HIRING A PORTFOLIO MANAGER IS LIKE HIRING A PROFESSIONAL GAMBLER:

Mind Your Ps and Qs

By Ron Surz, CIMA®

The future ain't what it used to be.
—Yogi Berra

The standard disclaimer, "Past performance is no guarantee of future results," doesn't square with investor behavior, but it does square with investor experience—yesterday's winners tend not to be tomorrow's winners. The real problem rests with the evidence we use to define winners and losers. The evidence is more than just performance—it's found in the evaluation and the attribution of that performance.

Specifically, if we mind our Ps and Qs we can zoom in on the evidence and improve the odds of better future performance. Investors will continue to want to pick winners. We just need to know who the winners are, and it's not as simple as scanning last year's rate of return. This article provides guidance for anyone who wants to hire good active investment managers. I prescribe a simple three-question process for identifying managers who can be reasonably expected to add value in the future.

Minding Your Ps and Qs

Hiring an active manager is like hiring a professional gambler. In both cases, you want to understand the following four Ps before you entrust your money:

People: Who are the individuals? Are they smart? Clever? Worthy of my trust?

Process: How do they gain an edge? What's their story? What game(s) do they play?

Philosophy: How do they view the game? What strategies do they employ?

Performance: What tournaments have they won? What are their lifetime winnings? Why do they need my money? Performance is the scorecard.

Similarly, you would only hire a professional gambler who you thought could win. No one is forcing you to hire an active manager. Also similarly, despite misperceptions to the contrary, you cannot buy past performance. You can only buy the people, process, and philosophy. The gamble is on future performance. No one has a crystal ball, but asking the right questions can provide confidence in the gambler, which brings us to the three Qs.

The Three Key Questions for Manager Due Diligence

The search for alpha requires accurate answers to the three key due diligence questions:

1. What does the manager (gambler) do?
2. Does the manager (gambler) do it well?
3. Why? Will success continue?

Although they appear straightforward, these questions are not easy to answer, even though some mistakenly believe that they are. In the following I examine each in detail, taking note that hedge funds present their own unique challenges. It's important to get and give the best answers you can. If you're an investor, you want to nail this test. If you're an investment manager, you want to provide the best answers to be properly understood.

What Does the Manager Do?

This question is typically answered by a style classification for traditional managers and as a strategy for alternative managers—for example, Russell large growth, or market neutral for a hedge fund. The reality for traditional managers is that only index huggers live in style boxes, so you really want to know if the manager is a blend of styles and sectors, as most are. Or put another way, many managers are liberated from style boxes and simply do whatever it is that they do well, which is best-suited to custom benchmarking. Some managers provide custom benchmarks, some as detailed as "normal portfolios" that specify neutral positions at the security level.

The answer is even harder to come by with hedge funds, which entail the following considerations:

- Approach long: exposures to styles, sectors, countries, etc., as well as exposures to economic factors
- Approach short: exposures to styles, sectors, countries, etc., as well as exposures to economic factors
- Direction: amounts long and short
- Leverage
- Portfolio construction approach: number of names, constraints, derivatives, etc.

In other words, managers should provide a detailed profile of what they do rather than a style or strategy oversimplification, and advisors should trust but verify this profile. With profile in hand you can proceed to the next question.

Does the Manager Do It Well?

This question addresses the active-passive decision as well as the make-or-buy alternative. Has the manager earned better returns

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than a passive alternative? Most traditional managers can be inexpensively replicated by blending style and sector exchange-traded funds (ETFs). Similarly many hedge fund managers can be replicated by going both long and short ETFs.

Hedge funds have enjoyed a certain mystique that has allowed some to answer the competence question with conceit and concealment, especially if performance has been good. The problem is that some very smart people have lost a lot of their clients' money, usually because the process or philosophy was flawed. Smart people are not infallible, and some are dishonest. Competing investment managers care because they do not want to lose business to cleverness rather than skill. They want a level playing field.

Investors want to know more than the fact that a manager has beaten a passive alternative, after fees and expenses of course. They'd like statistical confidence in the value add. They'd like some sense that it wasn't just luck, and managers are in the best position to explain how and why they are skillful rather than lucky. Hypothesis tests provide substantiation for this confidence. Peer groups are a form of hypothesis test that uses a sample of similar managers. This is the most common hypothesis test, even though different samples (peer groups) usually provide materially different rankings, i.e., inferences. The ultimate sample is all of the portfolios the manager could have held; this alternative, although less popular, approach uses portfolio simulations. The computer simulates all of the choices the manager could have made. Statistical confidence in this context is accomplished by beating a high percentage, say 90 percent, of all the possibilities. The idea is that the chance of it being luck is small (10 percent).

Importantly, hypothesis tests can be applied to short track records, so even emerging managers and newer hedge strategies can be validated. By contrast, regressions against a benchmark take decades to produce a statistically significant alpha.

Once you've established that there is potential skill, the next question addresses repeatability. Is success likely to continue?

Why Has the Manager Succeeded or Failed?

This last question is answered with performance attribution. Both investors and managers want to understand the manager's strengths, and whether the manager is likely to continue to produce superior results. So for example, if much of the value added has come from good picks in technology stocks, it's important to know that the people, process, and philosophy behind those choices are still in place. Returning to the gambling analogy, if the gambler has made most of his money playing Texas hold'em, it's important to know that this remains his game of choice.

It is very important to use the right benchmark in attribution analysis because if the benchmark is wrong all of the results are wrong. The unfortunate fact is that most attribution systems limit the benchmark to standard indexes, namely style boxes, so any manager who does not live in a box is penalized or rewarded for being different rather than good. Clients hire losers and fire winners when the benchmark is wrong.

Summary

At the end of the day, skill is familiarity and judgment supported by evidence. The evidence is not in the performance; it's in the performance evaluation and the performance attribution that accurately answer the three key due diligence questions. Accurate answers reveal that skill doesn't always win; it's just more likely to win, to add value. Accurate answers increase the odds that the investor will be rewarded. History is no guarantee, but it is a guide.

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Disclaimer: Past performance is not an indicator of future performance, but it can be a clue if properly analyzed.