IMAC Lecture: Manager Search and Selection

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Portfolio
Construction
Forum

Agenda

- Where are the good managers at? Diversification?
- How to choose a manager
- Berk and Green

1. Where are the good managers at? Diversification?

Diversified v concentrated portfolios

- In previous sessions, I have questioned the ability of the typical active manager to add value
- The two tasks of fund managers are:
  - Stock selection where as we will see they have most to offer
  - Portfolio construction which evidence suggests is not an area of value add
- However post-Markowitz, investors and managers alike have placed high emphasis on portfolio construction resulting in a typical situation of a non-optimal trade-off when building a portfolio between what the marginal stock brings to the portfolio in terms of return and
- As a consequence a manager who may be good at identifying mispriced stocks may not deliver excess returns to his clients because he is including in his portfolio stocks that he does not “like”.

Three great men

"As times goes on, I get more and more convinced that the right method of investment is to put large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes. It is a mistake to think one limit's one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence."
- Keynes, 1934

"Wide diversification is only required when investors do not understand what they are doing. Diversification is a protection against ignorance. It makes very little sense for those who know what they're doing." – Buffett

"The academics have done a terrible disservice to intelligent investors by glorifying the idea of diversification. Because I just think the whole concept is literally almost insane." - Munger

To which I would add - fund managers spend 90% of their time stock-picking and that is their expertise. They generally have no special expertise in portfolio construction. Time and again, I see managers give back their advantage when translating their stock preferences into portfolios.

Reconciling manager skill with manager performance

- Determine how best to use manager skills
- The method that we employ is to:
  - identify a manager’s preferred stocks
    - This is done on the basis of the extent of the active bets that they take on individual stocks
    - Build concentrated portfolios based on their most preferred stocks using conviction weights
  - Compare the performance of these concentrated portfolios with the manager’s actual performance and that of their benchmark
- We then compare two strategies:
  - Build a diversified portfolio of funds that hold concentrated portfolios
  - Build a concentrated portfolio of funds that hold diversified portfolios

Results – best bets (long only)

Total and Net Returns - Full Sample							
Conviction Weights Against Own Index							
Portfolios	Annualised Returns	Transaction Costs	Annualised Net Returns	Incremental Portfolios	Annualised Returns	Transacti-on Costs	Annualised Net Returns
Top 5	14.35%**	1.60%	12.75%	Top 1 to 5	14.35%**	1.60%	**12.75%**
Top 10	12.95%**	1.45%	11.50%	Top 6 to 10	11.10%**	1.25%	**9.85%**
Top 15	12.28%**	1.35%	10.93%	Top 11 to 15	10.30%**	1.04%	**9.26%**
Top 20	11.78%**	1.28%	10.50%	Top 16 to 20	9.60%**	0.98%	**8.62%**
Top 25	11.41%**	1.24%	10.17%	Top 21 to 25	9.19%**	0.94%	**8.25%**
Top 30	11.09%**	1.18%	9.91%	Top 26 to 30	8.46%**	0.80%	**7.66%**
All Funds	10.04%**	0.00%	10.04%	All Funds	10.04%**	0.00%	**10.04%**
Own Index	9.14%**	0.20%	8.94%	Own Index	9.14%**	0.20%	**8.94%**

- Performance calculated on an after transaction costs basis with an equal investment in each of funds available in each quarter – these are the returns of the typical manager
- The numbers suggest that managers do have good stock selection skills which are dissipated in the delivery process

An alternative strategy

	Rebalancing every three years			
	Concentrated Portfolios	Returns	Std Dev	Sharpe Ratio
1 Fund	*Top 5*	12.92%***	0.2374	0.356
	Top15	11.19%***	0.2001	0.339
	Top 25	10.02%***	0.1759	0.321
5 Fund	*Top 5*	12.91%***	0.2260	0.374
	Top15	11.25%***	0.1962	0.348
	Top 25	10.06%***	0.1735	0.328
Any 1 Fund		10.82%***	0.1943	0.329
Any 5 Fund		10.81%***	0.1939	0.331

- On an after-cost and risk-adjusted basis a strategy of investing in a portfolio of concentrated funds rather than in a diversified fund leads slightly better outcomes **when randomly choosing from the whole population of managers**
- Remember what Buffet said: *Wide diversification is only required when investors do not understand what they are doing.*

What about managers who do know what they are doing?

	Whole sample	Top 75%	Top 50%	Top 25%	Top10%
Top 1 to Top 5	12.75%**	13.49%**	14.26%**	16.49%**	**18.61%*** **
Top 6 to Top 10	9.85%**	10.41%**	10.92%**	12.16%**	**13.73%** **
Top 11 to Top 15	9.26%**	9.68%**	10.05%**	10.97%**	**12.42%** **
Top 16 to Top 20	8.62%**	8.92%**	9.30%**	10.47%**	**10.97%** **
Top 21 to Top 25	8.25%*	8.38%*	8.48%**	9.64%**	**10.40%** **
Top 26 to Top 30	7.66%*	8.18%*	8.20%*	9.15%**	**9.93%** **
Own Index	8.94%**	8.98%**	8.92%**	8.89%**	**8.94%** **

- One would expect that better managers would have much better stock picking skills in terms of both the performance of their most preferred stocks and the number of outperforming stocks that they can identify.
- Evidence suggests that even the very best managers can only identify 40 stocks worth investing in, and half of outperformance disappears past top five stocks.

Copycat strategy

	No Lags		Lagged 2 Months		Lagged 1 Quarter	
Portfolios	**Net Returns (annualised)**	**Sharpe Ratio**	**Net Returns (annualised)**	**Sharpe Ratio**	**Net Returns (annualised)**	**Sharpe Ratio**
Top 5	12.75%**	0.367	16.47%***	0.702	11.44%**	0.446
Top 10	11.50%**	0.350	15.55%***	0.676	11.44%**	0.451
Top 15	10.93%**	0.319	15.08%***	0.649	11.54%**	0.458
Top 20	10.50%**	0.333	14.82%***	0.671	11.82%**	0.485
Top 25	10.17%**	0.328	14.66%***	0.676	11.79%**	0.491
Top 30	9.91%**	0.322	14.54%***	0.683	11.80%**	0.499

- Problem is fund holdings data is not available until about the middle of the next quarter and not in electronic form until well into the third month after.
- This means that any copycatting has to be delayed.
- It seems that after two months, the strategy would still add significant returns.

Implications and extensions of findings

- Managers' stock selection skills are eroded by requiring them to hold diversified, risk-controlled portfolios.
- However, an obvious strategy of building a portfolio based on the preferred stocks sourced from a number of managers does only slightly better than current practice of investing via diversified managers.
- This highlights that there are two elements to the statements of Keynes and Buffett – hold concentrated portfolios but only if you are good.
- A few other insights:
  - Growth managers are by far the best stock pickers.
  - Worst bets perform even better than the best bets.
  - A long/short portfolio of best/worst bets has generated an after/costs return of about 10% pa over the last 15 years.

2. Choosing a manager

Hitting a moving target

- We have already seen that the studies of manager performance suggest that good performing managers are in a minority and it is even more difficult to identify them at the right time.
- The evidence is clear that past performance is not a good predictor for future performance nor do the rating agencies have a good record of identifying the better managers.
- Two articles provide some insights into where one where might look when choosing managers.
  - The first provides insights into the importance of not only being able to select the better managers but also firing the bad (or potentially bad) managers.
  - The second demonstrates how a number of manager characteristics that have been found to corelated with performance can be combined in a model which shows promise in adding value by manager choice.
    - It seems that the managers who believe that they are superior, are superior.

Foster & Warren: Why might investors choose active managers?

Asked why investors are willing to appoint active managers and pay them a sizable fee, given disappointing evidence on performance? F&W model:

- Even in a world where the average manager has an expected alpha of zero, a significant proportion of managers will generate a positive alpha over any measurement period.
- Once a manager is appointed, you are not stuck with them for life as you can always fire n existing manager and appoint a new one (i.e. you have a real option).
- The performance of successful/large managers tends to dissipate through time as a consequence of their own success which suggests that you should be willing to fire even a well performing manager.

Based on this model and presuming that the investor has a 60% probability of identifying a good manager:

- Investors with a hit rate of 60% who have around 6 managers in an asset class and who are willing to fire managers should expect to realise alpha of around 1%pa gross of fees.
- Expected alpha falls to 0.75%pa if the hit rate falls to 50%, emphasising the value of the option to fire managers.
- Expected alpha falls to 0.60%pa if investors were unwilling to fire well performaning managers as they grow “too large”.

Factors that impact fund performance

A number of recent papers have identified a number of other fund traits that are highly correlated with performance.

- Stock Bets
  - Active share (Cremers and Petajisto, 2009)
  - Return gap (Dyakov,2012)
  - R-squared (Amihud and Goyenko,2013)
  - Active weight(Doshi, 2013)
- Industry Bet - Portfolio industry concentration (Kacperczyk et al., 2005)
- Style Bet - Value, Size and Momentum (Bird and Yeung, 2015)
- Leading - Herding (Jiang and Verardo, 2013)
- Analysts - Ignoring forecasts (Kacperczyk et al., 2009)

The forecasting models

	OLS Regression		
	Total Sample	Years Split by Year	
		Good	Bad
1- Herding	+0.0257***	0.0499***	-0.0244**
Active	-0.0016**	0.0021**	-0.0103***
Value tilt	-0.0001	-0.0026***	0.0024***
Growth tilt	0.0002	0.0013*	-0.0013
Large cap tilt	0.0033***	0.0050***	0.0029**
Small cap tilt	0.0016**	0.0103***	-0.0057***
Winner tilt	0.0120***	0.0167***	0.0007**
Loser tilt	-0.0087***	-0.0037***	-0.0123***
Industry conc.	0.0623***	0.0844***	0.0235***
Gap	0.1182***	-0.0823***	0.4639***
Doschi	0.0096***	0.0041***	0.0135***
$1 - R^2$	0.0105***	-0.0409***	0.0639***
Age	-0.0000***		
Turnover	-0.0009***		
Funds Flow	0.0000***		
Fees	-0.2170***		
Size	0.0001***		
Index returns	-0.1833***		
Past returns	0.0477***		
Adjusted R^2	12.1%	15.1%	

The findings

Quartile Ranking	In Sample			
	OLS		Logit	
	Total Sample	Good/Bad Split	Total Sample	Good/ Bad Split
Top	+4.8%pa	+4.6%pa	+4.1%	+4.3%pa
2nd	+0.7%pa	+1.1%pa	-0.9%pa	-0.4%pa
3rd	-1.6%pa	-1.4%pa	-2.4%pa	-2.4%pa
Bottom	-5.4%pa	-5.7%pa	-2.7%pa	-3.2%pa

Quartile Ranking	Out-of-Sample			
	OLS		Logit	
	Total Sample	Good/Bad Split	Total Sample	Good/ Bad Split
Top	+3.9%pa	+3.9%pa	+4.0%pa	+3.5%pa
2nd	+0.7%pa	+0.6%pa	0.0%pa	+0.2%pa
3rd	-0.7%pa	-0.6%pa	-1.1%pa	-1.1%pa
Bottom	-2.5%pa	-2.5%pa	-1.4%pa	-1.4%pa

3. Berk and Green

And finally there is Berk and Green

- They provide a rational model to explain why fund managers are well remunerated when they do not seem to be able to outperform the market.
- The implication of no persistence in performance is that it is random (luck) and so why compensate for luck?
- Their model has three elements:
  1. Competitive provision of capital to managers
  2. Some managers do have ability but diminishing returns to scale
  3. Learning about manager ability from past returns
- As a result, funds chase performance to a point where future performance erodes and all rents are captured by the managers
- Think about it – all the better managers fully charge for their skill and then we are left with the lesser managers so…

Overall conclusions

- Managers have more skill than we give them credit for – but that skill lies in stock selection.
- Managers may be reasonably good at identifying, and providing signals of, their relative ability.
- Their stock selection skills are often lost due to constraints self-imposed on the managers or imposed on them by their clients.
- We have highlighted a number of factors that investors should consider when choosing managers:
  - What they take into account when choosing managers? Managers themselves may be best at this task.
  - How they contract with managers? Investor mandates cause perverse behaviour.
  - How they fire managers? We are even worse at firing managers than we are at hiring them.

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