Our Views on the Manager Selection Process

InvestEd | June 2023

PART 4

In this fourth segment of a multi-part investment education series, Biagio Manieri, Ph.D., CFA, will provide an overview of PFM Asset Management's (PFMAM) views and process with regard to manager selection. The final segment in this series will provide the firm's thoughts on the use of alternative assets in portfolios.

Manager Selection – The Big Picture

Past performance is not a good predictor of future performance. Therefore, quantitative measures (which provide a "snapshot" of a specific moment in time) such as the Sharpe ratio and Information ratio, are not by themselves reliable and cannot be the sole basis for selecting an investment manager. Instead, we believe that the most important factors in selecting an investment manager are qualitative in nature. When it comes to manager selection, quantitative factors supplement the qualitative judgment of our investment professionals and help ensure that we select managers that are capable of outperforming over extended periods of time.

Qualitative Considerations

When it comes to investment management, nothing matters more than the people making the day-to-day decisions. Like every other profession, some individuals will be more talented than others; some truly enjoy their profession and are highly motivated to do a good job, while others see it as merely a paycheck. We want to see a passion for investing and seek professionals that are motivated to "win," or outperform the benchmark and other managers for the simple sake of beating others.

Author Matthew Crawford (who earned a Ph.D. in philosophy and turned his back on academia in favor of pursuing a passion to become a motorcycle mechanic) compared two types of motorcycle mechanics in *Shop Class as Soulcraft: An Inquiry into the Value of Work*. Those who truly love their craft and will work long hours on a given repair versus those that take shortcuts to finish a job and move on to the next as a way to generate higher income. We like to hire the first type of manager and would prefer index funds to the second type.

Since people are the most important part of achieving great investment performance over time, by definition the investment decisions they make cannot be reduced to a quantifiable process. This creates an issue for some asset owners when selecting managers since the criteria for assessing the quality of the people is necessarily qualitative and the decision as to whether to hire a manager cannot be reduced to comparing numbers.

We also tend to favor managers that are independent minded and are comfortable being out of the mainstream. Our belief is that managers that are uncomfortable being “out of consensus” are often ill-suited to take advantage of opportunities in the marketplace.

We also tend to favor managers that are independent minded and are comfortable being out of the mainstream.

To us successful managers understand that to achieve performance that is different from the index, their portfolio cannot look like the index. They are comfortable being out of consensus. They are also often contrarian in nature and understand that the consensus is not always right. If an asset owner is not comfortable investing with these types of managers, then a better solution may be to take a more passive approach. After all, why hire an average manager that will deliver an average return and even less after fees?

Of course, no manager is right all the time. To that end, we attempt to determine whether a failure to outperform the benchmark was due to carelessness, or perhaps a deficient investment process. We also want to know how the manager’s investment process takes into consideration decision making in a world of imperfect and incomplete information.

Having a deep understanding of the manager, the people and their process is also important when the manager inevitably underperforms. An investor with a deep understanding of the manager is more likely to remain with that manager rather than placing the firm on a watch list and ultimately terminating that manager. Conversely, a superficial understanding of the manager based solely on past performance can lead investors to churn through managers and thereby achieve mediocre investment results.

Organizational Characteristics

One particular aspect of the organizational structure that we examine is whether the individuals managing the fund have a significant portion, if not their entire net worth, invested in the product we are considering. This helps to ensure an alignment of interest and that the individuals are focused on investment performance and not simply gathering more assets for the sake of increased fees. We also look carefully at soft dollar arrangements and the use of directed brokerage arrangements.

When conducting our due diligence, we believe that visiting the investment manager at their office is vital. Speaking with as many of the staff members of the firm including traders, analysts, and others is also important as we look to gain an understanding of the firm’s culture.

We believe the culture of the firm is particularly important in helping to attract and retain talented investment professionals. Something as simple as hearing different answers to the same questions from different people at the firm is instructive. For example, if the portfolio manager (PM) describes the investment process and interactions between PMs and analysts one way and the analysts describe it in an entirely different manner, this provides valuable information.

Speaking with different individuals outside of the firm is also an important part of the due diligence process. Asking one investment manager what he/she thinks of another provides useful insights about both. Speaking with former employees to hear their view (both positive and negative) can also yield useful information.

Monitoring the investment manager and portfolio is just as important as the original decision to hire that manager. Without proper monitoring and understanding of the portfolio, the asset owner has no way to judge the performance of the manager other than focusing on investment performance versus some benchmark. This will inevitably lead to manager churn during periods when the portfolio underperforms.

Over time, by continuingly maintaining a dialogue with the investment manager we gain a greater understanding of the people, process and firm and can spot possible issues on the horizon. For example, in a few instances, we terminated a manager because we observed emerging conflicts between senior people at the firm. Subsequent to our decision to terminate the Funds, senior people began to exit the firms and the manager saw significant asset outflows and deterioration in investment performance.

We consider the role that risk management plays for the investment manager when constructing the portfolio, and favor managers that have a risk management process in place. This helps to ensure that the manager is not making unintended bets. Such a process may also help limit the potential downside for the portfolio. Along these lines, we pay specific attention to the maximum dollar amount that the manager will hold in any one security before rebalancing the portfolio.

Quantitative Considerations

While qualitative analysis and considerations are the most important aspect of proper manager due diligence in our opinion, we do incorporate quantitative analysis and factors in our process. One aspect of our process is to quantitatively analyze the drivers of investment performance. In many cases what looks like “alpha” or outperformance relative to a specified benchmark may actually be “beta” relative to the proper benchmark.

Academic research has identified certain factors that earn a premium over time. For example, a fund that is outperforming in a rising market may simply hold higher risk or higher beta stocks. Small-cap stocks have historically outperformed large-cap stocks and low price/book stocks have earned a premium over high price/book stocks.[1]

If a manager consistently has a bias that favors lower average and median market-cap stocks and low Price-to-Earnings (PE) equities, we will not only compare the performance to a core index but also to Small- and Mid-Cap (SMID) and value indices and run a regression analysis using those indices to see if the outperformance disappears.

If an investment manager indicates that stock selection forms the basis of their investment philosophy, we want to see evidence of that in their performance. For example, after the bubble burst in Japan (in 1989), most EAFE managers outperformed the Index, but this was driven by a systematic underweight of Japan rather than superior stock selection.

1 Journal of Financial Economics 33 (1993). Common risk factors in the returns on stocks and bonds, Eugene F. Fama and Kenneth R. French.

We also examine the average turnover of a portfolio to see if it is consistent with the investment process as defined by the manager. For example, if the manager describes their investment process (as many do) as focusing on “quality” companies with “strong management” that are trading at reasonable valuation, we want to see that reflected in a low turnover number. After all, there simply aren’t many high-quality companies with top quality management where the stock is trading at attractive valuation to support high turnover.

One sign that we look for when determining whether a manager can add value over time is the degree to which the portfolio “hugs” or stays close to the benchmark. We believe that a manager with deep research capabilities and a concentrated portfolio provides the best opportunity to outperform over time, whereas active managers with no sustainable competitive advantage tend to hug the benchmark.

It should be noted that this benchmark hugging behavior is also sometimes combined with a focus on gathering as many assets as possible to generate even higher fees. When researching and selecting active managers, we are cognizant of this “principal/agent problem”. We specifically look for investment firms that have a good understanding of how much assets they can productively manage and a willingness to close their funds after reaching those levels.

Supplementing our qualitative manager due diligence process with quantitative analysis leads to a more robust overall process.

Stay tuned. In our final segment, Biagio will discuss the use of alternative assets in portfolios.

To learn more or discuss in greater detail, please contact us:

Biagio Manieri, Ph.D., CFA
Chief Multi-Asset Class Strategist
manierib@pfmam.com

PFM Asset Management LLC (“PFMAM”) is an investment adviser registered with the U.S. Securities and Exchange Commission and a subsidiary of U.S. Bancorp Asset Management, Inc. (“USBAM”). USBAM is a subsidiary of U.S. Bank National Association (“U.S. Bank”). U.S. Bank is a separate entity and subsidiary of U.S. Bancorp. U.S. Bank is not responsible for and does not guarantee the products, services or performance of PFMAM.

NOT FDIC INSURED : NO BANK GUARANTEE : MAY LOSE VALUE