In defence of manager research

Don Ezra | Russell Investments | 01 October 2015

Three Oxford University professors wrote a research paper in 2013[1] that severely criticised consultants for failing to pick winners via their fund manager research. *The New York Times* carried a piece on the paper[2] with no consultants willing to say anything in their own defence. In the blogosphere, the comments about consultants were scathingly and insultingly negative.

One of the authors was scheduled to present that paper at a conference at which I was also participating, but in a different session. So I suggested to the conference organisers that the author's session might be more fun if, after his presentation, I could be given 10 minutes for rebuttal, followed by a general audience discussion. The organisers and the author agreed. And, the session was indeed great fun and generated a lot of views from the floor.

PART 1: THE ACCUSATION

The Oxford paper is available online, if you want to read it in its entirety. Here, I will attempt to summarise its findings and conclusions.

The authors begin by examining the role of investment consultants in selecting fund managers. Using data from a comprehensive *Pensions and Investments* survey of investment consultants[3] the authors conclude that the role of consultants is important, even crucial.

The numerical data used by the authors comes mostly from Greenwich Associates' surveys between 1999 and 2011, and covers most of the consultant industry as measured by assets under advisement. (Before 1999, there was no information identifying which products were recommended.) The authors focused solely on long-only US equity products. Within that asset class, they examined seven different market-cap-style sub-categories. Consultants provided a short list of recommended products each year, in the data set, with ratings divided into multiple factors, some of which in turn are combined by the authors into what they call soft factors (clear decision making, capable portfolio manager, consistent investment philosophy). The authors also used data from eVestment on the returns of institutional US equity funds for the same period.

And then the rubber hits the road.

First, the authors examine what drives consultants' recommendations. They explain the equation they use to fit the data and then conclude that recommendations are at least partly

explained by past good performance and, to some extent, by service factors - but the most important driver of recommendations is the set of soft factors.

Second, they examine the flow of assets. Again, they explain their equations and conclude that changes in investment consultants' recommendations have a large and significant effect on flows into institutional investment products.

Third, they examine fund performance. They weight performance according to the extent to which a product is recommended, in the aggregate, in the given year. They use equations to identify the true alpha (that is, risk-adjusted return after seeking what is in retrospect the best fit of cap size and style indices to each set of returns) in each relevant case - and they use many different factor models along the way.

In this way, they obtain many estimates of alpha, distinguishing the aggregate of recommended products from the aggregate of non-recommended products. They also test value-weighted (that is, weighted by the size of the assets in the products) as well as equal-weighted estimates of aggregate alpha.

The conclusions regarding equal-weighting are:

- "The portfolio of all products recommended by investment consultants delivered... returns... lower than the returns obtained by other products available to plan sponsors, which are not recommended by consultants."
- "When we risk-adjust returns using the Fama-French three-factor model, or Carhart's four-factor extension, recommended products obtain an alpha... still significantly lower than the alpha obtained by non-recommended products."
- "Risk-adjusting returns using benchmarks chosen to match the products' style and market capitalisation delivers almost identical results."

And regarding value-weighting:

- "When we perform the same analysis on a value-weighted basis, recommended products still obtain lower returns (or CAPM alphas) than those obtained by non-recommended products, but outperform them based on a three- or four-factor model."

And so their overall conclusion:

- "Our results suggest that investment consultants are not able consistently to add value by selecting superior investment products."

After examining the data and proclaiming that backfill bias in the data is not a problem, they draw together their conclusions, including the statement "we find no evidence that consultants' recommendations add value to plan sponsors."

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I observe that this is subtly different from the overall conclusion cited earlier - and, the difference is fundamental. Above, the phrase "not able to add value" is qualified by the phrase "by selecting superior investment products". Superior to what? It's unstated. The evidence presented is that it's not superior to selecting non-recommended products. Nowhere is there evidence that the alpha from recommended products is negative. Yet "no added value" (without a qualifying phrase) surely implies negative alpha. The benchmark for adding value is zero alpha, not "the result of some other selection process".

Perhaps not surprisingly, it was the twisted conclusion implying negative alpha from recommended managers that the world seized on. The authors naturally sought publicity and got it.

In *The New York Times*, Andrew Ross Sorkin labelled consultants' fees as "worthless". He quoted one of the authors as saying "It's a waste of time listening to consultants. It's a service that's useless." (By now the implied negative alpha has been expanded to include everything consultants say.)

This is a subject dear to my heart. In my days at Russell Investments, I did what I believe was the first ever systematic study of results rather than anecdotes[4]. I also co-wrote a paper with Geoff Warren that said passive management should be the default choice, but we identified many circumstances in which active management should be chosen[5]. And, in my (semi)retirement, Russell Investments published a further paper of mine that provided insights for evaluating active management[j].

I stepped up to the plate.

PART 2: REBUTTAL IN DEFENCE

To lighten the atmosphere, I used parliamentary tradition, addressing my remarks to the Chairman rather than to the audience, and referring to my opponent as the Honourable Member from Oxford. Here's what I said"

> Mr Chairman: In the tradition of the Oxford Union, since the Honourable Member is from Oxford and, even more appropriately, in the tradition of the Cambridge Union, which preceded the Oxford Union and was the model for its development (and I am a Cambridge graduate) - Mr Chairman, in that fine tradition, I rise to make the case in favour of investment consultants.
>
> Let me start with the observation that the Honourable Member has put his case a lot more forcefully in public. In a newspaper interview, he was quoted as saying: "It's a waste of money listening to consultants. It's a service that is useless." And, in turn, that attitude led to comments in the blogosphere like: "There's no time like the present to fire your consultant." and "The pension

consulting industry: a cesspool by any other name would smell as rotten." Strong words, Mr Chairman!

And I intend to refute them – and go further. I will show that the Honourable Member should have reached a conclusion that is 100% in the opposite direction, based on this own data – that he stands condemned out of his own mouth!

Let me outline my argument.

First, I accept all his numerical findings. All of them. It is the conclusions that form a nonsequitur. And, since I am old enough to have had to study Latin, let me translate that phrase, for the Latin-challenged – it means, "It does not follow."

I will demonstrate that the right conclusion from the data studied is that the manager research advice provided by consultants is well worthwhile and profitable for sponsors.

Finally, I will express sympathy for the Honourable Member's plea for consultants to make the performance of their buy-ranked managers public. And I will explain why, in my own firm, I tried to do that, and failed.[6]

I'll start with the findings, of which three are fundamental.

First, he says that sponsors rate consultants as crucial, and their decisions are driven by consultants' recommendations. So it should be. A fiduciary's duty is not to do everything, but to see that everything is done. Most plan sponsors can't afford a large in-house staff. So they should be using consultants. Their process is good.

That leads to the next finding, which relates to the results. A good process doesn't guarantee good results. And here the finding seems unequivocal. Using Greenwich Associates data for both sets, he finds that results from recommended managers are worse than results from non-recommended managers.

I assert that that's irrelevant. The need for demonstrable process (which is essentially the legal definition of prudence) means that non-recommended managers become irrelevant. The only relevant comparison is between recommended managers and passive management. (And even that is raising the bar, because in the absence of consultants, look at retail choices to see what people tend to do. They tend not to go passive!)

Consultants do a lot of research. Among many aspects they look at, they check whether a manager had a distinct, explainable process, followed consistently. They check whether the people who produced the performance are still there, in positions in which their influence still holds. And, they check whether the market favoured that style at the time the performance was produced.

On the basis of these, and other, investigations, they make their recommendations for the future. That restricts the choices. But that's good process.

Mr Chairman, I'd love to get the Honourable Member in the witness box. "So, witness, you didn't check those obvious non-performance-related things? What did you do, then? Did you just assume that past performance is a reasonable guarantee of future performance, ha ha?"

I'm not a lawyer, but I'd enjoy seeing that line of questioning conducted by a skilled lawyer. He would make mincemeat of the witness! And the Honourable Member would surely have to resign.

So, the only relevant question becomes: did the consultants' recommendations add value? Frankly, among all the numbers in the paper, it's tough to find the relevant finding.

The Honourable Member says that his equally-weighted outcomes are worse for consultants than the dollar-weighted outcomes.

OK, then, let's go to Table V, Panel B, equally-weighted outcomes[7].

Here the finding is as follows:

A multi-factor analysis, net of adjustments for risks and fees, produces positive residual value added from recommended managers, relative to a reasonable benchmark. Plus 39 basis points a year, on average.

If you make different adjustments, or don't adjust at all for risk factor exposures, the positive value added could be 51 basis points or 162 basis points a year, depending on the methodology.

Before manager fees, these would come to anywhere between 114 and 243 basis points a year, on average. Positive.

So his conclusion should be: yes, consultants' recommendations do add value.

The Honourable Member keeps making the point that non-recommended managers would have added even more. Not relevant. Due process rules them out of consideration. If I pay you $1 and get $2 worth of value out of it, that's a great result, even if a different and out-of-reach alternative purchase would have gained me $3. I can only choose from my restricted set. And that restricted set gives me good value.

Consultants don't have a crystal ball to predict who will do best, in retrospect. The name of the game isn't to find the very best managers, in retrospect. The name of the game is to add value. Getting added value from consultants' recommendations is a fantastic and highly desirable outcome.

One final point. The Honourable Member's tests were the most severe possible, because he investigated only one asset class, US equities, notorious as the world's most efficient asset class and therefore the one in which adding this kind of value is the most difficult. And yet consultants passed even that test.

Finally, Mr Chairman, I do sympathise with the challenge that consultants should publish their results. I believe I was the first to do so, in 1998, when I headed Russell's manager research function and wanted the benefit of data, not anecdotes. The results for American sponsors were positive. In fact, the compensation of research analysts now reflects their research results. There's alignment of interests for you!

And so I then campaigned to publish our global results.[8] Internal answer: no. There was one region, out of I think four, where the results were negative. The business managers argued that, in that region, the results would be taken in isolation and our competitors would have a field day. The following year, when those results turned positive, a different region was found to be negative.

I've done some rough calculations that demonstrate why this problem will never be solved.

Let's suppose the probability that any region's most recent year is positive is 75%. People would kill for that level of success! But, even at that level of excellence, if outcomes in different regions are independent of one another, there's only a 33% chance that all four regions will be positive in the same year. Most of the time, at least one region will be hostage to local numbers.

> Even if you go to five-year results, where a 75% success ratio in one year becomes a 90% success ratio over five years, it's not enough, because the probability of all four regions being positive over five years is still only two-thirds.
>
> Forget it. No business is going to voluntarily launch a prominent piece of publicity which is likely to show them up one year in three.
>
> Mr Chairman, let me sum up.
>
> Fiduciary process requires due diligence. Most sponsors require consultants for that. Relying on consultants' recommendations produces added value, after manager fees, according to the Honourable Member's own numbers.
>
> I see that as a glass much more than half full. The fact that it isn't overflowing is irrelevant.
>
> That's why I believe that the Honourable Member's case fails. Thank you.

In the discussion that followed, two things came through.

1. Why do consultants not recommend these apparently superior managers?

Perhaps because, from year to year, their performance isn't consistent, but volatile? The author said he didn't have the data to investigate that angle. But the audience volunteered that as the obvious answer. (And, by the way, we all suspected that there was a problem with the data, despite the tests the authors used. The idea that both recommended and non-recommended products outperformed passive benchmarks just doesn't make sense. Neither set underperformed? Probably a biased sample - particularly for the non-recommended products, because the recommended products must have been pretty close to fully represented.)

2. Winning a silver medal is wonderful.

The fact that the consultants couldn't identify the gold medal winners in advance doesn't matter. Again, the audience follow-up was that sponsors treasure consistent silver more than occasional gold. Or, as it's more often expressed in the industry, rather have consistent second quartile performance year-to-year than jumping between first and fourth quartile, because consistent second quartiles will lead to top quartile over long periods.

I hope you have enjoyed reading this explanation of why I believe the Oxford paper was asking an irrelevant question. The criticism can be amusingly summed up in a soundbite.

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The response can't.

ENDNOTES

1. Jenkinson, Tim, Howard Jones and Jose Vicente Martinez. “Picking winners? Investment consultants’ recommendations of fund managers.” Said Business School, University of Oxford. September 2014.

2. Sorkin, Andrew Ross. “Doubts raised on value of investment consultants to pensions.” The New York Times. 30 September 2013.

3. Pensions and Investments, Consultant Directory, 28 November 2011.

4. Ezra, Don. “Insights for evaluating active management.” Russell Research. December 2011.

5. Ezra, Don and Geoff Warren. “When should investors consider an alternative to passive investing?” Russell Research. January 2010. Also published as a guest editorial in The Journal of Portfolio Management, Summer 2010.

6. Russell Investments has previously published the aggregated results of its manager buy lists, but has historically refrained from publishing results for specific managers or individual asset classes.

7. The relevant numbers extracted from this table are as follows: Average net returns of recommended products: 6.31%; Average excess return over benchmark: 0.51%; One factor alpha: 1.62%; Three factor alpha: 0.39%; and Four factor alpha: 0.39%

8. Russell Investments has previously published the aggregated results of its manager buy lists, but has historically refrained from publishing results for specific managers or individual asset classes.

Don Ezra is Director, Emeritus - Investment Strategy for Russell Investments worldwide. He is a widely published author and among many awards, he received the Lillywhite Award from the US Employee Benefit Research Institute in 2004 for "extraordinary lifetime contributions to Americans' economic security." After a 25-year career at Russell Investments, he "graduated" from full-time work five years ago. Don is now a member of the investment committee of two American charitable foundations, and serves on advisory boards around the world. This paper represents his own views.