The Risks of “Star” Searching

- Everybody loves a “star,” especially when that star is the manager of a top-performing investment strategy.
- But in the absence of a contingency plan, manager departures can be hazardous to investor returns.
- Thorough evaluations and a manager-of-managers approach can help investors overcome these challenges.

High-ticket marketing campaigns, coupled with media exposure, generate attention that can elevate successful investment managers to “rock star” status. When these managers change jobs or retire, the investors they served are faced with the dilemma of following them, staying with the remaining team or moving on to greener pastures. It can be both unsettling and disruptive.

The departures are also disruptive for the investment firms themselves, as we have seen with the exits of high-profile investment managers on both sides of the pond over the past few years.

The fallout began immediately in September after the abrupt departure of PIMCO co-founder Bill Gross following a 40-plus year tenure. It remains to be seen how deep PIMCO’s AUM losses will extend, but Gross’ exit is actually the firm’s second major departure this year. Mohamed El-Erian resigned his roles as CEO and co-CIO in early 2014; net outflows in the first quarter came to nearly $30 billion[1].

Overseas, when Neil Woodford announced his leave from Invesco Perpetual last fall, where he managed the UK’s largest funds, billions left with him. A year later, assets invested in the Invesco Perpetual High Income Fund had contracted by nearly 15%, while the Invesco Perpetual Income Fund has shed a staggering 40% of investor assets[2].

The Unanticipated Peril of Success

High-profile star managers make headlines every time they pen an amusingly-titled newsletter, deliver an investor conference presentation or even make broad economic prognostications.

The related news stories would represent the investment industry equivalent of tabloid culture except for one significant difference: Investors actually allow important decisions to be influenced by them.

The increased recognition a star manager receives begets outsized inflows from investors hoping for continued high returns. While that may sound like a positive ─ after all, more inflows means greater fees ─ it also creates potential complications.

Star managers have limited control over the effects their new capital commitments will have as they set about investing on an expanded scale. They may operate in a small investment universe or with a restrictive mandate, forcing them to lower standards or sacrifice quality in order to put new assets to work. They may also find that larger trades have a material impact on market prices and erode their expected margin of safety. This inability to maintain superior performance is often a by-product of success.

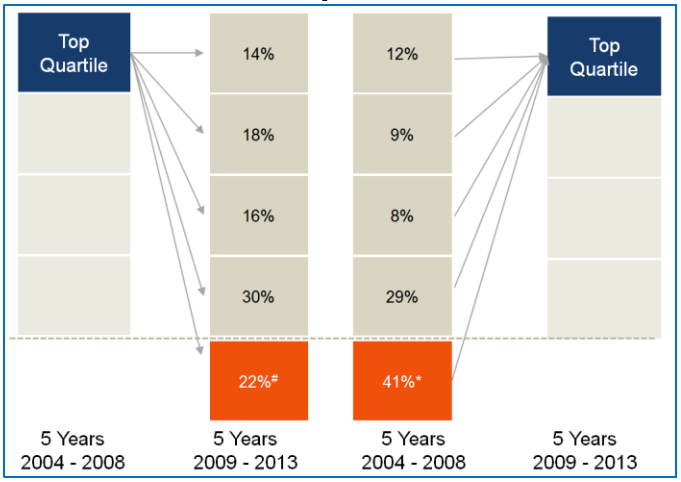
Performance Can Break Down

A recent SEI study, based on Morningstar data, uses large-cap blend funds to illustrate just how difficult it is for top-performing managers to maintain top-quartile performance in subsequent five-year periods.

In the study, large-cap blend funds were ranked in two five-year periods, from 2004 through 2008, and from 2009 through 2013. As Exhibit 1 shows on the next page, it turns out that only 14% of top-quartile funds from the first five-year period remained in the top quartile during the second period, while 30% moved all the way to the bottom quartile. 22% of those initial top-quartile performers disappeared ─ they were either categorized elsewhere as a result of style drift or closed altogether.

[1] “Allianz calls on Pimco to reverse investor flight” Gould, J. (May 2014). *Reuters*.
[2] “Is trouble brewing for investors in ex-Woodford Invesco Perpetual funds?” Morley, K. (Oct. 2014). *The Telegraph*.

Exhibit 1: The Unreliability of Past Performance



Source: SEI, Morningstar Direct–US Large Blend Universe

Meanwhile, 41% of the second five-year period's top quartile didn't have a long enough track record to be included in the first period. A further 29% of the second period's top quartile funds hailed from the prior period's bottom quartile ─ more than double the contribution from any other quartile.

When Investors Throw in the Towel: Outflows

Investors are not always patient, especially when star managers stumble, and can be prone to redeem investments when performance falls below expectations.

A rush for the exits creates another potential issue for star managers and their funds. They may need to sell securities if there is not enough cash in their portfolios to handle redemptions. This type of forced selling can tie managers' hands at inopportune times, forcing them to disregard their strategies and part with securities against their better judgment, further hurting performance.

Key-Man Risk

The attainment and maintenance of star manager status can be viewed as a reasonable confirmation of "key-man" risk. Not all top-performing managers crash and burn; some have enviable long-term records that stand the test of time. But there is always a risk that star managers will leave for more favorable opportunities as their investor base expands. If that happens, their old firms may face large outflows, not due to performance issues, but rather as the managers take their personal brands and investor followings to their new shops.

Outflows from PIMCO's Total Return Fund, the investment vehicle Bill Gross helmed for nearly 30 years, measured over $20 billion in September despite the fact that he departed with less than a week remaining in the month[3].

An announcement from Janus Capital Group—Gross' new home—that he would take over its new Global Unconstrained Bond was accompanied by inflows of more than $65 million in September, even though he did not begin work until October 6[4].

Last fall's announcement of Neil Woodford's departure from Invesco Perpetual led to immediate speculation that significant assets would follow him. Within two weeks, it was reported that slightly more than 4% of the assets under his purview had been withdrawn[5]. While this was regarded as a rather tepid initial response given the media's celebrity treatment of the announcement, he did not actually conclude his employment until April. Outflows from Woodford's funds reached 10% over the following three months and steepened after his exit[6].

SEI's Approach

Do these facts mean that star managers are bad? Not at all. They merely highlight the risks of putting all of your eggs in that proverbial single basket. To alleviate this risk, SEI's manager-of-managers asset management approach typically includes multiple investment managers in each of our portfolios to mitigate single-manager risk. This does not preclude us from employing well-known managers within our strategies, but it does lower the potential impact when a talented manager leaves.

Moreover, our manager monitoring process was developed to pre-empt and lessen the fallout from manager departures. We perform dedicated due diligence on each fund's portfolio management team ─ from lead portfolio managers to analysts ─ during our initial evaluation. Part of our assessment focuses on the risks that each of their potential exits would create. We decide beforehand whether these risks are palatable and develop contingency plans should an integral team member choose to take their leave. When investment managers choose to depart, our rigorous evaluation and planning helps us assess whether to join them at their new firms or hire replacements.

Star manager career moves typically make headlines, but other team members may choose to leave without attracting public attention. Our emphasis on full-team structures enables us to remain up-to-date on all relevant personnel developments. In fact, we often employ a maximum number of acceptable team departures for managers as a re-evaluation trigger, to identify causes of high turnover or avoid exposure to under-resourced situations.

[3] "Record Investor Funds Follow Pimco Boss Out the Door" Grind, K., Dieterich, C. and Zeng, M. (Oct. 2014). *The Wall Street Journal*

[4] "Bill Gross's Janus Fund Received $66.4 Million Deposits" Stein, C. (Oct. 2014). *Bloomberg News*

[5] "Update: Invesco Perpetual reveals £1bn Woodford outflow" Fedorova, A. (Oct. 2013). *InvestmentWeek*

[6] "Investors Back U.K. Manager Neil Woodford's New Fund" Cox, J. and Tryphonides, A. (June 2014). *The Wall Street Journal*

SEI's preference for team management and maintaining the consistency it engenders is supported by research: From 1996 through 2008, almost 20% of mutual fund managers that operated alone lasted one year or less, while more than 75% departed prior to the five-year mark[7]. Such high-turnover levels for key investment personnel would be a challenging environment for strategy continuity, at best.

An Exhaustive Checklist

Sensitivity to investor inflows and outflows can be a useful yardstick for measuring a manager's ability to navigate transitional periods. We also measure it for an idea how they might manage if they fell into, or out of, favor. Not every period of underperformance represents cause for termination given the cyclical nature of certain investment strategies, but we take care to avoid manager-induced volatility.

Our initial evaluations also include expectations for manager performance under various scenarios ─ stress, distress, recovery and expansion ─ based on their asset class, style and track records during prior periods. Inability to match our expected reactions during similar future periods could be a cause for re-evaluation.

At a fundamental level, we select managers on the expectation of strong potential risk-adjusted returns. We seek them out due to their demonstrated expertise in a particular asset class or investment style, so we expect a high degree of adherence to those specializations. We monitor manager portfolios for consistent characteristics and style maintenance to ensure they remain focused on their niche.

We believe detailed, thoughtful evaluations help identify quality managers and help us plan for the potential risks they could introduce should they choose to leave. Multi-manager exposures limit the impact of those risks upon realization, providing investors with consistency and flexibility rather than the fleeting appeal of star power.

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7 "The Career Paths of Mutual Fund Managers: The Role of Merit" Porter, G. and Trifts, J. (2014). *Financial Analysts Journal*. Volume 70, Number 4.