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## Tough times make the asset manager's choices tougher

It is becoming more difficult to separate good asset managers from bad ones and to identify who tomorrow's best performers will be says Geoff Blount, head of asset manager research at Investment Solutions.

Speaking against the backdrop of Absa Ca's annual retirement fund conference he says, "We research 63 institutional asset managers in South Africa, 23 of which are less than three years old. Client choice has never been greater in South Africa, but so is the risk of making poor manager selection decisions in volatile markets.

"Typically investors react to performance emotionally and consequently want to hire investment managers that have recently done well, and fire asset managers that have recently done poorly, making performance and alpha (i.e. how much they beat the benchmark by) the most obvious indicator of evaluating an asset manager. Other factors that drive manager selection are brand, relationships with the manager"

Blount says there is no hard and fast rule as when to terminate an asset manager and alpha and cautions that performance can be misleading. "The managers that did well for the first half of this year typically had exposure to construction stocks, and biases to mid and small cap shares in their portfolio.

"One could argue that these areas of the market had more bubble like tendencies. During the recent market falls, these same managers largely took the biggest fall, and did the worst. Which managers were wrong - those that shied away from aggressive shares in their portfolios and took pain in the first half, or those that did?"

He says it is key to understand what drove that negative alpha, "Poor short term alpha may lead to termination if it is driven by a negative defining event such as key staff changes, significant corporate activity or other issues

such as process and implementation failures."

Blount further says longer-term poor performance may also be tolerated if, for example, the original motivation to appoint the asset manager is still in place and there have been no negative defining events, or an asset manager's style is out of favour and the client understands and is accepting of this.

Poor performance should not equal "fire the manager". It is however, a clear signal to investigate the manager and understand what drove that performance. "In fact, any unexpected performance, good or bad, should be inves-

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igated. If a manager suddenly does very well, when for example, the market style does not suit that manager, investigate. If you have a low risk mandate, and the manager gets lots of alpha, than maybe they are taking on too much risk, investigate."

He suggests that a good strategy for trustees to follow is to lay out in advance the "shape of performance" they expect from a manager. When the manager deviates from that shape, they should ask questions.

"On the other hand," he says "investors should not be 'dazzled' by outperformance. Also do not automatically assume that new start up aggressive managers outperform."

His advice is: know where the source of the performance is coming from and consider: Was it luck or skill? How much risk is the manager taking, and assuming that risk is symmetrical, would

the investor tolerate an equal amount of underperformance if the bets the managers had taken had gone wrong.

"The industry as a whole has certainly raised its game over the last few years. What this means is that a board of trustees must have a very high level of conviction before terminating a manager's appointment. The principle of style diversification and proper strategic blending of different investment styles and philosophies has never been more important," says Blount.

Usually, an investment manager has been appointed to fill a certain requirement within the overall context of the fund's investment strategy. This can be expressed in terms of style and/or philosophy, targeted alpha (out-performance), risk budget (targeted tracking error) or a risk adjusted measure such as an Information Ratio (return per unit of risk).

It is crucial that the appointed manager be monitored continuously to ensure that the mandate is being complied with and that the appointed manager is indeed fulfilling the requirements of the fund in the context of the overall strategy.

The norm is to monitor asset managers formally on a quarterly basis, but this is far too short a time horizon to properly assess a manager's capabilities. Periods of at least two years or longer are more meaningful.

Offering criteria for firing an investment manager, Blount says "Asset manager appointments and or mandates should be formally re-evaluated whenever there is a significant change in the fund's overall investment strategy.

"It is possible that a particular manager and or mandate is no longer appropriate in the context of a revised strategy. The link between fund strategy and appointed managers/mandates is crucial and should be well defined in the fund's governance framework."

