

So...When Do You Fire an Investment Manager Anyway?

The 3 Big Ones: Turnover, Methodology and Poor Performance

By Bryan C. Taylor

DETERMINING WHEN TO FIRE an investment manager is a challenge that nonprofit organizations may face at some point in the future, and making the correct decision can have a tremendous impact on portfolio performance.

While such a decision is never simple, we believe that utilizing the following guidelines can assist an organization in successfully determining when such a termination is not only necessary but actually beneficial to the portfolio.

Although there are innumerable reasons that an investment manager may be fired, there remain three primary criteria that guide the majority of termination decisions: 1) senior investment professional turnover, 2) a change or newly identified weakness in investment selection methodology, and 3) extended periods of poor performance.

1. Turnover among portfolio managers at an investment shop is perhaps the most easily identifiable reason of the three. The departure of senior decision-makers may be indicative of either present or future problems for the investment firm. Regardless of which is actually the case, such turnover is universally negative for investors. The professional, or team of professionals, who was responsible for building the investment selection methodology and portfolio track record is no longer in place. Therefore, the investment shop can no

longer ensure that the methodology it was responsible for implementing and safeguarding will be rigorously maintained.

More importantly, investors may never know the true reason behind the turnover and may not be able to truly assess the damage caused by the departure of key personnel. If senior management departs in large numbers, or if a key decision maker leaves the firm, manager termination is advisable.

2. Investment selection methodology is perhaps the most important aspect in manager evaluation. The investment selection methodology employed by the manager resulted in the track record which initially attracted investors to the manager. Frequently, a change in selection methodology may be witnessed through style drift. A manager “tweaks” his (or her) discipline to allow the purchase of investments in an area that is currently performing well, regardless of whether his professed selection methodology would endorse such purchases.

Such changes were commonly seen among value managers during the growth boom of the late 90s, when many value managers’ methodologies prohibited them from investing heavily in technology. Many managers adjusted their models to allow the purchase of “growth” stocks to increase short-term performance thereby eliminating much of their benefit as true “value-oriented” managers.

Not all adjustments are negative. Many are simply enhancements to an existing strategy brought about by experience. Consequently, prudent judgment is required when evaluating a change in investment selection methodology. Although most significant changes should ultimately result in manager termination, occasional exceptions may be warranted.

3. Finally, the classic reason for manager termination—poor performance! Most skilled investment managers will experience periods of three to four quarters of poor performance relative to their respective benchmark and peer group. While systemic underperformance is a viable reason for manager termination, we would suggest that many institutions are too quick to fire managers for poor performance.

Frequent investment manager turnover often leads to poor portfolio performance because such turnover does not allow time for the manager’s “skill” to be reflected in portfolio returns. High turnover may also lead to “performance” chasing, a perilous activity which is incompatible with long-term investment programs.

Ultimately, in the case of prolonged underperformance (three or more consecutive quarters) we would advocate a thorough review of the investment manager and the reasons for which he or she was initially hired. If no convincing argument for retaining the manager is developed from this review, and performance continues to trail the appropriate benchmark and peer group, then termination is necessary.

In summary, many investment managers are incorrectly terminated due to poor performance, while many others are retained despite changes in management structure or selection discipline that render respectable track records irrelevant. These three guiding principles provide a basic framework for investment manager evaluation, and may also act as a guide for a more thorough review process.

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