Manager Research

Four Questions for Managers

Investment manager selection is difficult at the best of times. Persistent out-performance is hard over extended periods and few people successfully achieve success in the endeavor. As much as it is difficult to foresee what technology will change the world a decade from now, it is equally tricky identifying top investment managers in advance. A few key ingredients distinguish an environment that permits success to grow when it arrives. Determining if the situation is present with the investment manager requires artful questions that deliver scientific answers.

While not all questions have answers, all answers have questions. Determine where you want to go, and the questions naturally arrive as you work backward from your starting point. The challenge is developing relevant questions that focus on the people that will achieve the investment objective. When an investor is analyzing a prospective investment manager, the investor needs to ask how the investment manager:

- Aligns incentives?
- Assesses knowledge?
- Acts when executing?
- Adapts the plan?

These are relevant questions for all stakeholders and are particularly applicable when selecting investment managers. Investment decisions involve trade-offs, and the critical success factors for understanding the choices are ensuring alignment, understanding knowledge gaps, focusing on execution, and adapting to alternative outcomes.

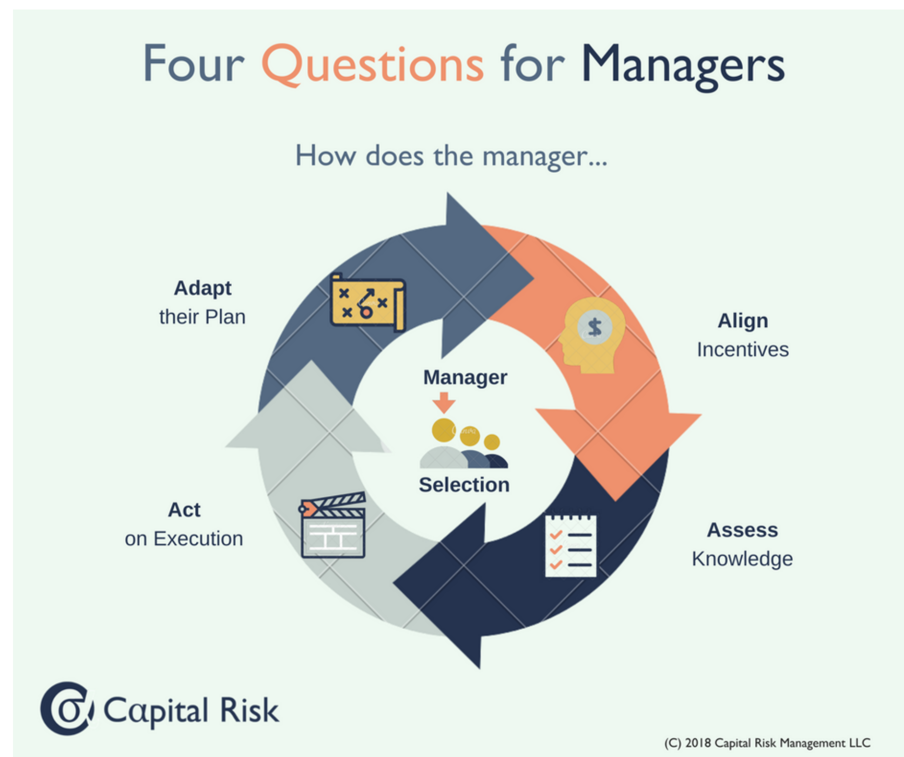
Manager research uses quantitative analysis to determine *what* the manager achieved but understanding *how and why* is vital to the investment program. Sustained investment success is derived from the consistent application of a coherent strategy and the same rules apply when selecting a manager.

Align Incentives

Incentives are not a strategy; they are tactics. Carlos Ghosn

Over the last few decades business and economic theory moved away from the rational and omniscient individual towards a more variable and incentive focused actor. The critical distinction is that the individual will act with imperfect knowledge and their actions will reflect not only their current state but also the present incentives. This evolution in thought for economic behavior is germane to investment management. Stakeholders acted to exploit the incentives present in their sphere of influence, rather than focus on the strategic objectives of the investment program.

Exhibit 1. Four Questions for Managers



Investment consultants earn fees for passive information, not positive outcomes. Asset managers receive fees for following asset benchmarks, not performance related to the investment program. Investment committees are mandated to manage investments irrespective of the impact on the viability of the broader organization. A fallacy of composition results, since stakeholders focus on their unique incentives that may not align with the overall investment objectives.

Aim to make the whole greater than the sum of the parts. Align all stakeholders with the investment objectives. Align investment consultants and managers by naming them as fiduciaries to the investor. Consider the investment objectives, so they are not in conflict with the operating business goals. Align asset managers with value-added regardless of benchmarks and use performance-based incentives. Aligning incentives leads to better outcomes.

Assess Knowledge

Information is not knowledge. Albert Einstein

The presence of information does not alone lead to the best decision. The information must be married with the experience to separate the relevant from the trivial. Information can label a hammer; knowledge is understating how a hammer can build a house. Investment fiduciaries do not lack for information: they need the wisdom that comes with experience.

Hallmarks of poor investment performance are a lack of awareness of the risk or, if aware, uncertainty on how to mitigate the risk. The former is usually the result of excess and unfocused information overwhelming the message, while the former is the product of insufficient capabilities to address the problem. Knowledge transforms information into coherent decisions.

Focused on extending the capabilities of the investment program by filling the necessary knowledge gaps. This experience starts at the highest level to ensure that the stakeholders understand the investment impact in the broader organization. Knowledge permeates down to the portfolio construction process where the risk tolerance is aligned with performance targets to create sustainable investment objectives. Diverse investment knowledge enables the investment program to access the inherent premiums embedded in varying assets classes.

The investment manager adds an essential dimension to the accumulated knowledge of the investment program: understanding the minutiae of the security-level risk within their focus. Their insight understands the trade-offs in investment decisions and accepts only compensated risks. When assessing an investment manager, analyze how they create the knowledge within their area of focus and why this knowledge led to success. As experience is unique, the investment program will benefit from diverse alternatives for deriving value.

Act on Execution

Everything depends on execution; having just a vision is no solution.
Stephen Sondheim

The devil is in the details. As the constant app updates on our mobile phones remind us, perfect execution is difficult. Perfection, however, is not the enemy of the practical. As with all skills, effective implementation is born in experience. Even with the incentives adequately aligned and the knowledge base expanded, execution remains the highest risk. Small errors in execution can lead to substantial changes in outcomes; hence, the details matter.

Efficient implementation realizes the potential of a well-developed investment strategy so that actual outcomes align closely with expected results. Execution starts at the portfolio level to ensure that unintended risks do not enter the portfolio. At the risk factor level, execution understands what risks to consider and when to accept them. At the investment manager level, implementation delivers on the promise of active investment performance. Execution manages the different levels of risk to ensure the strategic intent remains insight.

Active investment management is as much a cost control and error minimization task as it is a knowledge factory. Unrealized insights because of poor execution litter the business world. Investment management is no different. The first step in realizing perceived value is controlling the cost structure. An active investment management program that is unable to execute delivers the index at a higher cost. Analyze the investment manager and ask them to demonstrate why their process is efficient for their strategy.

While efficient cost management preserves an insight during execution, the ability to act when an opportunity is present is vital. The investment manager needs to demonstrate how they will execute their idea. Thus, understanding the how they identify the opportunity, how to share that information across the organization, and how to align the organizational design for execution are critical dimensions to success. Ask the investment manager how they align their people within the organization for efficient implementation.

Adapting the Plan

Failing to plan is planning to fail. Alan Lakein

Technology increasingly provides a multitude of information on all aspects of the organization and investment environment. In a data-driven world, the focus is on the 'number' rather than a coherent plan to achieve the 'number.' Switching the focus from reacting to the inundation of instantaneous information to developing a proactive plan that embodies an uncertain future improves performance. As the sage sailor knows, preparing for the storm before it arrives is easier during calm waters.

Investing is increasingly a measurement paradigm. Value-at-risk, volatility, active return, factor exposures became the words du jour without the sober second thought of what the numbers show, and more importantly, how to develop a plan of action with them. For an investment manager must have a program that can adapt to changes in their plan. Everything does not always go as planned and adaptability of the investment manager to a changing investment environment is necessary for sustained success.

To adapt, the investment manager needs to understand the changing principles that underlay the knowledge. Demonstrating a coherent plan that starts at the highest level with the investment objective for an investment horizon and down to the individual security. Knowing why the security is in the portfolio and how it will add value is required. When the first principals that underpin their knowledge changes, the investment manager most show how they adapt their investment strategy. Proper planning will not prevent a changing environment, but it will ensure that the investment manager can adapt.

As a road map to investment manager performance, each question requires identifiable and measurable key performance indicators. If strategic drift occurs, it is easier to make course corrections earlier than later. Identifying the critical success factors: align incentives, assess knowledge, act on execution, and adapt the plan, helps to minimize the risk of underperformance and the resulting strategic drift for the investment program. While not a guarantee of success, it does ensure the right people are driving together on a well-articulated route to a possible destination. Fixing a blown tire or correcting a detour are easy: choosing the wrong destination or people is not a capital risk worth taking.

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