Capital Trading Group
One Financial Place
440 S LaSalle Street, Suite 2301
Chicago, IL 60605
Ph: 800.238.2610
www.CTGtrading.com

The Alchemy of Manager Selection

Prof. Davide Accomazzo

Graziadio School of Business and Management, Pepperdine University

"It's not hard to make decisions when you know what your values are." **Roy Disney**

Choosing an external money manager to help implement a well-constructed portfolio is a task of significant importance. Most investors, retail and institutional, rely to some degree on outside managers to achieve their investment goals and yet the decision making process at both levels seems to produce generally disappointing results.

Perhaps, as Roy Disney pointed out, allocators and average investors do not know their "values" very clearly or perhaps the process of choice ends up being skewed by behavioral dynamics as it so often happens in financial matters.

It is the objective of this study to clarify the set of actions that define the process of choosing a money manager by reviewing reasons and drivers of the choice, contingencies that may influence such choice and finally by analyzing the available studies on the matter.

The first question an investor needs to ask is: do I need an active manager or should I pursue a passively tracking strategy? The answer is heavily influenced by philosophical beliefs as well as market contingencies. Believers in efficient markets might find active alpha – or the return produced strictly by active and skillful managers – a chimera and therefore they may prefer the low-cost passive replication products. However, there is enough evidence in actual performance results and historical studies to believe that pockets of inefficiencies do exist and that certain managers are able to exploit them. The problem then becomes how to identify such managers and how to analyze favorable contingencies that may help one manager over another. The timing issue is particularly important; many managers do outperform their indexes but often their outperformance is cyclical and by the time an allocator spots the talented manager, favorable conditions may be coming to an end. This problem with cyclicality explains why performance chasing is often disappointing.

To this point, two filters help mitigate the issue: the degree of a market's efficiency should be inversely proportional to the degree of utilization of active managers. In other words, the more efficient a market has proven to be historically, the less significant should be the allocation to active managers. For instance, the US Treasury market is very efficient, and the delta between the top and bottom managers in terms of performance is very small; therefore, passive strategies are generally more appropriate. The second filter is concerned with the macro conditions of the market in question. For example, momentum markets tend to lift all boats and make active management less relevant; however, even efficient markets undergo times of choppiness and uncertainty when active managers can help substantially.

A true understanding of the manager's strategy and the contingencies that he/she can exploit will help immensely in the process of discerning between true alpha and "statistical luck." Scott Stewart at the CFA Institute states that the theory of Efficient Markets implies that all relevant information is public and reflected in current prices and therefore if that is the case any realized alpha may just be erroneous measurement; such data could be reflecting pure luck, justified by the statistics of large numbers, or exploitation of misunderstood risk factors.

In fact it is quite recognized that markets suffer from asymmetrical information and that not all relevant data is readily available to all participants and therefore developing a model that screens appropriately those managers that are strategically positioned to arbitrage such information anomalies is worth the effort and the cost.

A look at the US equity mutual fund industry shows that more managers produce some statistical level of alpha in higher degree than would be estimated by just luck (Fama and French 2010). An additional problem arises when fees are factored in; unfortunately, a higher level of fees can quickly erode any alpha a manager can produce over the long term. It is therefore imperative that an allocator or an average investor take into consideration the impact of fees and be ready to properly value cost versus expected alpha.

An additional interesting point transpires from the available studies; where alpha seems to exist, it also seems to have some degree of "stickiness." In the US equity mutual fund industry, it was found with statistical confidence that alpha produced over 36 months tends to persist in the following year as well (Kosowski et al., 2006). Similar data is available in the hedge fund industry where outperformance may persists up to three years (Amman-Huber-Schmid, 2011).

And therefore, what could materially help us in screening these managers who can produce "sticky alpha?" In addition to the above referenced macro analysis, usually there are two other paths: qualitative and quantitative research. These two processes should both be implemented with similar dedication even though it is usually the case that an allocator or an investor will tend to favor one method over another; this preference is in our judgment a major mistake because quantitative and qualitative analyses do work best in synergy by helping uncover important elements of the manager in question which could not be revealed by only one methodology.

Qualitative due diligence is a high level process designed to overcome vacuums in analysis that a mere quantitative review may create. A qualitative process can also help mitigate fraud risk and because of the deeper understanding of the manager and his/her strategy, it improves the odds of a longer term relationship.

Scott Stewart provides six key qualitative characteristics based on research spanning from Warren Buffet to David Swensen and Jack Treynor. He states that most research quotes the following traits as pivotal elements of long term success for a money manager:

- Intelligence
- Knowledge
- Long term thinking
- Independent thinking
- Predisposition to alignment of interests.

The first element, intelligence, is a tricky one. It would seem natural to link superior intellectual skills to investment outperformance and this is often the case indeed; however, there are examples of spectacular failures in investment history by renowned Nobel Prizes such as in the incident of the Long Term Capital Management bust. This may be due to two factors: higher intelligence might lead to overconfidence and erroneous measurement of intelligence. The overconfidence issues may be mitigated by other areas of investigation, for example, in terms of strategy fundamentals. In other words, an allocator should truly understand the source of alpha rather than relying too heavily on the pedigree of the manager. The measurement issue, on the other hand, is rather personal; investors and allocators may have different belief systems that may lead to wildly different measurement systems. Usually basic intelligence can be measured by IQ tests, standardized aptitude assessments and school curricula. An interesting study (Zagorsky, 2007) researched IQ scores as a reflection of intelligence and also studied education degrees and their linkage to income and wealth; Zagorsky studied data from the period 1980-2004 and found education to be directly correlated to income and wealth while intelligence was only positively correlated to income.

On the subject of knowledge, there is more clarity as a higher degree of know-how is always preferable to a lesser level and such knowledge is easily confirmed and quantified by interviewing the manager or reviewing any research the manager might have produced.

In regards to long term and independent thinking, studies seem to agree that they are necessary conditions for success. New studies have recently pointed out how short-termism is weakening financial performance at the investment and corporate level as well (Ambachtsheer, 2014) while, conversely, there is empirical evidence that planning produces long term benefits. Furthermore, the mix of long term planning with independent thinking should ensure a higher degree of success as the risk of rigidity that may be introduced by long term parameters gets lessened by the natural inquisitive approach and desire for curiosity that comes with independent thought processes.

And last but not least, an allocator should carefully study how a manager positions him/herself in the framework of interest alignment. This point is of the utmost importance since it helps mitigate a classic agency problem, or that situation where one party is expected to act in another's party best interest. An investor should look for relationships where the manager has large amounts of personal wealth invested along with her/his clients and where some elements of retribution are linked to performance. On this last point, while there is evidence of higher risk adjusted returns being associated with higher levels of performance sharing (Stewart, 2014), one must also be careful with some unintended consequences such as the manager executing on a "call option with other people's money." In this instance, a manager might be incentivized to take on larger risks levels than agreed upon because of the asymmetrical nature of his/her reward; if the trade works out the reward might be significantly high but should it not work, 100% of the losses would fall onto the investors' shoulders. This problem is reduced by making sure the manager has other negative repercussions from a possible blow-up such as strong legal recourses, negative name recognition and possibly the inability to start over under a new brand with little adverse legacy. A deep understanding of the strategy and style drifting monitoring would also help greatly.

From a quantitative perspective, there are a number of analytics that should be carefully studied. In terms or risk adjusted performance, the Sharpe ratio, which takes its name from Prof. Bill Sharpe who

devised this measure, has over the years become a classic first screening test. The Sharpe ratio standardizes the returns of a portfolio by dividing the risk premium (the return of the portfolio minus the risk free rate) by its standard deviation. The measure allows to rank investments by values, where higher ratios indicate better risk adjusted performance. The problem with this approach is that it penalizes all kinds of volatility; this is especially an issue in alternatives where often the ability to control losses is of a higher order than beating an index on pure upside. For this reason, it is a good idea to also run the Sortino ratio. This measure is calculated by subtracting from the manager's return a chosen minimum accepted rate of retun divided by downside volatility or the so called "bad volatility." Normally, a Sortino ratio higher than the Sharpe value is welcome and it may help screen more carefully for managers who can produce a few unexpected "homeruns" and yet manage the downside even better.

On the subject of alternative asset managers, the issue with the Sharpe ratio highlights an additional hurdle the allocator must overcome: alternative portfolios are constructed in ways that differ significantly from traditional strategies, hence their name and their appeal as portfolio de-correlators. In fact, they often incorporate, leverage, illiquidity, non-linear pay-offs and option-like risk exposure. All these elements are difficult to capture via linear risk equations (just like the Sharpe ratio) and therefore require a higher degree of due diligence by the investor.

A careful analysis of returns should also identify maximum drawdowns, recovery time after losses, win/loss ratios and average gains and losses. Along these lines, two interesting studies (Stewart 198 and Hernandez and Stewart 2001) revealed how the frequency of quarterly positive returns has some utility in forecasting active returns and active returns consistency. Hernandez and Stewart created quintile groups of institutional US equity money managers by ranking the occurrence of positive quarterly returns in five years segments; they found out that quarterly performance consistency was useful in identifying outperforming managers over forward periods of three and five years.

Another important element of analysis falls in that somewhat grey area between qualitative and quantitative analysis: are emerging managers preferable to established ones? From a pure performance perspective, it would seem emerging managers do outperform. Many studies have made such claim; there is even a study from 1996 (Golec) which established a negative correlation between a manager's age and his/her excess performance. However, a deeper analysis should recognize that performance risk and business risk are much higher with emerging managers. To this effect, most studies underestimate the risk of permanent loss associated with business risk. In any case, it is undeniable that successful money managers, as they age, may become more preoccupied with retention of wealth and trading records than with excess returns. Another element that bears consideration in this debate is the infrastructure that can support an emerging manager. If a manager is constantly distracted by sales and operations, his/her performance will suffer and the ability to move to a higher level will be seriously jeopardized. From an investor perspective, the choice between an emerging manager and an established manager must come down to more than just performance and it should be made within a diverse set of asset allocation parameters.

As we approach the conclusion of this analytical review of best practices in managers' selection, it would be interesting to review real life case studies of how institutional allocators formulate their screening and decision process. For instance, the Harvard Endowment follows, among other more specific steps, the following major rules (source: www.endowmentinvestor.org):

- Managers with $5 billion - $15 billion in AUM
- Managers with only one or two products
- Managers where everyone in the firm is incentivized toward investment success through co-investing most or all of their personal assets
- Managers that own the firm.

While most of us see $5 to $15 billion as a major capacity investment, in the bigger scheme of themes, it is not a an outsized investment vehicle and it highlights an interest by Harvard to focus on managers with a specific set of skills (especially when point one and point two are seen in aggregate) and not an institution with purely an asset gathering focus. Points three and four are perfectly in line with our previous comments about designing a set of parameters geared toward a mitigation of the agency problem.

Another issue that is materially important for institutional allocators is management fees. Lower asset returns and higher competition has increased the negotiation power of allocators with many fund managers; some of the ways in which fees are lowered include focusing one's allocation with fewer managers, establishing separate accounts versus funds of funds, private equity co-investments and be early at the first close (source: www.endowmentinvestor.org).

In general, institutional allocators, do follow a more sophisticated approach than the average retail investor and their selection framework is a cocktail of the rules we have discussed in this paper. What transpires from a number of studies is the ability of institutional allocators to choose superior managers but a negative track record seems to develop in the retention process. In other words, it seems allocators are generally correct in their initial choices but their subsequent retention/timing decisions actually detract from net performance (Stewart, 2014). A careful process of selection and a buy and hold strategy might produce higher alpha.

In conclusion, the research that was reviewed in this analysis suggests that there are techniques that may help improve the manager's selection process; however, most investors seem to focus mostly on the quantitative part while success is probably determined by a balanced mixture of qualitative research and quantitative analysis. Focusing on past performance, for instance, leads to performance chasing, a subpar screening method due to the widespread cyclicality of most managers' records. Allocators and investors alike must retain flexibility, be driven by common sense, be realistic about future expectations and thoroughly understand the underlying drivers of a manager's performance.

Sources:

Ambachtsheer, Keith, "The Case for Long Termism" Rotman International Journal of Pension Management, Vol. 7, No. 2, 2014

Amman, Manuel, Otto Huber, Marcus Schmid, "Has Hedge Fund Alpha Disappeared?" Jouranl of Investment Management, 9 (1), 2011

Fama, Eugene, Kenneth French, "Luck versus Skill in the Cross-Section of Mutual Fund Returns" Journal of Finance, vol. 65, no.5 (October) 2010

Golec, J.H., “The Effects of Mutual Funds Managers’ Characteristics on Their Portfolio Performance, Risk and Fees” Financial Services Review, vol.5, no. 2, 1996

Hernandez, Cesar, Scott Stewart, “Overseas Equity Managers Are Not as Consistent as US Equity Managers” Working Paper, Fidelity Investments, 2001

Kosowski, Robert, Allan G. Timmermann, Russ Wermers, and Hal White, “Can Mutual Fund “Stars” Really Pick Stocks? New Evidence from a Bootstrap Analysis” Journal of Finance, vol 61, no.6, (December) 2006

Stewart, Scott, “Manager Selection” CFA Institute, 2014

Zagorsky, Jay, “Do You Have to Be Smart to Be Rich? The Impact of IQ on Wealth, Income, and Financial Distress.” Intelligence, vol 35, no. 6 (September – October) 2007

CTG CTA Services

Our professional services are designed to make every aspect of your CTA business as efficient as possible. Our operations will be configured to help make your life easier so you can focus on what you do best: Trade.

CTG will oversee allocations –We’ll help you set up your electronic or pit execution, and establish a single block trading account that will enable NFA required APS pricing across all FCMs. We’ll make every one of your accounts, across any and all FCMs, receive their respective trades. Every day we reconcile each client account for accuracy: positions, equity, margin, fees, etc.

CTG customizes Position and Equity reports to just how you, the CTA, want to see them. We include the information that you want to see every day. Our position reports are updated in real-time throughout the trading day, so you always know exactly what positions you have on overall, and in each respective account.

Lastly, CTG has a relationship with our money managers in efforts to help grow their business. We provide front, middle and back office administrative services but most importantly we focus on helping gain exposure to outside investors and raise money.

Principal - Patrick Lafferty

Patrick Lafferty is a principal and co-owner of Capital Trading Group (CTG). Patrick has a degree in Economics from DePauw University and has worked in the futures and options industry for 25 years. Patrick is the author of the books *Single Stock Futures, The Option Strategy Guide,* and *Breaking Through to Success: The Commodity Investor’s Guidebook.* He also edits the weekly *TradeView* and the *Easy Options Advantage* newsletters. Patrick speaks at investment and trading conferences around the US.

In 2006, Patrick formed Capital Trading Group, LP (CTGtrading.com) with Nell Sloane. An independent Introducing Brokerage, CTG was launched in an effort to provide clearing diversification and mitigate counter-party risk for large customers, including CTAs and institutional clients.

Principal - Nell Sloane

Nell Sloane is a principal and co-owner of Capital Trading Group (CTG). Nell began her career over 30 years ago at the Chicago Futures Exchanges. She initiated her introductory to the industry by working for a grain trader at the CBOT. As she continued to handle the trade execution, reconciliation and capital raising, she moved on to becoming a featured contributor to various online industry related publications. Nell eventually launched her own commodity newsletter providing fundamental and technical analysis entitled “The Opening Belle”.

Her registrations include the Series 3 and 7. Ms. Sloane presently is a member of the Vistage International, which is the world’s leading chief executive organization helping business owners make better decisions and becoming better leaders in their communities. She is an active participant in raising money for charities such as American Cancer Society, Mercy Home for Boys and Girls, Diabetes foundation and Make-a-Wish. Nell previously volunteered with the international au pair agency matching host families with childcare and was previously an Executive Member of Chicago Finance Committee. During her spare time she loves to golf, horseback ride and travel.

If you have any questions about this article, please feel free to call CTG at **800.238.2610** or email at info@CTGtrading.com

DISCLAIMER: Capital Trading Group, LP ("CTG") is an Introducing Broker and a member of the NFA. CTG does not warrant the correctness of any information herein or the appropriateness of any transaction. The contents of this electronic communication and any attachments are for informational purposes only and under no circumstances should they be construed as an offer to sell or a solicitation to buy any futures contract, option, security, or derivative including foreign exchange. The information is intended solely for the personal and confidential use of the recipient of this electronic communication. If you are not the intended recipient, you are hereby notified that any use, dissemination, distribution or copying of this communication is strictly prohibited and you are requested to return this message to the sender immediately and delete all copies from your system. All electronic communication may be reviewed by authorized personnel and may be provided to regulatory authorities or others with a legal right to access such information. At various times, CTG may have positions in and effect transactions in securities or other financial instruments referred to herein. Opinions expressed herein are statements only of the date indicated and are not given or endorsed by CTG unless otherwise indicated by an authorized representative. Due to the electronic nature of electronic communication, there is a risk that the information contained in this message has been modified. Consequently, CTG cannot guaranty that messages or attachments are virus free, do not contain malicious code or are compatible with your electronic systems and CTG does not accept liability in respect of viruses, malicious code or any related problems that you may experience. Trading in futures or options or other derivatives entails significant risks which must be understood prior to trading and may not be appropriate for all investors. Please contact your account representative for more information on these risks. Past performance of actual trades or strategies cited herein is not necessarily indicative of future performance. Privacy policy available upon request.