The Importance of the Manager Selection Process

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To gain a greater understanding of what goes into the manager selection process and to understand why this is a truly important subject, we conducted the following Q&A with Floyd Simpson, CFA, CAIA, CFP.

Floyd joined PFM Asset Management in 2019 and was the first external hire for the newly created Multi-Asset Strategies Group. As a director in our OCIO business, he works with clients across the country to develop and implement multi-asset class strategies for their portfolios. He is also a member of PFM Asset Management's Multi-Asset Class Investment Committee.

Why is manager selection such an important part of the overall investment process, and what does PFMAM do for its clients on that front?

Simpson: Selecting an appropriate manager is vital because when constructing portfolios beyond asset allocation, most allocators depend heavily on manager selection to generate alpha. This thought process comes out in the active/passive debate, fundamental/quantitative investment processes, and growth/value style debates. Manager Research has become more popularized and "front and center" if you will, with the addition of alternatives due to investors being obsessed with the success of the Yale endowment model.

For us, manager selection is another way that we seek to add value and protect on the downside in market segments that we view as inefficient. We prefer core managers because from our research, trying to balance growth and value styles creates more volatility and unnecessary risk for portfolios. Imagine if you annually or semiannually rebalanced between growth and value allocations within your portfolio. Over the past 10 years, that would have created a drag on returns a majority of the time.

Why does benchmarking play an important role?

Simpson: Utilizing the correct benchmarks and peer universes matters. Put simply, in order to properly evaluate a given manager's performance, an apples-to-apples comparison is a must. Therefore, when looking at an active manager that specializes in America's largest and most steadfast companies, a comparison to the S&P 500 could be more relevant than utilizing the Russell 1000 or 3000 indices if they purposefully skew towards mega caps. The initial screening universe of a manager should serve as a proxy of the available investment options, and then a possible benchmark can be determined based on their process biases along with calculating the Coefficient of the Determination, better known as R-Squared, by regressing a manager's past returns to determine benchmark fit.

Now alternatives are a different animal altogether, because the information is very opaque. There are some indices available based upon specialized providers, but secondary indices that can be either Private Market Equivalents or CPI plus some premium can also be used.

Professionals should remember that past returns do not dictate future performance, but most research processes are heavily reliant on past history. While history is not guaranteed to repeat, we believe it does often rhyme. It can be a valuable tool when it comes to manager evaluation, particularly if comparisons to given benchmarks can be made over time, but there needs to be a realization that benchmarks change/evolve over time. This is also a secondary reason why universe medians/averages are poor benchmarks.

When considering a given manager, how does one separate the wheat from the chaff and perhaps discern which managers are particularly skillful, versus others that may have had, shall we say, a streak of good luck?

Simpson: Discerning skill from luck is hard if solely reliant on returns and statistics:

- Being able to combine returns and holdings-based analysis can limit the unknowns.
- Having a firm understanding of how different factors can impact returns allows allocators to determine the true stock selection value-add from the stock selection
- Last but not least, a manager's portfolio construction methodology can also change the composition and expectation of returns/outcomes. For example, an equal-weighted type of portfolio weighting with quarterly rebalances can limit upside potential because names aren't allowed to run, but has the potential to provide outsized returns in markets that are trading sideways.

What else do you or PFMAM look for as far as manager expertise or characteristics are concerned?

Simpson: Managers should have an area of expertise. Whether it is a certain sector, region, credit space, or network, managers should have a specialty/edge that creates value. Relying solely on a valuation methodology can bring success, but it shouldn't be the only source of alpha.

When creating a portfolio, investment professionals must think about how the respective managers complement each other's expertise. They must also seek to provide higher returns and better risk-adjusted returns in comparison to other portfolios.

That said, correlation only tells half of the story:

- A heavy reliance solely on correlation goes against the notion that past performance does not dictate future performance.
- To pair managers effectively requires an in-depth knowledge of the manager's process and when coupled with styles, it complicates the equation beyond the overused correlation statistic. The problem most have is that we understand the science of portfolio construction but are oblivious to the "art" that may be involved.

What other changes or things are you looking for in a manager? For example, is employee turnover something that is considered and what can you ask a given manager to help determine their ability to generate alpha?

Simpson: From our perspective, it is vital to avoid complacency:

- Managers have changes in personnel/process and research professionals can miss critical details. That said, the ability to trust but verify and make swift changes can save basis points (bps) in the near- and long-term.
- Manager monitoring, along with consistently asking deeper questions to understand why a manager is either outperforming or underperforming, can provide meaningful insight in the allocation and portfolio construction decision-making process.

Does the current volatility in the capital markets perhaps make proper manager selection even more important?

Simpson: This environment highlights why diversification matters. Quantitative managers have struggled for the past couple of years as the explanatory power of their models waned, but fast forward to this year and the noise within the model has been filtered down. While on the other hand, some of the fundamental managers have struggled due to the buy/hold bias coupled with a static screening methodology that would bias their universe to certain stocks. Looking at the alternatives, the long investment period creates a significant opportunity cost if an allocator does not choose a top tier/quartile manager. Also, for those investing within the private markets, having a good understanding of future market developments is more crucial as these trends can either be a catalyst for an investment idea/strategy or force a manager to have pedestrian-like returns.

If readers would like further information about this topic, what do you recommend they do?

Simpson: For more information about how we can help your firm in its manager selection process, please contact your PFMAM relationship manager or reach out to me at: simpsonf@pfmam.com.

To learn more or discuss in greater detail, please contact us:

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