EPFIF

Making Hiring and Firing Manager Decisions

A consultant's perspective and how Investment Controlling can help avoid the pitfalls

Oliver Kunkel, MSc, Senior Consultant
PPCmetrics AG
Financial Consulting, Controlling & Research
www.ppcmetrics.ch

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Agenda

- Difficulty of the Manager Selection Task
- Manager Selection / Firing Strategies
  - Forecasting Based Approach
  - Risk Premium Based Approach
- Summary

Difficulty of the Manager Selection Task (1)

If you think that picking the right stocks is difficult…

MSCI World DM
Index:
+/- 1600 securities

MSCI ACWI All Cap
Index
+/- 14’000 securities

Difficulty of the Manager Selection Task (2)

If you think that picking the right stocks is difficult…

MSCI World DM Index:
+/- 1600 securities

MSCI ACWI All Cap Index
+/- 14’000 securities

SEC Registered Investment Advisors:
+/- 11’000

...then you might agree that picking the right manager is difficult!

Assume we made qualitative checks

Company
- Well run and profitable business
- No significant risks to business continuity (e.g. legal cases)
- …

Investment Approach
- Economically sound investment approach
- …

People
- Well educated and experienced professionals
- Team which is robust to loss of individuals (some key people risk might be tolerated)
- …

Investment Process
- Clearly structured processes
- Risk management
- Transaction processing
- Compliance
- …

Ground rule:
A manager that does not pass / score well on these criteria should in principle not be selected.

Investment Approaches

- **Fundamental**
  - Based on top down (e.g. region, themes) or bottom up (companies) forecasts
  - Usually a large amount of judgment and “gut feeling”
- **Quantitative**
  - Model driven forecasts (e.g. earnings) based on statistics / econometrics and rule based portfolio construction
  - Regular reviews of the validity of the model

Risk and Information Processing (1)

- **A turkey on its way…**

  Day 1: “I walk on the grass, the sun is shining, all is well”

  Day 2: “I walk on the grass, its raining, all is well”

  Day 3: “I walk on the grass, the sun is shining, all is well”

  …

Risk and Information Processing (2)

- **A turkey on its way…**

  Day 1: “I walk on the grass, the sun is shining, all is well”

  Day 2: “I walk on the grass, its raining, all is well”

  Day 3: “I walk on the grass, the sun is shining, all is well”

  …

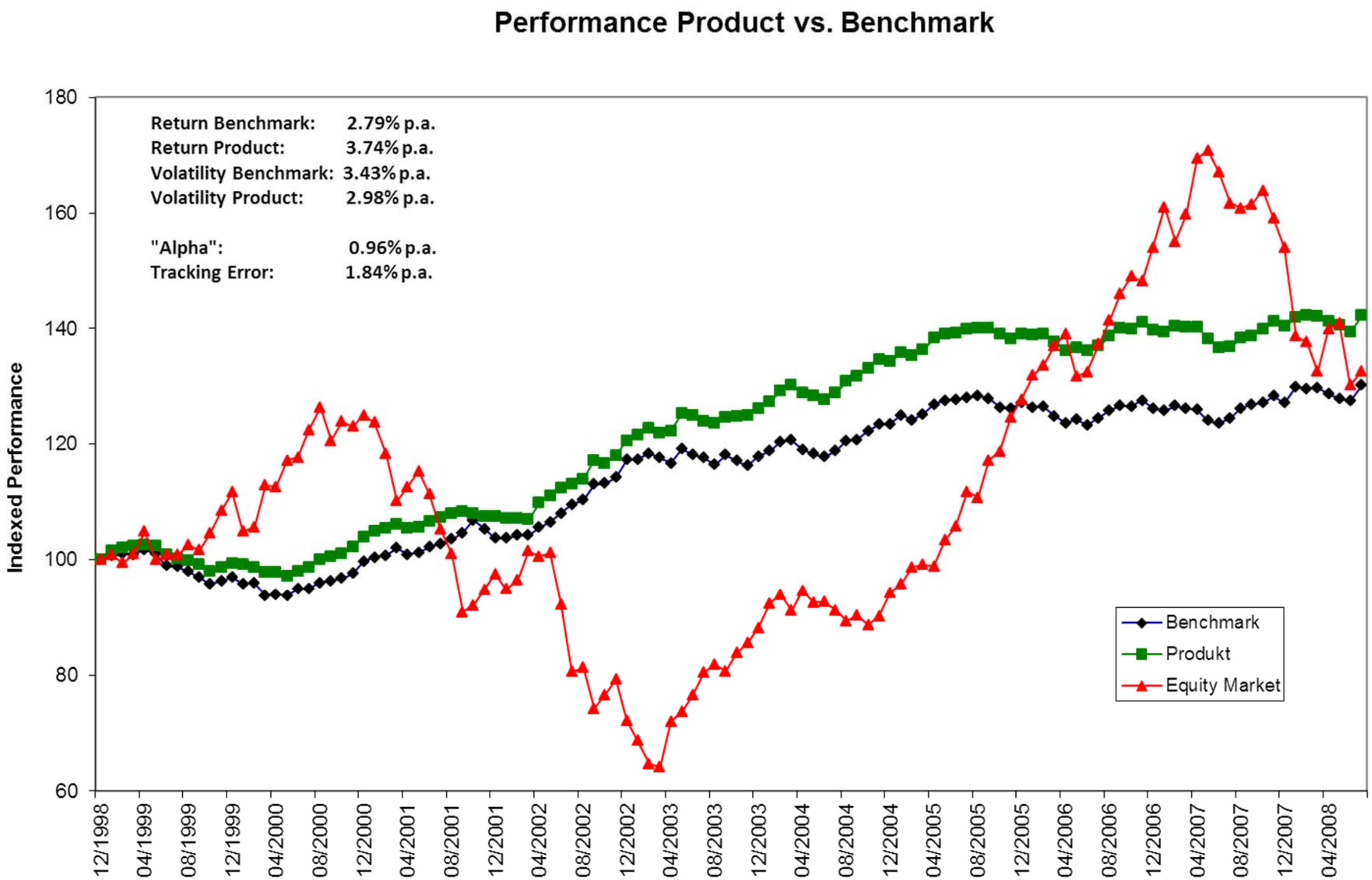
  Day 149: “I walk on the grass, the sun is shining, all is well”

… to Thanksgiving!

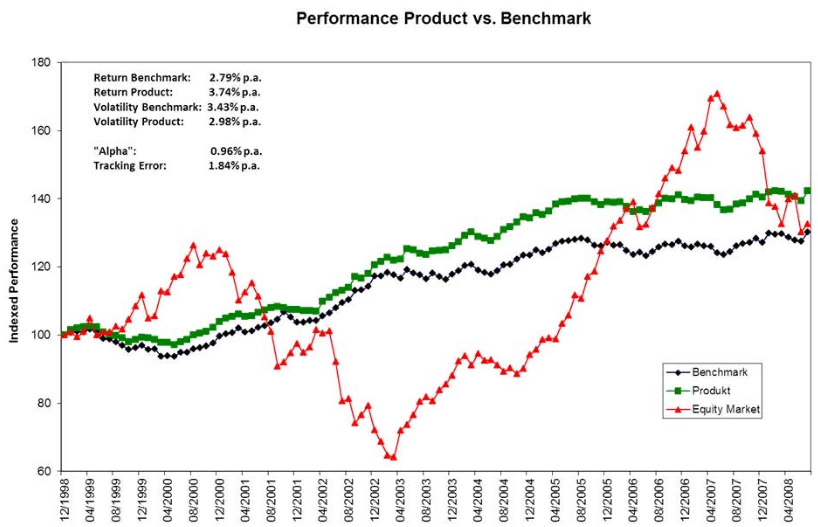
Portfolio construction is always based on information available of the past!

Unless the future behaves similar to the past, we run the risk of being exposured incorrectly.

Performance measures (1)



Performance measures (2)



- **Benchmark**
  - ZKB Bond Index for Government Bonds (Duration 5 - 7 years)
- **Product**
  - ZKB Bond Index for Bonds with “A” Rating (Duration 5 - 7 years
- **Equity Index**
  - Swiss Performance Index

- **It is extremely difficult to distinguish between pure alpha and hidden risk premia.**
- **If the benchmark does not cover the full investment universe, performance measures should be used carefully.**

Systematic risks vs. “Alpha” (1)

Benchmark

Government Bonds

Portfolio

Government Bonds

Corporates

Emerging Markets

Systematic risks vs. “Alpha” (2)

Benchmark

Blue Chips

Portfolio

Blue Chips

Momentum

Mid-/Smallcaps

“Postulates”

- Consistently delivering risk adjusted excess returns is extremely **difficult**.
- Active positions of managers often consist of exposures to **systematic risks** (e.g. corporate bonds, smallcaps, emerging markets, …).
- These systematic risks are expected to earn excess returns (**risk premiums**) over the long run.
- Evaluating managers over **short periods of time** is likely to result in frequent turnover, which causes higher transaction costs and thus making it even more difficult to achieve risk adjusted excess returns over time.

Statistics on hired / fired managers

1994 – 2003	Pre-Hiring Period (years)			Hiring Quarter	Post-Hiring Period (years)		
	-3 to 0	-2 to 0	-1 to 0	Qtr 0	0 to 1	0 to 2	0 to 3
Excess Returns	13.76	9.55	4.23	0.39	0.57	0.90	1.35
Standard Error	2.65	2.50	1.39	0.24	0.82	1.16	1.77
N	6,180	7,392	8,464	9,364	8,464	7,392	6,180

	Pre-Firing Period (years)			Firing Quarter	Post-Firing Period (years)		
	-3 to 0	-2 to 0	-1 to 0	Qtr 0	0 to 1	0 to 2	0 to 3
Excess Returns	-3.54	-0.33	-0.68	0.27	1.47	2.09	5.03
Standard Error	0.87	1.51	1.02	0.22	0.77	1.74	1.79
N	216	327	541	838	541	327	216

Source: Goyal, Amit and Wahal, Sunil, The Selection and Termination of Investment Managers by Plan Sponsors (November 2004). EFA 2005 Moscow Meetings Paper. Available at SSRN: http://ssrn.com/abstract=675970

Manager Selection based on Forecasts

- Managers are selected based on forecasts regarding **market conditions**
  - Quantitative managers / trend following in times of ongoing trends
  - Managers focussing on mean reversion in times of regime changes (e.g. fundamental / contrarian value)
- A “model” is needed to **forecast market conditions**
  - “Gut feeling”
  - Return forecasting based on factor models
- The crucial question is whether the models to predict the market condition really have long term forecasting powers or not
  - ▸ **In essence, the security selection question is shifted by one level.**

Manager Selection based on Risk Premiums

- Select managers that try to systematically exploit **risk premiums**
  - **Traditional** “academic” risk premiums or **non-traditional** risk factors identified by discussions with investment managers
- Discuss exposure to long run systematic risks as part of the **strategic asset allocation / mandate structuring**
  - Trade of between a) the separation of systematic risk and “true active returns” in active management and b) an **efficient mandate setup** (sufficient size of mandates)
- Identify managers with consistent exposure to risk premiums. Allow **periods of underperformance** vs. benchmark if they are identified to be related to the risk premium exposure.

Summary (1)

- **Hiring / Firing** decisions should be made recognizing qualitative checks / scores and performance
  - **Qualitative checks** and analyses are necessary and possible (e.g. leave of key people, process errors). These are done by a proper investment controlling.
  - **Quantitative measures** that focus on performance are insufficient to serve as basis for hiring / firing decisions.
  - Since active positions of managers often consist of **exposures to systematic risks**, evaluating managers over **short periods of time only** is likely to result in frequent turnover, which causes higher transaction costs and thus making it even more difficult to achieve risk adjusted excess returns over time.

Summary (2)

- **Manager Selection Strategies**

  1) **Forecasting Based Approach**

     - If you have forecasting ability it makes sense to use them at the manager selection level. The crucial question is whether models / people really have a long term forecasting power.
     - **In our experience, predicting the market and “chasing gurus” is difficult and leads to high turnover and below average results, i.e. lower than indexed alternatives!**

  2) **Risk Premium Based Approach**

     - Depending on the mandate setup, active management can serve as an efficient exposure to certain risk premiums.
     - **Staying with managers than provide consistent exposure to risk premiums can result in excess returns over the long run**.

Contact

Financial Consulting, Controlling & Research

PPCmetrics AG
Badenerstrasse 6
Postfach
CH-8021 Zürich

Telefon +41 44 204 31 11
Telefax +41 44 204 31 10
E-Mail ppcmetrics@ppcmetrics.ch
www.ppcmetrics.ch

PPCmetrics SA
23, route de St-Cergue
CH-1260 Nyon

Téléphone +41 22 704 03 11
Fax +41 22 704 03 10
E-mail nyon@ppcmetrics.ch
www.ppcmetrics.ch