# PERFORMANCE, PERCEPTION AND MANAGER SELECTION

**A study of institutional investor behavior.**

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# WHAT IS MANAGER SELECTION?

Mutual Fund Boards and other institutional investors hire managers to invest portfolios

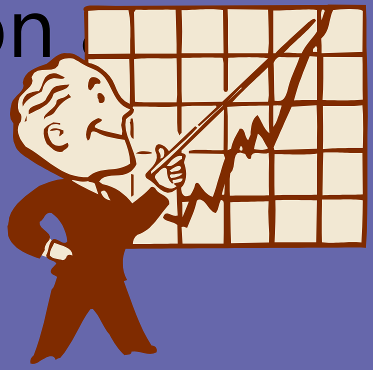
Senior staff at firms, with board oversight, assign managers to stock and bond funds.

# GOAL

Boards et al hire managers to
1) implement asset exposures
2) equal or outperform asset class benchmark indexes

Senior staff at mutual fund companies, pension officers and other institutional investors extend much effort to hire the best managers.

“Supervisors” measure, report and analyze performance on a quarterly basis, examining trailing periods.



# PROCESS

Board members study past performance over 1, 3, 5 and longer periods, versus indexes; analyze results; and interview managers

Boards ask questions and senior staff fire managers who haven't been doing well and replace them.

Example: Pension plans turn over approximately 10% of managers annually.

# QUESTION

Given that institutional investors have advanced degrees, much training and years of experience in the markets…

?

do they add value from their manager hiring and firing decisions

# HIGH CONFIDENCE IN SELECTION PROCESS

Institutional investors are confident in their ability to select managers.

Surveys:

2014: 11% don't
2017: 16% don't

Sole evidence may be quarterly performance reports.

Quarterly reports list information
- managers
- benchmarks
- multiple periods

# SAMPLE REPORT

Performance Summary as of 9/30/2015

| | Allocation ($ in billions) | Third Quarter | Year to Date | One Year | Three Years |
|---|---|---|---|---|---|
| **Managers** | **$6.1** | **-6.8%** | **-6.2%** | **-4.6%** | **5.7%** |
| Benchmark | -- | -6.3 | -5.4 | -4.1 | 4.6 |
| *Difference* | -- | -0.5 | 0.8 | -0.5 | 1.1 |
| **Manager A** | **$1.5** | **-6.0%** | **-4.3%** | **-2.5%** | **6.3%** |
| **Manager B** | **$1.6** | **-5.7%** | **-5.3%** | **-2.4%** | **7.0%** |
| **Manager C** | **$1.5** | **-8.6%** | **-7.4%** | **-6.0%** | **3.8%** |
| **Manager D** | **$1.5** | **-7.0%** | **-7.8%** | **-7.4%** | **5.8%** |

* The Managers in aggregate underpeformed the benchmark during the third quarter while outperforming during the trailing three-year period
  - All managers have 3-year returns above that of the benchmark with the exception of Manager C

# WHAT'S MISSING?

What's included:
1. Benchmarks' performance over multiple periods
2. Current managers' performance
3. Aggregate current managers' performance

So, using this data, we really don't know if manager selection is adding value

# THE EVIDENCE: WHAT DRIVES CHANGES

Data: Institutional Investors tend to chase past performance. Not simply total return, but return relative to benchmarks.

Del Guercio and Tkac (2002): study short-term returns on subsequent asset flows

Heisler et al (2007): study asset flows and account changes versus consistency in active returns

# THE EVIDENCE: RESULTS

Institutional Investors tend to destroy value by buying high and selling low.

One estimate: $170 Billion between 1984 and 2007

Goyal and Wahal (2008): terminated managers outperform matched new managers

Stewart et al (2009): products that receive inflows underperform products that experience withdrawals

Jenkinson et al (2016): consultant recommendations don't add value

# WHY THE DISCONNECT?

1. Reporting Convention
2. Psychology

Ellis (2011, 2012)

1. Observes higher levels of confidence may not be based on thoughtful reviews of decision-making processes
2. Recommends institutional investors spend more time setting manager selection policy and reviewing their hire/fire processes and less time monitoring short-term manager performance

# PSYCHOLOGY

## Einhorn and Hogarth (1978):

even professionals tend to overestimate their abilities, overweight data that supports their self-confidence and **underweight data on decisions not taken**

1. Biased feedback continues through time, resulting in growing unfounded confidence with experience
2. Thoughtful process reviews should outperform simple reviews if the former includes detailed understanding of the environment

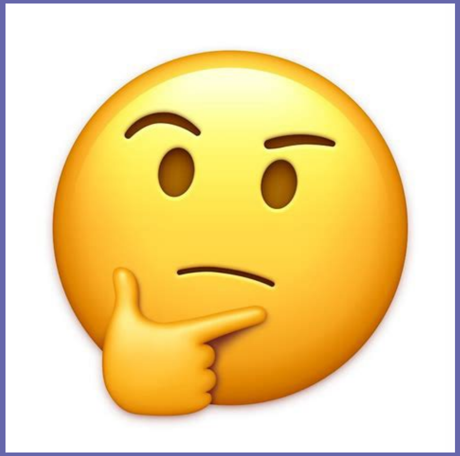
# PSYCHOLOGY

## Sniezek and Henry (1989)

hypothesize that group decision-making about uncertain outcomes should lead to lower confidence

Yet, experiments, using live subjects led to narrower ranges of estimates and "extreme overconfidence" by groups

# This Study's Hypotheses…using survey data



1a) Inst'l Investors broadly collect and carefully review performance data

1b) …prefer managers with strong abilities to communicate

2) …are highly confident

3) Their confidence is higher in larger committees

4) Their confidence is higher for more experienced professionals

5) **Their confidence is not based on thorough analysis of processes**

6) They spend more time on reviewing manager performance

# Survey Data

## $770 B in Plan Assets

100 Pension Officers

**Survey Respondent Summary Information**

| | Corporate | Public | Total |
|---|---|---|---|
| Sample Size | 44 | 56 | 100 |

| | Proportion of Respondents |
|---|---|
| Investment Committee Member | 10% |
| Committee Chairperson | 3% |
| Staff Person | 39% |
| Staff Head | 43% |
| Other | 5% |

| | Mean | Median |
|---|---|---|
| Years Experience | 13.4 | 11.0 |
| Years at Current Employer | 9.5 | 7.0 |

# Survey Data

Committee Structure

| | All | Corporate | Public |
|---|---|---|---|
| Staff Size (median) | 5.0 | 2.0 | 10.0 |
| Committee Size (median) | 7.0 | 5.5 | 8.0 |
| Decision Making Process | | | |
| Proportion Consensus | 25% | 38% | 16% |
| Proportion Majority Vote | 61% | 40% | 79% |
| Proportion Strong Individual | 14% | 21% | 5% |
| Proportion Utilizing Consultants | 79% | 70% | 85% |

# Survey Data

Sponsor Work Load

| | All | Corporate | Public |
|---|---|---|---|
| Annual Turnover of Managers (median) | 5.5% | 5.6% | 6.0% |
| Duration of Manager Search (median) | 5 Mos | 4 Mos | 5 Mos |
| Spent more time on Asset Allocation than Manager Selection | 34.0% | 26.0% | 38.0% |
| Believes asset allocation is more critical to plan success than manager selection | 86.0% | 80.0% | 91.0% |

# Survey Questions

Survey Constructs

| Construct Name | Description | Chronbach's Alpha |
|---|---|---|
| CommCON | Communication ability important | 0.653 |
| TrailingCON | Important to study past returns | 0.604 |
| RiskCON | Adjust returns for risk | 0.674 |
| StyleCON | Adjust returns for style | 0.632 |
| MPerfGdCON | Performance of current managers very good | 0.613 |
| ConMgrSelCON | Confident in Manager Selection skill | 0.734 |
| SubsPerfCON | Evaluate performance impact of decisions | 0.789 |
| EducCON | Decision maker education | 0.834 |

# INITIAL TEST RESULTS

## Importance of returns and communication

Track records important

Communication important

Important to analyze and adjust returns for style and risk

Spend more time on manager selection than asset allocation

# MORE TEST RESULTS

## Confidence

Current manager returns good

Confident in selection ability

Important to evaluate decisions

Confidence higher for larger decision-making groups

# KEY TEST

## Regression Model: Confidence based on appropriate analysis?

Seeks to explain whether confidence related to whether officers actually look at performance following hire & fire decisions, after controlling for other factors

$$ConMgrSelCON = a + b_1\ TrailingCON + b_2\ CommCON \quad (1)$$

$$+ b_3\ MPerfGdCON + b_4\ EducCON \quad (2)$$

$$+ b_5\ LN\_PlanSize + b_6\ Corp \quad (3)$$

$$+ b_7\ SubsPerfCON \quad (4)$$

# TEST RESULTS

Lots of numbers…

Regression Analysis Results
Dependent Variable: SubsPerfCON

Model

| Degrees of Freedom | Adjusted R Square | Std. Error of the Estimate | F-Statistic | Significance |
|---|---|---|---|---|
| 84 | 0.459 | 0.854 | **11.200** | **0.000** |

Coefficients

| | Un-standardized Coefficients | Standard Error | Standardized Coefficients | t-Statistic | Significance |
|---|---|---|---|---|---|
| (Constant) | -0.329 | 0.928 | | -0.355 | 0.724 |
| TrailingCON | 0.194 | 0.084 | 0.192 | **2.314** | **0.023** |
| CommCON | 0.185 | 0.089 | 0.178 | **2.085** | **0.040** |
| MPerfGdCON | 0.684 | 0.106 | 0.547 | **6.432** | **0.000** |
| EducCON | 0.110 | 0.071 | 0.144 | 1.553 | 0.125 |
| LN_PlanSize | 0.014 | 0.071 | 0.017 | 0.199 | 0.843 |
| Corp | 0.271 | 0.207 | 0.117 | 1.308 | 0.195 |
| SubsPerfCON | 0.008 | 0.094 | 0.008 | 0.089 | 0.930 |

**Figures in bold significant at the 5% level**

# NUMBERS MEAN:

1. Model powerful

***2. But, no relationship between confidence and importance of analyzing subsequent performance!***

Model F-statistic => significance better than 0.1%

Confidence related to:

1. Look at trailing returns
2. Think communication is important
3. Recall that performance of managers is good

Confidence NOT related…whatsoever…to whether officers think it is important to analyze performance subsequent to hire/fire decisions (t-stat $< 0.1$!)

# TAKEAWAYS

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| Terminated Managers | | | | | |
| **Manager E** | $0 | -2.5% | -2.0% | -1.0% | 4.6% |
| **Manager F** | $0 | -1.5% | -1.0% | 1.0% | 4.6% |

**1** … **ced**

**2**

**3**

**t**

**b**

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# *Thank you*

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1. **Copy** of paper at https://eprints.pm-research.com/17511/70867/index.html?96836
2. **Article** about paper at https://news.cornell.edu/stories/2022/04/data-fired-managers-performance-may-improve-investments