

THE ART AND SCIENCE OF MANAGER TERMINATION



Fiduciary Insights

DECIDING WHEN AND WHY TO TERMINATE AN INVESTMENT MANAGER IS ONE OF THE MOST DIFFICULT JUDGMENTS THAT FIDUCIARIES MUST MAKE.

Understanding the reasons for exiting a strategy, and the time and costs involved in terminating a manager, can help investors avoid common mistakes. This edition of our Fiduciary Insights series explores typical mistakes made in firing managers and outlines Strategic's approach to manager termination.

Introduction

Investors spend considerable time and energy on sourcing and selecting investment managers, often putting in place elaborate procedures to accomplish what they consider a fundamental task. Few, however, are as diligent in manager termination. With more than 25 years of investment experience, Strategic has developed a nuanced approach to manager termination that helps us avoid typical mistakes and keeps us focused on prospective alpha potential and overall fit with the total portfolio.

Mistakes Made in Firing Managers

Terminating managers is expensive in terms of both time and portfolio turnover costs. In some asset classes, the turnover costs of liquidating and then reinvesting a portfolio can consume a year's worth of expected value added. It is not unusual for institutional investors to become caught in a continuous cycle of ill-advised manager replacement, spending their hoped-for alpha in turnover costs and their staff's time in manager searches. There are several common reasons for this behavior.

- **Impatience.** Overreacting to short-term underperformance is perhaps the most common of all traps to which investors fall prey. Investors must be able to identify the specific drivers of underperformance and evaluate whether they are likely to persist. All managers underperform, at least for short periods, and even the very best can be expected to lag their benchmarks at least a third of the time. In our experience, most managers in highly efficient markets such as U.S. equity underperform at least 40% of the time, and a string of bad quarters, or even years, is a common occurrence. Statistically, a manager with an information ratio of 0.25¹ has a 33% chance of trailing its benchmark over any three-year period, and even one with a 0.50 information ratio has about a 20%

chance. Not knowing these odds, many institutional investors terminate on performance alone, without considering that they may be terminating a good manager that is experiencing a statistically normal downturn.

- **Bias Toward Action.** Executives often get to the top of their organizations because they have a natural drive to act decisively when presented with any perceived problem. Manager underperformance often appears to them to be a problem to be solved through manager replacement. The alternative of analyzing and monitoring underperformance but taking no immediate action, which is often the best option, seems feckless and emotionally unsatisfying to aggressive, executive personality types.
- **Inexperience.** There is a tendency at OCIO organizations and investment consultancies to have junior staffers monitor the performance of investment managers. This organizational oversight structure is suboptimal, since senior investment professionals, the ones with the most experience in working with investment managers, are a step removed from a critical business function. In their role as monitors, junior staffers are often charged with deciding whether to place an investment manager on a watch list, in the event of lagging performance. Their relative lack of experience can predispose them toward acting prematurely, and this can lead a firm to suffer from manager churn.
- **Episodic Governance.** In cases where sponsors have retained discretion over managers, it is often the investment committees that are charged with deciding whether to fire managers. This decision-making structure presents practical challenges because investment committees typically meet just four times a year. With only four narrow time periods in which to act, investment committee members may be tempted to decide to fire managers at the wrong time or with stale or insufficient information. Decisions about manager termination should not revolve around committee meetings, but rather should be made when the timing is right, and when there is sufficient information to make a call.

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¹ The information ratio is the quotient of value added over the manager benchmark divided by the volatility of the value added. It measures risk-adjusted value added over the benchmark.

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Avoid reacting reflexively to underperformance.

- **Rigidity (Rules-based Actions).** The complexity and uncertainty involved in terminating managers can drive organizations to substitute simple, mechanical rules for fact-based judgment. Rules can help to bridge the time gap for making decisions between investment committee meetings. Rules for terminating managers are especially appealing because they absolve any one individual of responsibility for taking an unpleasant action. Simplistic rules regarding terminations give investment committees a false sense of control, result in bad decisions, and contribute to manager churn. Rules-based actions may have an underperformance trigger (e.g., fire a firm if the underperformance is x%) or a time horizon trigger (e.g., fire a firm if it underperforms for one, three, or five years). Either type of rule can lead to ill-advised manager terminations.

Strategic's Approach to Evaluating Manager Underperformance

- **Get the Facts, and Investigate the Cause.** While it is tempting to act quickly when returns disappoint, Strategic tries to avoid reacting reflexively to underperformance. Most importantly, we investigate and analyze the cause of the underperformance before determining that it actually constitutes a problem. As market veterans, we always take into account the fact that manager results are strongly affected by market environment, which shifts over time, often enabling a manager to turn around performance. We are also cognizant of the difficulty of predicting how much incremental alpha one strategy will deliver versus its replacement, particularly after considering the cost of any change in strategy. We analyze the manager's situation on the basis of facts, not ill-defined negative feelings.

We also bear in mind that manager diversification produces diverse results. In any given period, some managers will be underperforming while some are outperforming. The result is lower volatility, which is a benefit to the overall portfolio. We know not to react negatively to what is the expected outcome of our own diversification strategies.

- **Case-by-Case Analysis, Not Hard-and-Fast Rules.** We do not have pre-determined tolerance bands for managers for deviation from the benchmark, because there are many possible reasons for underperformance. Some explanations lead us to the conclusion that the manager's process is still intact and can create value going forward, and some are sufficiently concerning that they undermine our confidence in the manager's methodology. Each case is somewhat different. The key is to discern what is driving underperformance, and to judge whether it is likely to persist in the market environment we expect.

- **Both Art and Science.** The factors that must support our determination that a manager should be terminated are both quantitative and qualitative. For example, the fact that a manager has been underperforming is directly measurable, providing information on how and when the performance has occurred. With our performance measurement tools, we can observe the duration of the underperformance, the batting average and volatility of the strategy during various market cycles, and the tendency of the manager to lead or lag in each of them. With holdings analysis, we can analyze the manager's response in terms of portfolio positioning. Our regular meetings and calls with the manager may reveal qualitative explanations for the decisions the firm made, such as the portfolio manager's attitude toward risk or the effects of an organizational change. The combination of quantitative and qualitative analysis leads to an informed judgment about whether a problem is transient, or will persist.

- **Decision Makers: Know thy Managers.** As we mentioned above, it is often the case at other organizations that junior staffers source and evaluate managers, and monitor them once they are retained. Junior staffers, as a result, own the sourcing and monitoring of managers, and the senior professionals at these firms are removed from what we consider to be a critical business function. In our view, this arrangement disadvantages the senior staffer charged ultimately with retaining or firing the manager. One of Strategic's competitive advantages is that seasoned senior executives manage the sourcing, due diligence, hiring/firing decisions, and monitoring of managers. These executives, who have years of investment experience, are better positioned to decide whether to retain or terminate managers in the event of lagging performance. They have gone through previous market cycles and have been charged throughout the process with monitoring the investments. This consistency enables us to make better decisions about manager changes and reduces the chances of manager churn. We believe that our approach brings invaluable experience to bear on critical decisions and consequently strengthens accountability.
- **The Proof is in the Pudding.** All major asset classes under our management have exceeded their target performance, net of all advisory fees for multiple time periods and since inception, on an absolute and risk-adjusted basis. At times, we have held managers within each asset class that are underperforming, sometimes significantly, expecting underperformance to turn around with a change in market environment. Although the exact timing of the shift in market environment is not predictable, the change itself is usually easy to recognize. Over time, we find that our patience is rewarded.

Valid Reasons for Terminating Managers

There are many sound reasons to terminate and replace a manager, once the facts have been properly analyzed and considered. The circumstances that have prompted most of Strategic's manager terminations have fallen into one of the following categories.

- **Adverse Organizational Changes.** As the main assets of manager firms are their people, organizational changes are a frequent issue, and the most common cause of manager terminations. There are myriad ways that organizational changes can occur. The departure of a key person can lead to unwelcome changes in investment process or firm governance, and nullify assumptions on which the original hiring decision was based. In most cases, the future effectiveness of a portfolio manager and his team becomes the central question. For example, we have terminated a manager when the lead portfolio manager left the firm. In other instances, we acted when a portfolio manager handed off his investment management duties to more junior staff, and became focused more on management responsibilities. High turnover in the research staff and instability within key management are other reasons for manager termination. We may also see fit to terminate a manager because of ownership changes at a firm. In such cases, we would closely examine the realignment of interests and the engagement level of key staff members in the business.

We strive to bear in mind that change is inevitable, and not always bad. Some organizational changes turn out to be very positive developments, especially if they re-energize a firm and enable it to adapt to new conditions. We have seen some firms thrive after passing through a period of significant turnover, whereas others lose their cohesion and focus. For example, one of our best and longest-standing managers

Organizational changes are the most common cause of manager terminations.

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has undergone several episodes of turnover and reorganization, and during each of these we have had to make a decision about the future capabilities of the firm. We retained the firm—correctly, as it turns out, to date—because we believed that its unusually talented staff would cope successfully with the changes. The challenge is to understand the depth of the remaining team and its readiness to step into the roles of departing key personnel.

- **Unfavorable Market Conditions.** A change in our asset allocation or a restructuring decision can also precipitate the need to terminate a manager. We hire managers to give us desired exposure to a market or investment strategy. Over time, we may alter our outlook for broad asset classes or styles within asset classes and adjust the exposures within portfolios, leading us to prefer different types of market exposure than that which a certain manager is providing. As a result, if we believe that the future market environment will be inhospitable for a manager's strategy for an extended period, we will consider terminating the manager, even if the strategy is otherwise sound. For example, we would not want to (and did not) hold a large growth manager in a year like 1999, when the market was in a historic bubble and large growth stocks were poised to crash. We make such market-based judgments to terminate only upon solid evidence of a market anomaly, most often a measurable valuation distortion or economic imbalance that is likely to correct. In such instances, we may terminate a manager, regardless of **past** performance, because our focus is on likely **future** performance.
- **Redundancy or Irrelevancy.** As we manage a client's assets on a total portfolio basis, we view managers as playing specific roles in an optimal portfolio structure. At times, we have initiated manager terminations when it became apparent that the strategy was no longer able or needed to fulfill its role. In some cases, where we have taken on a new client and inherited a roster of existing managers, we have determined that selected strategies did not fit into our intended manager line-up or offer anything unique. As another example, a strategy may outlive its usefulness in the portfolio because we have found another strategy that appears to be more robust.

- **Failure to Meet Return Expectations.**

Ultimately, every manager must meet return expectations, or we will proceed to terminate. The decision to terminate for poor performance occurs only after we have thoroughly investigated the causes for underperformance and satisfied ourselves either that the manager does not have sufficient skill, or that the strategy is not effective and will probably not be so in the foreseeable future.

- **Fiduciary, Ethical, or Operational Risks.**

Fiduciary problems have been rare, and we continue to conduct extensive investment and operational due diligence before hiring managers, and ongoing due diligence afterward in order to avoid such problems going forward. In this area, we look at operational risks and whether the manager has a poor control environment. If concerns emerge, we closely monitor the manager's attempts to rectify shortcomings. However, if we feel that the lapses were indicative of an underlying ethical problem or that the manager was not correcting the situation quickly enough, we would terminate the manager promptly.

Conclusion

Manager termination warrants just as much care as the sourcing and selection of managers in the first place. Strategic's approach has evolved over time to reflect the experience of our asset class officers who, having worked with hundreds of managers over many market cycles, have learned to eschew hard-and-fast rules. We regularly revisit our reasons for termination so as to make the most intelligent decisions possible. We believe that our practice of being as deliberative and decisive in firing as in hiring—in accordance with our experienced judgment—has paid off in helping us to retain high quality managers and deliver value-added.

Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

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