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**SUCCESS IN INVESTMENT MANAGEMENT –
IDENTIFYING TOMORROW'S
SUCCESSFUL MANAGER TODAY**

by

Roger Urwin MA, MSc, FIA

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SUCCESS IN INVESTMENT MANAGEMENT - IDENTIFYING TOMORROW'S SUCCESSFUL MANAGER TODAY

(1) INTRODUCTION

**"For success in all human affairs, the odds are always 6 to 5 against" -
Damon Runyon.**

(1.1) Investment management is undoubtedly a very difficult skill. There are numerous problems which stand in the way of success. Principal among them is the difficulty of organising the output of highly motivated, and talented people. It is this factor, more than any other, that makes the chances for success in investment management odds-against both for the investment organisations themselves and the trustees and other individuals responsible for selecting managers. The goal of this Paper is to help to improve these odds.

Scope

(1.2) This Paper is addressed to all those involved with the investment management of institutional funds be they pension funds, insurance funds, unit trusts, investment trusts, or other types.

(1.3) My aim is to identify the factors that are necessary to achieve successful investment management. As success in this field is considered principally in terms of investment performance, I concentrate upon describing those factors that will characterise tomorrow's high performers.

(1.4) The research is both quantitative and qualitative. I have used my Firm's considerable database on pension fund investment managers and applied various statistical techniques to identify important attributes. However, the qualitative analysis of investment managers described in this Paper turns out to be the more significant line of research, a point I will refer to later.

(1.5) Analysis of performance statistics should be treated with caution. This is because the results come from a very non-standard population. The problems are that:

- managers are not all operating against the same objectives (ie. in statistical terms, the cross-section sample is heterogeneous)
- the manager's relative skill varies in time as the individuals, investment style and market conditions change (ie. the time series of performance expectations is heterogeneous)
- the expected variation in performance varies in time with changes in the strategy (ie. the time series is heteroscedastic)
- there is some cyclicity of performance (ie. there is linear dependence)
- there are occasional predictable patterns in relative performance (ie. there is non-linear dependence including deterministic chaos)

In short this is a statistician's nightmare.

(1.6) On the other hand, there is now a considerable amount of past performance data available. This has made it worthwhile to try out statistical analysis using relatively straightforward tests. The use of model building and Monte Carlo simulations has been particularly helpful. Care is, of course, required in interpreting the results in this field in which scientific rigour is, at least with existing techniques, completely impossible.

Potential Uses

(1.7) The selection of managers is a field that I and other Partners in my Firm have been involved with for about ten years. While this experience has been immensely important in helping us to identify the better quality investment firms, we share the view that manager selection remains a problematic process. The research we have undertaken aims to provide a new basis for giving advice to trustees in this area. We believe this research can help address many of the difficulties in selecting managers.

(1.8) This Paper is also aimed at helping investment managers to recognise the attributes they must possess or acquire to achieve the greatest probability of success. I am privileged to spend time each year with well over 50 investment firms. These firms spend enormous time and effort in responding to my Firm's (and others') requests for information. As a response to their efforts, it is natural to direct to them some of my conclusions from this investigation.

(1.9) The final purpose behind this research is to achieve a better understanding of the value of performance measurement statistics. In this area, I am in no doubt that both trustees and investment managers stand to benefit. Performance measurement is currently the subject of an Enquiry commissioned by the NAPF and chaired by Maurice Stonefrost of British Rail. The relevant conclusions from this Paper have been communicated to this Enquiry.

Areas of Controversy

(1.10) This work addresses three of the major failings of contemporary fund management:

- (1) the failure to recognise the nature of the relationship between past performance and future performance;**
- (2) the failure to recognise the value of qualitative assessments in a field dominated by quantitative assessments of managers;**
- (3) the failure to set realistic and relevant objectives.**

(1.11) The widespread inability to grasp the importance of objectives has led us to spend inordinate time examining past performance relative to the time spent considering future performance.

(1.12) Later in this Paper, I am able to conclude that:

- (1) a relationship between past performance and future performance certainly does exist but it is both tenuous and extremely subtle;**
- (2) qualitative analysis is clearly superior to quantitative data in forecasting the future performance of investment managers;**
- (3) sensible time horizons are a necessary part of the investment process.**

(1.13) While these are important conclusions, the key results in this Paper are the ground-rules listed later, by which investment (both the primary function - fund management, and the secondary function - selecting fund managers) can be made into 'odds-on' activities.

(2) THE STRUCTURE OF INVESTMENT MANAGEMENT ORGANISATIONS

“Today, only a small motivated firm with highly qualified labour and good vertical mobility instead of oppressive hierarchy can hold up in a world whose principal characteristic is instability” - Andrea Saba.

(2.1) Compared to other organisations, investment management firms are extreme in many regards - their total reliance on people, the highly measurable output, the instability of their fortunes, and others.

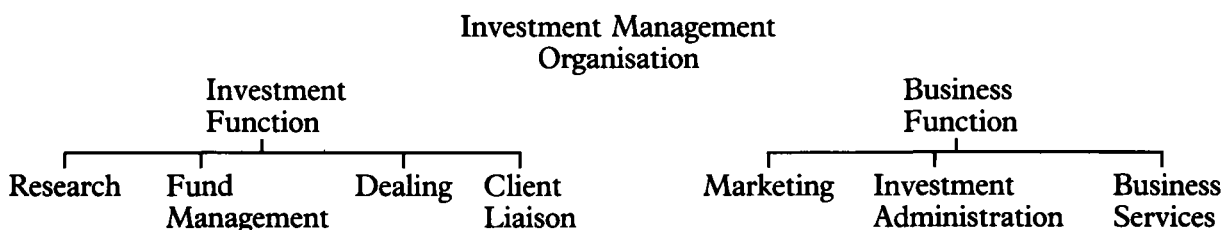
(2.2) Therefore full understanding of how investment firms operate is required before it is possible to consider the issue of the quality of management. This section comprises a brief description of the structure of investment management organisations.

Activities

(2.3) It is natural to divide the functions of an investment firm into two parts:

- investment function
- business function

The activities under these two headings which must be carried out in any investment firm are summarised in the chart below.



(2.4) The distinction between these two diverse functions is important in most investment firms. It is to be expected that the people fulfilling these functions will have different qualifications and types of background. Such a division is often a problem for the organisation's cohesion and in consequence there are difficulties about morale and motivation at times. For example, those involved in the business function of a firm often feel they are poor relations relative to the investment professionals and do not feel they have an equivalent career progression path.

(2.5) Marketing and investment administration will be classified as a business function in most organisations. However, in some organisations this is a blurred division. Indeed, marketing is increasingly widely carried out by investment professionals in the institutional market.

(2.6) Research is often carried out by fund managers rather than employing specialist research assistants. This is more common with smaller organisations given their more limited resources. However, a few very large organisations argue that research is inseparable from fund management and operate without this division.

(2.7) Where size warrants it, organisations may use product line and geographical divisions to provide further demarcation. There are two broad types of product line - institutional and retail. It is difficult for one organisation to achieve success in both fields. The demands of selling and administering mass market retail products are very different from those for institutional funds. Only a select few organisations have developed the separate skill bases and marketing franchise to compete successfully in both markets.

(2.8) All major investment organisations have global investment expertise. Geographical divisions can involve three or four regions - North America, Far East and Europe with UK possibly figuring as a separate entity. For a large organisation, such divisions can impose greater hierarchy but naturally lengthen decision lines. As is discussed later this poses problems for effective decision-making. The global nature of the investment expertise provides obvious scope for marketing to non UK funds. However, very limited activity of this nature has actually occurred. This mirrors international experience that cross border penetration is very difficult.

(2.9) The most evident attributes of the investment organisation are their people, investment style and form of client service. These are the three principal items in any marketing presentation.

People

(2.10) Broadly, we can categorise the investment professionals used by organisations as:

- Research analysts
- Fund managers
- Function heads (Dealing, Administration, etc)
- Product line heads (Pensions, Unit Trusts, etc)
- Investment Desk heads (North America, Far East, Bonds etc)
- Chief Investment Officer
- Chief Executive

The key output of investment firms is often produced by committees working to achieve a stronger conviction in certain key decisions. For example, most firms use a strategy committee to fix asset allocation.

Investment Style

(2.11) Many people talk mysteriously of 'investment style' without a clear definition of what this means. The field is littered with references to value, growth, etc. Such pigeon-holing is endemic in the US but rather dubious in the UK where such a simplistic description is often inappropriate. UK managers do not usually adopt a uniform approach to investment, being keen to change their strategy if market conditions warrant it.

(2.12) I believe the only useful definition of a manager's style will involve a full description of the investment process comprising:

Investment Philosophy. The orientation towards a particular type of stock or market.

Research. The access to and use of research on which individual decisions will be based.

Buy/Sell Disciplines. The rules (objective or subjective) which govern the decisions made on a fund.

Implementation. The process by which decisions are taken and actions are implemented.

Service

(2.13) By service, we are generally referring to all the components of individual client management. There are three aspects to this:

- administration
- reporting and communication
- portfolio management

(2.14) The last aspect needs elaboration. While most institutional funds grant very wide discretion to the manager, there is still an important need to be sensitive to client needs. As these needs are not usually communicated explicitly, this is a fluid process in which experience and individual attention will be required.

(2.15) Investment organisations often forget that success is not possible without these aspects of good service being evident alongside good performance.

(3) THE INVESTMENT PROCESS

**“In investment, you cannot succeed by doing things the same way as everyone else”
- Keynes.**

(3.1) The qualitative appraisal of the attributes required by successful investment firms is commenced in this section.

(3.2) My belief is that investment firms require high standards in three areas to be successful:

- the investment process
- the people
- the business management

Of these areas, the investment process is the most important and is discussed first.

Investment Philosophy

(3.3) The investment philosophy is at the heart of the investment process. There is a wide range of possible philosophies which could work successfully. No single philosophy can ever become dominant. As soon as such a paragon is discovered, the inefficiencies that allowed such an attractive position to exist would be arbitrated away. Consequently, it is important to recognise the inherent fragility of any investment philosophy and the need for it to be adapted in time. This provides the first challenge for any investment organisation. Those that have developed a successful investment philosophy may have to discard it at some stage. This is not easy as it conflicts strongly with human nature.

(3.4) The recent history of institutional funds is illuminating. High equity philosophy has proved a very successful policy in the 1980's. It is very unlikely that it will be as successful in the 1990's. First of all, overweighting equities relative to the competition now calls for close to 100 per cent exposure to equities, which is not acceptable to managers who place a value on asset diversification. Secondly, the margins between equity returns and other returns are very likely to narrow. The appropriate philosophy for asset allocation in the 1990's has not yet emerged.

(3.5) Good investment philosophy is generally built on a highly perceptive view of how markets work. This needs to pay investment markets due respect for their efficiencies but be ruthless in the identification and exploitation of their inefficiencies. Naturally, to do this successfully calls for top grade investment ability. It also requires an appreciation of the limitations and indeed frailties of other investors. Only by understanding the opposition, can an investor capitalise on any comparative advantage he might have himself.

(3.6) One further element, to which we will return, is the issue of unfashionability. The most successful investment philosophies through past history have clearly been associated with outstanding thinkers who pursued an unfashionable and consequently uncomfortable policy. Investment should be geared to taking tomorrow's decision today.

Research

(3.7) Research is the corner-stone for all investment decisions. If the markets were inefficient, an investment decision would involve a straightforward capitalisation on research. As markets are quite efficient in practice, the process must be more subtle than that. It is critically important that the investor recognises that many of the research recommendations he receives will be falsely based.

(3.8) One further hazard in research is embedded in the system. The majority of research is carried out by the brokerage houses not by the institutional investors direct. Brokers act in a 'sales' capacity. They must sell their advice to earn commission. Therefore, there is inevitably a lack of strict impartiality in their advice. This is a problem that has worsened significantly since the Big Bang in 1986. Generally, those investors who do not recognise this hazard run high turnover low performance funds.

(3.9) There are only two ways for a firm to gain a competitive advantage from research:

- to have superior access to research
- to make superior use of research

Both methods are possible in principle and very hard in practice. On balance, making superior use of research seems to be the easier of the two.

(3.10) For superior access to research an organisation must have its own top quality team or a privileged flow of research from outside sources. In the UK, investment management organisations have not favoured the development of high calibre research analysts. The career structure has encouraged budding analysts to develop into fund managers. Consequently, research teams employed by investment firms are not generally providing superior research. This contrasts with the US where research is a higher grade role.

(3.11) Superior access to research could also come from getting a better service from a broker than the competitors. This is undoubtedly a function of the size of the organisation. The greater the volume of transactions placed with the broker, the better the service. However, there is no evidence to suggest that any manager can sustain much of an advantage from this. The market share in investment management is spread across many firms. For practical purposes, I believe it is reasonable to suggest that large firms get a similar standard of service from brokers. Importantly though, this is clearly better than the standard given to smaller firms.

(3.12) Superior use of research appears more likely to pay off than superior access to research and certainly provides smaller firms the scope to make up for the lower standard of service they obtain. It is hard to be specific as to how fund managers are able to make better use of research than their competitors. Like other areas of investment, success will be achieved through experience and discipline. Generally, positive signs of the superior use of research would be the low proportion of brokers' recommendations taken up, the reliance on a handful of analysts rather than the whole field and an insistence on receiving conclusions but not buy/sell recommendations.

Buy and Sell Disciplines

(3.13) It is part of my job to ask fund managers the question: "What makes you buy or sell or continue to hold a particular security?" My experience is that few fund managers answer the question clearly. More importantly, very few have a distinctive answer which identifies their competitive advantage or difference.

(3.14) Those fund managers capable of an articulate and distinctive response mark themselves out as likely candidates for success. Having a discipline is the key attribute, the quality of the discipline appears less important. Being able to articulate the process shows an understanding of the discipline and a greater commitment to its implementation.

(3.15) Disciplines come in many forms. The most common identify relative value through PE Ratios and PE Relatives. Increasingly though, value is judged through a series of measures. The process may be largely subjective but the more parameters considered, the more necessary quantitative methods become.

(3.16) The application of quantitative disciplines is increasingly common. Numerical methods can easily provide a first screen for stocks satisfying various criteria. This leads the fund manager to make his decisions with the field of opportunities thinned to a more manageable figure. Alternatively, the quantitative process can drive the selection process to the extent where the traditional type of decision based on judgement is replaced. This systematic basis for stock selection is comparatively unusual but is growing rapidly.

(3.17) The vast majority of quantitative techniques involve substantial subjective input. Therefore, the common perception of quantitative techniques as being computer driven is misleading. The numerical methods are merely a tool. For this reason I believe it is wrong to think of quantitative stock selection processes as an investment style in itself, it is just one aspect of style. The critical part of the style lies in the live investment decisions which govern the statistical rules and the research that is coded for numerical processing. Quantitative techniques are discussed more generally from (3.35) following.

(3.18) Most investment organisations reject the value of relatively strict buy/sell disciplines. They argue that such disciplines breed inflexibility and conflict with the exercising of the Fund Managers' skills. Not everyone can be correct with this argument given that investment management is such a competitive business. The average Fund Manager, as already observed, is intelligent and well motivated. I believe the argument against tight buy/sell disciplines is only valid for the top grade investment organisations with the best quality Fund Managers. The rest, who have a competitive disadvantage relative to the top firms, will have to develop a greater degree of discipline in their investment process or they will fail to measure up.

Asset Allocation

(3.19) The above discussion has concentrated upon the disciplines involved with buying and selling individual securities. Similar principles apply to buying and selling markets - the asset allocation decision.

(3.20) While investment management organisations must employ a number of fund managers to take responsibility for stock selection, only one individual or a select group take the asset allocation decision for the organisation as a whole. This allows firms to have their 'best shot' at this decision rather than having an average decision scoring for them which happens in the stock selection area. Surprisingly, this elitism generally does not seem to provide higher quality decisions.

(3.21) There are several reasons why asset allocation decisions have proved disappointing:

- there is often a confusion in objectives with managers operating relative to more than one benchmark
- decisions are often taken in committees and represent lowest common denominator results
- the difficulties of implementing asset allocation decisions without disturbing stock selection restrain managers from taking positive action

These issues are discussed further under the section headed Implementation.

Decision Process

(3.22) Buy and sell disciplines define guidelines for investment decisions. Rarely will they be specific enough to define precisely which transactions should be carried out. This latter part of the investment process is the 'Decision Process'.

(3.23) The Decision Process is summarised by who does what in the specification of any transaction. There are usually five levels to any decision.

- Asset allocation
- Market sectors
- Recommended stock lists
- Stock buy and sell orders
- Transactions

Each decision could be taken at various levels:

- Chief Investment Officer
- By designated Committee
- By the whole team
- By a designated specialist
- The Fund Manager
- The Dealer

The level of decision making is a function of the size, structure and sometimes the philosophy of the organisation concerned.

(3.24) Certain key principles exist which govern effectiveness in the decision process. The first is that single person responsibility and accountability works better than decisions by committee. The larger the group of people taking the decision, the more the decision is likely to fulfil the personal needs of each individual rather than the pure investment needs of the problem. Also people generally respond more positively to the incentives implicit in individual accountability. It is interesting that these arguments have only lately been properly accepted in most investment organisations and the process of thinning down bureaucratic committees has been quite wide-spread.

(3.25) On the other hand, investment thinking requires teamwork and an open plan culture. Where individuals operate in isolation they will not easily develop an accurate and broadly based perspective on investment problems. All investors need the opportunity to bounce ideas off each other and learn from the findings of others. Asset allocation decisions certainly require team-work and a small committee may be appropriate. However this will only work well if there is one strong leader who makes the running after taking counsel from all parties.

(3.26) Broadly, specialisation in the division of responsibilities is better than generalist approaches. Investment managers need to understand the issues they are studying better than their competition. Only by making their investment team specialise and become expert in narrower fields will this be achievable.

(3.27) Again, there are dangers with allowing this argument to go too far. Specialisation can only work well in a very well organised environment. Furthermore, it can lead to inconsistencies in the strategy for any individual fund. If one fund is managed by a whole series of specialists, coherence and accountability may suffer. This is why there has not been a satisfactory replacement to the balanced fund manager who in most organisations is responsible for a mix of areas:

- UK equity selection
- Allocation of cash flow to other specialists
- Client service

It is unlikely this role will change much in coming years, although I anticipate specialists in client service will become more common.

(3.28) The specialisation/generalist balance dictates one critical aspect of the organisation's performance - their performance spread. As is identified later a wide spread of results across different clients is a big problem for the organisation and for an institution hiring a manager. Spread is due either to poor controls all round or the impact of the best investors becoming diluted. Some spread is inevitable in segregated management but few investment houses manage this aspect well. Many organisations delegate too far or too carelessly.

Implementation

(3.29) How are decisions implemented? This can vary widely both within organisations and across organisations. For example, an asset allocation decision will generally be mandated on all fund managers to implement. However, there is always some discretion in the timing of the change.

(3.30) In theory, such flexibility is very worthwhile. The Fund Manager can then reflect the individual cash flow of his funds. He can also exercise sensitivity to market conditions by buying into a weak market or selling a strong market. In practice, discretion of this nature can turn into an opportunity for rather loose practices. Often the reason for delay is not investment related but due simply to unavailability of the Fund Manager. This then introduces unnecessary spread into the organisation's aggregate results.

(3.31) Efficiency in dealing is clearly an important contributor to performance. Most dealing is now centralised with specialists responsible for taking the buy or sell instructions of the Fund Managers and implementing the trade. Apart from the vital search for the best price at any time, the Dealer must manage the commission flow. This is an increasingly important function. Measurement of the trading process is used widely in the US and similar processes are now being tried in the UK.

Sensitivity to Client Requirements

(3.32) While the majority of investment roles remain discretionary, there is a growing number of clients who ask for a more specific role to be played. This requires the manager's investment process to be adapted to the specific fund's needs. This tailoring is not straightforward and generally poorly handled by managers. It would appear that Fund Managers prefer to operate all their portfolios along similar lines (what psychologists would call staying in their 'preferred habitat') rather than having to reflect individual objectives.

(3.33) It is reasonable to expect the tailoring part of the process to grow in significance in time and become a key attribute for those that can develop appropriate skills and systems.

Quantitative Investment Processes

(3.34) The application of quantitative techniques allows investment ideas (philosophies or insights) to be applied in concentrated doses. If the ideas are good enough, then managers operating in this fashion will very likely outperform (that is, at least until the rest of the world catches up with the idea).

(3.35) Quantitative techniques can produce a very attractive mix of qualities:

- the process concentrates its effects very efficiently so performance can potentially be extremely good
- the process outlasts the people, so turnover of key individuals is less of a problem
- the process can be clearly described, has its own defined risk profile and is capable of very precise performance attribution; this all adds up to a very transparent style

(3.36) It is my belief that during the 1990's these factors will have a powerful influence and quantitative investment processes will grow strongly in popularity. This growth in quantitative techniques will involve existing groups developing expertise in this field rather more than the growth of a new generation of investment groups built on quantitative disciplines.

Conclusion

(3.37) **Excellence in investment organisations comes primarily from the quality of the investment process. The above discussion serves to prove that the analysis of quality is particularly difficult.**

(3.38) **It is interesting to highlight work done in the US which has explored similar issues to the ones covered in this Paper. Several years ago, AT&T carried out a study of the characteristics of successful US investment firms. They concluded that there were four attributes necessary for success :**

- (1) The existence of a structured decision-making process which can be defined easily.**
- (2) A stated investment philosophy applied consistently over time to the economy or to the market and used as a means of identifying an appropriate investment strategy.**
- (3) A clearly stated and acted-upon sell discipline enabling the organisation to prevent the consistent reinforcement of mistakes and create the realisation of gains from successful investments.**
- (4) The continuity of key personnel.**

The first three points relate to the investment process. The last point relates to the people which is covered in the next section.

(4) PEOPLE

“It is personalities not principles that move the age” - Einstein.

(4.1) The importance of the people who work for an investment organisation is self-evident. Research should examine the different people involved and determine how critical their respective roles are to the success of the organisation.

(4.2) The key determinants of success in any human enterprise are:

- quality of people
- depth of resources
- continuity of staff

This sub-division has been used in the analysis that follows.

Quality

(4.3) Not surprisingly the list of requirements for investment professionals is headed by calibre and experience. The particular mix of skills that one requires include numerical, communication and financial attributes. Limited ability in any of these fields is proving an increasingly difficult handicap as investment management becomes steadily more competitive.

(4.4) Training is naturally a very important part in the process. The most successful investment organisations will usually demonstrate a zealous attitude to training providing every means to help their professionals to develop and fine-tune their skill base. For their part, the professionals must respond and be willing to pay the price in time and effort in training to mature properly.

(4.5) Experience is a vital part of learning. The benefit from experience is most positive in the first ten years or so in the business. Thereafter, investment professionals generally derive diminishing benefits from further experience. There is evidence to suggest that bad habits or biased perspectives can be reinforced through experience rather than corrected, although this varies from individual to individual. This may argue for redeployment of people from time to time.

(4.6) Investment management involves the combined forces of several different types of professional. Naturally, the differences in the requirements of each role predicate a different mix of attributes.

(4.7) The Chief Executive does not require much investment expertise. As for any business, the Chief Executive of an investment organisation needs to be an expert in:

- the management and deployment of people
- the marketing and distribution of services
- the creation of a culture and operating environment in which the organisation can flourish
- the development of a strong external profile for the firm

Generally in the UK, Chief Executives have been promoted from among the Investment Directors. Frequently, age and experience have been the deciding factor in promotions rather than suitability for the job. It is not surprising that this role has been hard to fulfil. Many organisations should question the principles of succession they have adopted and perhaps recognise the place for a specialist, often drawn from outside the organisation or even outside the investment business. However, to make up for a lack of detailed knowledge of the industry, you need a fairly exceptional person.

(4.8) The Chief Investment Officer must be an investor of the highest class with a good knowledge of all investment markets. He must be an effective communicator and have leadership skills. He must be perceptive enough to recognise the quality of investment managers and their arguments. He will rely for detailed market knowledge on the Investment Desk heads. Their attributes will need to be similar to those of the Chief Investment Officer but be more specialised in their designated area.

(4.9) The requisite skills of the Fund Manager are rather harder to identify. The importance of the Fund Manager depends on the extent of their delegated authority. Some organisations have a very tight 'house policy' in which the majority of decisions are taken centrally and implemented by Fund Managers. At the other extreme, decision taking may be very decentralised. This aspect will directly affect the type of individual required. In the former case, relatively junior and inexperienced staff may be perfectly acceptable. In the latter case, experience and calibre are necessary.

Depth of Resources

(4.10) Investment management is a business in which the benefits of economies of scale are considerable (although there are diseconomies also, as are outlined under 'Growth and Size' in Section 5). As funds under management grow it is practicable either to spread the research overhead across a greater revenue base, or increase the research overhead.

(4.11) Extending and deepening the investment expertise in an organisation is clearly of positive benefit in principle. It is not always of practical benefit because of the difficulties in organising the output of a larger group of people.

(4.12) The most helpful way that this issue can be addressed is in terms of the minimum standards of resources required. There are many organisations which do not have sufficient resources in certain fields to make outperformance likely. It is not easy to generalise, but for major markets (like the US, Japan or Europe) to be covered by 1 or 2 people, asks a great deal of the person or people concerned. It is fair to observe that relatively few organisations have strong teams in the overseas markets.

(4.13) The UK equity field appears well resourced in terms of the numbers of people involved. However, this can sometimes conceal the true position in which the UK equity Fund Managers are spending a considerable amount of time in direct client service leaving a relatively light treatment of UK stock selection issues.

(4.14) Often the issue of resources is considered by calculating the funds per manager ratio. Too much attention is paid to this ratio. Without knowledge of the operating structure of each organisation, there is little useful information in a direct comparison. However, there is no doubt that the underlying workloads of Fund Managers is an important determinant of their ability to perform well and service clients well. Research must identify this individually.

Continuity of Staff

(4.15) As mentioned earlier, the AT&T study concluded that continuity of key personnel was a critical determinant of success. In examining the most successful UK investment management organisations it is immediately apparent that this has also been the case here. The pattern of success seems to be one in which the top people have in a sense 'grown up together'. This has led to the emergence of a shared set of values, culture and sense of mission which has proved immensely valuable to the maturity and consistent quality of the organisation concerned.

(4.16) Clearly staff turnover is damaging to the orderly management of an investment organisation. Therefore, turnover is a severe handicap. However, turnover is also a symptom of problems as well as a cause. Organisations in which staff have lost confidence will naturally exhibit high turnover.

Conclusion

(4.17) Having well motivated high quality people is a close second behind the investment process in the attributes of successful organisations. The best people demonstrate their quality through an intense concentration on their work - they are passionately committed to the investment business.

(4.18) Quality requires to be most apparent at the top of the organisation. In investment management as in most human enterprises, a few select individuals are responsible for the majority of the achievement. There is no successful investment firm of which I am aware in which there is not one or more outstanding individual at the top.

(4.19) Many of the aspects of this appraisal inter-relate with other points. In other words, having good people is a necessary but not sufficient condition for investment success. The final issue, that of business management, is considered in the following section.

(5) BUSINESS MANAGEMENT

“Managers do things right. Leaders do the right things” - Warren Bennis.

(5.1) The principles of sound business practice apply, naturally enough, to investment organisations. Four principles come readily to mind:

- creation of an efficient operational set-up
- attention to profitability
- attention to client and market requirements
- forward planning

Increasingly organisations also require the flexibility to adapt to the fast moving requirements of the investment services market.

(5.2) Investment management is clearly a service industry, but it has obvious production overtones. Success is measured by the quality of the product - the performance achieved. This narrow definition of success leads investment organisations into difficulties because performance is so hard to control. Higher quality organisations take care to define their service broadly (to include administration, communication, an enjoyable working relationship) and strive to satisfy their clients right across this broad definition. This means that when poor performance occurs, as it inevitably must periodically, there is sufficient comfort with the other parts of the service to tide the client over.

(5.3) The particular requirements of investment management organisations are best covered by three areas:

- support
- culture
- planning

Support

(5.4) Investment managers work most effectively without too many outside distractions. Therefore, an organisation needs to have an effective service infrastructure. A Fund Manager needs secretarial, administrative, marketing and personnel support. Where this support takes a time burden away from him, he is naturally free to spend more of his productive time managing funds. Where this support is not in place or fails to help him, frustrations will build up. Therefore organisations in which you hear Fund Managers complaining, for example, that they cannot get a letter typed in a hurry are failing an important test. You would expect this point to be taken as read at all major investment organisations, but it is surprising how many do not have an effective infrastructure in place.

(5.5) Increasingly, the Fund Manager looks to technology for support. Wherever there is high quality technology there is still low quality usage. A proper support infrastructure provides the training and maintenance necessary to use technology more effectively.

(5.6) Too much insulation, though, is likely to be counterproductive. The Fund Manager needs to work with client service, marketing and administrative support. It is important to make a Fund Manager operate in a full service environment which is recognised as a profit centre. Without profit motivation, excesses occur and rational choices are less likely. If the Fund Manager fully understands the commercial reality in his part of the operation, his efforts will be more motivated and more focused.

Culture

(5.7) Culture is adherence to a shared set of values and a shared way of operating. Individuals who work for an investment organisation with a strong culture will generally share similar beliefs about:

- the way investment markets work
- the best way for funds to be run
- the best way for individuals to work

(5.8) Culture nurtures cohesiveness and continuity. Both these attributes are vital ingredients to a successful firm.

Strategic Management

(5.9) Investment organisations operate in a highly uncertain environment. Their earnings stream is volatile, both because of the market's performance and their own relative performance. They rely heavily for their key output on a few individuals who are often quite difficult to manage. In this problematic environment, good organisations tend to be those that keep a sharp sense of shorter-term direction and longer-term mission. Strategic management matters, less in the early stages of an organisation's development. It matters critically when that organisation reaches middle size (the rule of thumb for this would be 30 funds).

(5.10) Profitability is an important aspect to this. Organisations need to be healthily profitable in order to take measured long-term decisions rather than reacting too much or too adversely to short-term problems or issues.

Growth and Size

(5.11) In any enterprise, strategic management involves planning the resources to meet future requirements. In investment management the capital requirement is mostly human although we have already observed how high quality technology is increasingly important.

(5.12) Like most service industries which rely largely on human capital, investment organisations find it very difficult to grow at a rate faster than about 25 per cent per annum without major difficulties in capacity and quality control. Nevertheless, many investment organisations seek and accept growth in clients and funds at a faster rate than this. This is a dangerous practice.

(5.13) As is commented upon later, there is correlation between fast growth in business and poor subsequent performance. However, this has not universally been the case and there are important secrets as to how the growth battle might be won in practice:

- investing in capacity - hiring new staff ahead of the new business or improving the technology and systems to allow Fund Managers to cover more accounts
- maintaining quality - not compromising in the quality of new staff and not diluting the positive impact of the existing staff on the investment process
- solving the liquidity squeeze - the growth of funds will naturally squeeze the liquidity of an organisation's choice of stocks; adaptation of the investment process is required

(5.14) The above three points are very tough challenges for management to meet. It remains the case that successfully achieving fast growth is an 'odds-against' activity.

(5.15) The question often arises as to whether size of assets itself affects success. There is no intrinsic reason why any size of firm should not be successful. Larger organisations carry some advantages in the depth of the resources but some disadvantages in the limited investment flexibility that their asset base dictates. It remains the case that a successful organisation will grow as clients will be attracted to it for obvious reasons. If success is to be maintained, the investment process must evolve and adapt to the different operational requirements that come with size. Perhaps success is more easily achieved by the middle size firms which have the critical mass to operate with proper resources and a significant position in the market-place, but which retain the flexibility to make strong moves with appropriate conviction. However, without restricting new business, successful middle size firms become large firms.

(6) PERFORMANCE: CHANCE OR SKILL?

“Variability is the law of life” - William Osler.

(6.1) Before considering the search for successful investment management amongst performance statistics, it is necessary to address the major part that chance plays in the process.

Evidence of Chance

(6.2) Every measurement of performance comprises two components:

- a skill factor
- a chance factor

When performance is measured, the client should be most concerned about the skill factor. That is what will directly influence the performance in future. The chance factor is purely down to chance and while it has historic significance, it has little practical significance for the future.

(6.3) The importance of chance is apparent to anyone who has used performance statistics.

If we consider performance over one year periods, the chances of an excellent manager outperforming the market will be good but far from overwhelming. This is because performance is subject to variation well beyond any human's control or anticipation. Investment managers are not super-humans so superior performance cannot be manufactured.

(6.4) Consequently, there are many managers with above average skills who achieve below average results, and vice versa. This is very common over one year periods but progressively less common over longer periods. The longer the period, the less influence chance will have.

(6.5) Over a period of time a body of opinion has grown up to suggest that the chance factor is of a much greater order of magnitude than the skill factor, and some suggest it will drown the measurement of skill. Is this true?

Evidence of Skill

(6.6) There is clear evidence of skill in historic performance statistics. CAPS provided data on the performance results from their survey over the 5 years 1985/89 which covers over 600 funds, and over the five previous 5 year periods. Three sectors were analysed: Total Assets (excluding Property), UK Equities and Overseas Equities. Within these sectors, the numbers of managers in two groups were considered:

- the good performers; those with 4 or 5 years of above average performance
- the poor performers; those with 4 or 5 years of below average performance

(6.7) Considering first the figures for 1985/89, in each of the sectors the proportion of funds achieving this record was greater than we would have expected purely by chance. While the margin of difference is small, the size of the sample is substantial enough to suggest that there is some systematic effect at work. We show overleaf the results observed including the 95 per cent probability level. **There is statistically significant evidence of skill in the UK Equities sector. There is weaker evidence of skill in Total Assets and Overseas Equities. It is intriguing that there is statistical evidence of below average skills in the UK Equities sector and that the picture of skill is quite clearly symmetrical between good and bad.**

TABLE 6A

Proportion of Funds

1985/89	Total Assets %	UK Equities %	Overseas Equities %
Good Performers	19.9	23.2	19.9
Bad Performers	19.3	23.5	20.9
Expected value if skills were equal	18.7	18.7	18.7
95% Probability Level	21.4	21.4	21.4

(6.8) We can interpret the more extreme results for UK Equities as emanating from the pureness of the discipline. Results for the other two sectors involve the aggregation of disciplines, probably mixing some weak with some strong. These figures provide crude statistical support for the principle of specialisation.

(6.9) The results for previous 5 year periods are stronger for Total Assets (averaging 24 per cent and 20 per cent for good and poor performers respectively) and slightly weaker for UK equities (averaging 23 per cent for both good and poor performers).

(6.10) On the assumption that more than pure chance is at work, we can develop a model of performance patterns as follows:

- define Skill Factor for each manager as the annual expected outperformance (relative to the median)

- divide managers into 4 equal groups

Skill Factor

Quartile 1 - Very High Skilled	X
Quartile 2 - High Skilled	Y
Quartile 3 - Low Skilled	-Y
Quartile 4 - Very Low Skilled	-X

- assume that the dispersion of skill across the group of managers follows the familiar Normal Distribution

- assume that the 1985/89 figures for Good and Bad Performers are fair results

(6.11) Using a combination of binomial and normal probability distributions we calculate these results for X and Y.

TABLE 6B**Expected Outperformance due to Skill**

Skill Factor Quartile (mid-point)	Total Assets % p.a.	UK Equities % p.a.	Overseas Equities % p.a.
1	+0.7	+2.0	+2.0
2	+0.2	+0.6	+0.6
3	-0.2	-0.6	-0.6
4	-0.7	-2.0	-2.0

(6.12) The reason for the high figures for Overseas Equities is the more concentrated portfolios in this area. This means that a small amount of skill can lead to a greater performance gain.

(6.13) The search for managers whose skill is in the first quartile is clearly a very worthwhile pursuit if these figures can be sustained in the long-term. Just a 1 per cent per annum gain to a pension fund will usually reduce its long-term cost by between about 15 per cent and 20 per cent. However, these results must be considered alongside the influence of chance in order to conclude how easy it is to measure skill.

(6.14) The average performance during the last decade in each quartile observed in the period 1980/89 is given below in Table 6C. It should be noted that these results reflect some skill, but are dominated by chance. In the case of Total Assets, for example, the influence of chance is about four times the influence of skill.

TABLE 6C**Observed Outperformance due to Skill and Chance**

One Year Periods Quartile (mid-point)	Total Fund %	UK Equities %	Overseas Equities %
1	4.1	4.7	8.5
2	1.0	1.3	2.3
3	-0.9	-1.2	-2.5
4	-3.6	-4.4	-9.0

(6.15) By combining the results in Table 6B and Table 6C we can model the respective influences of skill and chance. In Table 6D below we have shown the expected outcomes of performance for each of the four skills groups. Figures in the diagonal running from top left to bottom right represent the proportion of managers whose results were a fair reflection of their skill. For example, the top left figure of 31 per cent suggests that 31 per cent of the top skills group would achieve top quartile results in the following year. Figures off the diagonal represent situations where the manager's results were either luckier or unluckier than their skill deserved. We have summarised the proportions in each of these two categories at the bottom of each chart. These figures have been calculated for Total Assets results only, based on past data for the period 1980/89.

TABLE 6D**Expected Outperformance relative to Skill: One Year Periods**

Skill Factor Quartile	Proportion of Managers Observed Performance Quartile			
	1 %	2 %	3 %	4 %
1	31	27	23	19
2	27	26	24	23
3	23	24	26	27
4	19	23	27	31

Proportion of Managers in 'Correct' Performance Quartile : 29%

Proportion of Managers in 'Incorrect' Performance Quartile : 71%

(6.16) Different figures emerge if we measure performance over a five year period. It is natural in this case to allow for the skill factor to change over the period. Skill tends to regress towards an average level although at a relatively slow rate. The results calculated from such a model are given in Table 6E below.

TABLE 6E**Expected Outperformance relative to Skill: Five Year Periods**

Skill Factor Quartile	Proportion of Managers Observed Performance Quartile			
	1 %	2 %	3 %	4 %
1	40	27	21	12
2	28	27	25	20
3	20	25	27	28
4	12	21	27	40

Proportion of Managers in 'Correct' Performance Quartile : 34%

Proportion of Managers in 'Incorrect' Performance Quartile : 66%

(6.17) The proportion of managers whose results fairly reflect their skills has risen from 29 per cent to 34 per cent. This is certainly an improvement but still demonstrates a very limited connection between skill and performance.

(6.18) To deduce with reasonable conviction that top quartile results were indicative of above average skill would take upwards of 15 years' results (possibly more depending on the extent to which skill changed over time).

(6.19) This lends support to the idea that past performance is an unreliable basis for selecting managers. For example, the chances of an above average manager in one five year period performing above average in the following five year periods are only 52 per cent - marginally better than using a pin across the whole field.

(6.20) However, this should not be taken to suggest that past performance is a valueless indicator. The chance of an above average performer in the last 5 years having an above average skill factor in the subsequent five years is close to 60 per cent - certainly a better basis for selecting than using a pin.

Performance Objectives

(6.21) The above results carry implications for the setting of performance objectives. In the current industry environment, it is unrealistic to expect clients to set performance objectives over anything longer than a five year period. As the 'signal' as to skill does not clearly emerge after even five years, it follows that the qualitative analysis of performance relative to objectives must be as important as the quantitative assessment.

(6.22) Time horizons for measurement have undoubtedly become shorter for most institutional funds. Three year objectives have become widely accepted. These shorter term objectives have shortened the time horizon for the managers' decisions. Psychologists would explain this in terms of the 'Principle of Interdeterminancy' - that the investment process is naturally geared to the period of measurement.

(6.23) Shorter time horizons for investment decisions are directly associated with higher turnover in funds. As investment management must be seen as a negative sum game, this is clearly damaging to investors' interests. The average Fund Manager is not able to get enough of his shorter term decisions right to compensate for the transaction costs involved. Furthermore, he is not making full use of the opportunities from inefficiencies in the market stemming from shorter term decisions.

(6.24) Successful investment management involves identifying a suitable time horizon and developing an investment process to suit it. I believe, that greater long-term returns will be achieved by increasing that time horizon beyond three years.

Conclusions

(6.25) There are some important results arising from this work:

(1) there is strong evidence of skill in some managers' performance - to have found otherwise would have been anathema to my beliefs and those of most investment managers;

(2) the impact of the highly skilled manager is financially very significant in the long-term - this means that the search for skill is a very worthwhile cause;

(3) the evidence of skill is most significant in the pure discipline of UK equities selection and least clear at the Total Assets level - this is an invitation to those that believe in their ability to identify skill to select specialists;

(4) skill is largely drowned by chance in shorter term measurement (say one year periods) and emerges only in the longer term - given that skill levels alter with time this suggests that performance can make only a small contribution to the appraisal of a manager;

(5) performance objectives should be set over time horizons long enough to allow skill to emerge - this means periods longer than the three years that has become the accepted practice.

(7) PAST PERFORMANCE

“Life is the art of drawing sufficient conclusions from insufficient premises” - Samuel Butler.

(7.1) The link between past performance and future performance has been widely discussed. However, there has been very little detailed research to examine the nature of this link.

(7.2) Recently, there have been strong suggestions that there is no direct relationship between past and future performance. If there is indeed no such relationship, this must suggest that all managers' returns are uncorrelated from one period to the next. The only other interpretation would be for some managers' returns to be positively correlated, others to be negatively correlated. There is no evidence, either statistical or intuitive to support this possibility.

(7.3) For there to be a total absence of correlation, one has to expect either for all managers to have the same level of skill or the manager's skill factor to decay very rapidly in short spaces of time. This suggestion strongly contradicts the judgements and intuition of most investment managers. Indeed, there are several obvious examples of investment groups who have been able to sustain their advantage in skills relative to the competition over a long period of time whose performance has been quite consistently above average. Intuitively, I believe there should be a link between past and future performance, albeit a tenuous one.

Testing the Link

(7.4) To analyse the link between past and future performance, two samples of data were taken:

- the performance of pooled pension funds from 1980-1989 (a sample of 24 managers supplied by CAPS)
- the performance of segregated pension fund managers from 1981/1989 (a sample of 20 managers aggregate figures taken from Watsons database)

The period was broken down into two parts. The 'past' was the period ending 31 December 1984. The 'future' was the period of five years from 1 January 1985 to 31 December 1989.

(7.5) The proportion of above average managers in the past period who achieved above average results in the future period was analysed. The results of this analysis are given below in Table 7A. Clearly the link between past and future is quite limited and there seem to be very significant random effects at work. This is entirely as expected after the result in Section (6.18).

TABLE 7A

	Segregated Funds			Pooled Funds	
	'Past' - Above Average	1981-1984 Below Average		'Past' - Above Average	1980-1984 Below Average
'Future' 1985/89			'Future' 1985/89		
Above Average	4	6	Above Average	8	4
Below Average	6	4	Below Average	4	8

(7.6) This is a very crude statistical test and a more thorough approach is to consider the correlations between the past and the future performance. These are tabulated in Table 7B. It can be seen that for pooled funds there is significant correlation between the past and future. The statistic, of R^2 , which is 11 per cent suggests in other words, that 11 per cent of the manager's future performance could be explained simply by past results. This is a small proportion but nevertheless a very important result. These results are consistent with those from the model adopted in Section 6.

TABLE 7B

	Segregated Funds	Pooled Funds
Correlation between 'Past' and 'Future' Performance	0.17	0.33
R Squared	3%	11%

(7.7) The positive correlation for pooled funds contrasts with the absence of significant correlation for segregated funds. There is no doubt that the segregated managers have changed more over this period than the pooled fund sample and therefore skill may have changed more quickly in time.

(7.8) The individual years' figures were studied in detail and it was apparent that in most years there were positive correlations occurring between results. This pattern of 'trends' followed by 'reversals' is fairly typical of market returns generally. The likely explanation is that managers will have a run of good (or bad) results which will continue until a major internal or external event disturbs the pattern. At this stage, performance may revert to average or overshoot beyond and a new pattern starts to emerge. An example of this pattern relates to several investment groups which can certainly attribute a change in their fortunes (both positively and negatively) to the effect of the market crash of 1987.

(7.9) The implications for this on the interpretation of past performance are very significant. First of all, it is important to recognise that past results will usually say something about the future (although the results for segregated managers were inconclusive here). Secondly, it must be recognised that past results give a maximum of perhaps 20 per cent of the information and the remainder of the insight to predict a manager's future performance must be found from other detailed research. Thirdly, at certain points in time, past performance may become a negative indicator. This occurs when something significant, either internally or externally, changes the pattern. Evaluating when this event might occur is clearly of great importance. Subjective judgement and intuition may be able to help in this regard. Greater research is required before any true objectivity can be used.

(7.10) There is an analogue in stock market analysis to this framework. Technical analysts (chartists) use highly intuitive processes that are built on the likelihood of past patterns of results being reproduced in future. Such techniques have been supported by recent research which suggests that markets from time to time do follow (semi) predictable patterns. The study of non-linear systems and chaos theory is likely to improve our understanding of these phenomena.

Variability

(7.11) There are two aspects of variability of performance. First, there is variability of manager's performance in time where volatility of relative results is the usual measure. Secondly, there is variability of performance within an investment organisation, often referred to as 'house spread' (although this is not a consideration for pooled funds).

(7.12) As regards variability of results in time, a priori there is no reason to expect there to be a direct link with performance - high skill or low skill managers would seem equally likely to have volatile styles. However, this is not the case in practice. Analysis shows that the higher the variability of performance, the greater the subsequent performance.

(7.13) The explanation for this link is likely to be that managers with the greatest degree of skill take more positive action than those with less skill. If a manager believes he has above average skills, then it makes sense for him to accentuate his competitive advantage by taking more positive stances in his decisions than his competitors. Naturally this style will lead to above average variability.

(7.14) The consequence of this is that it is difficult to find a highly skilful manager who will follow a very cautious path. This provides justification for index tracking managers who offer average performance but with virtually no variability. Relative to the low variability low performance managers that are quite common this is clearly good value.

Spread of Results

(7.15) The statistical analysis suggested that a wide spread of results within an organisation was not positively or negatively associated with future aggregate performance. However, this spread of results is a serious issue for those selecting segregated investment management services. In this situation, the buyer of such services cannot rely on house results as being representative of what he might have achieved in the past. There is an additional factor to take into account which is the impact of the individual Fund Manager. This factor clearly represents a risk to the fund but it also presents an opportunity. If there is a means to ensure that the Fund Manager proposed is one of the better managers at that organisation, the fund has benefited.

(7.16) The variations in results experienced in our sample of managers are tabulated below with a comparison of the average spread of all funds in the CAPS sample. The sizes of these figures for the spread of results are disturbing and I believe managers should be doing more to combat this problem. The figures are better for Overseas equities than for the other categories. This is most likely because the use of pooled funds in this sector introduces greater homogeneity. Greater use of pooled funds would help this problem in other sectors.

TABLE 7C

Inter-Quartile Spreads: 1985/89	Total Assets % p.a.	UK Equities % p.a.	Overseas Equities % p.a.
House Spread Average	1.5	1.5	1.9
CAPS Sample	1.8	2.6	4.4

(7.17) It is often said by managers that the spread of results may be wide in individual years but it converges over longer periods. This is indeed the case. However, there is no evidence that this convergence is anything other than the statistical influence of chance reducing in time. The magnitude of the spread over five years is still considerable at many organisations as is clear from the figures.

(7.18) The issue of the uniformity of the results should not be confused with customised benchmarks. Where the investment objectives for funds are the same (which they are in the discretionary sample analysed above), spread of results is undesirable. However where benchmarks are different, spread of results is inevitable.

Conclusion

(7.19) The important conclusions in this section are the following:

- (1) Past performance is an indicator of the future performance of an investment organisation. However, it only explains a maximum of 20 per cent of the future performance. The goal of research is to try to determine the other factors at work.**
 - (2) The main value in past performance analysis lies in the opportunity to analyse the investment process and form qualitative judgements as to the skill factors involved.**
 - (3) Variability of relative performance provides an important guide to the level of conviction that a manager adopts; consequently, higher variability managers tend to be among the most highly skilled.**
 - (4) Spread of results within an investment organisation adds uncertainty to the results produced and is undesirable. However, there is scope to gain the expectation of better performance by selecting individual Fund Managers within a particular organisation.**
-

(8) OTHER STATISTICAL MEASURES

“You don’t have to eat the whole ox, to know its tough” - Samuel Johnson.

(8.1) There are various statistical measures which may help to anticipate a manager’s future performance. In this research, I have tried a large number of tests to check whether such measures have any significant predictive power.

(8.2) In carrying out this analysis, I have had to keep mindful of the problems of limited data and the changing characteristics of the sample. Indeed, given the weak relationship between past and future performance, it is unlikely that any other measurable quantity will produce a strong link. Therefore, much of the interpretation of the results relies heavily at times on intuition.

People and Resources

(8.3) There appears to be a slight link between the number of individuals in the team and the results produced which supports the idea that strength in depth is helpful. The link was slightly stronger in overseas markets than in UK equities.

(8.4) As noted earlier, adding to the UK Equity Fund Managers generally just adds capacity to take on more funds. It also adds to the problems of managing a large team.

(8.5) There is a stronger link between changes in the team and performance. The negative impact of staff leaving an organisation is statistically significant. On the other hand, growth in staff is positively associated with performance.

Funds and Clients

(8.6) Total fund size and growth of business appear not to have much relationship with future performance. In both cases this would seem to reflect two factors which cancel each other out. Fund size helps resources but hinders flexibility. Growth in business helps keep a successful team together but causes new business strain.

(8.7) While there was no obvious link between new business growth and future performance there was a clear inverse link between fast new business growth and future performance.

(8.8) There was no link evident at all between funds per manager and either Total Assets performance or UK Equity performance. We commented earlier that the statistic of funds per manager means very little without knowledge of the operating structure of the organisation.

Fees

(8.9) There was no apparent link between the level of fees and performance. This suggests that investment management continues to be priced like a commodity without much differentiation according to quality. Naturally, if fees were based on a performance related scale, there would be a strong link.

Type of Organisation

(8.10) The major categories of investment organisations are banks and other financial conglomerates, insurance companies and independent groups. While there has been clear evidence of year by year differences in performance between the respective groups, there is no evidence of any longer term differences. The search for the best managers should consider all types of organisation.

Conclusion

(8.11) A variety of other tests were tried. The results were informative without ever being dramatic. However, it is clear that this type of research is an important contribution to the evaluation of managers. As the data-base of statistics grows, I believe it will be possible to use statistical methods to much greater effect.

(9) CONCLUSIONS: GROUND RULES FOR INVESTMENT MANAGERS

“There are no whole truths. All truths are half truths” - A.N. Whitehead.

(9.1) This qualitative research suggests that these are the ten attributes that successful investment organisations require:

Investment Management Process

- (1) **Philosophy:** Developing a framework for successfully exploiting market inefficiencies and meeting client objectives
- (2) **Research:** Making superior use of research either through access to higher quality research or through better use of generally available research
- (3) **Buy/Sell Disciplines:** Using a well-defined process for buy or sell decisions on securities and market sectors
- (4) **Decision Structure:** Adopting short lines of communication and individual decision taking in preference to committees where ever appropriate

People

- (5) **Quality:** Using high quality and generally experienced investment professionals
- (6) **Resources:** Having in-depth resources in the aggregate research effort and the client to fund manager ratio
- (7) **Continuity:** Keeping key investment professionals

Business Management

- (8) **Culture:** Maintaining terms and conditions, working environment and code of accepted practice that get the best response from investment professionals
- (9) **General Support:** Ensuring the investment team is well supported in all respects (technology, communication, training, secretarial, etc)
- (10) **Strategic Management:** Planning the investment resources to meet future needs, keeping the size and growth of funds under management consistent with operating efficiency and liquidity constraints.

(9.2) I have discussed this list with top level individuals at all the major UK investment houses and collected responses as to which they believed to be the most important. In summary, this was the order in which the attributes were rated:

- | | |
|-------|-------------------------------|
| 1st: | Investment Philosophy |
| 2nd: | Quality of People |
| 3rd: | Continuity of People |
| 4th: | Investment Decision Structure |
| 5th: | Research |
| 6th: | Culture |
| 7th: | Strategic Management |
| 8th: | Resources |
| 9th: | Buy/Sell Disciplines |
| 10th: | General Support |

(9.3) These ratings appear very fair. However, I believe that Strategic Management is vital as the organisation grows and may be underrated in the list. I also believe that Buy/Sell Disciplines are not vital to top quality organisations but for the majority of organisations that are not in this position it is very important. Again, this may be underrated.

(9.4) Giving a list of attributes to be adopted often makes the task of success seem easier than it really is in practice. It is therefore appropriate to give a list of the faults that most investment organisations have that make the achievement of nirvana so difficult.

Faults

(9.5) Not playing to strengths

No organisation has a monopoly on investment talent. All organisations have weaknesses as well as strengths. Investment management is staffed by an army of highly intelligent well motivated individuals, so what may seem like a strong team may be weak relative to the competition. The recognition of weaknesses should lead to a more passive style in some areas or more centralised control. All too few organisations will 'own up' externally, or more importantly internally, to such weaknesses.

(9.6) Self delusion

Investment markets are often 'wrong' and those who capitalise on this effectively tend to be the most successful investment organisations. However, those who spend too long waiting for markets to become 'right' will have the story but not the results to prove their insights. The majority of managers, through ritual and inflexibility of thinking, tend to accept evidence that confirms their view of the world and tend to dismiss any that contradicts it ('cognitive dissonance' to a psychologist).

(9.7) Following not leading

Leadership is a difficult craft in investment because the world is so uncertain. Probably the best decisions are only 60 per cent-40 per cent in your favour, so the discomfort of following strong convictions may not be thought worth taking. In practice, managers hedge their bets and often spend too much time following rather than setting fashion. Followers inevitably underperform.

(9.8) Misunderstanding human responses

An understanding of psychology seems more and more important to operate effectively in investment markets. However, there are very few investment professionals with well-developed ability in this field. Most managers cannot judge dispassionately the perceptions of their colleagues and subordinates or the human response of the market.

(9.9) Information overload

No mind can process the amount of information now passing the Fund Manager's desk. Investment organisations have a choice to make; either they stick to a simple basis for taking decisions, in which they can easily throw away much of the information and research being received; or, they must marshal their thinking centrally and process this information in an orderly, and presumably quantitative, process. Most organisations appear to fall between the two.

Conclusion

(9.10) The successful investment organisation of the future will:

- **have an excellent investment philosophy and be prepared to change it as the world catches up with it**
- **build its strategy on independent thinking and take decisions with conviction**
- **have top quality people who are highly focused and intense individuals and view investment as a passion as well as a career**
- **be quantitatively minded (or have sufficient flair as not to need quantitative disciplines)**
- **know where their business is going and what steps they have to take to get there.**

(10) CONCLUSIONS: GROUND RULES FOR SELECTING INVESTMENT MANAGERS

“In the face of uncertainty, the wise decision is the one we can live with serenely - no matter how unlucky it may turn out to be” - who quoted this?

(10.1) I conclude with a description of the ground-rules that a buyer of investment services might consider in the process of selecting an investment organisation.

(10.2) The foundation to the process of selecting managers lies in recognising what makes a successful manager. Therefore, thorough research into investment organisations provides the only realistic means of selecting effectively.

Ground Rule 1 - Use a Specialist

(10.3) Research into investment organisations requires such highly specialised skills and experience, it is unlikely to be successful without the use of a consultant specialising in the field.

Ground Rule 2 - Plan Ahead

(10.4) Every process should start with a description of the role of the manager. This description is a useful tool throughout the process and can become more detailed as views of what is required are coloured by experience. It is unrealistic to expect the original specification to be detailed. However, it is important that the type of performance required (in particular the risk profile) is identified early.

Ground Rule 3 - Spend Time

(10.5) There is no substitute for time and thoroughness in selecting a manager. The process should be divided into five stages of appraisal:

(1) Past performance

Past performance acts as a crude ‘proof statement’ that the management system has worked in the past. It is an unreliable future indicator, but to appoint a manager without a good performance record requires greater conviction in the other stages of the appraisal. At the very least a good performance record provides a measure of ‘comfort’.

(2) Quality appraisal

The appraisal of quality is dealt with in detail in Sections 3 to 5. The process is a continuous one. Organisations change over in time and naturally, their quality changes also. This is the area where a specialised consultant has most to contribute.

(3) Role test

By this I mean, how suitable is any organisation for the role in question? This appraisal involves answering four basic questions:

- is the organisation an appropriate choice in general?
- can the organisation achieve the target performance?
- is the risk profile of the manager acceptable to the client?
- is the fee proposal suitable?

These questions can only be considered lightly from a written submission of the managers. They can only be appraised properly by meeting with the managers.

(4) Service

Earlier, I identified service as comprising administration, reporting and portfolio 'tailoring'. These are difficult areas about which to form a judgement. The most useful information will come from the recommendations of others who have experience of the service.

(5) Team

The range of results experienced within organisations has been shown to be very wide. Some of this relates to chance factors but much relates to skill. Therefore, it is vital that attention is given to selecting an appropriate individual as the Fund Manager. An important part of the selection process is to appraise the team proposed by an organisation for a particular fund. In most organisational structures, the Fund Manager is the most important member of the team (to that client).

(10.6) These stages should be considered as a sequence. The first two steps do not generally require much specific input from a buyer. These stages are best seen as 'pure' research to thin down the field to manageable numbers. The latter stages of the process progressively involve the specific needs of the buyer.

Ground Rule 4 - Keep Detached

(10.7) Investment managers sell hope. The process by which investment organisations market their services has undergone a radical restructuring and is now highly professional. With such an intangible product to sell, there is generally a large difference between what a product sounds like and what it is actually like.

(10.8) In my experience, buyers of investment services frequently misunderstand the basic messages of investment organisations and therefore gain a false impression of what they are buying. The only way to avoid this mistake is by keeping as objective as possible throughout the process.

(10.9) Some suggestions may help in this regard.

- the use of 'score-cards' to analyse the attributes of managers is helpful. The attributes for scoring can come largely from the description of the role and from the appraisal stages
- formal presentations (the manager's agenda) should be kept short; questioning and discussion (the client's agenda) is more useful
- client questionnaires (preferably short ones) are more helpful than brochures. Meetings are more helpful than written material
- selection processes are no place for large committees. A small well-informed sub-group should carry out the task and give recommendations to the full body

Conclusion

(10.10) This section is not intended to serve as a full description of 'dos' and 'don'ts' in selecting a manager. A considerable amount has been written on this already. What I have sought to achieve is some guidance as to how successful selection processes will be organised.

(10.11) I close with a self-serving remark. The reason that a high measure of success in manager selection can now be achieved is that research into managers has come of age. Consultants are now starting to tear up the largely sterile process of collecting questionnaire responses and are carrying out proper research. The 1980's were notable for an obsession with collecting information about managers related to their past. The 1990's will involve detailed research and analysis to identify what managers are likely to achieve in future.