Investment Manager Due Diligence Needs Help

by **Ron Surz**

If you can't find the time to do it right, when will you have the time to do it over?

In this challenge to traditional thinking you are shown the current problems in investment manager due diligence and how to fix them. If you are to improve investment manager due diligence you need to:

1. Acknowledge that there are problems
2. Care enough to fix them
3. Fix them

THE PROBLEM

The key problem with manager due diligence is laziness. We just don't care enough to do the job right. Here are some of the current practices that should change. Einstein said *"Everything should be as simple as possible, but no simpler."* We've made due diligence way too simple. We make poor decisions as a result.

- **Pigeonholing managers into style boxes.** Only index huggers live in a box, and they have tricked us into believing that tracking error is risk. Tracking error measures conviction.

- **The 4-corner solution for asset allocation:** large-value, large-growth, small-value, small-growth. This is the cart before the horse. Finding talent should come first, then asset allocation. A lot of investment talent ►

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is missed because a premium is placed on index hugging. Index hugger talent is clicking on software to "optimize" to a benchmark fit. There's nothing wrong with this, except other potential talents, like picking good stocks or economic sectors, never get on our radar screens.

- **Relying on name brand indexes without question.** Russell, S&P, & MSCI are name brands that generally rely on Price/Book ratio for their value-growth classifications, probably because professors Fama & French used it in their widely accepted style research. The problem in the current financial crisis is that the book values of some major financial institutions are grossly overstated because bad loans have not yet been written down. Consequently, these companies are classified as deep value. By contrast, a Price/Earnings-based classification views these companies as growth. What do you think? Are these distressed banks cheap? Are they risky?

- **Peer groups are used to evaluate managers.** All CFAs learn the serious problems with peer groups: survivor, classification and composition biases render peer groups useless, and no one can make these biases go away. But everyone, including CFAs, chooses to ignore these biases because it's easy to leave them stand unchallenged. Decades of use have led us to ignore well documented deficiencies. Marketers exploit this fact by finding a peer group that makes them look good. Ever meet a manager whose performance is below median?

- **Attribution analysis is performed haphazardly.** Attribution is the most powerful and forward-looking tool we have but it's important to use holdings and to get the benchmark right. Otherwise we'll be misled. We rarely use holdings and always settle for a pigeonholed index as the benchmark.

WHY WE CARE

What we tolerate we cannot change. Nothing will change unless we want it to; we need motivation. Laziness alone is not a reason to change. Remote controls for our TVs are here to stay. We need to change the old practices because

(1) the old practices don't work so we select inferior managers (that's the stick) and
(2) differentiating ourselves from the competition should bring more clients (that's the carrot).

The old ways cannot tell the simple difference between winners and losers. If we could tell the difference, the active-passive debate could be settled with active where we are confident in talent and passive in parts of the market where we are not, so-called completeness funds. ***"There can be no transforming of darkness into light and of apathy into movement without emotion."*** - Carl Jung. We need to get excited about a better future!

In simplest terms, the truth will set us apart, and it's not that much more difficult than the old ways we've been using for the past 40 years.

SOLUTIONS

Much has been written about the problems, but little has been offered to fix these problems. There is evidence to show that better managers are in fact selected when these problems are fixed. Here are some recommendations of solutions that work:

- **Pigeonholing managers into style boxes.** Use custom benchmarks instead. Indexes are barometers of performance in a market segment, like Utilities or Large Value stocks. Benchmarks are passive alternatives to ►

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active management, capturing the people, process and philosophy of the manager. Blended indexes can serve this purpose but the best indexes for this purpose are mutually exclusive (no stock is in more than one index) and exhaustive (the collection of indexes covers the entire market). These are criteria set forth by Dr. William F. Sharpe for returns-based style analysis, plus they apply even more for holdings based analyses. The popular indexes do NOT meet these criteria, but Surz Style Pure® indexes and Morningstar Style Indexes do meet these criteria.

- **The 4-corner solution for asset allocation:** Find talent wherever you can – look for love in all the right places. Then integrate this talent by optimizing across it and filling in voids with passive indexes where no talent is discovered. Dr Frank Sortino has been using this approach for a long time, so there is precedent, and it is documented to work.

- **Relying on name brand indexes without question.** Surz Style Pure® Indexes use Price/Earnings ratio as the primary value-growth differentiator, so they do not suffer from the current Price/Book distortion. As mentioned above, they are also mutually exclusive and exhaustive. The opposite of mutually exclusive is overlapping membership, as is the case with the Russell and MSCI indexes. Overlapping membership causes a statistical problem in returns-based style analysis called multicollinearity, which inflates the goodness-of-fit measure (i.e., R-squared) and can produce erroneous results called spurious factor loadings, where the style profile is just plain wrong. Similarly, being non–exhaustive like the S&P indexes, which have 1,500 companies selected by committee, means many portfolios have holdings that are not represented.

- **Peer groups are used to evaluate managers.** Peer groups should be replaced by portfolio simulations that create all of the portfolios the manager could have held, selecting stocks from a custom benchmark. This is classical hypothesis testing that compares the actual manager return to the universe of returns that could have been earned. There are no biases in these scientific peer group substitutes, and they're available days after report period end.

- **Attribution analysis is performed haphazardly.** There are only two holdings-based attribution systems that support custom benchmarks – StokTrib from PPCA, and Factset. If the benchmark is wrong all of the analytics are wrong. This very important tool in our decision making is worth the investment because it can easily add more value than a typical manager earning hundreds of basis points, and it can add this value over & over again for multiple clients.

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DUE DILIGENCE QUIZ

1) In the active-passive debate, passive tends to win because:
   A. There are no good active managers
   B. Indexes rule
   C. We can't make a simple distinction between winners and losers
   D. Passive is cheaper

2) Which benchmarks work best for determining value added of non index huggers?
   A. The popular indexes, like Russell and S&P
   B. Blends of mutually exclusive and exhaustive indexes
   C. Peer groups
   D. Morningstar ratings

3) What biases exist in peer groups?
   A. There are no biases
   B. Survivor
   C. Classification
   D. B and C

4) The 4-corner solution (large-value, large-growth, small-value, small-growth) to asset allocation has improved the performance of multiple manager portfolios.
   A. True
   B. False

5) Which value-growth classification variable might currently be misleading?
   A. Dividend yield
   B. Price/Earnings Ratio
   C. Earnings Growth
   D. Price/Book Ratio

6) Statistical significance of value added or subtracted is possible over short timeframes using:
   A. The Sortino Ratio
   B. Regression analysis
   C. Hypothesis tests that use simulations
   D. Manager interviews

7) The benchmarks in attribution analysis should be:
   A. Customized
   B. Based on the client's choice, like Russell or S&P
   C. Beta adjusted
   D. Best fit to a standard index

8) Low tracking error relative to a benchmark indicates:
   A. Low risk
   B. High reward
   C. Benchmark hugging
   D. The benchmark is wrong

9) A good framework for portfolio construction is:
   A. All passive
   B. All active
   C. Hedged
   D. A mix of active and passive

10) New and improved tools will be used by due diligence researchers when:
   A. Investment managers start using them
   B. Advisors demand their usage
   C. Clients ask for them
   D. Researchers discover them

Answer key

1.C 2.B 3.D 4.B 5.D 6.C 7.A 8.C 9.D 10.B

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