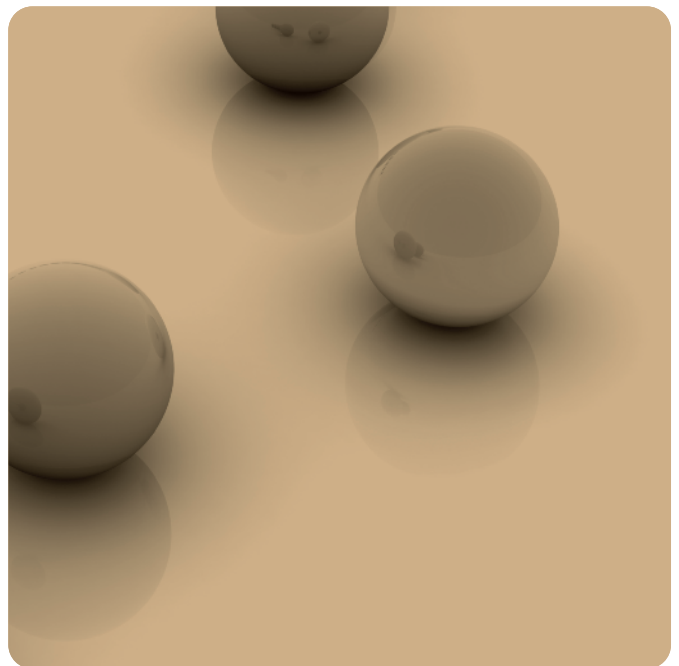
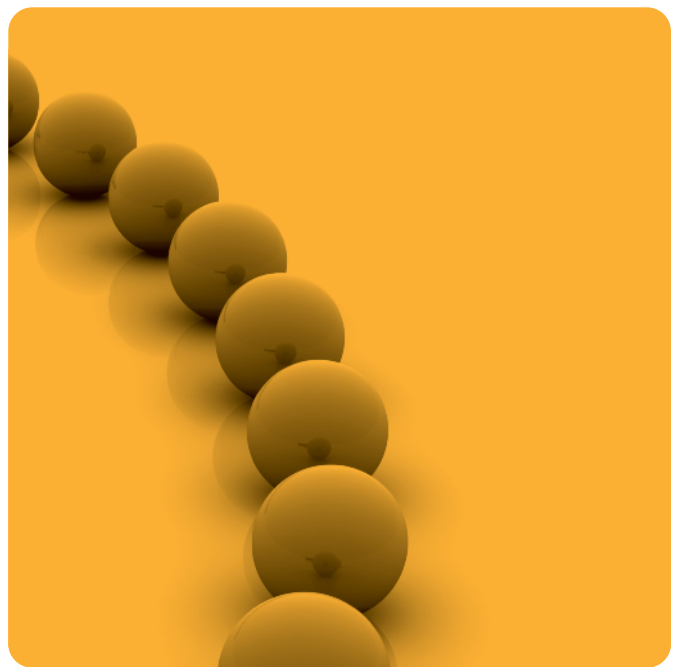


The SEI Trustee Education Series 2  
**What Makes a Good Manager?**



## ABOUT THE AUTHOR

### MARK K. PARSONSON, CFA

CLIENT INVESTMENT STRATEGIST

Mark joined SEI in 2003 and has held various positions with the Investment Management Unit at SEI's corporate headquarters in Oaks, Pennsylvania as well as London, UK. He is currently the Client Investment Strategist for SEI's African business based in Johannesburg, South Africa. Mark's specific focus is delivering strategic investment advice across SEI's African client base, including institutional DC and DB plans, as well as asset managers, consultants and private wealth managers.

Mark holds a BSc (Hons) Economics from the London School of Economics and Political Science. He is a CFA Charterholder and a member of the CFA Institute and UK Society of Investment Professionals.



# GOOD MANAGERS

# The Search For Skilled Asset Managers

In a recent paper “The Selection and Termination of Investment Managers by Trustees” Amit Goyal and Sunil Wahal of Emory University<sup>1</sup> analyzed manager hiring and firing decisions by pension trustees. The study covers approximately 3,700 trustees over a 10-year period from 1994 to 2003. Their analysis represents the allocation of over \$730 billion in mandates to hired investment managers and the withdrawal of \$110 billion from fired investment managers.

They conclude that these trustees hire investment managers following positive excess returns that occurred up to three years prior to their hiring. However, despite general persistence in investment manager returns, this return chasing behavior does not typically deliver positive excess returns thereafter. In particular:

- Post-hiring excess returns are indistinguishable from zero.
- Trustees terminate investment managers after under-performance but the excess returns of these managers after being fired are frequently positive.

Finally, using a matched sample of firing and hiring decisions, they find that if trustees had stayed with fired investment managers, their excess returns would be larger than those actually delivered by replacement managers.

In light of these challenges the obvious question to be asking is: how does one identify a skillful manager in order to improve the likelihood that the manager will out-perform after hiring?

At SEI, we’ve been engaged in the business of researching, hiring, and when necessary, terminating investment managers for nearly two decades. All of this plays an integral part in our Manager-of-Managers investment approach. Since our investment staff researches over 1000 investment managers a year and only a handful are actually hired, we are often asked: “What makes a good investment manager?”

Clearly, there is more to this question than meets the eye. The reasons our clients — current and prospective — are interested in our answer to this question is because of their difficulty finding investment managers who demonstrate the ability to deliver consistent out-performance once hired. Study after study, (starting with Jensen’s in 1968 which examined mutual fund performance from 1945 – 1968), has found little evidence that managers can consistently outperform; in other words there is a lack of *performance persistence*.

In this white paper, we’ll explore the challenges managers face in delivering consistent performance and provide insights into the type of managers who have the best chances of meeting or exceeding their clients’ expectations (i.e. being “good” managers). We will additionally explore the necessary research required to identify these managers and the factors that should be considered by trustees for the hiring process to have its best chance of being successful.

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**It is a commonly levelled accusation that studies find that *on average* active managers fail to add value after fees and therefore active management should not be used/does not work. In fact this is not necessarily the case. It simply means that one must a) find above average managers and b) be vigilant such that if they lose their skill or advantage, be aware of this and replace them with another *above average* manager.**

**This is besides the oft left out point that *all* (not just below average) passive managers are guaranteed to under-perform after fees!**

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## WHAT MAKES A GOOD INVESTMENT MANAGER?

Clearly, the most obvious answer to this question is that a good investment manager is one who consistently meets or exceeds their performance objectives. However, there is little evidence that managers can deliver out-performance consistently, and we believe managers face enormous challenges here.

In their seminal work “Fundamental Law of Active Management”, Richard Grinold and Ronald Kahn<sup>2</sup> postulated the three essential ingredients for generating superior active returns or alpha. In today’s hyper-competitive world of active management, a good manager must have these; at SEI, we call them ABCs of superior active returns.

- **Superior Alpha Source:** This is the ability of managers to forecast stock returns better than the market by utilizing their unique alpha source, their unique investment process, or alpha source.
- **Breadth:** This is the array of opportunities that the manager skill can be applied to.
- **Capture:** Build efficient portfolios by minimizing performance draining constraints.

<sup>1</sup> Amit Goyal and Sunil Wahal, “The Selection and Termination of Investment Managers by Trustees”, November 2004

<sup>2</sup> Richard Grinold and Ronald Kahn, “Fundamental Law of Active Management,” Journal of Portfolio Management, 1989

## ALPHA SOURCE

An alpha source can be defined as those anomalies or inefficiencies in the markets that lead to mispricings of securities that can be exploited in order to generate returns above a given benchmark.

A superior alpha source for a fundamental manager may be their unique analytical ability that allows them to understand the risk-reward trade off of particular equities better than the market. Similarly, for a quantitative manager, a superior alpha source may be a better factor or a combination of factors that allows them to capture better risk-reward than that offered by the market.

Managers who start with a superior alpha source may however experience a decline in their competitive advantage over time as it becomes arbitrated away. This could be the direct result of other managers seeking the same alpha source, which is not uncommon, as success attracts imitators. Therefore, in order to be successful a manager must strive to continuously evolve their alpha source and stay ahead of the competition.

## BREADTH

The second important requirement for a manager to be successful in active management is that their alpha source must have the ability to be employed on the entire breadth of opportunity offered by their passive benchmark.

Often we find instances of managers utilizing their alpha source on an opportunity set or even asset class where it does not have the ability to be effective. In other instances, changes made in indices and stocks can be under-appreciated by the manager and lead to a loss of investment opportunities. As an example of this, the below is a list of changes made by MSCI to their Global Indices over the past 40 years. Each of these represents a new opportunity or challenge for investment managers

- 1969 Developed Market Series (DM)
- 1988 GDP Weighted Indices
- 1995 All Country Series (DM + EM countries)
- 1997 Value & Growth Indices
- 2001 All Country Sectors, Real Time Equity Indices (all DM regions, countries and sectors), GICS Direct

- 2002 Real Time Equity Indices, Final Transition to Free Float Adjusted Market Capitalization for MSCI Equity Index Series
- 2007 MSCI Global Investable Market Indices
- 2008 MSCI Equal Weighted Indices  
MSCI Short & Leverage Indices  
MSCI Minimum Volatility Indices  
Final transition to Global Investment Market Indices Methodology for MSCI International Equity Indices

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**As can be seen the MSCI Global Indices recently transitioned to a new methodology — the MSCI Global Investment Market Indices Methodology. This has effectively expanded the coverage of MSCI indices and has significant implications for how global equity investment managers run their portfolios. This is something which you should be aware of and that should be addressed with your managers and investment advisers as to how they are reacting to this.**

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## CAPTURE

The third important ingredient for adding consistent out-performance is to minimize the constraints within a portfolio and therefore allow the manager to capture more of their out-performance potential.

Constraints in a portfolio are those factors that prevent the manager's investment ideas, or alpha source, from being implemented in a portfolio and translated to actual performance.<sup>3</sup> These include, but are not limited to:

- **Trading costs** – the costs associated with buying and selling securities. These act as a drag on portfolio performance.
- **Liquidity** – a manager may be unable to purchase sufficient quantities of a desirable security due to a lack of shares trading in the market.
- **Portfolio size** – successful managers often see their assets grow over time and as a result, their trading costs can escalate. The challenge these managers face is to manage their growth so as not to cut into their return with growing expenses, ultimately disappointing their clients.

3 Clarke, de Silva and Thurley, "Portfolio Constraints and the Fundamental Law of Active Management," Financial Analysts Journal, 2002

- **Long-only** – arguably, the most binding and prevalent constraint in the investment world is the long-only restriction. Managers that forecast returns typically form opinions on stocks that will both out-perform and underperform and take over- and under-weights appropriately. This is typically done in a long-only manner, that is, managers are prohibited from taking a negative exposure ('going short') on any particular stock. This may prevent them from meaningfully expressing a negative view on a stock when it has a small weight in the index, as they can only hold 0% of it.

Through a focus on these constraints, and ways in which they can be removed, managers who have good investment ideas are more likely to be able to translate these into good investment performance.

## SUMMARY

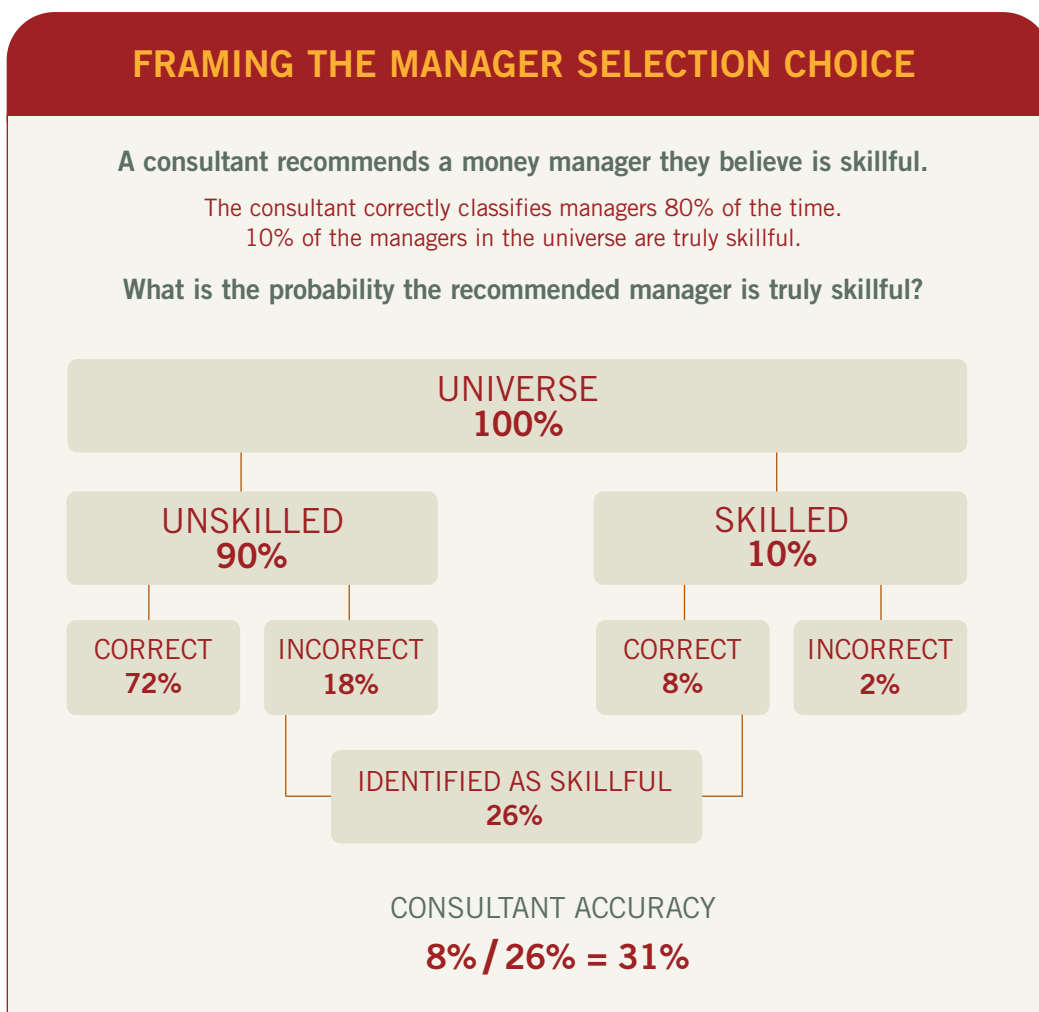
Based on the above framework we are able to identify those criteria that a good investment manager needs in order to be successful. The problem then becomes one of identifying these managers from the available opportunity set.

## THE MANAGER SELECTION PROBLEM

The problem of manager selection is what we call a conditional probability problem. That is, a problem where the outcome is dependent upon several factors. In this case, the probability of identifying a truly skillful manager is a function of:

1. The percentage of good managers in the universe; and
2. Our accuracy in assessing those managers.

The example diagram below illustrates this problem.



As can be seen, and repeated from above, the ultimate success of identifying a manager is dependent upon the skill of the party assessing that manager as well as the number of skillful managers within the selection pool.

Therefore, in order to improve our odds of success, we need to:

1. Make sure that we ‘fish in the right pond’ i.e. search where managers are more likely to be out-performers or skilled; and
2. Constantly improve and develop our ability to identify these skillful managers through on-going research and investment in resources, systems etc.

On this basis it suggests that the optimal way to research and identify skillful managers is first to identify an area of the investment manager universe where more managers are skillful, or likely to out-perform. This implies understanding what investment strategies, or alpha sources, are likely to produce out-performance i.e. provide a *tail-wind*.

After having developed this investment strategy view, instead of a broad manager view, we can attempt to identify managers who exploit these investment strategies alpha sources successfully.

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**A basic way to summarize this philosophy is that it is not enough for a manager to implement his investment strategy well if what he is doing won't actually add any value over time. Both the manager and their investment strategy must out-perform.**

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## CONCLUSION

At SEI, we believe that good managers have:

- A unique **alpha** source that is consistently enhanced so that it cannot to be arbitrated away;
- An alpha source that can be successfully employed across all the investable opportunities, or the **breadth**, presented by the manager's benchmark;
- The ability to build efficient portfolios to **capture** the performance consistently without constraints that drain performance.

Importantly one must also be able to identify these managers from the broader universe. As shown, to improve one's chances of this requires significant market and manager research. We believe this is both superior **and** analytically simpler than the traditional method, or consultative approach to finding good managers.

Unfortunately this is not a simple task. **Past performance is not a good indicator of future performance** — bad managers can get lucky, good managers can still under perform. Analysis purely based on office visits and

performance databases simply does not adequately capture the complexity required to understand the concepts above. Instead this requires the use of large amounts of resources — analysts, systems and data providers — especially given the huge number of managers throughout the world.

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**Often the hardest decision can be to hire (or stick with) a manager during a very bad period of under-performance. (When was the last time you reviewed and hired an under-performing manager?) Yet this may be precisely the best time to hire them, as the above study shows.**

**During the Internet Bubble value managers under-performed significantly. Yet for the next 7 years they were out-performers during a value-led cycle. Until recently, when growth has started to out-perform once again.**

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If this job is undertaken by those whom take direct responsibility for the assets and the decisions affecting these then they must ensure that they have the resources and capabilities in place to undertake this effectively. However, if one chooses to out-source the search for good managers, to a Consultant or Manager-of-Managers, how do they ensure that this research and analysis is actually undertaken and done so effectively?

Ultimately the most important issue is that of accountability. Just as an asset manager's historical decisions are available (through disclosure) in their portfolio history, the success of any investment advisor in their recommendations should also be readily transparent. The latter at the total portfolio level as this is their domain of responsibility and it is this that affects investors' wealth. Only through clear accountability can one ensure that the necessary resources and time will be truly dedicated to ensuring this process is a success.

Understanding this process is by no means a simple task. Nor is it an unchanging one. Depending upon the manner in which one searches for these “good” managers, detailed questions should be asked of asset managers and/or investment advisors as to whether each of the concepts outlined in this paper is understood and how it is addressed. Most importantly, clear answers should be given. If success is the goal, all of these factors must be present and understood. Through this one can improve the chances of identifying managers that will add value *in the future*, as opposed to those who were successful in the past.



# GOOD MANAGERS

## What Makes a Good Manager?

For back copies of our Trustee Education Series, please contact Nicola van Zyl at SEI on Tel (011) 994 4204 or alternatively view these papers on our website <http://www.seic.com/institutions/sa/ResearchCentre.asp>

### **ARCHIVE**

The SEI Trustee Education Series 1:

Global Equity: Not Just a Manager Choice: Mark Parsonson

The SEI Trustee Education Series 2:

What makes a good manager?: Mark Parsonson



1st Floor 3 Melrose Boulevard Melrose Arch 2196 Johannesburg, South Africa [www.seic.com](http://www.seic.com)

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