Challenging the Conventional Wisdom of Manager Selection

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Contrary to conventional "wisdom," our experience has demonstrated that decisions regarding manager selection can impact performance as much as or more than decisions regarding asset allocation. Success in this manner involves the ability to identify and access managers who are often not available in common formats, such as mutual funds and most open-architecture investment platforms.

Background

Since 1997, Gresham has been managing assets for families, family offices and endowments whose goals include both the growth of their capital over market cycles and the preservation of that capital during severe market events. In our earlier white paper, titled *Challenging the Conventional Wisdom of Portfolio Construction,*[1] we described our Risk Conscious® investment approach and the benefits accrued by our clients since the firm's inception nearly 17 years ago. In that paper, we described important principles, some of which have become conventional investment wisdom and accepted industry practice, and others that are decidedly unconventional.

We also alluded to the underappreciated importance of manager selection in an investment portfolio and, in particular, active management vis-à-vis asset allocation decisions. Our results contradict the numerous academic studies that suggest active management doesn't usually pay, as well as the conventional wisdom that the importance of asset allocation decisions far outweighs the importance of manager selection decisions.

[1] *Available at www.greshampartners.com.*

Key Concepts

- Many academic studies suggest that more than 90% of the variability of investment outcomes are derived from asset allocation decisions rather than manager selection decisions. Further, many studies also suggest that few active managers actually beat their benchmark after accounting for fees and expenses. Reasonable investors might deduce from the studies that they should ignore active management and simply focus on asset allocation.

- The investment industry has been its own worst enemy and the behavior of investment professionals – including asset managers, consultants and even investors themselves – has contributed to the chronic underperformance of many traditional active managers.

- Conversely, Gresham's investment history suggests that, although these studies are well researched, they have limited applicability to a globally diversified, multi-asset class portfolio. In fact, active management has contributed significantly to both return and risk reduction in our clients' portfolios.

- While there is no magic formula for choosing active managers, there are certain manager attributes, strategies and approaches that can be helpful in achieving success. However, the pursuit and due diligence of these managers is challenging, resource intensive and often requires uninstitutional behavior.

In the interest of full disclosure, we note that throughout Gresham's history our use of active managers in a wide range of asset classes has produced higher returns with less volatility and less downside capture during extreme market periods than our strategy benchmarks.[2] While this experience has resulted in some biases in favor of active management, we believe these biases are well-grounded in both theory and practice.

We should also note that conventional, actively managed investment solutions available to most investors are unlikely to produce similar results. This white paper describes why we believe these academic studies and related conventional wisdom provide investors with an incomplete picture of successful investment solutions and possibilities.

Conventional Wisdom Regarding Asset Allocation and Manager Selection

Over the last 30 years, a number of well-regarded studies have concluded that much or nearly all of the variability of investment outcomes is derived from asset allocation decisions rather than manager selection. At the same time, a different series of studies concluded that most active managers fail to beat their respective benchmark after accounting for fees and expenses. The findings of these studies have become generally accepted throughout most of the investment industry.

These studies, if true, should lead investors to focus mostly on asset allocation decisions rather than on manager selection decisions. Further, investors should build their portfolios using passive, low-cost strategies, such as index funds, rather than paying higher fees for active management. Notwithstanding these studies, the debate between active management and passive management rages on.

Portfolio Construction Basics

Before discussing various aspects of manager selection, we need to establish a broader portfolio construction framework to provide context for these decisions. In the previously mentioned white paper, we discussed the three primary decisions an investor makes when building a portfolio: strategic asset allocation, tactical asset allocation and manager selection decisions.

- Strategic asset allocation represents the long-term asset allocation targets that fully incorporate an investor's goals, risk tolerance and asset preferences. These targets become important long-term guideposts for a well-constructed portfolio.

- Tactical asset allocation represents the intentional or unintentional deviations from strategic asset allocation targets. Active decisions to deviate from long-term allocation targets can be driven by a desire to increase returns by exploiting attractive opportunities or to reduce the risk and volatility of a portfolio in difficult periods.

- Security or manager selection represents the decision to implement asset allocation decisions by selecting an investment strategy and/

[2] The performance of Gresham's clients is documented by the Gresham Client Composite performance record. Returns for the Gresham Client Composite represent the results since 1998 of Gresham-advised equity strategies, net of all fees and expenses charged by the investment managers and net of all Gresham fees, for all Gresham clients who meet certain criteria. Returns experienced by clients included in the composite may differ from those not included. For comparison purposes, the Gresham Client Composite uses the S&P 500 Index for the entire performance period and the MSCI World Index prior to 2011 and the MSCI All Country World Index after 2010. The Gresham Client Composite performance record with notes describing its calculation is available upon request. Past performance is no guarantee of future results.

or manager. Some investors still attempt to select individual securities, but that is difficult and counter-productive for all but the most accomplished professional investors. For the purposes of this paper, we will limit our discussion to manager selection.

Our earlier white paper focused on strategic and tactical asset allocation decisions, while this paper focuses on manager selection decisions, including the questions of whether and when investors should pay higher fees for active management rather than use lower-cost passive approaches for implementing their asset allocation decisions.

Should Investors Pay Active Management Fees?

Not surprisingly, it turns out that the answer to this question is not a simple yes or no, but rather "It depends." For starters, we believe the studies mentioned above, while generally well-conceived and well-researched, are misleading. Further, the conclusions from these studies have been extrapolated in ways that lead investors to reach false conclusions with regard to their portfolio construction and manager selection decisions.

Can We Gain Any Insight from These Historical Studies?

Fortunately, we can begin our exploration with an examination of the many historical studies on the question of the contribution of asset allocation to investment outcomes. One of the first and most important of these studies was the Brinson, Hood and Beebower study (and several subsequent related studies), "Determinants of Portfolio Performance,"[3] in which they concluded that more than 90% of the variability of portfolio performance is driven by asset allocation policy.

In a different vein, in 2010, Barras, Scaillet and Wermers published "False Discoveries in Mutual Fund Performance: Measuring Luck in Alphas"[4] in which they concluded that essentially no active managers generate returns in excess of their fees and expenses. Recent support for this conclusion comes from a Standard & Poor's report showing that a very small percentage of actively managed U.S. and international mutual funds outperformed their benchmark for the most recent three- and five-year periods.[5]

While these studies appear to be measuring different aspects of investment performance, we believe that they are actually examining two sides of the same coin. Said differently, if we observed that most of the variability of portfolio performance comes from asset allocation decisions, we should see very little deviations driven by manager selection decisions. If managers are generating limited deviations from their benchmarks, their ability to outperform is also likely to be limited.

As displayed in **Chart 1**, roughly 80% of U.S. large-cap core equity mutual funds underperformed their benchmark over both three- and five-year periods, while nearly 60% of international equity mutual funds underperformed over a three-year period and 70% underperformed over a five-year period.

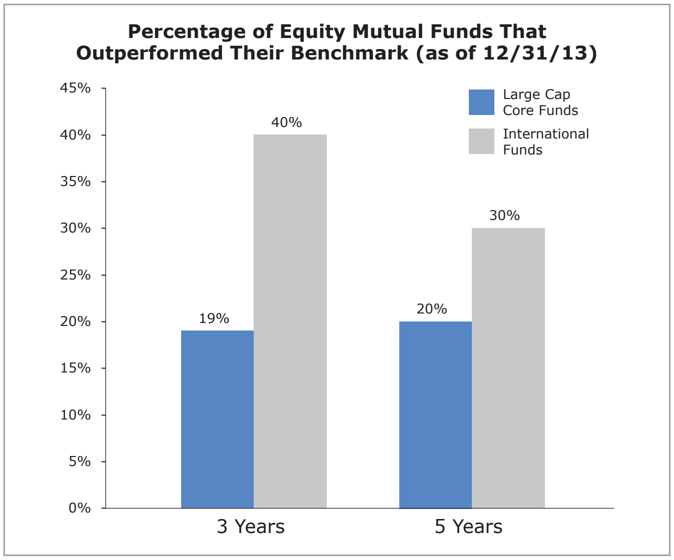
Further, Barras, Scaillet and Wermers concluded that the evidence of outperformance was so weak that the success of the vast majority of the few outperforming funds could be attributed to simple luck. Numerous other studies over the last few decades have reached

[3] *Brinson, Gary P., L. Randolph Hood, and Gilbert L. Beebower. 1986. "Determinants of Portfolio Performance." Financial Analysts Journal, vol. 42, no. 4 (July/August): 39–44.*

[4] *Barras, Laurent, Olivier Scaillet and Russ Wermers. 2010. "False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas." The Journal of Finance, vol. 65, no. 1 (February): 179-216.*

[5] *Soe, Aye M., S&P Indices Versus Active Funds (SPIVA) U.S. Scorecard, 2013.*

Chart 1. Few Equity Mutual Funds Outperform



Source: Soe, Aye M., S&P Indices Versus Active Funds (SPIVA) U.S. Scorecard. Year End 2013.

similar conclusions regarding the inability of most active management firms to generate returns that exceed relevant benchmarks after fees and expenses.

Our experience leads us to conclude that these studies, while well researched, have limited applicability to today's global multi-asset class investment portfolios. Further, investors have extrapolated their conclusions well beyond what they actually measured.

What Do These Studies Actually Measure?

These studies require robust data sets to substantiate statistically significant outcomes. The most robust, publicly available databases gather information on mutual funds and large institutional investment managers and, as a result, they are generally used for studies of this nature. For example, the Brinson, Hood and Beebower study referenced above used return data for 91 large pension fund portfolios invested in U.S. equities, fixed income and cash during the period from 1974 to 1983.

While these databases have advantages of size and reliability, they have two biases that severely limit their applicability to a broadly diversified global portfolio that would be typical of a Gresham client and other sophisticated investors:

- Asset Class Limitations. The asset classes used for these studies were limited to U.S. equities, fixed income and cash, which are among the world's most well-researched and efficient markets, making it less likely that active management strategies could gain a repeatable advantage and outperform their benchmark after paying fees and expenses.

- Manager Selection Bias. The vast majority of the managers whose results were analyzed in these studies were larger institutional and mutual fund managers. Managers with larger asset bases are limited in their ability to find and implement more interesting investments in smaller, less efficient areas of the market. These managers also tend to be limited with respect to the risks they are allowed to take relative to their benchmarks, as large institutional investment firms rarely want to accept the risk of failing unconventionally.

Why So Many Managers Underperform

Notwithstanding our views regarding the value of certain types of active management, we agree that the evidence of consistent underperformance by most actively managed mutual funds and institutional managers is clear. We believe that much of this underperformance is the inevitable result of how a majority of the investment management industry operates, making it its own worst enemy.

Charles Ellis wrote an insightful article in the July/August 2012 edition of the *Financial Analysts Journal* titled "Murder on the Orient Express: The Mystery of Underperformance."[6] In this paper, he likens the cause of underperformance to Agatha Christie's famous novel of a similar name by concluding that all of the usual suspects – investment managers, fund executives, investment consultants and investment committees – are guilty. He goes on to observe that "none of the guilty parties is ready to recognize its own role in the crime."

Mr. Ellis cites several reasons for widespread and persistent underperformance:

- Fees. He observes that high fees contribute to manager underperformance. He also contends that the true cost of active management includes more than management fees and other expenses and should include the cost of frequent underperformance experienced by investors. To add insult to injury, investment managers have historically been allowed to present their results gross of fees, which further obfuscates a manager's true performance.

- Focusing on Recent Performance. He also criticizes investment consultants and investment committees for trying to simplify the manager selection process by focusing on recent performance. This approach usually results in "performance chasing" that contributes to manager underperformance.

- Terminating Managers Quickly for Recent Underperformance. He notes that consultants tend to be quick to recommend firing managers for recent underperformance and investment committees tend to accept their consultants' recommendations. These behaviors create an incentive for managers to never underperform by a wider margin than other managers in the portfolio.

- Hyperdiversification. He concludes that consultants are motivated to recommend that their clients "hyperdiversify" their portfolios with multiple managers in a large number of asset categories. At the same time, managers react to the threat of being terminated for recent underperformance by over-diversifying their portfolios to avoid large deviations from the benchmark. The consequence of these two tendencies is benchmark-hugging behavior by managers who fill their portfolios with more securities in which they have less conviction, reducing the possibility they will generate good performance.

Investor Behavior Compounds the Problem

Unfortunately, the problem is worse than the above factors would suggest, as investor responses to poor performance actually compound the problem. Legendary investor Benjamin Graham is noted for saying "The investor's chief problem – and even his worst enemy – is likely to be himself."

Natural human behavior causes investors to want to sell losing investments and chase winners, which results in hiring the manager with great recent performance and firing managers who recently underperformed. However, even the best managers will experience rough patches when their strategy is out of favor or their investment opportunity set is limited.

A 2008 study of over one thousand institutional investors, including endowments and pensions, suggests that even professional investors are prone to making poor hiring and firing decisions.[7] The researchers examined the excess performance of investment managers both before and after hiring

[6] Ellis, Charles. 2012. "Murder on the Orient Express: The Mystery of Underperformance." Financial Analysts Journal, vol. 68, no. 4 (July/August): 13-19.

[7] Goyal, Amit and Sunil Wahal, "The Selection and Termination of Investment Management by Plan Sponsors," Journal of Finance, vol. 63, no. 4 (August): 1805-1847.

Chart 2. Performance After Managers Are Fired and Hired

All data is for U.S. funds. Excess performance is relative to the manager's defined strategy benchmark.

Source: Amit Goyal and Sunil Wahal, "The Selection and Termination of Investment Management by Plan Sponsors," Journal of Finance, vol. 63, no. 4.

and firing decisions by the institutions. As shown in **Chart 2**, the excess performance of new manager hires in the preceding three years was predictably very high, while the performance of fired managers was low. Over the subsequent three years, the fired managers went on to outperform, while the newly hired managers generated nearly zero excess returns. In effect, even the "pros" buy high and sell low.

To illustrate this dynamic, Charles Ellis asks: "Has any consultant ever presented a prospective investment manager to an investment committee by saying, 'While this manager's recent performance record certainly does not look favorable, our professional opinion is that this manager has weathered storms in a market that was not particularly hospitable to her style and has a particularly strong team that we believe will achieve superior results in the future?'" Not likely. Consultants and investment committees are human as well and, not surprisingly, they are generally unwilling to incur career risk to recommend or approve a manager whose recent performance is sub-par.

Benchmark Hugging

The advent and proliferation of style benchmarks and style boxes in the late-1980's and 1990's further exacerbated this problem. The style box framework was originally conceived as an objective and statistically elegant way to evaluate managers who follow a certain "style" of investing, such as growth or value. Over the years, consultants and investment committees have come to rely heavily on these categorizations when assessing manager performance.

Paradoxically, a tool designed to help investment professionals distinguish between investment skill and the impact of a manager's investment style, thereby enabling better hiring and firing decisions, now coerces portfolio managers to conform their portfolios to their defined style benchmark. Managers that dare to deviate from their benchmark, even in the pursuit of higher returns or the avoidance of risk, are at risk of being fired for so-called style drift.

As a result, managers feel pressure to closely track their benchmark, typically leading them to over-diversify their portfolios with more holdings. Not surprisingly, this benchmark-hugging behavior severely limits the potential for excess returns after management fees, further reducing the possibility that managers will beat their benchmark. It's no wonder that so many studies have concluded that the probability of managers consistently beating their benchmarks after fees is so low.

Relatedly, if most managers have very little incentive – and in fact have business and career disincentives – to deviate from their benchmark, it should come as no surprise that studies also conclude the vast majority of the variability of portfolio outcomes is driven by asset allocation.

What Should Investors Do?

We believe the methodology of these studies is sound, and we agree with their conclusion that a large proportion of investment managers studied will underperform their respective benchmarks after fees. However, we also believe investors have misinterpreted and over-extrapolated the results of these studies. David Swenson, Chief Investment Officer for the Yale University's endowment, went so far as to state that these studies "describe investor behavior, not finance theory."[8]

Would the results be different if we studied non-institutional managers and active management in less efficient markets? It turns out that the answer is "Yes." If we were to more narrowly restate the appropriate conclusions from these studies, we might say, "It's clear from these historical studies that investors should not pay high active management fees for large, diversified institutional managers in highly efficient markets, as their chances of beating the benchmarks after paying fees are quite low." Over the past 17 years, we have identified managers who have been able to accomplish this feat over extended periods of time, but they are exceedingly rare and most are closed to new capital or have long waiting lists for new investors.

So, what should investors do?

[8] *Swenson, David F. Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment, Fully Revised and Updated. Simon and Schuster, 2009.*

- Avoid Most Intermediaries. Unfortunately for investors, most intermediaries, such as investment consultants, private banks and broker/dealers in the wealth management industry, build their investment offerings around large, institutional managers. These managers provide the benefit of allowing the intermediaries to invest large sums and scale their businesses. Additionally, many of these investment managers pay the private banks and broker/dealers for distribution privileges on their investment platforms as an efficient means to raise more assets. None of this behavior benefits the end investor.

- Minimize Fees Where Appropriate. Alternatively, investors could attempt to minimize fees and expenses by using passive, low-cost investment solutions, such as index funds. This is a sound approach for simple portfolios that will invest primarily in efficient markets like large U.S. stocks and basic, high-quality bonds. While, this approach does not enhance returns or reduce risk through security selection, it does minimize the damage caused by unwarranted active management fees and expenses.

  However, this simple, low-cost approach can also be limiting, since many higher returning asset classes and more effective risk-reducing strategies will not be available to investors who use a fee-minimization approach. These strategies, in the hands of the right manager, can be important elements of a well-diversified portfolio that is capable of generating higher returns and/or dampening volatility through market cycles so that investors can better achieve their long-term investment goals.

Gresham's approach has produced strong results since the firm's inception (see footnote 2 on page 1). This approach attempts to capture the benefits of both asset allocation and manager selection, but it places a significantly higher emphasis on manager selection than conventional wisdom would suggest is warranted.

The results of our approach requires that we identify, access and construct portfolios of managers that can outperform or control risk better than their benchmarks or peer groups, while being mindful that the fees they charge are appropriately structured and commensurate with their potential to add value to a portfolio. We speak with experience when we say that this task is easier described than accomplished.

Where Should Investors Look for These Managers?

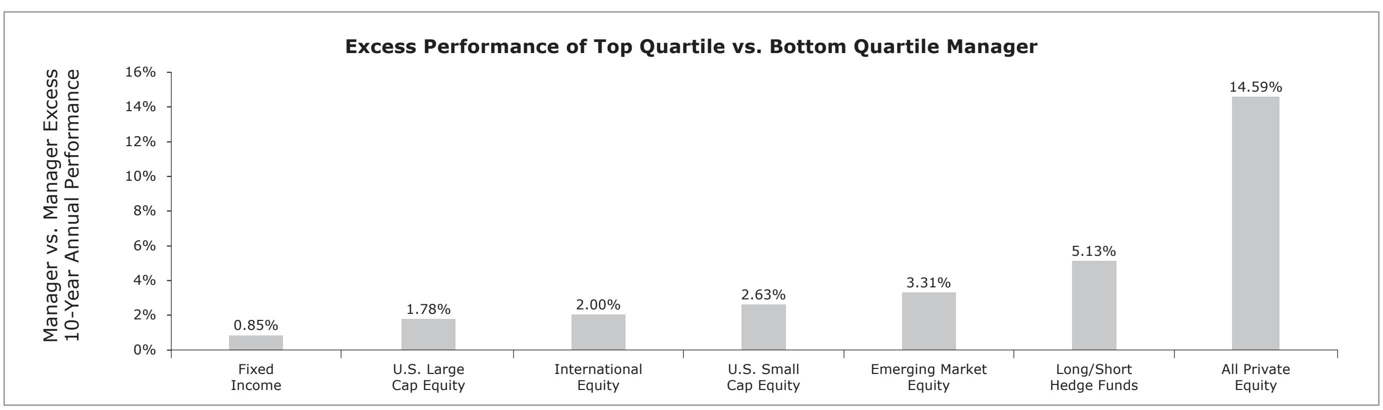
Ironically, one important criteria for finding such a manager has nothing to do with the manager itself, but instead is focused on the markets in which the manager invests. Less efficient markets present skillful managers with greater opportunities to exploit mispriced securities and generate excess returns. Very simply, investors should prioritize their manager search efforts on less efficient areas of the capital markets.

One easy way to estimate the relative efficiency of various markets is to examine the dispersion of historical manager performance. The spread between the best and worst managers across different asset classes is indicative of the degree to which managers have the ability to create differentiated results and hence the potential to generate excess returns.

Chart 3 shows the difference between the top quartile and bottom quartile managers for various asset classes over the ten-year period ending June 2013. So where should investors look for the best opportunities to add value through manager selection?

- Not in U.S. Fixed Income and U.S. Large Cap Equities. Not surprisingly, U.S. fixed-income and U.S. large-cap equities are at the efficient end of the spectrum. The spread between the top quartile and bottom quartile managers in these markets is a relatively narrow 0.8% and 1.8% per annum, respectively. Given these relatively tight bands between the top and bottom quartile managers, it is not surprising that, after accounting for fees and expenses, the median manager typically cannot beat its benchmark. Unfortunately, investors naturally focus a significant portion of their efforts to find active managers in these markets because

Chart 3. Asset Classes Where Manager Selection Adds Value



As of 06/30/13. Each asset class (excluding private equity) consists of the single manager at the 25 percentile vs. the single manager at the 75 percentile. Private Equity excess performance is the average annual difference between upper and lower quartile managers over the last 10 mature vintage years, 1997-2006.

Source: eVestment Alliance, Barclays Capital, Russell Investments, Morgan Stanley, Hedge Fund Research, Inc. Venture Economics.

they are more familiar with them, they are easier to understand and, for some investors, they receive a disproportionate allocation of portfolio assets.

- Perhaps in International Developed and U.S. Small Cap Equities. The performance spread between top and bottom quartile managers widens in less efficient markets, such as international developed equities and U.S. small cap equities, where the return spreads are 2.0% and 2.6% per annum, respectively. These markets have a broader universe of stocks, less research coverage and lower liquidity levels, which make it more difficult for institutional investment firms to effectively manage large asset bases within them. With less competition for ideas, skilled managers are better able to add value through stock selection.

- Likely in Emerging Market Equities. Although emerging markets have become more popular with investors over the last decade, these markets remain much less efficient than developed markets and the return spread for emerging market equities is relatively wide at 3.3% per annum. These markets are very broad, covering over 50 different countries and 20,000 listed stocks, creating significant opportunities to purchase mispriced assets. Importantly, the popular emerging market indices capture only 13% of the total universe of stocks in them and they are heavily weighted toward slower-growing, often poorly managed, state-owned enterprises in financials, materials, energy and infrastructure. As a consequence, opportunities for non-benchmark hugging approaches in these markets are significant.

- Definitely in Hedge Funds. While not an asset class per se, hedge funds exhibit the largest return spread between the top and bottom quartile for marketable securities managers at 5.1% per annum. In hedge funds, managers have more flexibility to implement their investment strategy, including the ability to take long and short positions and invest across different types of securities and geographies. With the ability to short securities, hedge fund managers typically have less market exposure and, as a result, a relatively higher percentage of their performance is determined by manager skill or "active management risk" than by the directional performance of traditional stock and bond markets.

- Absolutely in Private Equity. An investor's ability to enhance returns through manager selection further increases in private equity, which has the largest return spread at 14.6% per annum. The fragmented and illiquid nature of private market transactions allows for the greatest market inefficiencies, as far fewer investors are analyzing the same investment opportunities. Skilled private equity managers with access to strong deal flow and demonstrated skill in helping grow or improve the efficiency of their underlying companies increase the odds of achieving a positive outcome over a long time horizon. In fact, many investors with private equity experience conclude that they will not invest in private equity unless they have access to top-quartile managers.

However, these manager databases for alternative strategies often do not include the top performing managers, who elect not to report their returns, or the bottom performing managers, who simply stop reporting when returns suffer and the funds collapse. As a result, the return spread in both hedge funds and private equity is likely even wider than the reported figures suggest.

On a note of caution, it is important to remember that less efficient markets provide only the potential for wider disparity among active managers and certainly do not provide a guarantee of good performance. Furthermore, when analyzing past results, the importance of distinguishing between a manager's skill and luck is even greater in these less efficient markets. By definition, some managers will perform in the bottom quartile and it is particularly important with less liquid strategies to invest in top managers, as the consequences of these manager decisions are likely to impact portfolio performance for many years into the future.

Identifying Truly Skilled Managers: A Puzzle or a Mystery?

National Security expert Gregory Treverton introduced the concept of differentiating problems that are puzzles from those that are mysteries.[9] A puzzle is a problem that has a definite answer and can be solved by simply gathering more information. Conversely, a mystery is characterized by uncertainty and ambiguity that will require judgment to reach a decision. Most people tend to like puzzles because they can reach clean conclusions if they collect the appropriate information.

Unfortunately, finding truly skilled managers is a mystery and not a puzzle, with success depending on the future interaction of many factors, both known and unknown. While extensive data gathering and due diligence is critical to success, judgment is required for successful manager selection decisions. Not surprisingly, repeated successful decisions rely heavily on qualitative factors that include assessments of human characteristics such as motivation, insight and creativity.

One of the common mistakes some large investment consultants make is attempting to solve the manager selection problem as a puzzle, rather than the mystery that it is. This approach is appealing in that it simplifies the problem and suggests that a "correct" answer can be attained by gathering the right data. These organizations train armies of junior analysts, equip them with data-gathering checklists and send them forth to solve the puzzle. While this approach might eliminate some obvious poor choices, it generally won't identify or provide investors access to the best managers with the highest chance of future success.

How Can the Mystery be Solved?

Although some managers can generate excess returns, a far larger number will fall short. Almost by definition, one manager's relative gains are another manager's relative losses, even before considering the fees they charge. As a result, the number of truly skilled managers in the world is relatively small and the competition to access them is quite high.

Many people have written books on the proper way to evaluate an investment manager. Unfortunately, while we employ a number of techniques developed over years of evaluating managers, there is no simple process or checklist that leads to success. Often, the most attractive managers exhibit some form of uninstitutional behavior that will defy simple evaluation techniques, forcing a reliance on many subjective, qualitative judgments about the people and their ideas.

We carefully evaluate each manager's investment philosophy, historical record, portfolio holdings, past investment activity, organization stability and a multitude of other qualitative factors. Even with this level of evaluation, distinguishing true investment skill from luck is difficult. Worse yet, we won't know the outcome of our decisions and whether we have truly solved the mystery until several years or more into the future.

[9] Fishbein, Warren and Gregory Treverton. October 2004. Making Sense of Transnational Threats. The Sherman Kent Center for Intelligence Analysis Occasional Papers: Volume 3, Number 1. https://www.cia.gov/library/kent-center-occasional-papers/vol3no1.htm.

However, our experience has shown that certain characteristics are positive indicators of a manager's ability to generate strong future performance. While none of these characteristics are perfect and few managers possess them all, these factors tend to increase the chances of success.

- Limits on Assets under Management. We have a saying that "Assets under management are the enemy of every good asset manager." In other words, the best managers are those who limit assets under management to a level where even small ideas can have a positive impact on performance.

  There is no magic formula for determining the limit or pace of AUM growth for a particular manager, as each strategy and market can accommodate different levels and growth rates of assets. Unfortunately, most investment managers are willing to raise assets well beyond their ability to effectively manage them.

- Aligned Incentives. The most successful managers are those whose own capital invested in their fund constitutes a disproportionately large percentage of their net worth and a material percentage of the assets they manage, creating a strong alignment of incentives between the manager and investors. These managers are rarely found in large, branded investment firms that manage large pools of capital.

- Concentrated Portfolios. Successful investing often requires uninstitutional behavior, including building portfolios that are concentrated to focus on the manager's best ideas. As we discussed earlier, larger firms tend to constrain managers and limit their ability to deviate from their benchmarks, which requires the portfolio managers to over-diversify their portfolios into ideas that they view as less compelling.

- Absolute Orientation. Successful managers who survive severe market cycles tend to have an absolute orientation to risk and return, rather than a benchmark-centric framework for evaluating investments. This orientation is frequently achieved through a strong fundamental research process with an absolute sense of value that helps identify attractively priced opportunities and avoid overpriced assets. Most large institutions eschew this type of behavior, preferring to play it safe by conforming to their benchmarks as they strive to protect their asset base and their business from quick termination recommendations and decisions by consultants and large institutional investors.

Does a Manager's Experience Matter? How Important is a Manager's Track Record?

Yes, experience matters. Investing is an accumulated-knowledge business, where knowledge and judgment can lead to a competitive advantage by protecting capital and exploiting opportunities during market extremes.

Some consultants and investors use long, successful track records as predictors of future success, but our experience has taught us that it isn't that easy. Evaluating a track record can be more difficult than many believe. One of the greatest challenges for investors is to determine whether historical performance was due to temporary or cyclical factors, rather than structural or systematic advantages within the organization. One of the most common mistakes we see investors make is ascribing skill to excess returns that were a result of the manager's style, exposure or simply pure luck. Investors are inevitably disappointed when such an investment approach fails to replicate past success.

A note of caution is also warranted in the other direction. Some industry participants attempt to market the next "great manager" who has not yet produced a performance record by selling the idea that investors need to invest early. While every great manager had to begin somewhere, the failure rate of new managers is surprisingly high and the poor performance of multiple bad manager hires can far outweigh the potential gains of finding the next great manager early.

Additionally, sourcing the next star manager can be a daunting task; over 2,800 new funds were launched and nearly 1,900 funds were liquidated during 2011-2013, according to data from Hedge Fund Research. Investors should not completely ignore new managers, but they should recognize that they are searching for the exception, not the rule, and proceed cautiously when attempting to invest with a newer manager.

How to Identify and Access the Best Managers

Top-performing managers are disciplined with their asset base and are often closed to new capital. Marketing is a secondary consideration, and many of these managers don't even report their performance results to publicly available databases. So, while evaluating a manager can be challenging, sometimes the first challenge is simply to identify them. Finding these managers requires enormous amounts of time and effort, which for us requires persistent networking and referrals provided by our professional investor clients, investment managers we currently employ and other investment professionals.

Accessing these managers can be even more challenging. These managers are rarely available in a mutual fund format or on the open-architecture platforms of private banks and brokerage firms. Fortunately, every manager's asset base, even some who claim to be closed, has a natural turnover that occurs as current investors rebalance or otherwise choose to redeem their investment. This creates opportunities over time for patient investors to access these strategies and place capital in the hands of these accomplished managers.

In addition to usually being closed to new investors, these managers can also be highly selective regarding the investors they will accept. They generally want a smaller number of investors whom they view as long-term partners who will not withdraw assets at the first sign of short-term performance challenges. New investors need to convince these managers that they are a stable source of capital with a long-term orientation.

How Much Should an Investor Pay for Active Management?

What an investor should be willing to pay for active management depends on the asset class and strategy involved, as well as the investor's ability to access top-performing managers. In today's investment environment, with the proliferation of index funds and exchange-traded funds ("ETFs"), investors generally have access to low-cost investment solutions across a wide range of asset classes.

While it is only natural for an investor to want to pay less, we believe many investors focus too intently on absolute fee levels rather than on ensuring total fees are commensurate with the manager's ability to add value to a portfolio. What should matter to investors is the net, after-fee, after-tax performance that a manager generates. In some cases, relatively low fees are too high; in other cases, relatively high fees could be considered fair or even a bargain.

As an example of overpaying for asset management, let's consider the economic incentives of the active mutual fund industry. A 2013 study by the Investment Company Institute[10] estimated that the average actively managed U.S. equity mutual fund charges 74 basis points (0.74%) per year, while the average expense ratio for index U.S. equity funds is just 12 basis points (0.12%). Based on this cost differential, investors expect their actively managed U.S. equity mutual fund manager to add more than 62 basis points of value per year over time. Yet, as showed earlier in **Chart 1**, 80% of U.S. large-cap core equity mutual funds underperformed their benchmark over the preceding five years.

A primary contributor to this underwhelming performance is the mutual fund company itself, which is often publicly listed or owned by a large conglomerate. Under this structure, the fund's primary motivation is to satisfy the company's owners by growing revenue and earnings of the management company. However, by focusing on this growth, the manager may fall into some of the traps we discussed earlier, such as benchmark-hugging to ensure it remains in favor with consultants.

According to the previously mentioned 2013 report by the Investment Company Institute, the median number of stocks held by equity mutual funds was 100, demonstrating that over-diversification and benchmark-hugging is alive and well in today's mutual fund industry. Our experience has shown that the few managers who have been able to outperform in this market typically exhibit some uninstitutional behavior, such as concentrating their portfolio in a small number of names.

We believe investors should avoid the "muddled middle" of active management, where fees are high and managers add little value because they adhere to conventional investment approaches in efficient markets. Investors appear to be moving in this direction somewhat because, as shown in **Chart 4**, index domestic equity mutual funds and domestic equity ETFs received net inflows of $795 billion during 2007 - 2013, while actively managed domestic equity mutual funds experienced net outflows of $575 billion during the same period.[11]

Nonetheless, index funds still comprise less than 20% of the total net assets of domestic equity mutual funds and, sadly, we estimate that an even smaller percentage of assets are managed in non-traditional, unconstrained domestic equity strategies where outperformance is more likely. Consequently, the vast majority of investors remain stuck in the muddled middle of this asset class.

When High Fees Make Sense

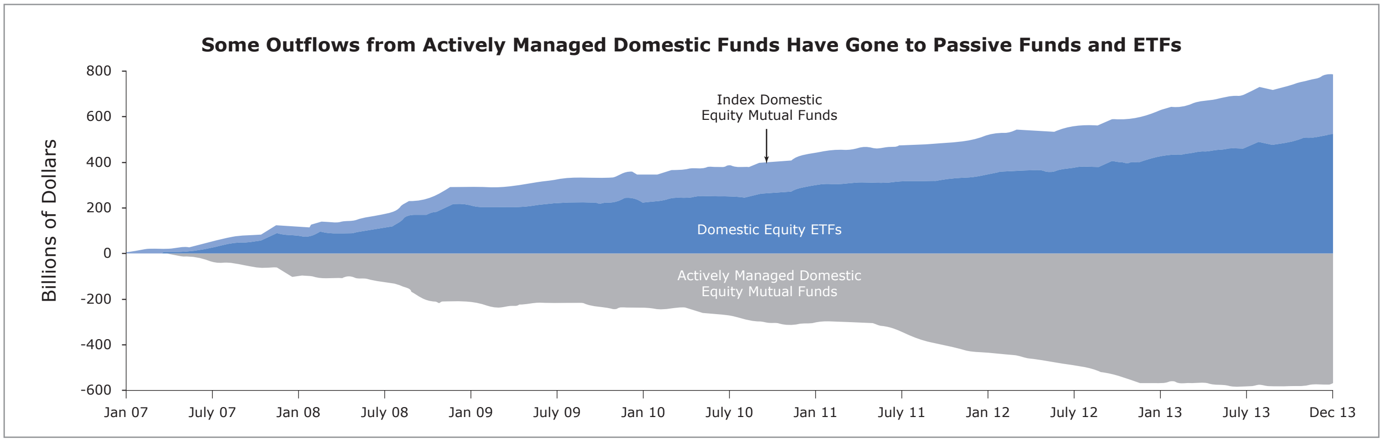
In contrast, evaluating hedge fund and private equity fees is a more complex exercise. While cost minimization may be an appropriate strategy in some traditional strategies, following that approach in most alternative strategies will simply exclude the best performing managers. Recall that the spread between the top- and bottom-quartile managers for hedge funds and private equity is quite wide and getting access to the top managers is critical to success.

The performance of these strategies is dominated by manager skill, rather than market movements, and the best investment organizations will also likely command higher fees. These managers are typically closed to new investors and some of the most successful managers actually return capital to investors periodically to shrink their asset bases. Under these circumstances, investors have no ability to negotiate fees and the managers feel no pressure to reduce them.

[10] *Investment Company Institute. ICI Research Perspective: Trends in the Expenses and Fees of Mutual Funds, 2013. Volume 20, no 2. May 2013. http://www.ici.org/pdf/per20-02.pdf.*

[11] *Investment Company Institute. 2014 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry 54th edition. http://www.ici.org/pdf/2014_factbook.pdf.*

Chart 4. $600 Billion of Outflows from Actively Managed Domestic Equity Funds



Note: Cumulative flows to and net share issuances of domestic equity mutual funds and ETFs are shown in billions of dollars monthly during 2007-2013. Equity mutual fund flows include net new cash flow and reinvested dividends.

Source: Investment Company Institute. 2014 Investment Company Fact Book: A review of Trends and Activities in the U.S. Investment Company Industry 54th edition. http://www.ici.org/pdf/2014_factbook.pdf.

In our experience, low fees can be expensive and high fees can be well worth paying depending on the circumstances.

Portfolio Construction: Pulling It All Together

Portfolio construction involves integrating strategic and tactical asset allocation decisions with manager selection decisions. A common mistake made by investors is to view their asset allocation decisions separate and independent from their manager selection decisions. This approach is encouraged by some consultants and private banks to better specialize and scale their capabilities in each area, but it works to the disadvantage of most investors. Separating these decisions is counterproductive for investors as it ensures that they will miss important interactions between these decisions.

Manager Selection Can Undermine the Diversification Benefits of Asset Allocation Decisions

The first form of missed interaction occurs when investors try to implement within an asset class a specific strategy that actually serves to undo the diversification benefit of their allocation to that asset class. A common example of this mistake occurs with fixed income allocations.

The primary reason investors allocate to fixed income is to reduce the risk of their portfolio. Secondary benefits can include protection against the impact of deflation and the reduction of an asset-liability mismatch. However, when fixed income asset allocation and manager selection decisions are separated, the tendency is to attempt to maximize returns within the reasonable boundaries of the asset class.

In fixed income, this can entail investing in low quality corporate bonds and even high-yield “junk” bonds. As investors shift from high-quality fixed income investments, whose performance is primarily driven by interest rates, to these other investments, whose performance is primarily driven by spreads over high-quality instruments, the risk and return profile of the allocation changes, defeating the original intent. The return premium that these shifts seek to capture produces higher volatility and higher correlations with equity markets, reducing the risk reduction and diversification benefits of the asset allocation decision to fixed income. Worse yet, these return premiums are actually poor substitutes for equity investments during most periods and investors would be better off investing in equity markets.

Asset Classes Where Manager Selection Determines Performance

While some asset classes, like equities and bonds, are easily defined, other names used for asset classes are really descriptions of strategies. The names of many alternative "asset classes," such as hedge funds and private equity, describe the investment structure rather than the strategies employed by the manager. In these so-called asset classes, gaining access to the top-managers is often more important than the decision to invest in the asset class.

Hedge funds have disappointed most investors over the last few years, as returns generated by average hedge funds have trailed well behind equity markets. This result may not be surprising during a period when equity markets performed extremely well. However, even after accounting for the lower net market exposure embedded in these funds, it does not appear that the average hedge fund manager added value during the last few years. On the other hand, the superior performance of top-performing hedge fund managers clearly has added value during this period, providing strong returns and a diversifying exposure to investment portfolios.

Similar asset allocation and manager access interactions exist in private equity and natural resources, to the point where some knowledgeable investors claim that without access to top managers they would prefer to not make allocations to these asset classes.

Concluding Thoughts

While asset allocation remains a very important element of portfolio construction, successful selection of active managers can have any equally important impact on portfolio outcomes. Furthermore, the impact of active management tends to increase in less efficient asset classes, such as hedge funds and private investments.

While we view active manager decisions as additive, mistakes in manager selection can be very detrimental to investment outcomes and the achievement of long-term financial goals. Accordingly, great care should be taken to ensure that proper resources and expertise are dedicated to the pursuit and due diligence of these managers; otherwise, investors could end-up worse off than if they had not attempted to add value through active management.

About Gresham

Gresham Partners, LLC is a nationally recognized, independent investment and wealth management firm that has been serving select families, family offices and endowments since 1997. Known for its commitment to delivering superior investment performance and highly personalized wealth planning, Gresham's client-focused solutions feature hard-to-access managers without the conflicts typical of other firms. With over $4 billion under management, Gresham's Risk Conscious® investment approach and holistic planning are focused on preserving and growing clients' assets. The firm's team of highly skilled professional advisors allows families greater freedom to pursue career and personal interests.

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