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CREATING THE WINNING TEAM

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The Challenge

Once an investor has designed the asset allocation strategy for their portfolio(s) they still must fill the various allocations with investments. Depending on the asset class decisions made and the investment philosophy ascribed to the choice can be relatively simple or complex. Interestingly the holders of significant wealth and their surrogates are not faced with too few options. The phones are ringing weekly with a variety of investment options that could be considered for investment. Occasionally a gem is found in the fire hose like a stream of options, but more often one could wonder if their is an inverse relationship between the unsolicited approach and the quality of the offering. With tens of thousands of investment options to consider the question is how to sort through all the options and separate the wheat from the chafe. There are many considerations to be weighed.

Passive? Active? Both?

First of those decisions fits in the investment philosophy arena. Should the investor seek a "Passive" approach and choose index funds and/or ETF's to allocate assets, or endeavor to seek "Active" managers to allocate assets to. The "Active" versus "Passive" debate has raged in the industry for decades with valid points on both sides of the argument. The "Passive" devotees will argue with great enthusiasm that a LARGE percentage of the active managers do not outperform the market over time. It is true that 60-80% *(depends on the specific date in time one is looking at the data) of active managers do not beat a relative market index over time.

Additional points that are pointed to as part of the debate on the "Passive" side are that active manager's higher fees are a reason for the underperformance. Passive choices can be an excellent choice for those not willing to invest the time and resources in the search for a suitable, active manager. Pursuing an active approach takes more time and money for the resources to ascertain managers who have delivered over time the Alpha required to justify the effort.

While it can be proven that a large percentage of active managers do not outperform some passive indexes; that is true in many parts of life. The often reference Pareto Principle for many events, roughly 80% of the effects come from 20% of the causes. Only 20% of professional athletes "outperform" the average player. Only 20% of executive leaders are exceptional and so on. It would logically follow that to accept that more than 20% of the active managers would outperform is unrealistic. The real quest is how to find exceptional managers in the 20% and keep the portfolio full of more of them on average. Like a professional sports team, orchestra or other high level endeavor excellence does not happen "on average". It happens with process and ongoing diligence.

Clearly the burden of proof for "Active" managers is their ability over time to out perform a relative benchmark. Due to the extra effort involved, one does not begrudge a firm higher fees if they deliver results. Active management does involve more effort and one could question the value of paying extra for a passive approach. After all, Large Cap is Large Cap. If you are seeking to match that index the process is quite simple. Of course, there is a certain elegance in simplicity and the above comment should not be interpreted as a dig against those who promote a passive approach, but a simple recognition that the process will result in a tracking error to the extent of fees, if the process is carried out to its logical conclusion.

Passive approaches seem to work best in “directional” investing approaches that are highly liquid. Funds/ETF’s that are designed to track the market movements closely. While there have been many ETF’s, ETN’s and 40 Act Mutual Funds that seek to replicate the effect of certain types of active fund managers, the results are early but not very encouraging in the writers opinion. By way of contrast, active approaches tend to work better in asset classes that tend to be less liquid like Emerging Markets, Real Estate, etc.

Size of the portfolio can be a factor as well for a few reasons. First, the impact of any excess returns or Alpha may seem to not be worth it for a small portfolio on a nominal basis. The excess costs of research and database subscriptions could overwhelm a portfolio of $1,000,000 but be well justified for a portfolio of $10,000,000. Example: an excess return of 1% of a $1,000,000 portfolio yields $10,000, where on a $10,000,000 portfolio it brings in another $100,000. Of course, outsourcing the approach may bring costs down as the fixed costs of databases and salaries can be spread over a larger base of assets. To be sure there is effort involved in the quest for excess returns the process needs to cast a wide net, be disciplined and be applied consistently. We have found many cases over the years where none of these have been part of a portfolio, and the results show it.

Passive approaches can also be effective where the differentiation between active managers found through research and screening do not offer a significant advantage over a passive option. Why take the risk if there is not a better option to take advantage of? Other approaches may be to use passive indexes or sector funds to take a particular tactical position, in order to take advantage of a high probability idea.

Tools

If one has adopted a passive approach they may want to skim over this part, or ignore it completely, as it deals with tools and ways to select active approaches. As mentioned above, there is no shortage of ideas being tossed over the transom for consideration. While most, if not all, have their merits one must consider “compared to what?” and how the idea may or may not fit into the portfolio. With tens of thousands of managers and ideas out there, how does one find the proper solution?

It is clear that no one can “know” all the thousands of managers in the marketplace. Relative results change with every reporting period and a manager’s relative rank changes as well. Finding a top manager is Mission Impossible, but finding managers that consistently find themselves in the top quartile can be achieved and managed over time.

Access to data is a must if one is taking the active approach. A number of companies offer databases of managers with performance and statistical data to allow individuals/families to sort through massive amounts of data, with the intention of creating a short list to consider more carefully. The costs of these databases can be significant and, most often, customizable to the individual’s/families’ need. For example, some may only want equity managers and do not want to pay for hedge funds. Others may want to focus on Hedge Funds/Private Equity. By doing a Google search you will come up with names like Pertrac, BarclayHedge, Morningstar, Informa IS and many others.

The larger the database by number of managers/funds there are, brings more options to screen through, which makes the appearance in the upper quartile all the more significant. Also important is the number of data points relative to your search. Data points like: Beta, Alpha, Up Capture, Down Capture, Category, Relative Benchmark, Manager(s) Tenure, Size, Returns over Various Time Periods, Expenses/Fees are some of the primary items we look for.

Evaluating investment options in a vacuum is problematic on a few levels. First, all investment proposals will always have some merit and look good; they have too. If not, the marketing/sales person may just as well move on. The merit of a particular proposal should always be evaluated relative to other investment options. What if a better option exists? Second, how does the proposal fit into your asset allocation plan? Will this require some change in thinking? Remember, it will look good but ultimately it needs to fit. The allocation plan should be viewed as the blueprint of your portfolio.

The Screening Process

Once you have determined your asset allocation plan, use your database to create screens, with the objective in mind, to have a shorter list for making judgements on. For example, one asset class you need to find solutions for could be Large Cap US Stocks. An approach we have found successful is to screen this asset class for managers with a minimum 5 year track record and a manager tenure of, at least, three of those 5 years. Another criteria is to screen for positive Alpha for 3, 5,7 and 10 years. The list soon becomes short using this approach. First to be cut from this "farm team" are managers with exceptional results in only one or two periods. This reduces the "lucky" once approaches reasonably well.

Of course, we are seeking managers who hit the upper quartile consistently and have the people in place. Replication, while not guaranteed, has a reasonable chance of recurring consistently. The "farm team" is re-screened each month to receive early warning signs of changes that may require action. By reviewing multiple time periods, the risk of investing with a "hot" manager who "cools off" is reduced, as well as, by reviewing the early warning signs frequently and other relevant players that should be considered.
Other data items that could be considered important are Up Capture and Down Capture. This measures how the manager's performance will change with different market environments. For example, a manager who captures 110% upside of the relative asset class and realizes 120% of the downside would be less attractive than a manager that captures 108% of the upside and 80% of the downside.

Accuracy of the category is also at issue. I hold memories on Don Phillips, President of Fund Research saying " the easiest way to get a good star rating is for the fund to be mis-characterized". While I'm confident that Morningstar made every effort to be correct, it does pay to look at the underlying portfolio and assess if the labels for that particular strategy are accurate.

Of course, data is only the beginning of a due diligence process. There are many qualitative issues such as personality fit, quality of the organization, depth of resources, etc. that need to be considered. This is often, best accomplished once the selection has been narrowed down to three to 5 prospects and then personal interviews can be scheduled to ascertain the qualitative fit.

For some, this turns the process upside down. In many cases an approach is made by a manager/sales representative and tends to be very relationship based at the beginning. Data is provided and sometimes evaluated in a vacuum with little comparison, other than personal experience. By saving the relationship piece to last, the process objectively seeks quality candidates then assesses relationship.

Many purport to perform such a process in the investment community. Some do have a lot a flexibility in searching the universe of options available, but many start off with a "shrunken" list of available options that the firm has selected for use. Occasionally, but not always, the managers share revenue with the firm. Sometimes the "revenue" department may have a bigger role in the 'due diligence' process than appropriate. This may cause otherwise quality managers that chose not to be on the platform, and share revenue, to not be included in a search. Questions to ask are: Specifically how many managers are included in the search? Does your firm create an approved list for you to use? Can you offer managers/products that are not on the approved list? A wider search may likely lead to better results and overall lower fees if compensation is not shared.

Hedge Funds and Other

More and more investors are including Alternative Investments in their portfolios to mitigate volatility and bring in more absolute return pieces to their portfolio. The type and scope of the database is particularly important when researching Hedge Funds. This topic is beyond the scope in this limited paper but, in general, many of the steps would still hold true when beginning the research in this space.

Deal terms, fees and liquidity need to be carefully considered. In addition, review of audits, administrators, custodians, auditors and tax preparers add to the complexity of making a good choice for a portfolio. Many a hedge fund has been spawned via the friends and family fund raising approach. Many times accompanied by back tested hypothetical results. Careful consideration needs to be given to offerings of this type as hypothetical performance may have little in common with actual performance. As mentioned above having third party administrators, legal and tax professionals give at least some idea that others are "watching" the process and assuring that certain processes are in place to maintain custody of funds.

Summary

By following an intelligent asset allocation strategy and combining it with a process that objectively screens a large amount of managers, to bring the best performers over time to a manageable list of candidates, will populate an active management approach. When focused on the upper quartile of managers in a particular category, excess returns are possible to compensate for the additional time and expense of active management.