

# What Investors Need To Understand About Investment Decision-Making

## You and Your fund Managers

### Six Sets of Questions That Identify Good Managers<sup>28</sup>

**Philosophy** (when performance history cannot be counted upon, this should be trustees first consideration).

Does the investment manager have a clearly articulated, well-defined, and sensible philosophy on investing?

*(If not, chances are that historic results, whether good or bad, are largely luck.)*

Is the philosophy sufficiently innovative and different to offer superior returns? Do these results appear to be sustainable?

*(If the investment philosophy sounds familiar – don't draw comfort – start to worry. Remember, outperformance can only be achieved if you are doing something no one else is.)*

*(Some investment philosophies might sound very convincing but are impossible to execute in the timely fashion required to add value. Make sure you have proof that a manager can do what he says he's going to do. – See Process.*

The performance of 87% of top quartile South African asset managers tends to drift to lower quartiles over the following three years.

Source: Fleming Martin

## What Investors Need To Understand About Investment Decision-Making

### People

Does the investment team have the skill to add value?

*(Notice that the key issue is “skill” – not age, experience, education or any of these other factors that marketing people like to promote. The problem is, there is no correlation between those factors and performance.*

- Do they have the talent to adapt?

- Is the structure / compensation set to keep key people?

*(Some people are not motivated by money alone. Being in an environment where your voice is heard, where you have the ability to influence change, and where you just enjoy the people you work with are often far greater factors in retaining people).*

Are there gaps in the organisation?

*(You may have a great investment team and lousy administration in the background. Both count in the overall success of the strategy.)*

**“Selecting superior managers or funds is harder than selecting winning stocks.”**

- 1. The people making decisions have far less information about managers than investors have about publicly traded companies.**
- 2. Trustees must balance the conflicting propaganda of asset managers against the only facts available to them, i.e. past performance....As sensible people, trustees will invariably base decisions on available facts rather than unproven marketing claims”<sup>1</sup> ... in spite of the meaninglessness of performance histories.<sup>30</sup>**

**“The most treasured (and rarest) asset in investment management is a steady hand at the tiller”<sup>31</sup>**

## What Investors Need To Understand About Investment Decision-Making

Are they a team?

*(Politics are just as rife in an asset management company as they are in any “people-driven” organisation – maybe more so. Check out whether this is a potential issue.*

*On another note - selecting a specialist manager that may be a top performer but the only one of his or her kind in the company is a recipe for disappointment. Find specialists within companies that support and nurture that specific specialist orientation.)*

### **Pedigree –**

*(Trustees tend to confuse the business success of an asset management company with the true skill of its managers. Prestigious client lists provide no assurance of future performance.)*

*(Big is not necessarily better for investment management*

- *Most top performance comes from smaller, more focused investment teams.*

- *Smaller companies tend to involve less politics, greater participation and, hence, greater buy-in from their investment professionals, and greater overall loyalty.)*

**There is no correlation between the size of an asset management house and its stability.<sup>32</sup>**

## What Investors Need To Understand About Investment Decision-Making

### Process

- Does the company have the investment process in place that can translate investment ideas into performance?

*(Some companies have superb investment ideas – and yet are totally incapable of translating them into portfolios that can adequately capture these ideas. Performance attribution analysis is one way to determine whether the manager's ideas are what is really driving performance.)*

- Does the company have the R&D capability to adapt to a changing world?
- Are all the elements of the process optimally designed in accordance with the firm's philosophy?

*(Most manager performance comes from bets he or she doesn't even realise they are making. Test this point with performance attribution analysis.)*

- Is there "slippage" between the investment decision process and the implementation process?

*(Great ideas can completely fail if the administration support for the asset manager can't ensure that these ideas are executed timeously and error free.)*

- How does the manager control the risk exposure of the portfolio he or she manages for you? Get your manager to show you how they go about structuring the fund

Most asset managers tend to place the greatest focus on the one decision they have the least probability of getting right: market timing the asset allocation decision. The potential added-value of one decision they have the highest probability of getting right, the stock selection decision, can easily be wiped when the manager fails to minimise any changes in the asset allocation mix..

**Richard Grinold: "The Fundamental Law of Active Management"**

## What Investors Need To Understand About Investment Decision-Making

### Performance – The Least Important Consideration

- How has the manager performed against their pre-stated benchmark?

*(Manager skill can only be measured against the manager's pre-specified investable benchmark. Performance tables that compare one manager against another tell trustees nothing about skill.)*

- Has the long term performance been a direct function of the stated strategy?

*(Only performance attribution analysis can answer this question.)*

- What are the results relative to the tracking error?

*(It is important not to take return numbers at face value. Each performance record has to be evaluated within the context of the risk the manager assumed to generate the performance. A really skilful manager is one who can deliver returns that are in excess of the risk (or tracking error) assumed.*

- What results are NOT being discussed? Any failed strategies?

How a manager performs in a survey provides no indication as to how well a manager's performance will combine with other managers to add value)<sup>33</sup>

"Trustees would prefer to live in a world of certainties, but investment managers can only live in world of probabilities."<sup>34</sup>

# What Investors Need To Understand About Investment Decision-Making

## Price

Make sure you ask how your fund manager plans to keep the *real* costs to the fund under control. (see sidebar). If you are being provided with 41k reporting, ask if the fund manager can break these charges out for you.

Ask your fund manager, your investment consultant, your actuaries and your administrator whether they pay out any portion of your fee to a third party, and if so, for what reason.

Ask directly whether any of the above parties receive an on-going fee from the fund manager or the fund and if so, for what.

*Perhaps the key to any charges is that they are fully disclosed to the fund and the trustees believe that these fees will be genuinely reflected in the added-value to the fund.*

*Irrespective of what or what isn't disclosed, trustees cannot act in self interest or to the benefit of anyone other than the fund itself.*

**“Too often the primary focus for trustees and consultants is on the management fees paid to the asset manager. The truth is, the fund incurs far greater costs over time from stock brokerage fees, market impact costs from trading in adverse conditions, bank charges, and sometimes even hidden commissions –and yet many trustees ignore this point completely.”<sup>35</sup>**

**Trustees have the ultimate responsibility for knowing who the fund is paying, why the fund is paying them, and how much is being paid for what service?**

## What Investors Need To Understand About Investment Decision-Making

### **What Your Fund and Bafana Bafana Have In Common:<sup>27</sup>**

A good soccer coach needs to build a team that has complementary skills while ensuring that individual skills contribute to the overall game plan. If we look at a winning strategy it involves:

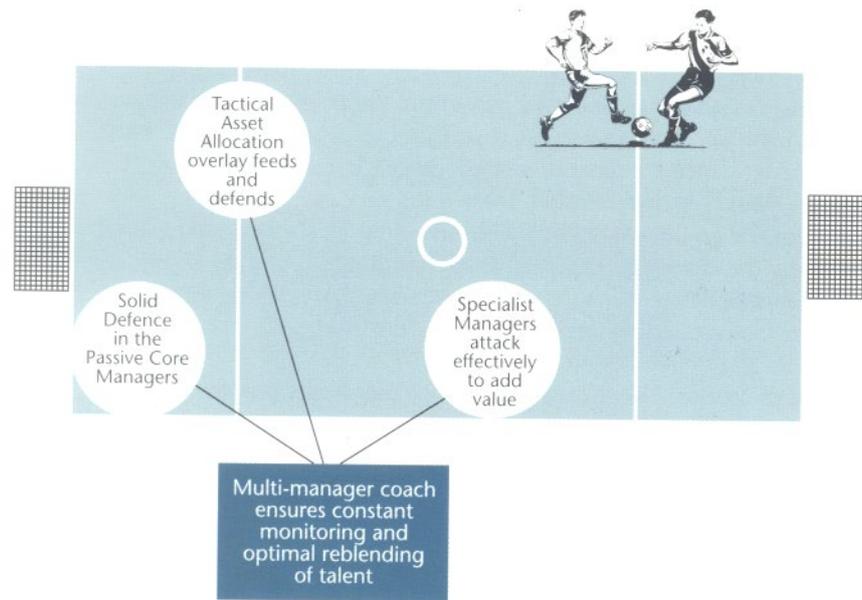
- Solid defense that acts in unison to close gaps and cover for each other
- A midfield that feeds the forwards while getting back to defend
- Explosive forwards that can split the opponents defense and attack effectively

Success requires a complete team, where each member has a well-defined role that doesn't overlap with the role of other players, and where the combined efforts of all the players provide strength in all quarters of the field. You cannot have an effective team of forwards only or defense only. Each member of the team must play in the position they are best at, and they must stay in that position if the game is going to be adequately balanced. Each member must be chosen not just for how well they play in that position, but for how well they can complement the other members on the team.

In addition, a good coach will know how to blend his men on the field. What strategy maximises the team's strongest points and minimises exposure to its weakest points. A good coach will have substitutes for the critical positions and will only change players where the team is not at peak performance. The coach must be able to continually communicate with the players and make positional changes or game plan changes that are not too costly but add value to the teams' objectives.

## What Investors Need To Understand About Investment Decision-Making

So it also goes for trustees of pension funds. Trustees need a multiple manager structure than can achieve the primary objectives of the fund and a mix of managers that collectively contribute and cover the investment field:



## What Investors Need To Understand About Investment Decision-Making

### David Salem's Reverse Order Screen for Managers

36

When it becomes impossible to *really* determine whether an asset manager is as good as he says he is, try using Salem's elimination test as a further screen.

1. Eliminate Managers Displaying Disqualifying Attributes:
  - Investment decision-makers engaged primarily in financial planning or stock brokerage (as opposed to portfolio management).
  - Clear conflict of interest between asset manager and consultant or other service provider
  - Inability to supply relevant performance reporting information timeously.
  - Criminal convictions
  
2. Eliminate Managers Displaying Undesirable Attributes
  - High degree of personnel turnover
  - Inadequate administrative systems or personnel
  - Investment decision makers unduly burdened with administrative tasks.
  - Unwillingness to specify asset size limits for products or services that require such limits
  - Does not adhere to global performance standards promulgated by the AIMR

"In general, the more important and desirable an attribute (e.g. a well-defined and innovative investment philosophy), the more difficult and time consuming it is for trustees or their consultants to confirm its presence in a given manager." Conversely, undesirable attributes (e.g. portfolio managers with conflicts of interests are easy to detect. <sup>37</sup>