SILLY SELECTION PRACTICES IN HIRING HEDGE FUND MANAGERS

By Wendy Brodkin, president, Goodman Institutional Investments

With all the time spent on governance issues these days, it is surprising that many of the commonly used investing practices fail to measure up. One of the worst offenders is the process used for investment manager selection. It is still driven by historical performance results that we have known for years aren't predictive of future returns yet we still continue to rely on them as a core criterion for evaluating managers. Although style characteristics and new risk measurement techniques have supplemented the return analysis, generally the manager with the best returns gets the business time and again.

Typically, very little else is known about the performance of the winners such as the types of risks taken and the source of their returns, likely due to the behavioural bias of "overconfidence". This is a well-documented decision-making phenomenon wherein experts who are confronted with uncertainty are overconfident in their judgement[1]. In the case of manager selection, both the managers who generated good returns and the investors who want these returns are overconfident that the performance will persist. It's interesting to see that underperformers are grilled with tough questions but there is minimal scrutiny of the performance of the winners to understand if it is sustainable. It's almost to the point where it is bad investment etiquette to question a top performer.

There are many anecdotal examples of this overconfidence. During the heady days before the corporate governance scandals and during the now infamous Enron conference call, an analyst was dismissed from the call (with a four letter word) for asking about some of the undisclosed partnerships. In the early days of raising money, Long Term Capital Management did not disclose even their process for generating returns and yet investors believed they were sustainable. I personally encounter this phenomenon regularly. Recently a large value manager in European equities was asked how they managed to outperform not only their peers but also growth managers in 1999; their response was "we don't remember". The issue was not pursued.

I think the many sophisticated ways the historical results are sliced and diced today, (e.g. information ratio, tracking errors, value at risk etc.) give a false notion that we are improving the selection of managers. But all of these statistics are still focused on the past. My particular pet peeve is the use of correlation analysis to evaluate how a particular manager will fit into an existing portfolio. This is neither predictive of the future nor is it a meaningful exercise to model the past given that the managers are typically benchmarked and the bulk of their return is beta. If the value added over the benchmark is used for correlation analysis, the results make more sense but the usefulness of the exercise is still limited to the historic pattern of past returns.

Another commonly used practice in selecting managers is attribution analysis. It is a top down process evaluating returns against a benchmark and attributing the components to: first asset mix, then country and sector selection and, whatever is left, to security selection. The results are biased because of the methodology but, more importantly, the

results provide only minimal information for most managers, and none at all for stock pickers. If this technique were applied to hedge fund returns, the results would be meaningless because there is no benchmark.

There are three discernable sources of a manager's return: alpha, beta and exotic beta. Alpha is skill (and luck and noise), beta is market exposure and exotic beta is a beta that is not yet widely recognized or easily produced[2]. An example of exotic beta is high yield bond exposure in a universe bond portfolio or a long value/short growth strategy in a market neutral portfolio. The convention of benchmarking traditional managers led to calling any difference between the benchmark return and the manager's return "alpha". For example, we called the value added from small cap biases in equity portfolios alpha. Today, we recognize it as "beta".

An attribution that explains returns in terms of the combination of alpha, beta and exotic beta is more meaningful and indicates as well the type of risks the manager is taking and the sustainability of the returns in different markets and at varying capacity levels. For example, a fixed income hedge fund manager generated 36% total return net of fees in 2003 from the following sources: 70% from high yield bond investments (beta), 25% from arbitraging between different securities of the same issuers, primarily long debt and short equity because of the yield (exotic beta) and 5% in various shorts. This explanation of the return identifies the risks (e.g. credit spreads) and the sustainability of the results. The manager's true "skill" will be demonstrated in his ability to restructure the portfolio appropriately to exploit varying market conditions that may include lower yields and stable credit spreads and limit his growth in order that capacity doesn't impair future results.

It is not surprising that hiring mistakes happen in the process of manager selection given the silly practices of: undue reliance on returns, reluctance to scrutinize the source and sustainability of returns, analysis without accounting for the beta component and a flawed attribution analysis. However, it is worrisome that these same techniques are now being applied to select hedge funds because they practically guarantee errors that go beyond simple underperformance of a benchmark. Selection risk with hedge funds could be a lot more costly in terms of reputation, "headline risk", capital loss and inability to redeem the investment on a timely basis.

Most hedge fund failures can be traced to three causes: fraud, illiquidity and excess leverage. The conventional selection practices would not identify these issues. Although most institutional investors invest through hedge funds of funds (FoF) and rely on their FoF manager for the selection and monitoring of the underlying funds, they still must select the FoF in a manner to avoid these issues. This means using different selection practices to hire the FoF manager, as well as ensuring that the FoF manager himself has in place rigorous decision-making standards to choose the underlying funds.

Consider a recent FoF search. The screens that were used to identify a list of potential candidates were: ownership, size as measured by assets under management, personnel

turnover, performance, style (market neutral) and transparency of the investments. Here is an example of some of the attributes of the managers selected:

- Good returns because of a leverage overlay
- A market neutral style that produced returns that were 80% correlated with the market at certain times
- The portfolio of funds constructed using correlation analysis and historical returns for both strategies and funds
- No independent pricing of the securities held in the portfolio and no independent verification of the returns
- 100% security level transparency but no system to analyze the portfolio for liquidity and any other investment or business risks of the underlying funds

This outcome highlights a number of areas of concern that weren't screened out in advance. This manager selection process is intuitively appealing and less costly than actually doing research but it is simply not effective. Furthermore, it is not prudent because it doesn't produce information on a go forward basis or identify the risks in order to make good decisions.

A better selection process relies on fundamental research that is not predicated on historical results. Transparency to evaluate the liquidity, overlapping positions, offsetting positions and other risks of the underlying investments is important in order to be able to replace the FoF manager if necessary, and for the FoF manager to replace the underlying funds. An independent verification of the pricing of the securities in the portfolios and a subsequent independent verification of the return of theses portfolios is the only way to know if the historical performance results are real in order to analyze their source and sustainability. The sources of returns should be easy to articulate in terms of beta, exotic beta and alpha and how they have changed over time in response to prevailing market conditions. It is also important that the portfolio construction, underlying fund selection and future expected returns are well-grounded in economic rationale and not designed around historical returns or reliant on high degrees of leverage.

Hedge funds will play a bigger role in the management of institutional investments because they preserve capital, manage short term market volatility, and generate returns in unexploited areas of the markets. Certainly, there will always be good managers and bad managers out there. However, silly selection practices keep the bad ones in business. The quality of the industry can only improve by improving the quality of decision-making and using selection techniques that steer us to good managers. A research-based process is especially critical for hedge funds but can also improve the quality of decision-making for traditional money managers as well.

NOTES:

1. See for example, "Judgement under uncertainty: Heuristics and biases": Edited by Kahneman, Slovic and Tversky, Cambridge University Press
2. "Distinguishing True Alpha From Beta": Laurence B. Siegel, CFA Proceedings 2004.