What Criteria Should Be Used To Hire and Fire Investment Managers?

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The above question is a topic that every Wealth Manager should address in helping their clients develop and maintain an investment plan. Although a consistent process should be applied to all investment managers, one must recognize that the process is more art than science, particularly when it comes to changing managers. A Wealth Manager should know that the buy or hiring decision is much easier than the sell or firing decision.

The criteria that are used at Morgan Stanley by the Consulting Group Investment Advisor Research (CG IAR) team to provide the Fishbein Group and other Wealth Management teams with a diverse selection of high quality investment managers are listed below. For each client, we then try to evaluate the vast amount of data provided by CG IAR to create a portfolio of suitable managers that are excellent individually and are complementary to each other.
The criteria are:

- **Investment Process** – This is the essence of how an investment manager decides what securities to buy and what securities to sell. To some extent, it is the unique, secret-sauce of the investment firm. In our opinion, the investment process is the most important factor in evaluating an investment manager. If a manager has a rational investment process, implements the process consistently with reasonably competent people, the long-term performance is usually satisfactory.

- **Personnel** – The credentials, depth of experience, and history of success of the individuals managing the assets should be evaluated. In addition, it is important that a manager has a low turnover rate in key personnel. In many cases, it is essential that the team members responsible for the performance record are still managing the portfolio in question. In fact, an unexpected change in key personnel is a prime factor in considering replacing a manager.

- **Research Capabilities** – While we have no bias for or against any particular research approach, we expect each investment management firm to possess adequate resources to effectively apply its process. For example, CG IAR may review the number of companies that each research analyst is expected to follow to determine whether the analyst can give sufficient time to each company that they follow.
- **Business Operations** – We need a reasonable assurance of the investment firm’s commercial viability. Relevant factors may include the trend of assets under management, growth or stability of personnel, and legal or regulatory issues.

**How Do We Match Managers With Clients?**

The previous paragraphs have outlined the general criteria that CG IAR uses to provide Wealth Management teams with suitable managers. But how does The Fishbein Group decide which managers are appropriate for a given client?

The primary factor that we examine in deciding which manager(s) to hire for a given client is the manager’s performance in various market environments. That is, we examine how the manager has performed in strong markets, weak markets, and average markets. This same process would apply regardless of whether the manager is an equity manager, bond manager, or can use both stocks and bonds. Unfortunately, we have never seen a manager that does well in both strong and weak markets, so we have to match the strength of the manager with the needs and temperament of the client. Thus, if a client should be somewhat risk averse, the most important factor in evaluating a manager is how well they have performed in weak markets. We would be looking for a manager who lost substantially less money than the typical manager in down markets and had reasonable performance in average markets. The likely consequence of an approach that would produce these types of results, however, would be significant underperformance in strong markets.
Although investors often want to see a comparison of a manager to some arbitrary market index, and investment firms are willing to provide such comparisons, such comparisons are meaningless unless the portfolio has the same risk level as the index used for comparative purposes. So, if a manager is at a risk level of 3 on a 1 to 10 scale (1 is the least risky and 10 is the most aggressive), it should outperform a market index that is at a level 5 in risk during weak markets and underperform such an index in strong markets. The more appropriate comparison would be to compare a risk level 3 manager with other risk level 3 managers, with particular emphasis on performance in weak markets. Whether a manager at risk level 3 beats a market index over a period of years, such as 10 years, depends upon the skill of the manager and how well the market has done over the 10 year period.

A second important issue that we examine in choosing a manager for a client is the degree of dependency of the manager on the personnel who are responsible for the performance record. Although there are investment firms with one or more superstar portfolio managers, and in many cases these managers should be employed, we would much prefer a firm that had used an investment process that was less dependent on individual skills. In that way, any competent portfolio manager trained in the process could implement it.

A third question related to personnel is the length of time that the key people responsible for the performance record have managed the portfolio. Preferably, one would
want to see a performance record of at least five years managing the strategy for retail and/or institutional accounts.

**How do we decide to replace (fire) a manager?**

As previously indicated, one of the reasons for hiring an investment manager is that they use a definable, repeatable investment process that has been shown to work over a complete market cycle. The number one reason for replacing a manager is if they change their investment approach when their approach is not in favor. For example, if the approach of buying large companies with above average earnings growth is doing poorly and a manager has been hired to implement this approach, we would fire such a manager if they suddenly started to invest in small companies. In most situations, the investment style will come back into favor, and we want exposure to that style.

A second important reason for replacing a manager is if a key person has suddenly left the investment team and a suitable replacement is not available. We would not be concerned in cases where the lead manager retires or changes roles within the firm, if the change has been planned. An important question to ask is whether the investment firm’s approach was process-dependent or manager-dependent. As indicated earlier, we tend to favor firms that are more process-dependent.

**Summary**
Wealth Management teams at Morgan Stanley are fortunate in that the firm devotes considerable resources to evaluating investment management firms. In addition, extensive statistical information is provided to us that allows us to match appropriate managers to clients. The most important factor in matching an investment manager to a client is that the manager’s performance in both up and down markets is consistent with the client’s risk tolerance level. Unfortunately, in the real world of investing, it is virtually impossible to find a manager that does well in both up and down markets. We compare a given manager’s performance to other managers with similar investment styles and levels of risk. Performance compared to a market index is less useful because the manager’s approach may result in a portfolio at a different level of risk than the index.

The two primary reasons for replacing a manager are style drift and the unplanned loss of important personnel. Style drift is when a manager changes their approach to investing such that the resulting portfolio is quite different than the expected portfolio. Although a manager can sometimes underperform similar managers for several years, if the investment process used has not changed and the key personnel are the same, this underperformance usually disappears. In fact, there is academic research which has indicated that changing a manager may hurt subsequent performance (see Goyal and Wahal: Journal of Finance, 2008, 63[4]: 1805-48). The same phenomenon, unfortunately, is also true for the manager who has significantly outperformed their peer group over several years. For those with some knowledge of statistics, underperformance compared to the manager’s historical relative ranking or
excellent performance over several years, is caused by the phenomenon known as regression towards the mean. The underperformer often regresses upward toward their long-term ranking and the significant outperformer usually regresses downward.

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