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# The Steward

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## **Beyond the Numbers: When to Fire an Investment Manager**

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Numerous studies have shown it is inevitable that even top-performing investment managers suffer stretches of underperformance. The markets of 2008 provided serious headwinds to active management. After prudently selecting a manager, returns begin falling short over multiple time periods. Thorough manager analysis should occur regularly regardless of performance but if a manager's returns fail to outperform on a consistent basis, when is it time to fire an investment manager? While no single reason dictates automatic termination of a manager, diligent Sponsors and Trustees of retirement plans, pension plans, endowments, foundations and unions should look beyond the numbers and analyze several key areas to determine the next course of action.

### ***Stability of Management and Organization***

Has manager underperformance coincided with a recent change within management or the organization? Investment professional turnover and firm changes should be thoughtfully evaluated with or without underperformance. How long has the new portfolio manager been with the firm? Has he or she worked side-by-side with the prior portfolio manager? Examine the portfolio manager's investment background and track record at other strategies. Will the new manager's investment style differ significantly from the preceding portfolio manager? The loss of a star analyst or a co-portfolio manager may not necessitate immediate termination for a manager that employs a collaborative, team-based investment approach, however personnel turnover for a mandate that is largely driven by a single portfolio manager warrants greater concern.

Furthermore, a multitude of investment firms have undergone restructurings, consolidations and ownership changes in the wake of the financial crisis. With any organizational change, it is imperative these changes have minimal impact on the daily operations and management of assets. Ultimately, the firm should continue to provide the essential resources, compliance and back office infrastructure to keep pace with both the current asset base and future growth and allow the investment professionals to focus their efforts exclusively on managing assets.

### ***Investment and Style Consistency***

Even during periods of underperformance, one expects the manager to remain true to its style and investment philosophy. Based on the manager's investment philosophy, has it performed as anticipated in the current market environment? One of the first steps in evaluating an extended period of underperformance should include an understanding of why the manager has underperformed and if history in similar markets aligns with this performance.

Additionally, if the manager exhibits style drift with shifts into a different market capitalization or increased concentrations in out-of-index markets typically not utilized in the past, a manager search may be the next logical step. Specifically, within a Trustee-directed portfolio or plan, style consistency is of integral importance as the manager fulfills a defined role within the asset allocation framework. A small cap growth manager that does not consistently behave like a small cap growth manager counteracts your selected asset allocation strategy.

Finally, it is critical to consider the investment manager's role within the appropriate context. Performance swings for a manager that characteristically makes big bets, initiates non-benchmark holdings or deviates sizably from its benchmark may be tolerated if the investment manager still fits within the existing asset allocation structure and if such swings are customary for the manager.

### ***Risk-Adjusted Performance***

Look beyond pure returns-based performance and give an eye to risk analysis. Risk metrics such as standard deviation, alpha, Sharpe ratio, information ratio and batting average offer equally valuable measurements of performance that are often overlooked. The Sharpe ratio, for instance, represents the excess return per unit of total risk as measured by standard deviation. The higher the Sharpe ratio, the greater return received per unit of risk. Ideally, the investor should be adequately rewarded for the level of risk taken. When both returns-based and risk-adjusted performance begins to break down for a sustained length of time, it may be time to look at alternative options.

### ***Expenses***

Continue to mind expenses and associated fees such as custodian, trustee and audit fees. The search process provides an initial screen to weed out costly managers but numerous managers have increased fees recently despite the market downturn. Even if an active manager is within the category average, is the fee reasonable for what you are getting? For example, it becomes more difficult to justify expenses for an active manager whose portfolio characteristically hugs the index.

### ***Conclusion***

Most importantly, consistent underperformance merits another round of due diligence. Interview the manager regarding not only the underperformance but also firm developments, confirmation of investment philosophy, market outlook and future positioning. Since no single reason commands termination, often times kicking the tires with the manager either in person or on the phone will point you in the right direction. Lastly, review the Investment Policy Statement and make certain the Committee adheres to the established guidelines for ongoing performance monitoring and managers failing policy. For separate account managers, violation of any manager-specific guidelines requires further examination.

In the midst of evaluation for manager underperformance or the initial management selection process, the same tenet applies: past performance alone is a poor predictor of future returns. Returns communicate historical performance and may indicate how the manager performs in various market environments yet they offer limited insight into future performance. For this reason, Committees and Sponsors should consider more than just past returns and assess the qualitative aspects of an investment manager in tandem with the quantitative results. If you find yourself explaining away deteriorating performance, defending qualitative shortcomings and revisiting the same red flags over a prolonged timeframe, it may be time to initiate a manager search and prudently evaluate potential replacement candidates.

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