Evaluation of active manager skill

More art than science?

KEY POINTS TO INVESTIGATE

1. How do you determine luck vs. skill?
2. Do big or small managers have a market advantage?
3. The science of due diligence

- Want to keep it simple since in simplicity lies some modicum of truth. Einstein and Occam's razor principle: *"Everything should be made as simple as possible, but not simpler."* Just like in stock selection, the more assumptions the decision maker has to make the more unlikely the explanation of return vs. risk source

- **Just a reminder: all value is created in future so subjective issues are essential in making suitable manager decision. No amount of numbers can give full picture**

- Hard not to get into philosophy, human nature, and organization psychology in order to optimally answer above issues

- Isn't it time to go beyond sharpe ratio (and it's many corollaries)?

INHERENT FLAWS IN EVALUATION PROCESS THAT MUST BE MITIGATED

- Any time period chosen is ultimately arbitrary if goal is to invest in fund for decades. 2008 drawdown affect: Legg Mason Opportunity Fund I annualized 36% in five-years to Feb 28, 2014. If take the 6-year return to Feb 28, 2014 then 6% annualized (lower than S&P 500). Star and renowned from 1991-2005; shunned post 2008

- The problem is that skill and luck are not independently observable (Prof Bradford Cornell of California Institute of Technology)

- Allocator must have thought through inherent incentive flaw (especially if she is a fiduciary, her goal is (or at least should be!) to maximize long-term (5+ years minimum) return while keeping drawdowns lower than market/other funds in category and ideally yearly outperformance. Basically, better, consistent returns than market, without hassles

- On other hand, the fund manager is highly incentivized to reach his performance targets yearly to "crystallize" the incentive fee. Many times, as we have read about and seen countless time, the short-term outperformance is not able to sustain and even if the allocator stays with a manager over several business cycles he doesn't do as well as he could just by buying index ETF

Buffet (again!) but why not try to follow the student who is at/near top of his class?

- Is it fair that Buffett perennially bashes active managers (average plumber adds more value than average fund manager?!)?
- Actually its just his way of going to next logical step of **Charles Ellis**….**more than 40 years** ago. Charles Ellis**,** the US investment consultant**,** called active management the "loser's game”.
- Basic point was that he likened endeavor to a long (very long!) game of tennis- the basic point is that to succeed over time you need to make as few unforced errors as possible
- Sounds obvious but are most allocators in position to evolve their business model/teams to logical conclusion? Exclusivity principle: people with money to invest can’t fathom/accept that in most cases the return they get with active managers will be less than market
- Check out Buffett’s national coin flipping thought experiment if you haven’t read it….in my view, has presented quite damning “proof” for vast majority of active managers- regardless of their size, they are basically lucky/packaging beta

Personal experience/thoughts from marketing Metis Opportunity Fund

- 6 year track record (17% net annualized vs. 11% gross for benchmark index) in listed Indian equities, yearly outperformance average of 5%, max drawdown of 21% vs. 27% for index; $25m firm wide assets with a long-term asset base of families in Gulf, India, and US- growth (5x AUM growth in last 3 years)

- We fund managers all have our canned stories (winning and losing ideas, etc.)- the allocator must ask questions that truly probe and give them insights into how manager will perform in the next recession and over future economic cycles

- Has to be a mutual fit with long-term goals aligned and as much transparency as desired by investor

- Definition of risk must be in basic alignment: our key definition of risk is not volatility, Sharpe ratio, etc but permanent loss of capital given our long-term business model

- It is hard and a real treat since so rare when the investor and manager come into alignment and able to build long-term wealth together

Since successful long-term investing is a careful blend of art and science it is only natural that manager evaluation also lends itself to transparent, wide ranging 1-on-1 discussion. Please contact me anytime to discuss further.

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