August 2017 Investment Publications Highlights

Does Past Performance Matter in Investment Manager Selection?

Bradford Cornell, Jason Hsu, and David Nanigian, *The Journal of Portfolio Management*, vol 43, no 4 (Summer 2017): 33–43

The authors find that firing managers that recently underperformed actually eliminates those managers that are most likely to outperform in the future. They advise against using past performance as a selection criterion and instead suggest that investors focus on qualitative factors.

The authors review three portfolios that invest equally in managers based on trailing benchmark-adjusted returns from January 1994 to December 2015. If a manager's trailing returns are ranked in the top decile, that manager would be included in the winner strategy. Those managers whose funds are near the median or in the bottom decile fill out the median or loser strategies, respectively. At the end of each three-year period, the portfolios are re-allocated based on performances across that time period.

At the end of the review period, the authors' results show that the average annualized benchmark-adjusted return for the loser strategy was the highest, followed by the median and winner strategies. The loser and median strategies also outperform the winner strategy using other performance metrics, such as absolute return and Sharpe ratio. According to the authors, the results highlight the occurrence of mean reversion in manager performance.

The authors assess the robustness of their results by examining hypothetical rules for firing managers based on the level of underperformance relative to the benchmark. They find that managers fired as a result of underperformance, be it 1% or 3%, ended up outperforming other funds that remained in the portfolio across two-year and three-year windows. This holds true across performance metrics, as well as when fund size is varied.

The authors recognize that a policy of firing successful managers and replacing them with poor performers is unlikely. Therefore, they recommend investors focus more on qualitative factors like stewardship, governance, manager tenure, incentive alignment, etc. The authors argue that a better link exists between these qualitative attributes and long-term manager performance.

The Bad Arithmetic of Active Management

Brian J. Jacobson, *The Journal of Portfolio Management*, vol 43, no 2 (Winter 2017):115–122

In this article, the author argues against the assertion that active portfolio management is either a zero-sum or negative-sum game. Through a number of theoretical and empirical examples, he argues passive investing is not necessarily better for investors than active management.

In 1991, Professor William Sharpe penned an article titled "The Arithmetic of Active Management" in which he laid out the case against active portfolio management. He argued that a passive investment in the entire market must perform just as well as the average actively managed portfolio before costs, and that after costs are taken into consideration, the passive investment will outperform the average active investment. Thus, investors would benefit more from a passive investment in the entire market than from active portfolio management. But Jacobson argues Sharpe's conclusion does not follow from his oversimplified claim.

One reason Sharpe's conclusion does not hold is because it does not account for the reality of the marketplace. According to Sharpe's definitions, any investor who does not buy the entire market portfolio should be considered to be an active investor. Since passive investments typically do not include the entire investment opportunity set, they may not truly represent the market share necessary to meet Sharpe's condition. Additionally, every dollar entering and leaving the marketplace must also be accounted for to hold Sharpe's math true. How these dollars flow represent complexity not covered by Sharpe's math.

Another reason the author discounts Sharpe's conclusion is based on real world evidence to the contrary. If investing in the entire market portfolio is superior to every other option, then long-term outperformance based on factors such as quality, value, or small-cap could not exist. However, empirical evidence from exhaustive academic research has shown the opposite—these factor premiums do, in fact, persist in the long run.

Further, even assuming it is true that the average active investment dollar will perform the same as the entire market return, that does not mean every dollar will perform the same as the entire market. There is nothing in the argument for us to determine if a particular investor or active portfolio manager can persistently outperform the market, which is an entirely different question that must be answered by the data. The author concludes Sharpe's basic assertion may be valid in theory, but in practice it does not hold.

Rethinking Due Diligence and Manager Selection

Tom Brakke, CFA Institute, *Conference Proceedings Quarterly*, vol 33, no 2 (Second Quarter 2016): 10–16

From 30 years of experience working with asset managers, the author finds that manager due diligence has evolved into a checklist-like exercise, relying heavily on data and returns. Yet, understanding the organization and other qualitative factors may be more important to determining which mangers are poised to outperform.

A focus on returns in manager due diligence assumes the investment environment of the past 30 years—characterized by globalization, disinflation, and declining interest rates—will continue. Similarly, data are constantly changing, but models used to interpret data often stay stagnant. For example, investors often use Sharpe ratios as a helpful tool to make investment decisions, but risks change over time. The author asserts that understanding the context around data will lead to better investment results.

Recommending a manager that has recently underperformed can be a tough sell for many advisors; however, chasing good investment returns can actually increase risk. This is because as "winning managers" attract more capital, they may be forced to make less-than-optimal investment decisions to accommodate their growing asset level.

The author compares an analyst's job to that of an anthropologist who is trying to understand the workings of an organization. Finding asset managers that are multi-dimensional, and that may be able to better maintain performance in different market environments, is essential. Due diligence should also uncover manger weaknesses and how managers plan to improve. The author argues that the strongest portfolios are composed of a mix of passive and active managers, with active managers used when the analyst has deep knowledge of the asset class. However, for both passive and active managers, diligence should favor qualitative information over quantitative measures. ■

CAMBRIDGE C|A ASSOCIATES