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Perception and Practice in Manager Selection

"A steady, second-quartile performance ranking every quarter should result in first-quartile status over time."

"Every manager with good long-term performance goes through a bad patch from time to time."

These perceptions among investment professionals relate directly to decisions made by plan sponsors and others in the business of selecting investment managers. These decision-makers may well ask:

- Is it possible to find those "steady second-quartile managers?"
- Just how bad should you expect a future "bad patch" to be before you start questioning your manager choice?

The first topic is strictly theoretical. Nobody should expect to find a manager holding the same universe ranking quarter after quarter. In fact, when we examine this "theoretical steady second-quartile manager," second quartile is the last place they will likely end up. The second topic better lends itself to practical analysis. We identify a subset of "consistently good" managers in the international equity universe and examine how often, and for how long, they underperform.

For the first topic, we examined both U.S. and non-U.S. equity portfolios. We used tax-exempt data from 1992 to 2003, based on InterSec Research Corp.'s active international equity universe and Callan Associates Inc.'s broad U.S. large-cap universe.

Based on our results, it does appear that a steady second-quartile ranking generally will result in first-quartile status eventually – with an important exception.

Our analysis showed that to achieve a first-quartile ranking over the average five-year period through a consistent second-quartile rank, a manager needed only to place at the 41st percentile every quarter in the international universe, and the 43rd percentile in the U.S. universe. This was measured by comparing the linked, quarterly universe returns (as reported) with the universe returns reported at the end of the measurement period.

Higher percentile rankings were required to achieve a first-quartile ranking sooner than five years. To get to the first quartile in three years, the ranking needed to be 39th percentile (international) or 41st (U.S.).

No matter how low a manager's ranking within the second quartile, as long as that ranking is consistent, will the portfolio eventually make it into the first quartile? (Here is the exception alluded to earlier.)

Based on our study, the answer is no. If that second-quartile ranking is *too* low, the manager may drop below median into the third quartile. In effect, there's a "tipping point" low in the second quartile. A manager who ranked steadily above it would move eventually into the first quartile. One who scored below it, even if the result was above median, was destined over time for the third or fourth quartile.

Perception and Practice in Manager Selection *continued*

There are two factors that actually may make it harder for a slightly above-average performer to appear *well* above average over time: "survivorship" and "new entry" biases. In any dynamic universe of portfolios, some are added and some drop out over time. Survivorship bias recognizes that those dropping out tend to have had results overly concentrated in the third and fourth quartiles.

New entry bias recognizes that managers may test a strategy before introducing it into the universe. The new entries usually will be those that have tested well and they'll tend to enter a universe with above-average past results. So, over time, for a portfolio that consistently has been around median every quarter, competitors that on balance trailed it quarterly are dropping out, and ones that on balance beat it, are coming in. Given these effects, we should expect to see the linked quarterly median tend to fall *behind* the median of results over more extended periods. This is in fact exactly what happened over three and five year horizons in both universes. In other words, if a manager had been the median performer in each quarter over that horizon, it would have been below median for the period as a whole.

COMPARISON OF "LINKED QUARTERLY" MEDIANS TO ACTUAL MEDIANS
1992 - 2003
(Quarterly Rolling Data)

	One Year 42 data pts.	Three Years 34 data pts.	Five Years 26 data pts.
INTERNATIONAL			
Average of Actual Median Managers*	7.43%	6.09%	7.64%
Linked Average, Quarterly Medians*	7.01%	5.33%	6.66%
Difference	+0.42%	+0.76%	+0.98%
U.S.			
Average of Actual Median Managers*	10.92%	12.08%	15.23%
Linked Average, Quarterly Medians*	10.97%	11.88%	13.57%
Difference	-0.05%	+0.20%	+1.66%

*Source: InterSec Research and Callan Associates data, Brandes Institute

This effect illustrates the "tipping point" just above the median ranking that makes *staying* in the second quartile over the longer term statistically difficult, if not impossible. Managers who always performed just above this tipping point would migrate into the first quartile. If they were steadily just below it, they likely would fall into the third or fourth quartile. For example, in the international universe, the tipping point on a 3-5 year period appeared to be the 48th

percentile. Thus, if a portfolio consistently ranked at the 48th percentile, it would drop *below* median over both the 3- and 5-year periods.

Based on our observations, steady, second-quartile performance over time can indeed result in a first-quartile ranking. Even with survivorship and new entry biases, our study shows that a first-quartile result may be achieved over five years from as low a base as a steady ranking in the fifth decile for either the international or U.S. equity universe. However, as we also have shown, over time, second-quartile managers who are just above median can "tip" into the third or fourth quartile.

We realize this is a hypothetical exercise and the likelihood of a manager achieving a steady rank quarter after quarter is effectively zero. But there are two lessons here, we believe. The first is how surprisingly quickly a consistent ranking almost anywhere in the second quartile is likely to propel a manager into the first quartile. The second is the existence of this "twilight zone," just above median, where managers would struggle to avoid being sucked into the bottom half of the rankings.

Turning now to a more practical topic, we look at how frequently a "consistently good" manager may appear in the lower reaches of the manager universe. This particular example should be viewed as an illustration, as opposed to a "proof," as we are using one specific universe (international equities), over a limited period (the last 14 years). It may still prove instructive for plan sponsors who have to decide whether a bad performance patch is a typical, temporary phenomenon, or something indicative of more serious issues.

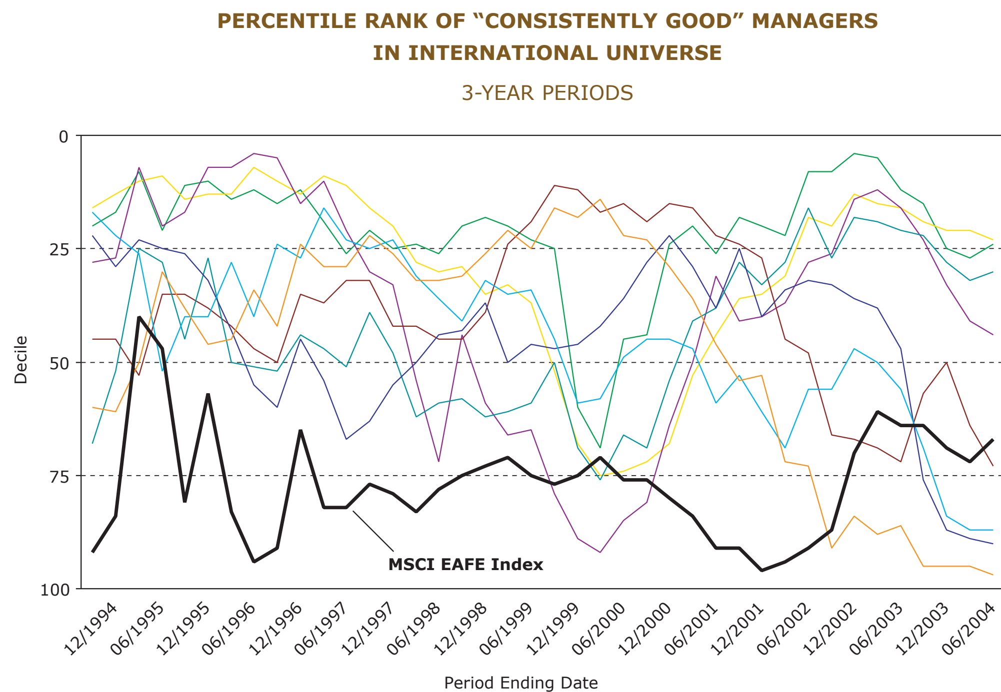
For this study, we used the PSN database[1] of active international equity managers in order to examine the performance over time of specific managers. In order to establish "consistency," we needed to apply the test over relatively long periods, so we included only those 53 managers that had track records going back to 1990, out of the 245 in the database. We defined "consistently good" as those managers whose three-year <u>and</u> five-year rolling universe rankings (over the whole period) averaged above median, and above the MSCI EAFE Index[2], in the whole PSN international equity universe.

After that, to ensure an "apples-to-apples" comparison, we excluded portfolios in the PSN list that were small cap, regional, or emerging market only. To simplify, we left out ADR-only versions of other strategies already included. We were left with 29 managers with extended track records. Ten of these managers met our definition of "consistently good." This may seem a high proportion, but (1) the universe has already "pre-selected" good managers, as managers with poor records may have disappeared from the PSN database due to market forces and (2) this was a period when most managers beat the relevant index. Conversely, we defined "bad" as "the trailing three-year record dropping into fourth quartile <u>and</u> behind the index for four

consecutive quarters." In practice, this definition of "bad" may lead a client at least to question the manager choice, and possibly to fire the manager on performance grounds.

What then was the chance of a "consistently good" manager turning "bad"?

Let's start by looking at the percentile rankings of all 10 "consistently good" managers. Using quarterly data, this chart illustrates percentile rankings for rolling, 3-year periods.



Source: FactSet, 40 quarterly periods ending 6/30/04

We note that not only did these "consistently good" managers drop below median fairly frequently, but their three-year records were in the fourth quartile for 7% of the periods measured. While in aggregate they beat the MSCI EAFE Index 91% of the time (which suggests they were probably meeting their client objectives), the times they didn't overlapped substantially with fourth-quartile rankings. In this example, we note that all the manager rankings are substantially different from EAFE over time, demonstrating significant active risk against benchmark. As benchmarks can vary widely in their universe rankings over time, this is an additional factor that clients should monitor when judging "good versus bad" performance.

Our illustration thus shows that four of the 10 could have been fired for "bad" performance, as we defined it earlier. Extending the measurement period to 3Q 2004 is likely to move that

statistic up to five of 10. This universe and period is only an illustration. However, given that most managers in this example beat the index most of the time, it may give pause for thought that close to half the "consistently good" managers may have been "bad" long enough to get terminated.

What are the implications for manager selection?

- If you believe you have found a manager with the potential to be "consistently good," then, even if you are right, expect extended periods when your manager's "long-term" record is below median, and some material periods when it may be both fourth quartile and below the index.
- Before firing a manager, it may be prudent to examine the long-term record over extended rolling periods, as opposed to a single time horizon. If the "non-performance related" reasons for the original hiring (people, process, etc.) are still intact, then this more extensive analysis may prevent an expensive mistake.
- This data provides support for "contrarian manager selection" as practiced by some plan sponsors. In this approach, they identify their universe of "consistently good" managers, and then wait for the "inevitable" periods of "bad" performance to place assets with them.

These findings may remind readers of the last line in Benjamin Graham's classic book, *The Intelligent Investor*: "To achieve *satisfactory* investment results is easier than most people realize; to achieve *superior* results is harder than it looks."[3]

[1] The PSN database provides historical returns for approximately 1,600 investment managers, representing more than 6,000 U.S., global, and international investment products.

[2] The MSCI EAFE Index consists of equities from Europe, Australasia, and the Far East. The index is often used as a benchmark for international equity portfolios and includes dividends and distributions, but does not reflect fees, brokerage commissions, or other expenses of investing.

[3] Graham, Benjamin. *The Intelligent Investor: A Book of Practical Counsel.* Fourth Revised Edition. New York: Harper & Row. 1973 (page 287).

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