When to Fire an Investment Manager

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Knowing when to fire a manager is a complex professional decision. A number of factors beyond the mere analysis of past returns need to be taken into account so that a "case" builds for termination. Whatever model you rely upon, it is important that you have a process incorporated into your practice procedure to handle this inevitable event.

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Background

Knowing when to fire an investment manager[1] always will be a difficult decision and requires a professional judgment call. Firing a manager is to some extent an admission of failure, and our emotions can play havoc in such situations. It's important to get beyond this very human response by making sure you have a process in place at your practice for terminating managers. In our practice, we do not believe in a cookie-cutter, purely returns-driven termination method—even though, at times, relative performance or lack thereof is the dominant factor in this decision. It is important to remember that inputs to the firing decision are usually multi-factor, at times non-quantitative, and don't necessarily reveal themselves all at once, so it is reasonable to expect some variation in approach among practitioners.

Knowing when to terminate a manager is somewhat analogous to knowing when to sell a stock. Just as you rely on your investment managers to have and execute a sell discipline in your client's portfolio, you should have guidelines that you rely upon to help you know when a manager is entering the "firing zone." It can be difficult to pull the trigger for lots of reasons (i.e., taxes, operational challenges, relationships with managers, etc.) even when the facts indicate that firing is prudent. Vigilance and impartiality in observing your self-imposed guidelines are prerequisite. We have found that, even though we are not always right from a purely after-the-fact performance standpoint, it is better to be safe than sorry. It is always better to have a prudent process in place than none at all.

What follows are thoughts of practitioners who exclusively perform manager due diligence. Knowing when to terminate a manager or not usually isn't a clean, straightforward decision; rather, a picture emerges or a case develops over time. Here's some advice you can use in your practice to sharpen this part of your skill set.

Chief Termination Factors

The chief factors on our radar screen when considering the need for firing a manager include the following:

Organizational Stability

The principal assets of any money management firm are people—especially the investment professionals. You want to know whether they are highly motivated to manage your clients' money. To find out, it's necessary to identify the key people to whom you can attribute the portfolio's track record. Changes in this group or the organization often can disrupt the investment process, and you should stay aware of changes that could negatively impact portfolio decisions such as the following:

- Employee turnover, especially departures of firm leaders and key investment professionals such as portfolio managers and valued analysts (whether they work on the portfolio strategy you are using or not)
- Changes in ownership or control of a money management firm's equity, which can influence power and the personal satisfaction of employees
- Leadership changes or changes in professional responsibilities of key investment personnel, which can change the focus of investment professionals
- Proliferation of products offered and the addition/integration of new investment teams to support them, which can challenge firm resources and focus
- Rapid growth, loss of assets under management, or rapid expansion or

contraction of distribution channels, which can be disruptive to smooth portfolio management and even cause style drift
- Advancing age, impending retirement, or declining health of key personnel
- Legal or regulatory actions or ethical lapses, which can inform your assessment of the quality of a firm
- Lack of a succession plan or smooth transition of authority, both of which pose risk to a portfolio

Organizational changes, legal and regulatory events, and ethical lapses can wreak havoc on an investment firm and be the precursor to poor relative performance.

Single events, such as the departure of staff or changes in control, by themselves can be cause for termination, especially if the changes affect the key investment personnel to whom you attribute the performance track record. Remember that your clients are buying an investment process and the organization that executes that process, not the past returns that process has produced.

Track Record Analysis and Performance Cyclicality

Performance is always what matters in the end. Remember that short-term performance is not a good indication of a manager's skill. And, it is unrealistic to expect any manager to beat a properly chosen performance benchmark without interruption. Even the best managers underperform from time to time.

A manager's unique investment style will influence portfolio behavior during different market environments. Consider both absolute and risk-adjusted performance in your firing consideration. When we want a manager with low downside risk characteristics, we are willing to accept less than benchmark returns. So it's important to analyze returns over a full market cycle and rolling time periods. For example, some manager styles will excel in a momentum market but lag in a sideways market or vice versa. These market episodes don't always neatly fall into calendar years, so ample backward-looking investigation is important. Looking at portfolio behavior over three, five, seven, and 10 years, and in different market environments will give you a stronger indication of the manager's ability to add value through active management over time. By sampling more investment periods you will be less prone to rely on market noise, short-term fluctuations, or artificial time periods as firing determinants.

How long should you hold on to a manager whom your analysis ultimately determines is failing? Significant short-term underperformance should trigger an immediate review. An equity manager's relative underperformance of more than 150–200 basis points in three consecutive quarters should trigger a formal review, which includes manager contact and a holdings-based analysis of the period in question. We also may place the manager on hold, i.e., we won't send any more client money until we feel the manager is turning the corner. Similar weak results continuing for one to two more quarters, especially if the market environment supports the manager's style, are grounds for termination. These guidelines can be modified as appropriate for different asset classes while also taking unusual market volatility into account.

Holdings-Based Attribution Required

A complete termination process requires understanding why the manager underperformed. What were the sources of underperformance? Is the underperformance correctable? Does the manager still possess the skill you believe it had when hired? An attribution of portfolio performance and analysis of portfolio holdings is required to answer these questions. We receive this information from two sources. We get attribution of portfolio performance directly from the manager via a quarterly conference call (or intra-quarter if necessary). We get analysis of portfolio holdings from our own proprietary research. The manager's explanation must agree with our independent research. If it does not agree we will want to understand the source of our differences to determine if they are meaningful (e.g., the manager is deemphasizing areas of weakness or mistakes) or not (e.g., sometimes differences may be the result of the classification system used to place a stock in an economic sector). Analyzing the causes of underperformance in its proper context helps determine whether the problems are correctable and when acceptable performance is likely to resume.

Problems With Peer Groups

Evaluating manager performance via peer group rankings is a common practice that is also the basis for ratings from Morningstar and others. We do not include peer ranking within our hiring or termination process because peer groups are poor benchmarks and the results often are misleading. The problem lies with construction of the peer group itself, in which managers are grouped together based on rough, quantitative parameters. (A manager has to fit somewhere, even if the differences are vast within the same peer group.) Often the best (and worst) performers are outliers, i.e., extreme representations of that asset class. Leadership within the peer group most often is attributable to these varied sub-styles coming into and out of favor rather than investment manager skill. As an alternative, we prefer simulated portfolios (PODs, or portfolio opportunity distributions) that better reflect the investment universe available to the manager (see www.ppca-inc.com for more information).

Know Your Benchmark

It's common in the industry to use off-the-shelf, name-brand benchmark indexes to gauge relative performance of a manager. But these comparisons have limited utility with respect to termination and may lead to a flawed analysis. Often indexes are driven by unique, short-term factors that reflect more about index construction than anything else. For example, the inclusion of real estate investment trusts (REITs) in the mid-cap value indexes can be disruptive, particularly for managers that avoid REITs systematically as part of their investment process.

cies are very broad or virtually nonexistent, your judgment and analysis of the prospects are the only basis for firing. However, when a manager violates its policies or drifts into new investment space, it creates grounds for firing. You can decide for yourself how tightly you want to hold managers to those self-imposed disciplines, but letting them stray too far or for too long creates its own set of problems including:

> "...When a manager violates its policies or drifts into new investment space, it creates grounds for firing."

Management styles are almost invariably a combination of styles and capitalization exposures that can and do vary from a standard benchmark. Management investment guidelines and active bets will by design cause structural and even out-of-benchmark deviations from the composition and structure of the performance benchmarks.

Traditional benchmarks are not created equally. You should review the construction methodology and composition of the major provider indexes such as Russell, S&P, MSCI, Surz, and Wilshire and use the brand that makes the most sense for your needs and is a best fit given the alternatives. Regardless, don't rely on the manager to tell you which benchmark to use to gauge effectiveness and skill. And if you use an incorrect benchmark you could hold or fire a manager for the wrong reason.

Investment Policy Violations and Style Drift

Get the manager to disclose its explicit investment policies for portfolio strategies, i.e., rules relating to sector, industry, security, capitalization weights, security characteristics, etc., and even sell disciplines. When a manager's poli-

- irrelevance of a track record when an investment approach is fundamentally altered
- unintended security overlap, style, economic factor, or capitalization concentrations in your client's overall portfolio that changes the risk profile and may be unsuitable for your client

Available Alternatives

When you have the facts at your disposal and have concluded that a manager is in the firing zone, make sure you have similar investment management alternatives available. To reiterate, because all managers in the same style are not created equally, make sure any replacement you consider reflects the substyle or investment thesis you want to use for your clients. The change may be a simple replacement, or it may be a shift to another substyle that you believe would fare better. Use a termination as an opportunity to reflect on what type of active bets you want the manager to be taking for your client.

Summary

Knowing when to fire a manager is not a simple decision. Rigorous, thorough, and ongoing due diligence is the tool best suited for helping you make these decisions with high conviction. However, that tool comes with a price: It takes patience, knowledge, and resources that are fashioned into a working model you can reliably execute in your practice. In the end, consultants should have a manager termination process in place when managers are hired; it should be a process like the sell discipline expected of managers. If you take the time to build such a process for yourself, you are more likely to avoid a second mistake and unnecessary manager turnover.

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Endnote

1 The use of the term "investment manager" in this article pertains to separately managed accounts as well as mutual funds.

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