

How High Does Your Manager Bounce?

Don't pull the plug on that underperforming manager yet

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Here in Red Sox Nation, we know a thing or two about sticking with your team during the bad times. Sure, we grumble among ourselves, but just let one of those New York fans pass a snarky comment and we close ranks quicker than a Roman phalanx. “You just wait,” we say. “They’ll bounce back. They always do.”

Not only do the Sox bounce back, but their rebounds are often spectacular. Just look at their 2013 World Series win, just one year after their worst performing season in 47 years. As Gen. George Patton said, “Don’t measure a man’s success by how high he climbs, but how high he bounces when he hits bottom.”

There’s a lesson in this for institutional asset owners: Think twice before pulling the plug on an underperforming manager. Here are two very good reasons why:

1. The odds favor a performance bounce back.

Red Sox fans may be insanely loyal, but there is method in their madness. It relies on the mathematical concept of “mean reversion,” which holds that things like investment returns and stock prices (and win-loss ratios) may bounce around quite a bit, but they will eventually settle down to their historical average levels.

Barring any structural reasons for a period of underperformance, such as an ownership change or a new investment philosophy in play, return patterns should smooth out to produce the manager’s long-term expected return. In fact, the more severe the underperformance, the bigger the bounce back is likely to be.

› A 2008 study showed that fired pension fund managers outperformed their replacements by 1.4% over the three years following their termination.

But the impatient asset owner gets caught up in the gut-wrenching pain of loss and the criticism of naysayers, and will often terminate the offending manager when they are down and reallocate assets to a new manager with great short-term numbers—a move that is the asset allocation equivalent of selling low and buying high. Not only will they miss the likely performance upswing of their terminated manager, but they may also see their new manager’s numbers erode as they revert to more sustainable averages. And so it goes. A vicious cycle that consulting firm RVKuhns & Associates calls “The Negative Selection Cycle.”¹

2. Terminating an underperforming manager is very expensive.

In his excellent book “Manager Selection,” Scott D. Stewart writes that “the impact on performance from institutional investors changing their manager allocations is negative.”² There are several academic studies that support his assertion.

In 2008, researchers Amil Goyal and Sunil Wahal examined the performance of institutional pension plan managers hired and/or fired between 1994 and 2003.³ Over half (52.3%) were terminated for performance reasons. Their research showed that, on average, most managers were hired after a period of positive excess returns. No surprise there.

But the shocker was what happened after they were hired: Most earned zero excess returns. And the hapless underperforming managers who were terminated? Not only did they tend to outperform once they were canned, but they outperformed their replacements by 1.4% over the three subsequent years, before transaction costs. According to a TowersWatson⁴ analysis of the study, when poor performance was the cause of the termination, plan sponsors lost 0.79% of cumulative potential value in the three years after the transition, before for transition costs.

› The economic effect of institutional manager changes was estimated at more than \$170 billion—before transaction costs.

A similar study in 2009 looked at the manager selection record of institutional asset owners by studying the flow of assets across investment managers between 1985–2007.⁵ Their findings cast new light on the opportunity cost of changing managers:

- First, they confirmed that asset owners did not add value by changing managers.
- Second, they found that investors’ changes to manager allocations led to underperformance in all asset classes.
- Finally, adding insult to injury, the study estimated the economic effect of these manager changes at more than \$170 billion—before transaction costs.

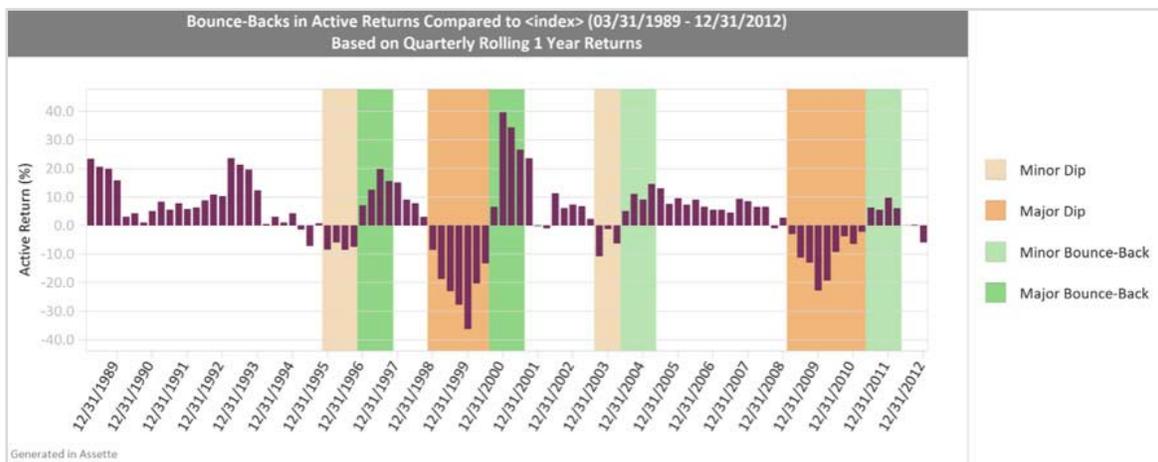
What’s a fiduciary to do?

Most institutional asset owners have a fiduciary duty to select and monitor investment managers. That includes terminating investment managers who are not meeting expectations. But while most asset owners are familiar with the findings that show changing managers for performance reasons alone is essentially a loser’s game, those decisions are still made with regularity.

Some consultants suggest that asset owners need a model that will quantify the value they expect to lose or gain by switching a manager for performance reasons.⁶ Others counsel their clients to set realistic expectations for investment manager performance, rely more on qualitative factors in manager evaluation, and include a variety of quantitative metrics, like fees and risk analyses, to supplement performance considerations.

Be sure you have the right data

All excellent advice, to which we would add: When evaluating a manager’s performance record, be sure to have the all the data you need to assess their return pattern over long periods of time—preferably in a report that highlights what the manager’s history of underperformance and bounce back is. See chart, below, for an example of a simple bounce back report.



This chart illustrates a manager’s history of rolling 1-year performance, shown quarterly, including underperformance and performance bounce backs, from 1989 to 2012.

Periods of 3 or more continuous quarters of negative active returns vs. the benchmark are defined as the “dips” in the chart. They are broken out into two categories: minor dips, shown in light orange, signify active returns that are less than -10% on average for the cluster; and major dips, shown in darker orange, signify returns greater than or equal to -10% on average for the cluster. This helps quantify the magnitude of the negative returns generated for the period. These thresholds could be different, depending on what your manager’s typical return parameters are, but you get the idea.

Bounce backs illustrate the positive active return of the portfolio for the four quarters following a dip. They can also be categorized by the magnitude of excess return vs. the benchmark in order to assess the positive effect of the recovery. In the example above, minor bounce backs appear in light green; major bounce backs are shown in darker green.

Knowing the frequency, duration and magnitude of periods of performance shortfalls and bounce backs go a long way toward giving asset owners the quantitative information they need to begin to assess a manager’s performance.

So what about those Red Sox?

As of June 23, 2014, here’s where the BoSox stand, based on their win-loss percentage of .461%:

- 4th quintile in peer group (MLB AL East)
- Bottom quintile in total universe (MLB AL)
- Performance pattern: highly volatile with sustained dips of 7–10 days of underperformance, followed by occasional bounce backs of up to 5 days
- And Red Sox Nation? Well, we’re not dancing a jig, but we’re not pulling the plug on the season, either. We know they’ll bounce back. They always do.

¹ RV Kuhns & Associates, Inc. “Manager Retention and Watch List Policy Review.” LAFPPS. February, 2012. www.lafpp.com.

² Scott D. Stewart. “Manager Selection.” 2013. The Research Foundation of CFA Institute. <http://www.cfapubs.org>.

³ Amit Goyal. Sunil Wahal. “The selection and termination of investment management firms by plan sponsors.” 1.8.2008. The Journal of Finance. Vol. 63. Issue 4.

⁴ Robin Penfold. “How Much Value Should You Expect to Gain or Lose by Replacing Your Investment Manager?” 4.1.2011. Towers Watson. Journal of Asset Management. Volume 13. Issue 4. (August 2012): 243–252.

⁵ Scott Stewart. J. Heisler. C. Knittel. J. Neumann. “Absence of Value: An analysis of investment allocation decisions by institutional plan sponsors.” Nov/Dec. 2009. Financial Analysts Journal. Vol. 65. Issue 6.

⁶ Ibid. Penfold.