



ASSETTE 

How High Do You Bounce?

Keeping clients loyal through periods of underperformance

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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 investment managers: Make sure your clients know how high you bounce back from a period of underperformance.

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

Avoiding the negative selection cycle

Asset owners continue to terminate underperforming managers despite compelling evidence that doing so is costly and counterproductive. Consulting firm RV Kuhns & Associates calls it the “Negative Selection Cycle”¹—firing an underperforming manager when they are down, then reallocating assets to a new manager with great short-term numbers only to see the new manager’s performance revert to more sustainable levels.

To avoid falling victim to this “sell low, buy high” mentality, the savvy manager must be vigilant in their client communication and education efforts. A client well-versed in mean reversion theory, bolstered by relevant academic findings and empirical evidence of your own performance patterns over time, is more likely to stick with you during the inevitable periods of underperformance.

Here are some key concepts to reinforce with your clients:

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 levels consistent with your long-term expected excess return.

In fact, the more severe the underperformance, the bigger the bounce back is likely to be. The bounce-back effect is an excellent reason for your clients to give you more assets when your numbers are down, but most of us would be happy just to keep what we’ve got during the bad times.

To make this tangible for your clients, provide them with data that illustrates your own performance history in terms of dips and bounce backs. The graph at the end of this paper shows how powerful this information can be.

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.

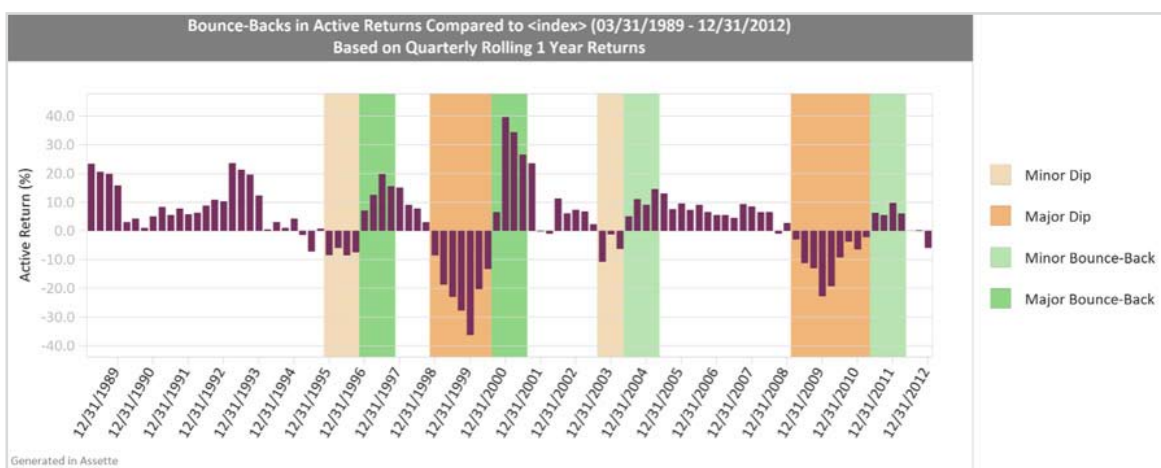
A similar study in 2009 looked at the manager selection record of institutional asset owners by studying the flow of assets across investment managers between 1985–2007.⁵ Their findings cast new light on the opportunity cost of changing managers:

- 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.

Be sure your clients have the right data

Make sure your clients have all the data they need to assess your return pattern over long periods of time—preferably in a regular report that highlights your history of underperformance and bounce backs. Not only will this information tie the theoretical arguments you've been sharing to the client's immediate concerns, but it will help you reinforce realistic performance expectations from Day 1 of your mandate.

Here's an example of a simple bounce back chart.



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 is typical for your particular return pattern, 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 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 your performance in a more realistic light.

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.