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To Fire or Not to Fire, That is The Question

Many funds have been losing faith in active management as some trusted managers with good long-term track records have failed to meet expectations in recent times.

In many cases, the response has been to fire the manager and move on. This may seem the logical thing to do. After all, fund fiduciaries are accountable to their beneficiaries, and many are under intense pressure to take action of some kind after poor investment performance.

But is firing managers the right response in this context? It is a tough call. On the one hand managers are responsible for their results and, in business, people who produce poor results usually have their relationships terminated. On the other hand, investment management is a more complex business than most, with more extreme outcomes possible.

The ultimate step

Assume that you hired a manager because you thought he was skilful. In this case, there are four possible explanations for bad performance:

- The manager has not been skilful. You were simply wrong.
- The manager is skilled, but has made some mistakes.
- Bad luck.
- Poor timing. Positions in the portfolio may turn around some day, but not yet.

In our view, only one of these explanations justifies the ultimate step of firing a manager. If you were wrong, and the manager has clearly turned out to be unskilled, then he should be fired. In the other three cases, a change of manager is not justified on the basis of skill alone. The possible exception is the manager who has made mistakes. This manager is definitely under a cloud and needs to regain your confidence, although all three cases clearly call for things to be kept under review.

There is a big caveat. Real life does not fall into such neat categories. You never quite know if the bad performance was caused by lack of skill, a few mistakes, bad luck or bad timing. If you suspect that several factors are involved, the best approach is to list them in order of how likely they are. You can then weight the factors based on their importance. Given that only lack of skill should lead to termination, the decision should still be reasonably straightforward.

What went wrong?

In 2008, a large number of bond and equity managers performed poorly against their benchmarks, in many cases extremely poorly. Although returns have typically improved in 2009, many funds' faith in active management remains badly shaken.

The credit crunch created highly abnormal conditions for all managers, in particular fundamental equity managers and active bond managers who were overweight non-benchmark assets. Securities valuations became detached from underlying fundamentals.

The fourth quarter of 2008, after Lehman Brothers collapsed, saw the most fragile market conditions in the memory of most participants. Liquidity dried up, and many high quality securities were caught up in forced sales as investors raised cash by selling their most liquid assets. Some security prices were affected by government intervention. Investors seemed to be gripped by fear and a flight to perceived quality ensued.

Under these extreme conditions, it was unrealistic to expect managers to take strong views. They could not anticipate price moves, and would almost certainly have been acting outside their comfort zones or their mandates had they tried. Any decisions would also have involved taking a dangerously short-term view. What is more, any portfolio changes would have been very expensive because of the poor liquidity and increased transaction costs.

For most managers to recover their underperformance to 31 March 2009, conditions would have to return to 'normal', or at least close to it. In other words, security prices must once again reflect fundamental values. Arguably, the last 12 months has seen a lot of this happen.

Of course, rare periods of price dislocation should not absolve all managers of responsibility for their poor returns. Those managers that have produced the most extreme performance relative to their benchmarks will have to face the toughest questions. One is whether their philosophy and process has been designed to work only in the kind of environment they have been used to over the last 20 years, or whether it can adapt to long-term changes in the market.

Performance and skill

It is important to remember that poor performance does not necessarily mean poor skill. That said, performance that is extreme clearly warrants further investigation. By this we mean underperformance in a year of worse than twice the manager's expected tracking error.

Against the backdrop of the past two years, it is useful to remember that tracking error is a backward-looking measure that is not suited to unusual investment conditions. Also, chance alone can cause underperformance on this scale about one year in 40.

Firing (and hiring) decisions should be based first and foremost on an assessment of a manager's skill. Track record comes second. A truly skilful manager with poor recent performance can rebound.

However, if your manager has produced a tracking error of this magnitude, work needs to be done to find out why. Most likely, there will be three main reasons for the poor result.

The first is that the manager's style or investment convictions did not suit market conditions (a so-called 'fat tail' result). If this is the reason, other managers with similar portfolios will show similar results. These returns may not reflect a lack of skill. However, they do justify monitoring the manager more closely, especially if he lost his nerve and made inappropriate position changes at a critical moment.

The second possibility is that one or more positions went against the manager. Losses may have been magnified by leverage in the manager's strategy, or the unwinding of leverage in stressed market conditions. This may signal a failure of skill, as well as a possible lapse of risk control.

Thirdly, the manager's business may well have been destabilised by client losses, reduced resources (for example, loss of key investors) or a change of leadership. In this case, the manager should definitely be re-assessed, which may well lead to a downgrade of his skill rating.

This should give us a clearer process for analysing where the poorest performing managers went wrong in the recent past. The point we wish to emphasise is that firing (and hiring) decisions should be based first and foremost on an assessment of a manager's skill. Track record comes second. A truly skilful manager with poor recent performance can rebound.

How bad is too bad?

What if the manager has posted five years of poor results? Skill should generally emerge during a five-year period, but there is no law saying that it will, especially during abnormal market conditions. Of course, clients do not have endless patience, and relationships can break down as exasperation builds up.

However, even after five years of disappointing results there is a strong case for keeping faith with a manager whom you believe to be truly skilled. This argument is based on evidence that funds tend to change managers at exactly the wrong time, thus impairing their future performance.

A research study published in 2005¹ showed that investment committees of very large US pension plans were on average firing underperforming managers who subsequently saw their performance rebound. The new managers on average added less value than the old managers would have done. The study concluded that the funds would on average have done better to stay put.

So in answer to the question "How bad is too bad?", we suggest that performance alone is never a sufficient reason to fire a manager, however bad it is. Only when the poor performance is clearly accompanied by a loss of skill, or a failure of risk control, should we reach a point of no return.

What is past is past. The manager line-up should always be managed with respect to the future.

Picking the point of no return

Firing decisions are never easy at the best of times. In troubled markets it might help to consider the following:

- Past performance helps when assessing skill, but it never tells the whole story.
- Firing and hiring decisions should be based on expectations of future performance.

- In extreme conditions, manager outperformance is very difficult to predict.
- When asset prices become detached from fundamentals, performance may suffer in the short term but tends to rebound as 'normal' market conditions return.

¹ *The selection and termination of investment management firms by plan sponsors*, May 2005, by Amit Goyal and Sunil Wahal of the Goizueta Business School, Atlanta. The selection and termination of investment management firms was examined between 1994 and 2003.

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