A Call for Investor Action:

Demand Better Investment Manager Consulting.

(You deserve & need it. Otherwise use a Robo advisor.)

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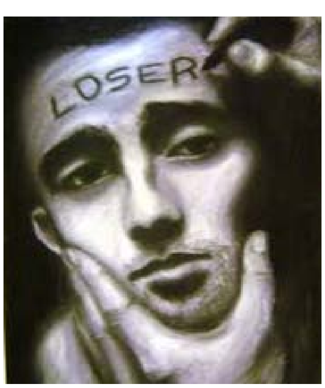
True genius resides in the capacity for evaluation of uncertain, hazardous and conflicting information. Winston Churchill.

A front page story in the September 15 issue of ***Pensions & Investments,*** "Move to passive likely to build still more steam," prognosticates the slow death of active investment management. The unfortunate fact is that most active management should just fade away, leaving it to the few who actually have skill. Investors pay good money to active managers because they expect them to earn a return above an index, but this money has been wasted. Even worse, the cost has been more than fees; it's also cost in lost performance. Furthermore, investors pay even more good money to advisors who recommend active managers so even more money has been wasted. Investors need to demand real due diligence from their advisors, rather than the sham that has been served up for the past 40 years. They need to get what they pay for.

The Proof of the Pudding is in the Tasting

Numerous studies by S&P, Vanguard, Morningstar, and others conclude that the vast majority of active managers fail to outperform passive, frequently reporting that more than 80% underperform. There are simply way too many incompetent active managers who get business because intermediaries – consultants and fund-of-fund managers – can't tell the difference between good and bad managers. In his popular book, ***What Investors Really Want***, Professor Meir Statman explains that investors want to play the investment game, and they want to win. They believe their investment advisors can identify skillful active managers. But investors are losing the investment game, so they should either stop playing or change the game.



Always Change a Losing Game

Few would claim that all active managers are dolts, that none add value. But candid advisors acknowledge that finding skill is a challenge, especially when it comes to complicated strategies, like some hedge funds. This challenge could be overcome by contemporary due diligence, although hardly anyone is willing to do the hard work that this requires. The search for skill continues to be conducted with the same old lazy tools that have never worked and never will. It's like the allegory of the drunk and the streetlamp: The drunk loses his keys at night in a park across the street but he looks for them under a nearby streetlamp because it's easier to see.

Antiquated Evaluation Tools

The old performance evaluation tools are indexes and peer groups. These are awful barometers of success or failure. Indexes don't work because many skillful managers don't live in style boxes, nor do they hug indexes. Peer groups don't work because they are loaded with biases, with classification bias causing the biggest problems. Also, more than 80% of the managers in peer groups failed in 2014. Consequently, investment managers are evaluated relative to a bunch of losers. Beating the losers is not a win. **Peer groups of hedge funds are exceptionally silly because hedge funds are unique so they can't be grouped together by definition: "unique" means without peers.** Hedge fund peer groups epitomize classification bias because the members don't belong together. For further details, see "The Compelling Case for Changing Hedge Fund Due Diligence."

Investment manager consulting is a fungible credence good, i.e. a service that is difficult if not impossible to properly assess before or even after consumption. Credence good markets emerge when sellers are much more knowledgeable than buyers. This fact has propelled so-called "Robo advisors" into the limelight because if you can't tell the difference, you might as well buy the cheapest. Clients (buyers) need to wise up. There's a good reason that active managers selected by consultants fail to deliver value added: **consultants aren't trying hard enough because they don't have to**. This laxity applies to advice-only consultants as well as outsourced chief investment officers (OCIOs). It would be better to not pretend at all. That's why intellectually honest Robos have given up on the search for skilful active investment managers.

A couple of years ago I had dinner with a friend who owns a hugely successful institutional consulting firm advising more than $800 billion. He acknowledged that his firm's investment manager research and performance evaluation could probably be better, but asserted that it wouldn't change anything because clients don't know what they don't know. I think he's wrong, and that a first mover into contemporary due diligence will revolutionize the entire investment consulting industry, and most importantly deliver significant client outperformance exceeding what any individual investment manager might provide. Consultants can and should earn an alpha.

Get What You Pay For: Contemporary Due Diligence

The odds of actually finding skill can be improved with custom benchmarks and scientific peer groups. Custom benchmarks address the make or buy decision. We can replicate (i.e. make) most managers inexpensively with blends of ETFs long and short, as determined through custom benchmarking approaches like style analysis or factor exposures.

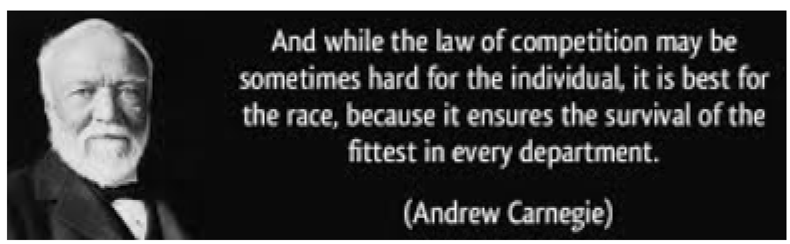
Scientific peer groups, or universes, use hypothesis testing to determine if performance in excess of a custom benchmark is statistically significant. The hypothesis "performance is good" is tested by comparing the manager's actual return to the returns on all the portfolios the manager might have held, following his portfolio construction rules and using his eligible stocks; it's a portfolio simulation.

In its Benchmark Subcommittee Report, the CFA Institute recommends custom benchmarks and cautions against the use of peer groups. Custom benchmarks are a good suggestion, but they come with a problem. It takes many decades to establish statistically significant alphas with custom benchmarks. Scientific universes solve this waiting problem by testing the hypothesis "performance is good" in the cross-section of all possibilities, whereas alpha tests this hypothesis across time using regression analysis.

Conclusion: Demand Better & Consolidate the Best

Investors deserve a better chance of finding good active investment managers. This task can be accomplished by rejecting the credence good aspect of investment manager consulting. Clients need to learn the difference between haphazard and assiduous due diligence, between pay-to-play-based and objective recommendations. In other words, clients need to research and understand consulting processes, so they can get what they pay for.

In a June 5, 2014 research post, "*There are too many active managers*", Towers Watson asserts that active managers should be only 30% of all managers rather than the current 80%. This realignment would be more cost effective for investors and would continue to keep markets efficient. In other words, active management should mostly fade away, but not die altogether.



A reduction in the number of active managers will happen naturally if clients insist that intermediaries (consultants and fund-of-funds) actually figure out who's good and who's not. Then Darwinian principles will prevail so only the fittest will survive. Clients hire intermediaries to perform a talent search, but it fails because the processes remain in the dark ages, and include golf (pay to play). Contemporary manager due diligence could change all that and consolidate the active manager pool down to just the most worthy. Advisors who are looking for ways to compete against Robos should wave the contemporary due diligence flag as an important differentiator, especially its potential for outperformance.

We're all hardwired to resist change, so the advancement to contemporary due diligence requires more than just my voice. It needs and warrants client help. Clients deserve better, and should demand it.

Please see our Active Manager Infograph.

Ron Surz is President and CEO of PPCA Inc and its Target Date Solutions subsidiary. Both are in San Clemente, CA. PPCA provides contemporary investment manager due diligence software and Surz Style Pure Indexes® including Centric Core. Target Date Solutions manages target date funds using its patented Safe Landing Glide Path®, and has published a book to help fiduciaries select TDFs.