Manager Selection and Retention: Putting the Odds in Your Favour

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Reliable, long-term historical manager returns or even risk-adjusted returns are generally not available for manager evaluation. Shorter-term historical manager returns are not statistically significant and have always failed to predict future excess returns. Yet investment committees continually use a period of five years or less to evaluate manager success. This is the manager selection conundrum. If an investment committee truly is seeking consistent performance over a reasonable time period, then focusing on a good multi-manager asset-class strategy with lower tracking error is more likely to provide consistent value added. The vagaries and randomness of the market can never be removed, but a good asset-class strategy and proper investment committee education and communication put the odds in your favour.

Practical Solutions to Put the Odds in Your Favour

No single action will eliminate the uncertainties of manager selection, but the following ten practical steps may reduce risk and put the odds of adding value in your favour:

1. Prepare a long-term asset class strategy that is founded in research and consistent with your risk tolerance and objectives.
2. Educate yourself in the fundamental research of asset class success factors. This research generally concludes that the two factors that result most consistently in good manager selection are high-quality internal research and good security selection (not market timing). Additional factors include a good decision-making approach, disciplined processes, etc.
3. Implement using a lower-risk (low TE) asset-class strategy to improve the odds of outperformance in the conventional five-year evaluation period to limit the downside in case of any underperformance.
4. Choose a structure with multiple specialist managers to diversify manager-selection risk, reduce the exposure to one single manager, increase potential value added, and minimize asset-class turnover costs.
5. Communicate and document the asset-class structure. This will help the investment committee to buy into the strategy and focus at the asset-class level during performance evaluation.
6. Recognize that skilled individual managers can underperform the benchmark for prolonged periods of time, but that the whole may be greater than the sum of its parts. Focus on the performance of the asset-class strategy.
7. Use a combination of qualitative and quantitative research to analyze manager selection and retention decisions. I recommend a three-tiered approach to performance measurement: superior qualitative research, portfolio profile analysis at the manager and asset-class level, and core performance measurement to ratify the outcomes.
8. When using quantitative performance data, try to remove end-point sensitivity. Do this by looking at all manager returns during the entire product history for rolling one-, three- and five-year periods to determine consistency, average value added and changes in approach.

9. Perform ongoing due diligence of the individual managers and their asset-class holdings. The information gathered will help you control the asset-class risk and make necessary manager replacements or reallocations.
10. Continuously monitor the asset class structure and its overall risk relative to the benchmark to refine the process.