PACIFIC CURRENT GROUP

COMMENTARY

Outdated Due Diligence: The Enemy of Manager Diversity

By Paul Greenwood, CFA

During the summer of 2020, we saw dozens of statements from across the asset management industry calling for greater diversity and inclusion. In his commentary, Paul Greenwood, the CEO & CIO of Pacific Current Group, examines the ways that long-standing and outdated manager selection processes are biased against women- and minority-owned investment firms and suggests a new approach to due diligence that avoids the shortcuts that perpetuate these biases and in turn hinder investment performance.

Introduction

Within the last year, we've seen dozens of statements from investment managers and institutional allocators calling for greater diversity within investment firms, along with more support of women-and-minority-owned investment firms. Though the former mission—to increase diversity within firms—is still not as far along as most would hope, leaders of investment firms already have the power to drive that change from within their organizations. By contrast, the latter goal—to increase the share of assets under management (AUM) by women- and-minority-owned firms—will require a systemic disruption of the very norms and processes that drive manager selection.

The reality is that typical investment manager selection practices have the effect of being biased, albeit unintentionally, against women- and minority-owned firms. Modifying these practices would not only improve diversity but would likely also improve investment performance.

To understand how these biases arise, we must first consider how allocators select investment managers. The process typically begins when an allocator is frustrated by the weak intermediate-term performance of an investment manager and asks its consultant to give it a list of replacement managers that will ostensibly perform better. After filtering out those firms with track records that are too short or below average, whose AUM remains below a threshold, and whose investment teams haven't worked together long enough, a handful of managers are suggested to the allocator. Sometimes the allocator supplements the consultant's work with their own suggestions, but more often than not the allocator simply requests that three or four managers appear at a finals presentation, where the managers pitch their capabilities. After the presentations, unless they're unwittingly wooed by a manager's appearance or presentation skills, the allocator typically selects the manager with the best intermediate-term performance.

Obviously, there is a lot wrong with this type of selection process, and the problems go far beyond mere performance chasing. Such processes are fraught with behavioral biases and have the effect of diverting allocators away from diverse firms, which tend to be newer and smaller than their peers. The table below displays self-reported data on active traditional investment managers from eVestment. The meaningful difference in size and tenure between firms with and without significant women or minority ownership is readily apparent.

Size and Age of Firms by Percentage of Women or Minority Ownership

	Number of Firms	Median Firm AUM	Median Year Founded
> 50% Women or Minority Owned	135	$568m	2003
< 50% Women or Minority Owned	543	$3,526m	1994

Source: eVestment as of June 30, 2020; Note that only 678 firms out of 1832 firms listed in eVestment reported on women or minority ownership percentage, AUM, and year founded for Q2 2020.

Most firms do not even report on their minority ownership levels, but among firms that did as of June 30, those that reported greater than 50% women or minority ownership had a median AUM that was only 16% of the median AUM of firms with less than 50% women or minority ownership. Likewise, firms with greater minority ownership were founded on average nine years after those with less.

The use of criteria that happen to be skewed against diverse firms would be more understandable if it was shown to add value to allocators. However, considerable research suggests that smaller (and presumably newer) firms tend to perform better than bigger (and thus likely older) ones in most asset classes.[1] Accordingly, these widespread selection practices are not only biased, they are also injurious to allocators' own economic interests.

To see the shortcomings of this approach, allocators should look no further than the criteria used the next time a large public plan wants to hire a new small-cap investment manager. It's common to see minimum requirements such as $2 billion of firmwide AUM, $500 million of product-level AUM, and a GIPS-certified track record of at least five years. Once allocators overlay the inevitable strong recent performance required for inclusion, they have the perfect recipe to identify a manager that 1) has benefited from recent stylistic tailwinds; 2) has grown rapidly; and 3) now manages enough capital in the selected strategy that its future return prospects are notably less than they have achieved historically.

As the example suggests, it is typical for allocators to exclude investment products and firms from consideration solely based on the amount of AUM. Presumably, such criterion is used as a proxy to eliminate situations where there may be serious questions about the manager's financial health, its commitment to a product, the scalability of a particular strategy, or the relevance of its historical track record. These are all legitimate lines of inquiry, but each of these issues would be more appropriately addressed through direct discussion and analysis. To put a finer point on it, if an allocator is concerned about the financial viability of a firm or the relevance of prior performance, then they should take the time to ask questions and perform the level of analysis that allows them to make that assessment directly rather than infer an answer through the application of arbitrary criteria.

What Can Allocators Do?

I believe no one should allocate to a more diverse firm simply to check a box, but neither should they employ criteria that are implicitly biased against such firms while also detracting value. The real answer is that allocators need to revisit their approach to manager selection. This shift begins with shedding the shortcuts and simple quantitative proxies and instead doing the hard work of directly analyzing the factors that really matter. The following pages show examples of how an allocator could target their analysis to get at these truly relevant questions.

"These widespread selection practices are not only biased, they are also injurious to allocators' own economic interests."

1 Krum, 2007, Potential Benefits of Investing with Emerging Managers: Can Elephants Dance?; Aggarwal and Joirian, 2009, The Performance of Emerging Hedge Funds and Managers; Christopherson, Ding, and Greenwood, 2002, The Perils of Success: The Impact of Asset Growth on Small-Capitalization Investment Manager Performance; Mozes and Orchard, 2010, The Relation Between Hedge Fund Size and Risk.

Track Record

There should be no arbitrary minimum requirement, nor should people insist on GIPS compliance of a certain number of years. Instead, allocators could focus on questions, like the ones below, that actually address the risks they're aiming to mitigate.

- *Is the track record consistent with the investment philosophy and process?*
- *Does the track record cover a long enough period and enough market environments to get a sense of how the product should perform over the long term?*
- *How relevant is the track record based on people and process changes that have occurred over time and are likely to occur in the future?*

Experience

Though it is probably safe to say that more experience is better than less, many managers lose their edge over time due to factors such as the increased hubris and complacency that often accompany investment success and wealth or the natural evolution in the roles and responsibilities of different team members. Instead of lapsing into a simple construct of "more experience is good and less experience is bad," allocators might seek to understand the impact of experience on a particular manager's investment proposition.

- *How relevant is their prior experience?*
- *Do they have the experience to manage this product throughout different market environments?*
- *Have they already developed a healthy level of humility with regard to the risks inherent to their strategy?*
- *How have the roles and responsibilities of the investment team evolved over time?*
- *What motivates their team? How has their motivation changed over time?*

Size

It is not uncommon for allocators to set a minimum AUM threshold for managers they will consider. They may also limit the relative proportion of their proposed investment to a manager's total asset base. Such size requirements are likely intended as a rough proxy of an investment manager's financial sustainability or their ability to accommodate larger allocations. That said, these risks could decline significantly if the allocator gains sufficient answers to the following type of questions.

- *Does the firm have the necessary resources to effectively implement its investment strategy?*
- *To what extent does the historical AUM impact the relevance of the track record?*
- *How will the strategy change with larger AUM?*
- *How much, if any, performance degradation should be expected as AUM grows? Why?*
- *With no new revenues, how long is the business sustainable?*
- *Does the manager have additional sources of capital that can fund the business if needed?*

Conclusion

Track record, size, and experience are just three broad components of any investment manager allocation, and there are certainly many more. Given that diverse businesses tend to be newer and smaller, they will continue to be disadvantaged so long as allocators stick to these crude rules of thumb to filter their opportunity set instead of thinking critically about which managers are most likely to produce the best results in the future. Real manager diversity will only occur when allocators employ more defensible criteria and demand the same from their consultants. In doing so, not only will the diversity of manager selection improve, but so will performance.

About the Author

As our Pacific Current Group's Chief Executive Officer and Chief Investment Officer, 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 of 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 US-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 with a BA in Finance from Washington State University and is a CFA® charterholder.

About Pacific Current Group

Pacific Current Group (ASX:PAC) is a global, multi-boutique asset management business with offices in Sydney, Melbourne, Tacoma, and Denver. Our mission is to discover truly exceptional investment managers and leverage our resources and experience to help them grow.

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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