

ACHIEVING LONG-TERM INVESTMENT SUCCESS

The purpose of this paper is to summarize a systemic approach for the selection of fund managers. The intention is not to develop a finished product, but to outline a few ideas in order to stimulate further investigation of these theoretical ideas. The focus of this paper is investment managers/funds selection rather than quantitative tools used in portfolio construction.

Process:

- I. Set Investment Objectives
- II. Establish Investment Policy
- III. Select Investment Managers/Funds
- IV. Measure and evaluate results

Manager Evaluation:

1) Qualitative Factors

a) Leadership and Culture¹

- **Candor** - engaging in courageous truth-telling to increase power and speed in decision making > Authentic **self-confidence**
 - Aptitude in clearly articulating **self value**
 - Acknowledgment of **strengths** and **weaknesses**
 - Ability to **go beyond being right or wrong**
- **Authenticity** - discarding facades, then addressing actual conflicts to eliminate needless intrigue > Genuine **humility**
 - **Recognition** of the importance of each member of the team
- **Accountability** - taking 100% responsibility for the results created as opposed to expending energy searching for scapegoats
 - Ability to **admit mistakes**
- **Awareness** - understanding, and tapping into, every emotional and intuitional resource for decision making
 - Culture precedes performance and **cultural fit** complements "brain power."
- **Genius** - discovering and allowing people to do what they do best, thereby leveraging their natural areas of genius
 - Focus on measuring and managing **people**, rather than hard data
- **Appreciation** - expressing gratitude and fostering an across-the-board culture of sincere cooperation
 - Obsession with **fairness** and **ethical** behavior
 - **Share** success with other members of the team
- **Curiosity** - knowing when you are becoming defensive and shifting back to an open and receptive attitude of learning

¹ Inspired by Jim Ware and Jim Dethmer, 2006

b) Personality²

- Extroversion versus introversion
- Sensing versus intuiting
- Thinking versus feeling
- Judging (organized) versus perceiving (flexible)

The most common asset management personality is INTJ. The most common culture of asset management firms is NT or Rationalist.

c) Fit: Investment Personalities and Behaviors

- Confidence, intelligence
 - Decisive, creative
 - Leadership
 - Ownership
- High expectations
 - Stretches team's talent
- Direct communication style
 - Efficiency, clarity
 - Values
 - Management
- Discipline; makes and adheres to plans
 - Sets and achieves objectives
 - Procedures
- Detachment, objectivity
 - Focused on task
- Culture and structure
 - Individuals vs. teams

d) Quality of Service Providers

- Prime Broker
- Administrator
- Auditor
- Legal Advisor

² Myers-Briggs:

<https://www.mbticomplete.com/mbti.aspx?chk=t>

<http://www.humanmetrics.com/cgi-win/JTypes1.htm>

The Forte Institute:

<http://www.theforteinstitute.com/public/index.asp>

2) Quantitative Factors

- Products
 - Type of assets, securities
 - Indexed vs. managed, active vs. passive
- Process
 - Well documented, formalized, and clearly explained
 - Top Down, bottom up
 - Fundamental research
 - Sector analysis
 - Security selection
 - Quantitative/rules-based
 - Quantitative/judgment-based
 - Technical analysis
 - GARP
 - Etcetera
 - Consistency
 - Approach
 - Return
 - Style
- Results
 - Environment and horizon
 - Peer groups
 - Benchmarks
 - Risk-adjusted returns
- People
 - Investment advisor
 - Investment history
 - Competitive strengths
 - Resources
 - Ownership
 - Portfolio Manager
 - Credentials
 - Star (survivor risk) vs. team (dilution)
 - Process-oriented vs. eclectic
 - Compensation structure (alignment with client interests)
 - Psychological alignment³
- Experience
 - How long on the job
 - Relevancy of track-record
 - Old dogs (experience) vs. new tricks (innovation)
- Clients
 - Quality and history of customer base
- Competitors
 - Sustainability of competitive advantage

³ See 1) c)

Performance Evaluation:

- Consistency: product, style, returns
- Cost: management, portfolio
- Return/Risk: peer, style, cycle

1) Statistical Measures

a) General

- Mean Return
- Median Return
- Cumulative Return
- Annualized Return
- Modified M^2
- Variance
- Standard Deviation
- Annualized Standard Deviation
- Downside Risk
- Correlation
- Skewness
- Kurtosis

b) Equity Portfolio Measures

- Alpha, Beta, R^2
- P/E Ratio; P/B Ratio
- Market Capitalization

c) Bond Portfolio Measures

- Yield Curve
- Duration, convexity
- Credit quality

d) Active versus Passive Management

- Asset allocation level
- Sector allocation level
- Security selection level

2) Qualitative measures of possible weakness

- Arrogance, demeaning attitude
- Failure to appreciate
- Fear, gossip
- Unreasonable demands
- Aloofness, uninspirational behavior

Case Study: Long-Short Equity Manager

Process:

- 1) Formalized?
- 2) Well documented?
- 3) Clearly explained?

Experience:

- 1) Manager?
- 2) Style?
- 3) Portfolio?

Qualitative factors:

- 1) Leadership and culture
- 2) Personality
- 3) Fit: investment personalities and behaviors

Product:

- 1) Capitalization/Value style box
 - a. P/E
 - b. P/B
 - c. Market Cap
 - d. Diversification (ratio of top 10 Holdings vs. total portfolio)
 - e. Long-short vehicles and bias, holding periods
- 2) Compare portfolio ratios to target ratios
- 3) Compare style dispersion vs. benchmark and peer group
- 4) Return consistency
 - a. Frequency of manager's outperformance to benchmark and peer group
 - b. Risk-adjusted return
 - i. M^2
 - ii. Excess return to standard deviation ratio
 - c. Relative performance in both up- and down-markets
- 5) Cost
 - a. Manager vs. peer group
 - b. Portfolio vs. peer group

Clients and Competitors:

- 1) Customer base
- 2) History

Performance evaluation:

- 1) Risk-adjusted quantitative measures
- 2) Qualitative measures and risks

Quality of service providers