
Manager Selection (a summary)

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The Importance of Manager Selection

Manager selection is a critical step in implementing any investment program. Even though investment objectives may be finalized and targets for asset class weights set, an investment plan is not productive until it is implemented through the purchase or sale of securities, properties, commodities, and derivatives. In most cases, investors choose portfolio managers to determine the most appropriate instruments in which to place assets. Investors hire portfolio managers to act as their agents, and portfolio managers are trusted to perform to the best of their abilities and in the investors' best interests.

Investors must practice due diligence when selecting index managers or active portfolio managers. Investors want managers who are highly skilled, diligent, and persistent, and they also want managers whose interests are aligned with their own. But investors need to do more than identify skillful managers; they need to determine the appropriate weights to assign to those managers.

The goal of this book is to help investors improve their practice of manager selection. It highlights the influence that investment policy statements have on manager selection and proposes techniques for hiring active, indexed, and alternative managers. Strategies for setting portfolio manager weights are also reviewed, along with techniques for monitoring current managers. A large part of the book is devoted to providing an in-depth look at the value of quantitative and qualitative methods for successful manager selection. Special issues for financial advisers and individual investors are also addressed. The book concludes with a summary of key recommendations.

How Manager Selection Fits within the Investment Process

An investment policy statement (IPS) has important implications for manager selection. It should include a description of the client or investor, the overall mission, and the goals for investing. It should also document the investment objectives that the investor considers most relevant in determining appropriate managers and setting relationship expectations.

Investors' views, horizons, sizes, and experiences influence the formulation of an IPS and, in turn, affect the selection process. For example, investors' liquidity needs, quality preferences, and risk guidelines will constrain the search for appropriate managers. Investors should carefully consider the implications for manager selection when formulating their IPS.

Identifying Skilled Active Managers

If we gather the returns of all portfolios—both indexed and active, institutional and retail—and weight them by their values, the result (before fees and transaction costs) will equal the return on the market. If all portfolios are not identical in composition, some will exhibit performance that is higher than the market and some will exhibit lower performance. Empirical evidence supports these conclusions, but the estimates must be prepared with care. For example, many portfolios are not publicly observable.

The arithmetic of active management illustrates that some managers will outperform or underperform market averages. The efficient market hypothesis questions whether any manager has the ability to create alpha. Given a large sample of managers, it should not be difficult to find some with performance records that appear to reflect statistically significant alphas. But this approach ignores the fact that the best performing managers are cherry-picked from the market sample. Based on sophisticated tests, it appears that skillful managers do exist, but the number of managers that demonstrate skill with high statistical confidence appears to be small.

This book details the techniques investors use for selecting active managers and reports on their effectiveness. For example, there is evidence that alphas persist at least for a short time. There is also evidence that superior scores on aptitude tests are positively correlated with superior investment performance. But there is no guaranteed method to identify managers who will outperform in the future. In fact, evidence shows that both retail and institutional investors on average do not profit from their manager hiring and firing processes.

Index Fund Investing

The goal of investing in index funds is to replicate the performance of a pre-specified equity or fixed-income benchmark. Index managers provide investors with inexpensive access to returns on the market. The term “passive management” is sometimes used to describe indexing, but it does not reflect the skill that index fund managers need to have to deliver accurate results, which in many cases are defined by deviations of a few basis points relative to published indices. This book reports that index fund performance, net of fees, shows evidence of persistence; therefore, investors can improve their selection process by reviewing managers' historical record of benchmark tracking.

Asset Allocation Policy and Its Implications for Manager Selection

The asset allocation process entails setting optimal weights of broad classes of securities, such as stocks and bonds, within a portfolio. The more complex a set of assets is, the more effort will be required for manager selection. For example, selecting a large-cap equity index fund is a relatively straightforward process, whereas private equity investing requires a thorough and lengthy process of due diligence of managers and partnerships. This book recommends that investors consider the implications for the manager selection process when formulating their strategic asset allocation policies.

Setting Weights for Active and Index Managers

The manager selection process involves conducting due diligence, identifying the most skillful managers, and determining the proportion of assets each manager should control. Investors set manager weights to meet strategic asset allocation goals, capture alpha potential of active managers, and access the tracking abilities of index managers.

Determining optimal mixes of portfolio managers is dependent on investors' expectations for alphas, their attitudes toward active risk, and managers' risk exposures. Investors may seek optimal trade-offs between active return and active risk or, alternatively, maximize active return while holding active risk to an acceptable level. This optimization problem can be expressed as a mathematical model and is illustrated in the book by using a case study and a Microsoft Excel template that investors can use to set manager weights.

The Dynamics of Manager Selection: Performance Analysis, Monitoring, and Fee Incentives

Investors' horizons, market characteristics, and manager alphas all vary over time. Ideally, an IPS should specify prompts, independent of performance, for conducting special reviews of current managers. Investment professionals should avoid hiring managers at the top of their performance cycle and should use several different tools to evaluate their managers over time. These include tools to estimate alphas, compute performance attribution, and evaluate fee structures, including performance-based schedules. These issues are reviewed, and an Excel template is included to explain how to estimate manager alphas.

Research Findings on Manager Selection

Finance research literature explores whether active managers earn statistically significant alphas, whether alphas persist once found, and whether investors profit from hiring and terminating investment managers. This book contains

a chapter that summarizes research on portfolio managers and entrepreneurs (who share traits with portfolio managers) and outlines manager selection techniques that have been shown to be successful in the past.

Issues for Financial Advisers

Individual investors, including high-net-worth and retirement investors, face more challenges than institutional investors in successful manager selection. They are subject to higher expenses, including taxes, and have less time to focus on investing. Individual investors are often less sophisticated and less experienced than institutional investors and, as a result, often seek the support of financial advisers. Several approaches are proposed for financial advisers to improve their manager selection processes.

Manager Selection for Global Markets and Alternative Asset Classes

The manager selection process is more complex for global investing than for domestic investing, and the same holds true for alternative versus traditional investing. This book reviews research evidence on active global equity, private equity, and hedge fund investments and proposes techniques for selecting managers for these asset classes.

Key Recommendations and Best Practices

The final chapter of the book summarizes key recommendations for manager selection, including advice shared by experienced investors, pension consultants, and money managers.



The complete monograph can be found at <http://www.cfapubs.org/toc/rf/2013/2013/4>.

Use your smartphone to scan the QR code to go straight to the webpage.