unique sources of information for their investment research as well.

This line of questioning also provides insight into the managers' investment processes. While both managers claimed that depth of research was a competitive advantage, Manager A wasn't focused on this when hiring. Instead, they emphasized generic characteristics, such as experience and organizational fit. On the other hand, Manager B emphasized candidates' contact network and research intensity, which indicates thorough research is more deeply ingrained within the organization. Further, because Manager B's desired characteristics are closely aligned with its investment philosophy, its analysts are more likely to be successful. Assuming this process was used for previous hires, we can infer that Manager B's analyst team is more capable than Manager A's without even meeting any analysts.

Keep in mind that the importance of investment analysts is not equal for all investment strategies, so the rigor of the hiring process does not carry the same weight in all cases.

Suggested Questions

- *What steps did you take to hire your newest analyst?*
- *How were candidates identified?*
- *How many candidates were interviewed?*
- *Who was involved in the interview process?*
- *What was the structure of the interviews (e.g. case studies, behavioral, quantitative test, etc.)?*
- *What key characteristics do you seek in an analyst?*
- *Bonus: Ask the analysts about their experience during the hiring process to confirm the answers.*

LINE OF QUESTIONING 2

Evaluate the compensation structure for members of the investment team.

Investment team compensation significantly impacts motivation, time allocation, and prospective team stability. These topics are extremely important for allocators, but it is ineffective to ask about them directly since the "correct" response is obvious and astute presenters will tailor their presentation appropriately. Compensation structure, on the other hand, is purely factual. Before getting into the details of compensation structure, it's worth assessing how a firm documents and communicates the key determinants to employees. These criteria should be transparent and well understood by the investment team. Opaque compensation structures may lead to frustration for some members, since motivation is stymied when there is an unclear connection between effort, success, and compensation. Further, imprecise structures can motivate the investment team to focus on responsibilities that are unrelated to investment performance—i.e. building relationships with the firm's senior management.

If there is a well-defined, transparent compensation structure, ask for the formula that determines annual variable compensation. The formula provides insight into the behaviors a firm values. For example, if it emphasizes marketing and asset gathering, the investment team will focus on those responsibilities at the expense of managing investments, which is detrimental to returns.

There is no "correct" formula, but investment-related responsibilities should dominate. That said, investment returns shouldn't necessarily be the primary driver, since investment performance can often be more noise than signal, particularly when measured over a shorter time period. A person's effort and analytical capability can be more reliable indicators of skill than past performance. As such, it is often preferable for investors to be rewarded based on the quality of their work (e.g. research reports, models) and productivity (e.g. idea generation, volume of due diligence meetings, etc.) rather than investment outcomes (i.e. returns). This allows investors to have more direct control over their compensation and minimizes the probability of skilled investors being fired due to relatively short periods of poor performance.

Allocators should also consider how much of an investment team's compensation is tied to the strategy under review. Products with a smaller weight in the compensation formula are likely to receive proportionately less attention. For example, the amount of variable compensation tied to investment performance for each product is often determined by AUM or revenue, which leads smaller, less profitable products to receive less attention. By evaluating the weight of each product in the compensation formula, allocators can obtain an objective data point regarding the expected investment support for each strategy.

Suggested Questions

- *How do you determine bonus compensation for members of the investment team?*
- *Do you use a specific formula? If so, what are the most heavily weighted factors and what is the relative impact of the strategy under review in the formula?*
- *What proportion of compensation is fixed versus variable? Note: If the proportion of variable compensation is low, tenured investors with large base salaries are more likely to rest on their laurels.*
- *What is the typical annual spread between the highest and lowest variable compensation among investment team members with similar experience? Note: Larger spreads imply greater emphasis on effort and can lead to increased motivation if the determinants of compensation are appropriate.*

"Ask for the formula that determines annual variable compensation. The formula provides insight into the behaviors a firm values."

LINE OF QUESTIONING 3

Focus on the due diligence process, rather than the investment thesis, when discussing specific investments.

To assess a manager's investment capability, it can be valuable to have a detailed discussion of specific investments. Allocators typically favor managers who display thorough knowledge of their portfolio companies and provide a convincing thesis. However, a manager's ability to tell a compelling story is often a better indicator of presentation skill and meeting preparation than investment capability. The manager will naturally know more about the company than the allocator, so it's easy for a good presenter to sound impressive.

For example, consider two managers that seek to invest in companies with high long-term growth. When asked about the thesis for a recent investment, the managers provide the following responses:

Manager A recently purchased a retail company. They describe the appeal of the company's concept and explain that they expect store count to grow from 50 stores to 200 stores over the next few years.

Manager B recently purchased a robotics company focused on minimally invasive surgery. They describe the regulatory landscape and the appeal of the company's newest product.

Based on this, it is difficult to tell which manager is more compelling. Even worse, these descriptions probably consumed 15 precious minutes of meeting time. Now, imagine we ask the same managers about the due diligence process for these investments.

Manager A said they met with the CEO and CFO and read several industry reports.

Manager B said they met with multiple layers of management, spoke with public and private peers, including small industry disruptors, and surveyed at least 100 doctors in each of the company's targeted growth markets to assess demand for the new product.

It's now very clear that Manager B is more compelling, without needing know anything about either company. This isn't necessarily because Manager B's due diligence is more rigorous. It's because their due diligence will likely uncover better information that is relevant to their investment approach.

Given that these managers seek companies with high long-term growth, they must have a strong understanding of a company's ability to sustain growth and its addressable market. Manager B's meetings with peer companies provide insight into competitive threats to growth and the surveys provide proprietary information about consumer demand and growth potential.

Now, it can still be useful to discuss the companies, but rather than asking generic questions about the company or investment thesis, ask targeted questions and assess only information relevant to the manager's approach. In this example, we should focus on whether the managers have a differentiated understanding of the company's long-term growth prospects. This streamlines the discussion by reducing extraneous information and minimizing the importance of presentation skill.

> **"Rather than asking generic questions about the company or investment thesis, ask targeted questions and assess only information relevant to the manager's approach."**

This approach helps allocators make a more objective assessment of investment capability. It isolates the signal from investment discussions that often consist largely of noise. Be impressed by a manager's process for uncovering information and insights that are relevant to their investment philosophy, not their encyclopedic knowledge of a company.

Note that it is important to ask for specific examples of the due diligence process in action. Presentation skill and preparation are more prominent during high-level discussions of the investment process. Of course, sample size is important, so numerous examples should be discussed over several meetings.

Suggested Questions

Note: Ask about a specific investment that was made recently. Revisionist history and poor memory can skew discussions of older investments.

- *Walk me through the process for purchasing a new investment from start to finish—i.e. idea generation, due diligence process, valuation, etc.*
- *What were the key questions you sought to answer during due diligence?*
- *What resources were used for due diligence?*
- *What were the key assumptions in your financial model and how did you develop them?*

Conclusion

The tactics in this paper should help elicit fact-based responses from investment managers, leaving less room for embellishment or showmanship. The recommended questions focus on specific examples of the manager's process (e.g. investment due diligence and hiring) and concrete aspects of the organization (e.g. compensation structure). These should allow allocators to draw more objective conclusions about managers and mitigate influence from less relevant factors.

Ultimately, these lines of questioning should lead to more effective, unbiased identification of skilled investors and better investment performance. Further, they can help allocators identify untapped talent by discounting external indicators, such as height or verbosity, that are falsely associated with capability. But if all else fails, tell the investor to take off those fancy glasses and drop the British accent.

About the Author

Curtis Yasutake, CFA, is a Vice President at Pacific Current Group. Based in our Tacoma office, he works closely with our CEO & CIO, Paul Greenwood, to source investment opportunities and analyze asset management firms. Previously, Curtis spent eight years on the Manager Research team at Russell Investments, most recently as Senior Research Analyst, where he led manager research efforts related to US quantitative and fundamental strategies across the cap spectrum. He also worked with Verus and Morgan Stanley. Curtis has an MBA from UC Berkeley's Haas School of Business and a BA in Business Administration from Seattle University.

About Pacific Current Group

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Every investment we make serves a strategic, growth-oriented purpose that's unique to each of our portfolio companies. We might, for example, provide working capital to fund a new start-up manager, buy out a passive shareholder, or help a firm's management meet GP commitment obligations for their next fund. Our team works diligently to ensure that we are aligned with each portfolio company's management from the beginning, so that we win or lose together.

We diversify our portfolio across global public and private markets and are always looking to expand into the investment industry's most promising market segments. Our investment research team focuses on "sunrise" areas of the market, particularly those in which smaller, more entrepreneurial teams are best equipped to create value for investors.

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