

Module 25: Investment Manager Selection

Module 25.1: Manager Selection Process.

25.a : Components of manager selection process (including due diligence).

Manager Universe.

- consists of manager suitable for the portfolio in terms of objectives & constraints of the IPS. & will manage the appropriate balance active vs. passive.

Quantitative Analysis

- Via performance attribution & appraisal, one can distinguish b/w managerial skill vs. luck.
- Capture ratio would examine performance in good & weak market conditions.

Qualitative Analysis.

- 2 main issues: 1) Continuity of returns 2) Risk Assessment
- Continuity of returns: Look at 4 Ps (philosophy, process, people & portfolio)
- Risk assessment considers the firm & whether it's robust & performing well.

25.b. Type I & II errors

		Realization	
		Below expectation	At / Above Expectation
Hire / Retain	Type I error	Correct	
Not Hire / Fire	Correct	Type II error	

/ /
Type I receives more attention than Type II

Type I : error of commission (more visible).

Type II : error of omission (more implicit / opportunity cost, difficult to determine)

Preventing Type II errors.

Obvious: track subsequent performance of manager not selected.

Costs of Type I & II errors.

Type I error is associated w/ retaining weak managers

Type II error is associated w/ not retaining strong managers

Assuming 2 separate groups of managers (i.e. strong & weak), the greater the diff. in sample size & mean, the greater the cost. The greater the dispersion b/w. strong & weak managers, the easier it is to distinguish b/w strong & weak & therefore lower the error & expected cost.

Efficient market \rightarrow harder to achieve alpha

\rightarrow lessen the cost of Type I errors.

Mean-reverting \rightarrow Type I may occur when firing a poor manager only to have performance improving subsequently.



MODULE QUIZ 25.1

1. Quantitative analysis of the manager selection process includes:
 - A. defining the universe.
 - B. evaluating a performance appraisal.
 - C. performing investment due diligence.
2. The difference in expected cost between Type I and Type II errors is:
 - A. higher the lower the perceived difference between the distribution of skilled and unskilled managers.
 - B. lower the greater the perceived difference between the distribution of skilled and unskilled managers.
 - C. higher the greater the perceived difference between the distribution of skilled and unskilled managers.
3. A return distribution of skilled managers that is not distinct from the return distribution of unskilled managers, most likely implies a:
 - A. highly inefficient market.
 - B. low opportunity cost of not hiring a skilled manager.
 - C. high opportunity cost of not hiring a skilled manager.

1. B
2. B
3. B

Module 25.2 : Approaches to Manager Analysis

25.c : Uses of returns-based & holdings-based Style Analysis

RBSA (returns-based style analysis)

- estimates portfolio sensitivities to security market indexers for a set of key risk factors.
- risk factors are estimated (rather than using predetermined style categories)
- top-down in nature & need little additional data.
- can determine the key risk factors & return drivers.
- has objective data & allow comparability b/w managers.

Drawbacks :

- lacks precision (b/c it assumes portfolio is static for the period) & does not work well for multi-period investment decisions.
- stale prices can underestimate risk exposure & decrease report timeliness

HBSA (holdings-based style analysis)

- estimate risk exposure using a bottom-up approach
- more appropriate for equity-based strategy.
- drawback:
- more computational complexity.
- stale prices can understate risk exposure & decrease report timeliness

25.d: Use of capture ratio, drawdown

upside capture ratio (UC) : capture when BM has \oplus return.

downside capture ratio (DC) : capture when BM has \ominus return.

capture ratio = UC Ratio / DC Ratio.
↑
measure of return asymmetry

capture ratio $> 1 \Leftrightarrow$ positive asymmetry / convex shape
 $< 1 \Leftrightarrow$ negative asymmetry / concave shape

if positive asymmetry, need to examine if investment strategy is naturally convex or if convexity occurs b/c of manager skill

/ /

When betas are increasing (decreasing), momentum strategies should have higher (lower) UC than value-driven strategies.

A low-beta (high-beta) strategies will have lower (higher) UC & DC. Therefore, CR can be used to confirm the investment strategy.

Drawdown.

- total peak-to-trough loss
 - Drawdown duration = total time from when drawdown begins to when drawdown recovers to zero.
 - useful for ID-ing poor / poorly executed strategies.
 - fine line b/w self-preservation & risk management.
 - lower risk tolerance / shorter time horizon
- ⇒ smaller / less extended drawdowns.



MODULE QUIZ 25.2

1. Which of the following statements is *least likely* an advantage of HBSA over RBSA?
 - HBSA is a more precise tool.
 - HBSA is generally easier for equity strategies.
 - The data required for HBSA is generally easier to obtain.
2. A manager whose relative performance is better during market upturns *most likely* has a capture ratio that is:
 - equal to one.
 - less than one.
 - greater than one.

1. C

2. B

Module 25.3 : Evaluating Managers.

25.e : Investment Philosophy & Investments decision-making process.

Investment Philosophy

if believe market is efficient

⇒ passive strategies & earn risk premiums

2 broad types of inefficiencies :

1. behavioral (mispricing caused by other investors & their biases)
2. structural. (i.e laws & regulations)

Investment Decision-making process.

1. Idea Generation
2. Idea Implementation
3. Portfolio Construction
4. Portfolio Monitoring

25.f : Costs & Benefit of Pooled Investment Vehicles & Separate Accounts.

SMA holds the fund of one investor in a separate account so a key analysis is the cost-benefit trade-off of holding investment in a SMA.

SMA cons: higher transaction cost
 pros: control, customization, tax efficiency, separate reporting, transparency.

SMA requires an extra layer of due-diligence



MODULE QUIZ 25.3

1. Passive strategies earn risk premiums based on bearing:
 A. systematic risk only.
 B. unsystematic risk only.
 C. both systematic and unsystematic risk.
2. Which step in the investment decision-making process focuses on the attributes of information in exploiting inefficiencies?
 A. Signal capture.
 B. Signal creation.
 C. Portfolio construction.
3. One reason for an investor to choose a separately managed account over a pooled investment vehicle would *most likely* include the investor:
 A. is tax exempt.
 B. desires lower costs and fees.
 C. desires real-time details on investment positions.

1. C

2. A

3. A

Module 25.4: Manager Contracts & Fees.

25.g: Compare types of investment manager contracts.

Liquidity

Closed-end funds & ETFs have the highest liquidity

Investments held in limited partnership structures usually involve investment capital that is tied up for more time.

limited partnership key advantage: ability to have a long investment horizon, not allowing investors to overreact to short-term aberrations.

limited partnership key disadvantage: impaired ability to change portfolio allocations or meet sudden liquidity demands.

25.h: 3 basic forms of performance-based fees.

Management Fees.

Basic Forms

3 basic forms of performance-based fees:

- ① Symmetrical structure w/ full upside & downside exposure:

Fee = base + performance sharing

(greatest alignment b/w investor & manager incentives but increased risk to the manager)

- ② Bonus with full upside & limited downside exposure:

Fee = base + max (performance sharing, 0)

- ③ Bonus with limited upside & downside exposure:

Fee = base + max (performance sharing, 0)

OR.

base + min (performance sharing, limit).

Call Option

25.i : Analyze & Interpret a sample performance-based fee schedule.

Figure 25.4: Sample Performance-Based Fee Schedule

Panel A. Sample Fee Structure

Standard fee	0.50%
Base fee	0.25%
Sharing*	20%
Breakeven active return	1.50%
Maximum annual fee	0.75%

Panel B. Numerical Examples for Annual Periods

	Active Return		
	$\leq 0.25\%$	1.50%	$\geq 2.75\%$
Billed fee	0.25%	0.50%	0.75%
Net active return	$\leq 0.00\%$	1.00%	$\geq 2.00\%$

* On active return, beyond base fee.

The fees is bonus w/ bonus upside & downside exposure. There is symmetry within the active return range of 0.25% & 0.75% & centered around a breakeven active return of 1.50%.

$$\begin{aligned}\text{Breakeven return} &= (1.50\% - 0.20\%) \times 0.20\% \\ &= 0.25\%\end{aligned}$$

$$\begin{aligned}\text{Total Billed fee} &= \text{base fee} + \text{performance fee} \\ &= 0.25\% + 0.25\% \\ &= 0.50\% \text{ (same as standard fee!)}\end{aligned}$$

**MODULE QUIZ 25.4**

1. Which investment fund generally has the *least* amount of liquidity?
 - A. Hedge fund.
 - B. Closed-end fund.
 - C. Private equity fund.
2. Which of the following fee structures *most likely* has no impact on the volatility of a portfolio's net returns?
 - A. Incentive fees only.
 - B. Management fees only.
 - C. Neither incentive fees nor management fees.
3. Fund X earns a -3% gross return for the year. The computed management fee is equal to a base fee of 2% plus a 20% sharing of both positive and negative performance. The sharing is based on return net of the base fee. What is Fund X's total management fee for the year?
 - A. 1.0%.
 - B. 1.4%.
 - C. 2.0%.
4. Fund Y earns a gross return of 12% for the year, while the relevant benchmark earns 3%. The computed management fee is equal to the higher of either a base fee of 0.4%, or base plus a 20% sharing of positive performance, up to a maximum annual fee of 2.9%. The sharing is based on active return. What is Fund Y's total management fee for the year?
 - A. 2.2%.
 - B. 2.8%.
 - C. 2.9%.

1.

2.

3.

4.