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SEI Manager Research

Lessons Learned: Enhancing Our Decision-Making

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Snapshot

- SEI Manager Research reviewed 66 strategy downgrade rationales from 2017 to 2019 across all asset classes in an effort to identify recurring themes.
- We identified 40 distinct downgrade rationales, which we used to build a lessons-learned checklist that has been formally incorporated into our research process.
- We expect this checklist to evolve over time as we refine our decision-making process.

In early 2020, SEI Manager Research undertook a first-of-its-kind project for our team: reviewing investment manager downgrades made between 2017 and 2019 to see if we could use them to improve our decision-making process.

Background

As part of our downgrade process, analysts must provide a rationale to the Manager Review Committee that explains why they are seeking such an action. To us, a downgrade is not necessarily related to poor investment performance; it may be due to a number of reasons, such as personnel changes, style drift or changes in the broader investment environment.

What we learned

We reviewed the collection of our downgrade rationales from 2017 to 2019 across 66 strategies covering all asset classes overseen by Manager Research in an attempt to identify common themes.

Our research uncovered 40 distinct downgrade rationales, which have formed the basis of a lessons-learned checklist that we have formally incorporated into our research process. We view this checklist as a way to highlight potential evolving risks to a strategy and believe it should help us improve our hiring and selling discipline over time.

Our analysts now complete this checklist not only during the initial recommendation of new strategies, but also during the annual strategy recertification process. The components of the checklist align with the seven key evaluation criteria that we use to assess all managers:

- Firm
- Product
- People
- Philosophy
- Process
- Portfolio construction and risk management
- Empirical support

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Many of the points on the checklist reflect our historical considerations in our manager evaluation process. The benefit of this approach is that it has prompted us to not only revisit whether we should place more emphasis on these points when hiring or removing a manager—but to also think more creatively about how we might assess some of these points.

Lessons learned checklist examples

Below are examples from our checklist—one for each key evaluation criterion that we use to assess managers, accompanied by a description of how we have evolved our approach to better capture the risk associated with each respective point.

Firm
A number of downgrades over the last three years were a result of cultural shifts within an organization. Examples include a culture that became too sales-driven (leading to portfolio managers departing to work at a more investment-led firm); an organizational change that disrupted the focus of key investors/teams (such as a merger/acquisition); and internal tensions between equity owners on the direction of the business, which led to elevated levels of management turnover.

Checklist question
Does the culture of the firm promote investment professional stability?

How we have evolved our approach
We now place more emphasis on meeting with non-investment members of an organization's senior management team (or individuals to whom the portfolio manager may report). We also now place greater emphasis on assessing the evolution of a firm's culture and are more likely to pass on a manager if there is evidence of internal tension.

Product
Capacity is always a consideration for investors. If a strategy gets too large, its performance may deteriorate. That said, small strategies also face challenges—typically with respect to resourcing, access to markets and higher risk of closing.

Checklist question
Has the product grown to such an extent that the portfolio is no longer nimble enough to execute trades that have historically added value?

How we have evolved our approach
Measuring capacity can be difficult, as it is a function of portfolio construction, manager style, trading capabilities and opportunity set. To address these challenges, we have developed in-house frameworks across a range of fixed-income asset classes to provide estimated capacity (with a similar approach in development for equities). We commonly leverage third-party risk tools—such as BlackRock Solutions—to help measure the liquidity of a portfolio.

With respect to strategies that have a small amount of assets under management, we have added a criterion for product viability to PRISM, the proprietary quantitative scorecard our team uses to codify our assessment and compare managers on a like-for-like basis. PRISM also provides transparency to the analyst's conviction for a given strategy.

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People
Our research has shown that staffing changes can materially impact a team's culture. We have also noted that tension within a team can often rise as a result of promotions (or, conversely, a lack of promotions). This can foreshadow future turnover or reduce team productivity on account of increasing disillusionment.

Checklist question
Has a recent promotion potentially had a detrimental impact on the culture of the team?

How we have evolved our approach
While we have always met with junior team members, we now focus more on internal team cultural dynamics and how they view the team structure. For example, we have been spending more time sitting in on internal meetings to better understand team dynamics. We are also more wary about junior team members taking over a product following the departure of a senior member of an organization. Accordingly, we have added a criterion that addresses team culture to our PRISM scorecard.

Philosophy
Many of the portfolio managers with whom we work started their careers as specialists in a particular asset class. Over time, they may have been asked to run strategies in other asset classes. For example, a U.K. fixed-income specialist manager may have been tapped to run a European fixed-income strategy. We have noted that managers tend to take the philosophy that worked well for them in their original asset-class specialty and apply it to other strategies they run—where it may not work as well. We note that this sort of philosophical misalignment is something we often witness more with fixed-income managers.

Checklist question
Has the philosophy been ported over from another product or asset class with little regard for the intricacies or nuances of the asset class in which the team actually invests?

How we have evolved our approach
We now place a greater emphasis on understanding the intricacies of a manager's investment philosophy and how appropriate it may be for a given asset class given the unique aspect of each market and its technicals (such as different price-incentive buyers, forced sellers, trading costs, and so forth). Using our risk systems, we are able to closely examine a manager's portfolio to understand its alignment with the original philosophy in the new asset class.

Process
We often see managers behave in a manner inconsistent with what we might expect, given their style. In many cases, this can be linked back to well-known behavioral biases, such as endowment bias, anchoring and more.

Checklist question
Does the manager exhibit any of the common behavioral biases associated with their investment style (for example, falling in love with a position, loss aversion, and so forth)?

How we have evolved our approach
We have developed a proprietary decision-making grid to help us assess how a manager reacts to a challenging period of underperformance. We have also developed buy/sell tools to assess trading behavior on individual securities. Lastly, within our PRISM scorecard, we now disaggregate portfolio manager attributes into six criteria. We believe this may provide some insight into which managers may be more likely to exhibit behavioral biases based on our view of their thoughtfulness as investors.

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Portfolio construction and risk management
Macro investing (such as forecasting interest rates and country growth rates) is tough. While we think a number of managers have a competitive advantage in forming macro views, we also believe there is an even smaller subset of managers who can translate their macro views into trade ideas that should capture alpha if the macro view is correct. Essentially, we believe there are two key components of a successful macro investor. The first is getting the macro call right. The second is positioning the portfolio in such a way that allows it to benefit from that macro call.

Checklist question
Is there deviation between the formation of macro views and how they are expressed in the portfolio?

How we have evolved our approach
Using third-party systems (such as BlackRock Solutions and FactSet), we are able to stress-test a portfolio based on potential future market conditions to determine if it will move in line with expectations if a manager's macro view plays out. In addition, we now place more scrutiny on trade construction, particularly in fixed income.

Empirical support
Sometimes, managers react to previous performance in a way that is inconsistent with what we view as appropriate. Examples include cutting risk after a period of strong performance to "lock in" alpha, despite ample opportunity to add more alpha, or adding risk after a period of poor performance to try and "catch up" returns with an alpha target. Some managers have a captive client base in which the main risk to the business is outflows (which are usually the result of significant underperformance); therefore, we see some managers in this category perpetually running low amounts of risk.

Checklist question
Have we seen evidence that recent poor/strong performance may have caused the manager to change its risk profile or other exposures to broad factors that are inconsistent with what we would expect?

How we have evolved our approach
We have quantitative tools to analyze trading patterns, assess buy and sell timing and to understand characteristics of securities at purchase and at sale (and to see if those are different from a historical basis). We have also developed SEI custom peer groups to allow us to better compare managers against appropriate peers and to understand whether performance has been favorable or unfavorable given the manager's style. We also have an internal library of SEI equity factors that help us evaluate a manager's style exposures over time.

Conclusion

In our view, our lessons-learned exercise not only provided us with one-time valuable perspective on how to improve our decision-making; our findings from this exercise were meaningful enough to warrant incorporating into our approval and review processes. We expect our checklist to evolve over time as we refine our decision-making process.

With more than 30 years of experience in assessing investment firms, SEI Manager Research is tasked with sourcing skillful managers that help to meet our clients' investment goals. To that end, we look to continuously learn from our experiences and to improve our processes. We view our lessons-learned checklist as one way to apply the knowledge we have gained through the years to benefit our clients.

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