I recently read a disturbing study by Professors Amit Goyal and Sunil Wahal (2005). It indicates that some institutional investors may be as prone to chasing performance as individual investors. I call the study disturbing because it indicates that, although institutional investors use consultants in 63 percent of hiring decisions, many of them are either getting bad advice, not following good advice, or making poor manager selection decisions on their own.

Goyal and Wahal, using data provided by Mercer Investment Consulting, Institutional Investor, and other trade publications, discovered the following:

Our hiring sample consists of 9,684 decisions by 3,737 plan sponsors between 1994 and 2003. A total of $737 billion is delegated in these hiring decisions . . . The results are striking. The average excess holding period return of hired investment managers from three years (one year) prior to the hiring quarter is 13.8 (3.9) percent and is statistically significant. At each horizon after the hiring decision, the excess returns are statistically indistinguishable from zero. . . . Post-hiring returns are negatively related to pre-hiring returns, indicating considerable return reversal. (page 3)

Goyal and Wahal also studied terminations, where the news is not much better.

Our sample of investment manager terminations consists of 933 firing decisions involving almost $117 billion by 515 plan sponsors between 1996 and 2003. The number of termination decisions is substantially smaller than hiring decisions because data sources are geared toward assisting investment managers in obtaining new business, and because there is a natural disinclination to report terminations by both investment managers and plan sponsors. . . . Out of 933 termination decisions, we identify 296 (32 percent) as being related to the performance of the investment manager, 124 (13 percent) as due to organizational reasons, 106 (11 percent) as asset reallocations, and we are unable to identify reasons for the remaining. . . . The average excess return of fired investment managers from three years (one year) prior to the firing is –1.0 (–1.0) percent, with a standard error of 0.9 (0.8) percent. The large standard errors reflect the heterogeneity in reasons for termination. Not surprisingly, the pre-firing returns for performance-based terminations are significantly negative. Three years (one year) after the firing decision, the corresponding excess returns are positive, 4.2 (0.7) percent with a standard error of 1.5 (0.7) percent. For performance-based terminations, the return reversals are larger. (page 4)

These hiring and firing decisions were not all related, and the authors point out that it would be much more informative if they could have examined “round-trip” hiring/firing decisions (manager replacements).

They state that, however, they were able to construct . . . a sample of “round-trip” firing and hiring decisions manually. We identify 660 round-trip decisions between 1996 and 2003. For these decisions, pre-firing returns are negative and pre-hiring returns are positive. On average, post-firing returns are positive and in some cases, statistically significant. Post-hiring returns are statistically indistinguishable from zero. (page 5)

As investment consultants, we all are aware of individual investors’ propensity to chase returns, either in stocks or mutual funds. Individual investors also are notorious for abandoning their asset-allocation strategies at the worst possible times, increasing their equity exposures in the froth of bull-market tops and cutting their exposures in bear-market troughs. Institutional investors, by and large, tend to stick with their asset-allocation strategies much better than individual investors. I think that as a professional community we can take some pride in having helped our institutional clients in this regard.

I had assumed that institutional investors also were more disciplined about not chasing returns than individual investors and that they would be more patient with short-term underperformance. Goyal and Wahal seem to indicate that my assumption was unfounded. As I reflect on this, however, I can see that this shouldn’t have surprised me. Many of the requests for proposals (RFPs) I see from institutional investors specifically require superior trailing excess

Get Off the Performance Treadmill

BY JOHN P. COLLINS, CIMA, CHFC

Institutional Consulting

If we are recommending active managers to clients because they can add value, we should give active managers more room to be different from benchmarks. We often encourage clients to evaluate managers by how consistently they outperform benchmarks in relatively short periods of time, and we often are nervous if a manager’s tracking error gets too high. Does that make sense? I think not. Look at figure 1.

Davis Advisors examined the track records of 116 large-cap equity managers who ranked in the top quartile of their peer groups for the 10-year period ending December 31, 2004. We often advise clients to look for longer rather than shorter records of outperformance, implying that long-term outperformance is a more reliable indicator of manager skill. But look at what the Davis study uncovered. Of those 116 10-year, top-quartile performers, 110 out of the 116—94 percent of them—ranked in the bottom half of their peer groups for at least three consecutive years. Amazingly, 28 percent of those managers were in the bottom decile of their peer groups for a three-year period during that 10-year span. How many of us would defend those managers during those times?

Of course, it would have depended on what was causing such poor performance. We need to have sophisticated attribution-analysis tools so we can determine what is driving performance and, more importantly, whether the manager is sticking to a stated investment discipline. If we determine that a manager is running a portfolio strictly according to the investment strategy that has served well over the long-term, but we see that that strategy is not being rewarded in the market, then we should use attribution tools to defend the manager and have the client stay the course. I’m wondering how many investment consultants saw a classic growth-at-a-reasonable-price (GARP) manager underperform a growth-manager peer group during 1997–1999 but outperform the peer group by a wide margin during 2000–2002 and
called that style-drift. If we use attribution tools to punish differences from the benchmark for its own sake, perhaps we ought to recommend indexing.

The GARP manager’s mandate is not to track the growth index; it’s to follow the GARP strategy, which has elements of valuation that will look like style drift on a returns-based style analysis chart. But if the adviser convinced the plan sponsor that a GARP strategy made sense, don’t fire the manager for following that strategy. If a sponsor and the consultant are worried about not having exposure to growth sectors during a bull market, the answer is not to fire the GARP manager for underperformance, it’s to mix the GARP style with a more aggressive growth strategy or a growth index fund. We can dial tracking error up and down by mixing an index vehicle with an actively managed vehicle. But we should not advise a client that a particular active-management strategy makes sense and then fire the manager when the market stops rewarding that strategy for a while.

You likely have heard the lament from some money managers that financial strength has not been rewarded in the market for the past several years. For the period January 1, 2003–September 30, 2005, publicly traded companies with a Standard & Poor’s Earnings and Dividend Quality Ranking of B– have returned 925 basis points annualized over the return for those with a ranking of A+ (see table 1). Managers using financial strength screens have tended to enjoy lower volatility and better downside performance on average over long periods of time. Lately, however, many of them have found themselves on sponsor watch lists for underperformance. If sponsors believe that managers employing financial strength screens have a place in their portfolios, they ought not to be worried if these managers have underperformed in the past couple of years—it is to be expected.

That is provided that the sponsor and investment consultant have done the underlying holdings analysis and performance attribution and satisfied themselves that the manager hasn’t changed the investment process and that the underperformance likely is due to the strategy being out of favor. If the underperformance is accompanied by turnover in the investment team, changes in the investment process, or attribution work that indicates something is amiss in addition to the strategy being out of favor, perhaps a watch list or termination decision is warranted. There may be good reason to place the manager on notice, but it ought not be solely due to recent underperformance. If the sponsor cannot tolerate short-term underperformance in pursuit of longer-term profit, the sponsor should rethink the decision to use active managers and perhaps move toward indexing.

The story of a well known large-cap core/value bias strategy manager proves my point. In the late 1990s, this firm was a well-regarded and large manager using a large-cap core/value-bias strategy. The firm, one of the biggest firms in the retail separately managed account market, enjoyed prestigious institutional client relationships. It also enjoyed superior returns compared with core/value peers. But in the late ’90s it began to stray from the stated goal of searching for companies misperceived by the market and under-priced. While other managers with a value tilt stoically suffered through the tech bubble (and perhaps paid for it with net investor outflows), this firm posted top-tier returns. When the bubble burst, it sank to the bottom of the peer group rankings and meaningfully underperformed the benchmark. In 2005, the firm shut down its domestic equity portfolio. This was a prime example of search and termination criteria combining to favor a manager because of relative performance when detailed attribution work would have highlighted a shift in investment strategy. This shift, for

<table>
<thead>
<tr>
<th>S&amp;P RATING</th>
<th>2003</th>
<th>2004</th>
<th>JANUARY 1–SEPTEMBER 30, 2005</th>
<th>3.75 YEARS ANNUALIZED</th>
</tr>
</thead>
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<tr>
<td>A+</td>
<td>−4.11%</td>
<td>0.91%</td>
<td>−4.29%</td>
<td>−2.03%</td>
</tr>
<tr>
<td>A</td>
<td>0.93%</td>
<td>5.92%</td>
<td>−0.01%</td>
<td>1.79%</td>
</tr>
<tr>
<td>A−</td>
<td>3.42%</td>
<td>4.33%</td>
<td>7.07%</td>
<td>3.92%</td>
</tr>
<tr>
<td>B+</td>
<td>7.45%</td>
<td>3.57%</td>
<td>3.21%</td>
<td>3.76%</td>
</tr>
<tr>
<td>B</td>
<td>9.51%</td>
<td>9.07%</td>
<td>10.86%</td>
<td>7.77%</td>
</tr>
<tr>
<td>B–</td>
<td>8.98%</td>
<td>12.35%</td>
<td>6.09%</td>
<td>7.22%</td>
</tr>
</tbody>
</table>

Source: Rittenhouse Nuveen Investments
Standard & Poor’s Earning and Dividend Quality Ranking
How can we, as investment consultants, help our institutional clients avoid this destructive behavior? If the sponsor believes in efficient markets, then the solution is easy: Stop hiring active managers and index.

and allow them to be different. But if a manager holds a large number of stocks with tight sector-weighting limits versus the benchmark and a high turnover ratio, it’s likely to look a lot like the benchmark, so why not just index? On the other hand, if a manager has a “value bias” in terms of investment style, believing that over the long-term such focus on security valuation at time of purchase—whether in a “value” style account or a “growth” style account—will benefit the Plan.

I believe that if we start talking to our clients about expected behaviors driven by specific investment strategies—instead of letting clients focus on how managers are doing against the benchmark or peers—then we can help them avoid the behavior that Goyal and Wahal document. We also must change the way we draft investment policy statements. Instead of defining termination criteria as benchmark underperformance, let’s describe the behaviors we expect from managers in different market environments. It should be OK to state in an investment policy statement that a GARP manager will be expected to underperform peers and the benchmark in strong bull markets and outperform in bear markets. Otherwise our clients are doomed to watch the manager just fired outperform the manager just hired.

I often hear from investment-consultant colleagues that they are exasperated by their clients’ propensity to chase excess returns. I submit that client expectations can be properly managed if we persevere in reframing the discussion properly.

Here is an example, based on an actual investment policy statement for a $40-million defined-benefit pension plan. The adviser has no problem with this board when one of the plan’s six money managers underperforms the benchmark.

A word about the Trustees’ investment philosophy is appropriate here to guide the Consultant and Managers in their activities. The Trustees believe that diversification is a critical element of risk control, however they also believe that active portfolio management can add meaningful value both in terms of return enhancement and risk reduction. The Trustees also have a “value bias” in terms of investment style, believing that over the long-term such focus on security valuation at time of purchase—whether in a “value” style account or a “growth” style account—will benefit the Plan.

The Trustees have a bias against aggressive growth strategies such as momentum investing or short-term trading strategies, preferring growth managers who buy good growth companies at reasonable prices with the intent to hold these securities for relatively long periods. The Trustees recognize that this belief in active portfolio management as well as their value bias will necessarily lead to meaningful tracking error relative to
various market style benchmarks, and the Trustees believe this tracking error tradeoff in pursuit of better risk-adjusted return is justified. Generally, the Trustees expect their equity managers to underperform market benchmarks in strong bull markets (e.g., 1997–1999 in the U.S. equity markets), on the average, but expect them to outperform in flat to down markets (e.g., 2000–2002 in the U.S. equity markets).

I’m reminded of a paper that Ron Surz, CIMA, wrote for the Journal of Investing in 1998. The title says it all: “R-Squareds and Alpha are From Different Alphabets.” Active managers behave differently than market benchmarks. Let them be different, or index. But let’s get our clients off the performance treadmill.

John P. Collins, CIMA, ChFC, is a regional director for PFPC Managed Account Services in King of Prussia, Pa. He provides training and general sales support to PFPC client advisory firms, and he provides support to client advisers on large institutional accounts in the areas of asset allocation, asset liability analysis, portfolio construction, and manager selection. He earned a B.S. in economics from Rockford College. He serves on the IMCA Monitor editorial advisory board and recently earned the IMCA Investment Strategist Certificate. Contact him at jcollins@advisorport.com.

References


“Evaluating Risk and Return,” the seventh in the IMCA educational training series featured in Bankers’ Investment Consulting, December 2005, discusses how investment consultants assess the risk and return associated with a specific investment or portfolio. Subsequent articles will describe additional measures of return as well as various types of risk and how they are measured.

Marc Hogan of Ignites reported on December 1, 2005, that a new trade group has formed to address the demographic shift reshaping the fund industry. The Retirement Income Industry Association (RIIA), based in Washington, D.C., will take aim at financial and public-policy issues relating to retirement income. The group says it will support training and education efforts provided by IMCA, the Financial Planning Association, and the Society of Fiduciary Advisors.

IMCA and the PGA Tour have teamed up again for 2006. Look for the IMCA ad on page 91 of The Official Annual 2006 PGA TOUR magazine. It invites golf aficionados to learn about the five market forces industry leaders say will have the biggest effect on their portfolios by visiting www.InvestmentHelp.org.