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Making Hiring and Firing Manager Decisions

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

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- 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.**

- **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

- **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"

...

- **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”

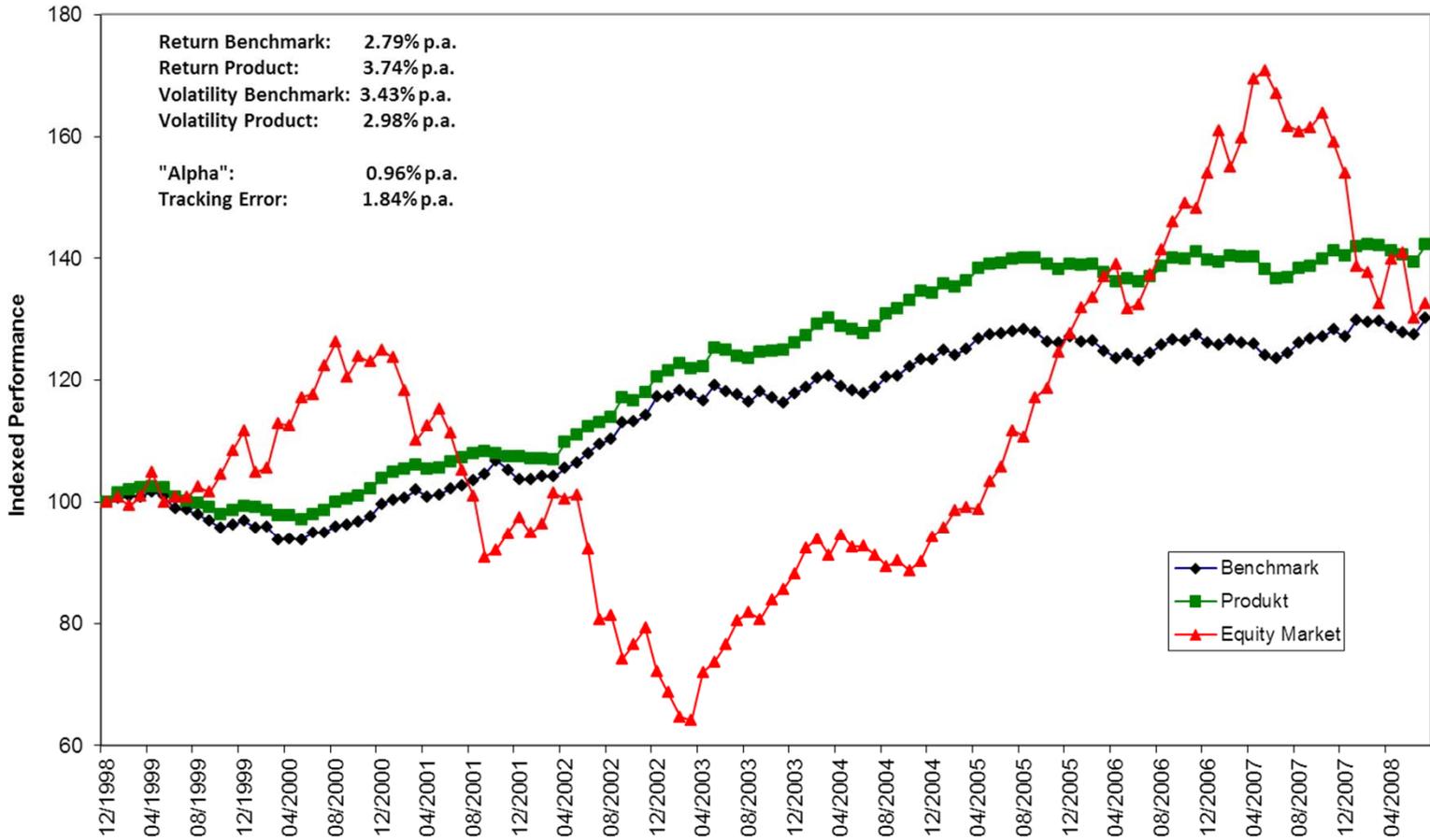
... to Thanksgiving!

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

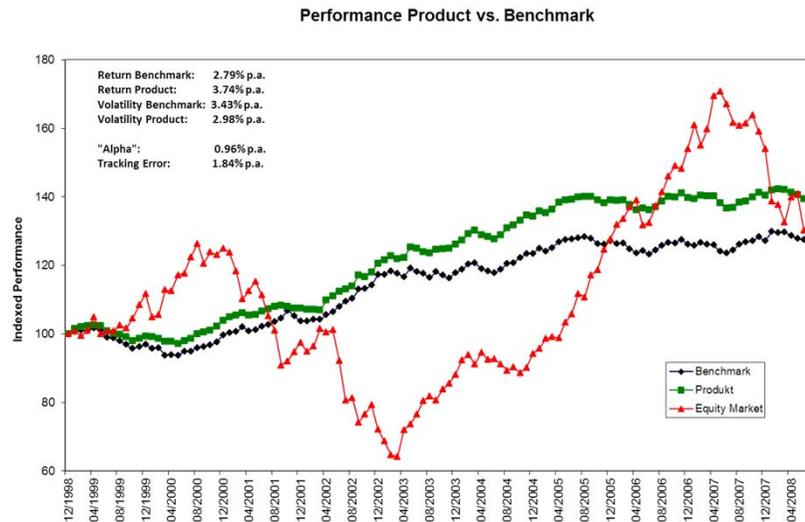
Unless the future behaves similar to the past, we run the risk of being exposed incorrectly.

Performance measures (1)

Performance Product vs. Benchmark



Performance measures (2)

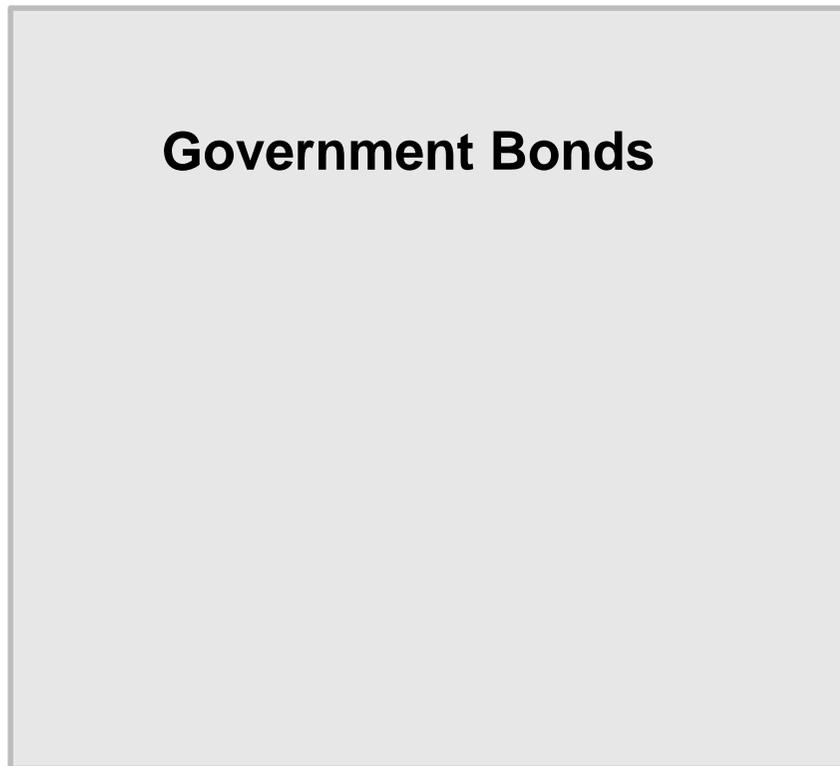


- **Benchmark**
 - ZKB Bond Index for Government Bonds (Duration 5 - 7 years)
- **Product**
 - ZKB Bond Index for Bonds with "A" Rating (Duration 5 - 7 years)
- **Equity Index**
 - Swiss Performance Index

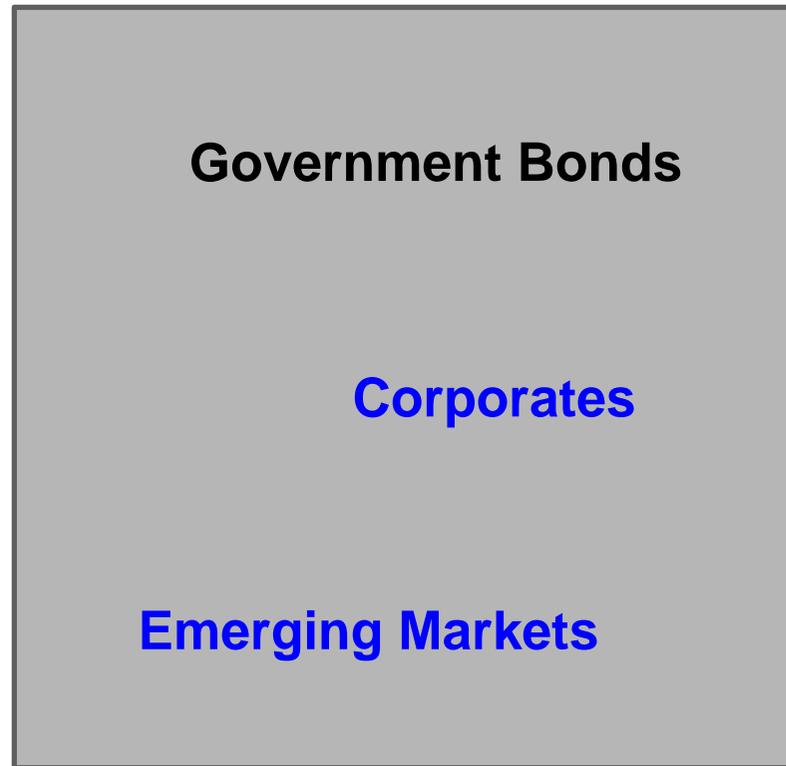
- **It is extremely difficult to distinguish between pure alpha and hidden risk premia.**
- **If the benchmark does not cover the full investment universe, performance measures should be used carefully.**

Systematic risks vs. “Alpha” (1)

Benchmark



Portfolio

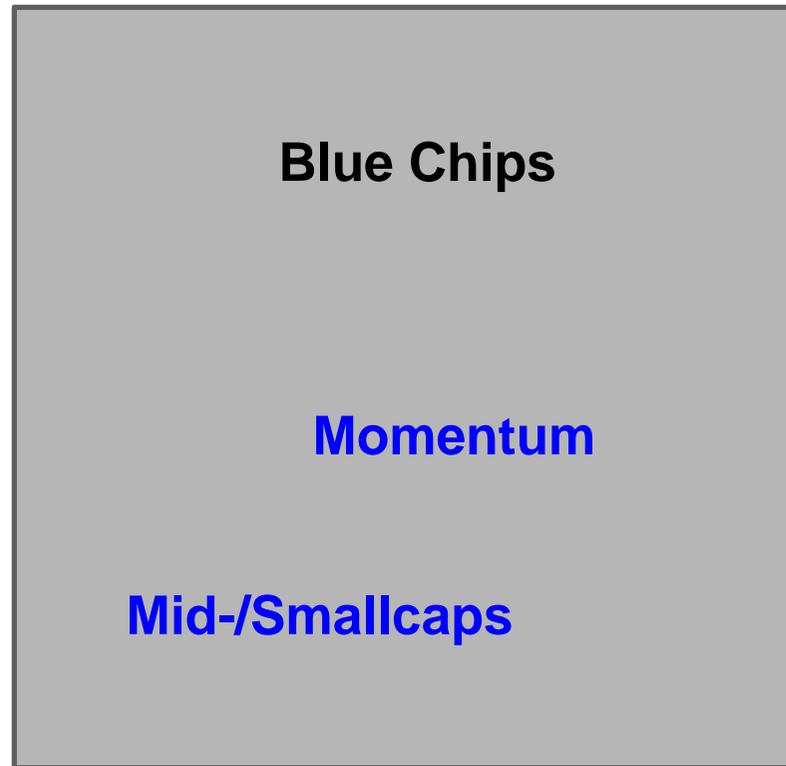


Systematic risks vs. “Alpha” (2)

Benchmark



Portfolio



“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

- 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.**

- 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.

- **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.

▶ 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.**



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