Behavioral Pitfalls of Selecting Managers, Essayists, or Otherwise

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In 2022, the U.K. Diversity Project inaugurated a scholarship award in honor of board member Jane Welsh, its erstwhile project manager. Few have worked harder than Welsh in pursuing the Diversity Project’s goal of accelerating progress toward an inclusive culture in the U.K. investment and savings profession. To earn a chance at winning the cash prize and a mentorship or work placement, people younger than age 25 were challenged to write an essay on the topic “How can the investment industry attract more diverse talent from within the U.K.?” Welsh was one of the three judges; another board member was a second; and your author, as a diversity project ambassador, was invited to be the third.

I think it is safe to say that the Diversity Project had been careful to assemble a panel of seasoned judges who genuinely cared about fairness, equality, and meritocracy. All three of us are acutely aware that unfair discrimination in recruitment and promotion decisions denies organizations the opportunity to profit from their human capital, undermines their attractiveness in the competition for talent, and delegitimizes them in their interactions with external stakeholders, i.e., customers, investors, regulators, etc. We are equally conscious that unfair discrimination adversely impacts the lives and careers of women, racial minorities, people with disabilities, and those from many other social and socio-economic groups. It makes our entire society poorer.

So, we were judges who were strongly motivated to make a fair decision. Despite this, we insisted that the essays be passed to us with the candidates’ names scrubbed. We mutually agreed to adhere to a strict scoring protocol that allowed us to consider only key aspects of the essay submissions, and that specified the weight to be allocated to each aspect. In addition, we also promised to submit our individual evaluations before meeting to discuss who the winner should be.

Even diversity, equity, and inclusion advocates like us needed a fair and robust process.

Even the best need a little help

Did all of these self-imposed constraints mean that we did not trust ourselves to judge fairly and consistently? No. But we did recognize that simply knowing about nonconscious biases, and caring about fairness, was not enough to ensure just outcomes. Even diversity, equity, and inclusion advocates like us needed a fair and robust process. Our knowledge and care only served to assure our commitment to that process.

Why do I mention the travails of the Jane Welsh Scholarship Award judging panel? It is because our task was not too far removed from that faced by the selectors of asset managers. They, like our panel, believe that their experience, professionalism, and passion to deliver the best results for their clients make them well-placed to serve as judges. Yet do they also recognize that these traits alone are not enough to ensure just outcomes? The evidence suggests that asset manager selectors are not always the shrewd judges they believe themselves to be.

Consider the evidence on the flows to asset managers in the United States. Although the performance of female asset managers is statistically identical to that of male asset managers, and it is more likely to persist, mutual fund investors direct significantly less money into funds managed by women—40 percent less—than to comparable funds managed by men (Niessen–Ruenzi and Ruenzi 2018). Investors also direct about 10 percent less in annual fund flows to U.S. managers with foreign-sounding names (Kumar et al. 2015). This group of managers, who are not necessarily all foreigners, by the way, also is less celebrated with inflows following superior performance, and more severely punished with outflows following poorer performance, compared to their peers with traditional American names. Once again, the performance of the two groups is statistically identical.

In one study that compared hedge funds managed only by women to hedge funds managed only by men, researchers found no statistical difference in performance and similar risk profiles (Aggarwal and Boyson 2016). Yet, the women-only funds attracted significantly less capital. The difficulty that women who are hedge fund managers experienced in building a critical mass of assets also explained the higher failure rate of these funds. It seems that men-only funds that deliver average performance still manage to attract...
sufficient assets, whereas women-only hedge fund managers need exceptional performance just to survive. Conditional upon survival, therefore, funds run by women only outperform funds run by men only. Despite this, they still have fewer assets under management.

The obstacles facing racial minorities in asset management also have been well documented. In a recent study of the implications of hedge fund managers’ race on investment performance and capital flows, researchers found minority hedge funds attracted more than 3 percent less in annual flows compared to non-minority hedge funds (Lu et al. 2022). In addition, minority-launched hedge funds manage start-up capital that is one-third less than that managed by non-minority-launched hedge funds. And this occurs despite minority-operated hedge funds delivering higher alphas, Sharpe ratios, and information ratios than non-minority-operated hedge funds, and minority fund managers having attended more prestigious schools and being more likely to hold post-graduate degrees.

A 2020 study revealed the extent to which potential investors make associations between race and gender and the very notion of risk-taking (Wages et al. 2020). In experiments among essentially White Americans, the perceptions and mental representations of risk-takers evoked racial connotations. The negative, masculine, impulsive stereotype of Black Americans resulted in Black men being perceived as Black and feminine. When paired with Black traits, was considered reckless, whereas when paired with White traits was considered responsible. When experimental subjects were shown blurry facial images of “reckless risk takers,” they tended to stereotypically perceive them as Black and masculine; when subjects were shown blurry facial images of “responsible risk takers,” they tended to stereotypically perceive them as White and feminine.

THE BLIND SEE MORE CLEARLY
The evidence from other domains reveals that the diversity judges’ simple first step of blinding the selector to the identity of the candidate results in women and other underrepresented groups emerging victorious more often. Consider the evidence about submissions by female scientists for publication in academic journals (West et al. 2013), proposals for peer-reviewed grants (Bornmann et al. 2007), or their applications for personal research grants (van der Lee and Ellemers 2015). Such studies have revealed that a greater proportion of women were published, and received research funding, when their identities were hidden from selectors (Kolev et al. 2019).

One of the most famous studies about selector bias concerned auditions by female musicians to play in major U.S. symphony orchestras. It showed that the hiring of women grew meaningfully—a 50-percent increase in the likelihood of selection—following the introduction of blind auditions in the 1970s (Goldin and Rouse 1997). It should be noted, though, that auditions needed to be genuinely blind for the effect to be seen. In the blind condition, the procedure was for all musicians to play behind a screen. When, however, the jury members recognized the familiar sound of high heels walking behind the screen, the meritocracy disappeared.

Given the number of musicians in a typical orchestra, this means that before blind auditions, scores of men must have occupied positions they did not deserve, and countless symphony music lovers were denied superior performances despite the fervent desire of those selectors to do precisely the opposite. Similarly, one could wonder how many significant scientific research findings were left unpublished, or research projects uninitiated, because editors and institutional decision-makers who claim to be in pursuit of knowledge are not able to overcome simple human biases. Poor selection has real costs.

DECIDE IN ADVANCE WHAT IS REALLY IMPORTANT
Does this mean that selectors are deliberately sexist or xenophobic? Well, sometimes, but not always (although we did have to wait another three decades for Marin Alsop to become the first female conductor of a major U.S. orchestra). The reason we humans are such poor selectors is because our preferences are not consistent. Rather than feeding static preferences into a utility optimization process, we, instead, mentally construct our preferences each time we have a choice to make. This mental construction involves selectively recalling knowledge from memory about what constitutes a good candidate or a good fund manager. But the right knowledge is not always retrievable. Nor is that knowledge correctly weighted because it includes information that was subject to earlier biased decisions. For instance, if one chose a given option in the past, one might conclude there must have been a good reason for it. So, at orchestra auditions, jury members’ mental construction of a good musician might be that of a man simply because they selectively recall more examples of good male musicians or have previously chosen male musicians.

Rather than constrain our choices, constructed preferences might serve only to justify a choice that already has been made. This means that if selectors like a particular candidate, their preferences might be reconstructed to give prominence to the attribute the desired candidate possesses. Selectors might say they simply know what the correct choice is—that they can feel it. Indeed, evidence suggests that one’s preferences might shift between one candidate and the next (Simon et al. 2008). It should be said that a constructed preference probably could not transform a negative attribute into a positive one. However, it could impact the goodness of a positive attribute and the badness of a negative one. This alone is sufficient to lift one candidate above another, even though such a choice would not have been justified by preferences as stated at the outset.
PREFERENCES MUST DETERMINE CHOICES, NOT VICE VERSA

To avoid suboptimal choices due to momentarily constructed preferences, it is essential to specify in advance the desirable attributes and the weight they are to be given in the overall evaluation. In other words, one must construct preferences that are rational and coherent before being confronted with the candidates’ attributes. Those explicit preferences must then constrain one’s choices. For instance, on the Diversity Project’s judging panel, we were concerned primarily with essay characteristics such as the originality of the ideas, the thoroughness of the research, the practicality of the implementation, and so on. There were no points for spelling, grammar, page formatting, etc. The ability to use a spellchecker is undoubtedly a worthy trait in any essay writer, but it has zero implications for the quality or applicability of a policy suggestion. As a consequence, it was denied any chance to influence our scoring.

In the same way, asset manager selectors must decide in advance which characteristics genuinely have implications for the outcomes they seek, as well as the weight each should be given in the overall evaluation. These explicit preferences help selectors overcome several decision-making hurdles, the first of which is to remember the task. Selection tasks might be complex and have multiple attributes as well as multiple objectives. Not all of these can be recalled easily from memory. In addition, the task might not be the only drain on the selector’s cognitive resources. Yet, the decision-makers must not overlook any key component if they want to optimize their choices.

Similarly, encoded preferences help to focus a selector’s attention on factors that have genuine diagnostic power, and away from factors that are merely salient. Evidence-based preferences also have the advantage of helping selectors avoid reintroducing bias via the back door. For instance, does excluding hedge fund managers whose launch capital is one-third below the median genuinely have implications for future risk-adjusted returns, or does it only serve to reintegrate the wider investor bias against minority-led funds? Similarly, is it genuinely in the client’s best interest to screen out a high-performing hedge fund due to below-average assets under management, or does it serve inadvertently to exclude women-led operations?

DECISION-MAKING IN GROUPS

The final step of the diversity judges’ decision process also might be instructive for asset-manager selectors who decide in groups, namely the independent submission of evaluations. If an organization goes to the trouble of assembling a group of experts to reach a decision, it is because it values the multiple perspectives, experiences, and expertise of these individuals. It also recognizes that each voice has an equal weight; at least, one would assume the organization would not recruit someone to the group whose opinion it does not value. However, human beings are social animals. When we come together, we invariably pursue some social objectives, and these are not always congruent with the organizational goals. For example, our desire for social approval in group settings might influence what is said and done in groups, and what is not said and not done.

It matters for most of us what others think, and what they think about what we think. Therefore, we tend to seek their recognition and approval. We do not even need to like those others to want them to see us favorably. One consequence of this social motive is that we are likely to moderate our opinions, e.g., self-censor, whenever we suspect that our views will be met with hostility within the group. We especially are wary of provoking the ire of high-status group members. So, instead of each voice having an equal weight, opinions expressed in a group might be overrepresented by those with the highest social status, those with a recent history of success, the most articulate, or simply the loudest.

By submitting evaluations independently, judges have no opportunity to shape their views to better match the popular opinion of the group. Ahead of the big reveal, they have no idea what the popular opinion is. In addition, the individual evaluations are all expressed in the same way, with no voice having any particular priority. Of course, differences of opinion still might remain, but at least the eventual discussion starts from a short-list that has been determined by a reliable process that has considered all the expert opinions in the group in equal measure. I confess that our group did not agree, in advance, on a rule for settling these final differences of opinion. However, even this could have been resolved through, for example, a majority rule; the most senior person’s prerogative; or we could have let Jane Welsh, the award’s namesake, have the final say.

THE OTHERS ARE BIASED

One of the most common human biases is the “I’m—not—biased” bias. So, it shouldn’t surprise anyone that very few multi-manager portfolio selectors would admit to having been influenced in their choices by manager attributes that have nothing to do with their stated goals and their own convictions. And certainly, none would confess to having denied their client access to successful fund managers due to factors such as gender or a foreign-sounding name. Yet, the aggregate data on fund flows reveals that this is precisely what is happening. They might not recognize it—they might even be convinced that this is not the case—but many manager selectors must be doing it at least a little.

Like almost all behavioral biases, this one cannot be undone simply by knowing about it. Expertise and experience might reduce the bias but are unlikely to remove it entirely. To ensure consistency of opinion, it is necessary to make our preferences explicit. This approach ensures, primarily, that...
nothing important is forgotten. It also focuses our attention on attributes that have been demonstrated by evidence to have diagnostic power. At the same time, we are denied the possibility to integrate into our thinking attributes that, while salient, are not relevant. Our code also ensures that appropriate and consistent weights are applied to all the relevant attributes. This is particularly pertinent with complex decisions that might require the use of decision-making tools like decision trees.

Coded preferences do not mean that they can never change, though. The opposite is the case. As evidence evolves, goals change, and experience builds, it will be necessary to modify our preferences. Even the context in which we decide, for example, the availability of new sources of information about the manager pool, might require a change to our preferences. When preferences are explicit, though, it is far easier for external observers to audit decision quality, for devil’s advocates to kick the tires of our assumptions, and for novice selectors to learn from the experts.

Finally, wherever groups are responsible for selection decisions—or any important decision—it is essential to have in place a mechanism to ensure the group’s social motive does not undermine the organizational goal. Without being conscious of it, human beings are prone to place social status and group harmony above the goal of reaching an optimal decision. Simple rules, decided in advance, can ensure that the experience and expertise of the group flows into the process in equal measure. These simple rules can even spare the group the dissonance and disputes that sometimes accompany the final step to a decision.

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