



# INVESTMENT RISK AND PERFORMANCE

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## Assessing Manager Risk: Looking beyond the Numbers

*The qualitative aspect of manager due diligence can yield more insights about a firm's future performance than an analysis of the performance figures themselves. Factors such as ownership structure and size can lead to poor performance through risk of manager turnover or lack of resources, and a firm's philosophy, process, and people can indicate the quality of its investment strategy as well as its commitment to superior results.*

Investors know that past returns cannot predict future returns. There is even proof. Of all existing U.S. large-cap and small-cap mutual funds with at least 10 years of return data as of year-end 2010, on average, only about 28% of top quartile managers in three-year periods from 2003 to 2007 were still in the top quartile in the subsequent three-year periods. For five-year periods, about 80% of managers were no longer in the top quartile during the following five-year periods.<sup>1</sup>

This article looks at assessing manager risk beyond the numbers—the qualitative aspects of manager due diligence. Interviews with L. Joshua Wein, director of alternative investments at Sterling Capital Management LLC, and Frederic C. Filippelli, CFA, director of investment governance at Prudential Retirement, provide two perspectives on the due diligence process—a process that is unique to each consultant or investor. Wein, who serves as a consultant for clients investing in alternative mutual funds as well as hedge fund products, says he tries not to look at returns when evaluating managers and does not focus primarily on performance screens. He is cognizant of identifying successful managers as a first step in the due diligence process because of longevity or survivorship bias—riskier or unsuccessful firms in the alternative space typically do not survive. “I am aware that past returns are not indicative of future returns. Bad teams can do well, so I don’t rely only on returns,” says Wein. Filippelli leads ongoing governance of full-service investment products for Prudential with a focus on fund selection,

monitoring, and replacement. Filippelli notes a fund must fare well on metrics before he moves ahead with the due diligence process, but he also cautions against relying solely on returns to judge a manager. “Even the best managers can spend time in the fourth quartile,” he says, “sometimes relatively long periods of time.”

The process of manager due diligence is often quite complex. The nature of due diligence depends on the type of firm or product being evaluated—assessing a hedge fund manager can be very different from assessing a traditional, long-only investment manager. Qualitatively assessing manager risk generally involves a review of a firm’s organizational attributes, such as ownership structure and assets under management, and internal controls, such as compliance, operations, and trading. Due diligence typically also includes a review of some combination of a firm’s philosophy, process, people, and/or portfolios—all of which can provide clues about a prospective manager’s performance.

### ORGANIZATIONAL AND OPERATIONAL RISK

Types of ownership structures include employee-owned, parent-owned, and publicly owned firms; each form carries risk. The risks inherent in ownership structure include whether a firm’s owners (parent or stockholders) have goals that conflict with investor or manager goals and whether a firm is a takeover target or at risk for losing key employees. Employee ownership of a firm is often perceived as being the least risky of the ownership

structures.<sup>2</sup> Brian Tipple, chief investment officer of equities at Russell Investments, says, “Firms whose managers have large personal stakes in their firms are often the most committed to achieving successful outcomes for clients.”<sup>3</sup> Wein echoes the importance of employee ownership, noting, “Employee ownership that is dispersed down to the analyst level is always important, in that the management team should be more stable and less likely to leave after a bad year when they don’t foresee a bonus.”

When Filippelli assesses a manager, he evaluates how committed a firm is to its investment management business and whether senior executives are growing or expanding the business. He hires both widely recognized institutional managers as well as boutique firms. As an example of how risk can be found in ownership structure, Filippelli once chose not to hire a manager with a very attractive track record because the parent firm’s private ownership structure appeared conducive to a buyout. Within a few years, the firm was taken over and less than half of the fund managers remained with the new firm.

Assets under management (AUM) may also provide clues to risk at the organizational level. Although a steady or steep decline in AUM certainly warrants further investigation, a significant increase in AUM presents a different type of risk. A firm may be overwhelmed by a large increase in AUM, which could stretch firm resources and lead to difficulties in implementing strategies that invest in less liquid assets, such as small caps. Investors should also compare the amount of AUM per strategy with a firm’s total AUM. Too few assets in a strategy might signify an orphan strategy that lacks proper support. Filippelli looks for a minimum level of AUM at the strategy level, although he notes that certain ratios of AUM to firm size are not necessarily inappropriate. For example, “Does the firm offer only one investment strategy? That may be okay, because we know all the firm’s resources and energy are going into that strategy.”

Operational risk—the potential for fraud, costly errors, or insolvency—clearly won’t show up in performance numbers. Here, AUM sometimes can serve as a barometer for a firm’s internal controls. Managers with approximately \$5 billion in AUM are generally considered institutional size; these large managers are less likely to have lax internal controls, whereas smaller firms may be more prone to internal control issues. Large, established asset management firms also typically have audits

performed by independent third parties, including the SSAE 16 control standards report<sup>4</sup> that attests to the appropriateness of a service organization’s internal controls. A “qualified opinion” issued by an external auditor indicates the auditor has found control deficiencies. According to Tipple, a lack of an independent, third-party audit is one of the most glaring potential red flags revealed by Russell’s due diligence process.

## PHILOSOPHY

What can an investor learn about manager risk from a manager’s philosophy or process? The answers can be surprising. Wein becomes wary when he hears managers discuss expectations for unrealistic performance goals; such expectations may signify a lack of experience. Rather than relying on a set of scripted questions, Wein prefers manager interviews to flow naturally to see what the manager chooses to say. If a manager doesn’t talk about risk control, that’s a good sign he or she is not thinking about it.

In “The Role of Investment Philosophy in Evaluating Investment Managers: A Consultant’s Perspective on Distinguishing Alpha from Noise,” John Minahan, CFA, writes that managers with investment philosophies that sound like marketing slogans or product positioning statements often rely on the fact that random returns will cause even a mediocre investment process to periodically outperform. These managers do not fully understand where their alpha is coming from, nor do they put great effort into consistently generating alpha through a well-defined, intelligent process.<sup>5</sup> Wein finds a lot of commonality in managers’ processes, to the point where they often seem scripted. Filippelli agrees: “You can tell who’s giving the elevator speech,” he says. Overall, scripted processes or canned speeches can be a sign of a portfolio manager who is not fully vested in the process or committed to the strategy. “In addition to talking with the portfolio managers, interviews with other members of the investment team can often provide insight into the consistency of the philosophy,” says Filippelli.

## PROCESS

Consistency in the investment process is critical to performance results. “Managers can’t really control their performance results, but they *can* control the process,” says Wein. “I like to hear the story, see the process, then see the results.” Wein examines correlations, standard

deviation, and beta for evidence of a consistent process. “If managers keep these metrics within a reasonable range, that’s a good indication of a consistent process,” he says.

Filippelli also examines the investment process closely to determine what factors contribute or detract from consistency. Is there a team approach? Is there a lead portfolio manager? If so, is he or she in charge of other strategies? Is the manager spread too thinly? Philippelli doesn’t necessarily favor a team approach versus a “star manager” approach, although he does identify the star manager approach as a risk. All else being equal, given a choice between two identical candidates, he would likely favor the fund with a co-manager rather than a star manager.

Style consistency, another major performance risk, can be identified at the portfolio level. Style drift subjects an investor to either unintended or more-concentrated risk exposures. To determine if a manager or investment team is applying their style consistently, Philippelli’s analysts obtain portfolio holdings from the manager and run an attribution analysis to understand where the performance is coming from. Philippelli looks for confirmation that the portfolios are performing as they are supposed to according to their investment style.

Perhaps the most important aspect of a manager’s process is risk control, says Philippelli. “What type of risk management do they have in place?” he asks. “Do they understand where their bets are?” An example of effective risk management might consist of one designated person at a firm who is focused on risk controls to ensure portfolio managers are well aware of their risk exposures and to alert them if their portfolios exhibit unintended exposures such as a size bet.

## PEOPLE

Finally, assessing manager risk comes down to assessing the experience and skills of the people who are actually managing the money. A significant people-related risk comes from turnover in investment talent. Some investors are wary of hiring a firm whose investment team has changed recently. An investment team that has been in place for the duration of the performance period being evaluated can demonstrate how the manager’s approach has fared during market cycles and during crises, such as the 2008 credit crisis or late 1990s “dot-com” bubble, and can show what the manager learned from each period. Similarly, for markets that have witnessed a lot of

change, such as the non-U.S. markets during the past 10 years, a team that has invested in those markets as they have evolved will likely have more wisdom and perspective to draw upon when making investment decisions. Although turnover does not automatically lead to poor returns, an investor should consider whether turnover is a material factor in poor performance or might lead to a decline in returns in the future.

Tipple says optimal manager due diligence involves evaluating managers on what he calls the “tangible four Ps”—people, process/philosophy, portfolios, and performance—and on what he refers to as the “intangible four Ps”—passion, perspective, purpose, and progress. Managers who are highly motivated and intensely competitive are more likely to be focused on excellence in performance results.<sup>6</sup>

Wein gains insight into the caliber of managers by reading the monthly letters they e-mail to clients. He looks for a “culture of writing” at a firm and says most good managers place an emphasis on writing. Writing is an effective way for managers to organize their thoughts and to articulate the rationale behind their investments, he says, which can lead to more thoughtful investment decisions. “It is rare that very experienced people with thoughtful processes don’t perform well over the long term,” says Wein.

## CONCLUSION

In some ways, parallels can be drawn between assessing manager risk on a qualitative basis and assessing performance risk on a quantitative basis. Investors must build a set of qualitative screens to discern in which areas a manager is most susceptible to risk and which factors will have the greatest impact on performance results. Tracking error and style analysis are two performance-based measures that can be used qualitatively to predict the future: If the manager has a history of deviating from his or her style in the past, the style inconsistency likely will persist. Most investors are unwilling to accept a deviation from the style mandate. Managers who lack external audits or have lax internal controls are generally perceived as high risk. When the requisite internal controls are in place, managers who are committed and consistent tend to fare best. “The goal of due diligence is forward looking,” Wein says. “Ultimately, it is a bet on people and their process.” ♦

## NOTES

1. From Romhilt (2012). The data represent U.S. large-cap and U.S. small-cap manager peer groups as published by InvestWorks. According to Barclays, “While this data focuses on long-only U.S. stock mutual funds, the conclusion holds true for non-U.S. equity funds as well. The conclusion is less true for hedge funds and not applicable to Private Equity.”
2. From Romhilt (2012).
3. Statements on Standards for Attestation Engagements.
4. From Tipple (2010)
5. From Minahan (2006).
6. From Tipple (2010).

## REFERENCES

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