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Asset Manager Selection based on historical performance

PPCmetrics

Management Summary

Historical performance is a frequently used criterion to select asset managers. Therefore, an asset manager with an outstanding past performance (track record) has a significantly higher chance of getting new customers than a comparable manager with a slightly worse performance. Our empirical analysis, however, shows that after hiring an asset manager with such an outstanding performance, the asset manager performs significantly worse in the period after the selection. In some cases, the selected managers even performed significantly worse than a control sample. This empirical evidence is consistent with prior academic studies. As a result, our conclusion is that a selection of asset managers mainly based on past performance is not a successful method. Thus, asset managers should be evaluated through various criteria founded on experience as well as academic findings such as the investment approach, the portfolio construction process, the characteristics of the product team, and all kind of costs.

Content

1. Introduction

Historical performance is a frequently used criterion to select asset managers. As a result, an asset manager with an outstanding past performance (track record) has a significantly higher chance of getting new customers than a comparable manager with a slightly worse performance. In this paper, we argue that a selection solely based on historic performance is rarely successful.

In a broad study covering more than 3,000 mandates, Goyal and Wahal analyzed (2008) the selection of asset managers by institutional investors in the U.S. between 1994 and 2003. The following table shows the annualized excess returns of the asset managers before ("pre-hiring") and after ("post-hiring") they were hired.

Annualized excess returns of asset managers before and after hiring

	Pre-hiring period (Years)			Post-hiring period (Years)	
Out- / Underperformance p.a.	-3 to 0	-2 to 0	-1 to 0	0 to 1	0 to 2
Fixed Income	1.2%	1.2%	1.2%	0.3%	0.3%
Equities US	4.0%	4.3%	4.3%	-0.2%	0.0%
Equities Global	5.4%	5.7%	5.7%	3.3%	3.5%

Source: own table based on data from Goyal and Wahal (2008)

Although the study did not require that the selection was exclusively based on past performance, it provides valuable insights. **The majority of the asset managers strongly outperformed their benchmark before they were selected by institutional investors. However, the relative performance of the investment managers was less convincing after hiring (yet in most cases still positive). In the following simulation, we will analyze a strategy of "picking past winners" for the Swiss institutional market.**

2. Simulation

The finance industry provides publicly available performance rankings and several investors rely on those rankings. However, since we are interested in the performance of institutional mandates for Swiss institutional investors, we analyze not publicly available data gathered by the PPCmetrics market screens. For more information, please refer to the website at www.marktscreen.ch. The following table summarizes the number of track records (total 372) included in our analysis for different investment categories.

Number of asset managers per investment category

Class	Number
Balanced	46
Bonds Global	27
Bonds Corporates	34
Bonds EmMa	60
Equities Switzerland	40
Equities Global	123
Insurance Linked Securities	11
Commodities	31
	372

Source: PPCmetrics market screen

The data is used to simulate a selection exclusively based on past performance. We assume that an investor randomly awards a mandate to an asset manager which belongs to the 25% best performing managers in the past three years. The investor measures the success of his selection by evaluating the manager's performance after two years. By repeating this procedure for a sufficient number of investors, we get the following results:

Results of the hired asset managers based on past performance

	Pre-hiring period (Years)			Post-hiring period (Years)		
Out- / Underperformance p.a.	-3 to 0	-2 to 0	-1 to 0	0 to 1	0 to 2	Number
Balanced	3.4%*	3.7%*	3.7%*	-1.3%	-0.3%	12
Bonds Global	4.7%*	9.4%*	5.2%*	1.6%	3.3%	7
Bonds Corporates	6.5%*	8.1%*	4.7%*	0.0%	3.4%	9
Bonds EmMa	5.6%*	11.5%*	4.3%*	-2.6%*	0.6%	15
Equities Switzerland	4.8%*	6.6%*	7.4%*	-1.7%	0.7%	10
Equities Global	7.3%*	9.7%*	7.2%*	-0.9%*	0.3%	31
Insurance Linked Securities	9.4%*	12.0%*	9.6%*	-1.1%	2.7%	3
Commodities	13.3%*	13.6%*	12.6%*	2.1%	1.9%	8

Calculations: PPCmetrics AG; * significantly different from average of all other mandates with a confidence level of 90%.

3. Results and Summary

The results of our historical simulation are similar to the findings of Goyal and Wahal (2008) and to other academic studies. After hiring an asset manager with an outstanding past track record, the performance is less convincing the in the years following its hire. In some cases, the selected managers even performed significantly worse than a control sample.

Our conclusion is that a selection of asset managers mainly based on past performance is not a successful method. Thus, asset managers should be evaluated through various criteria founded on experience as well as academic findings such as the investment approach, the portfolio construction process, the characteristics of the product team, and all kind of costs.

4. Reference

Goyal A., Wahal, S., 2008. The Selection and Termination of Investment Management Firms by Plan Sponsors. Journal of Finance 63, 1805-1847.

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