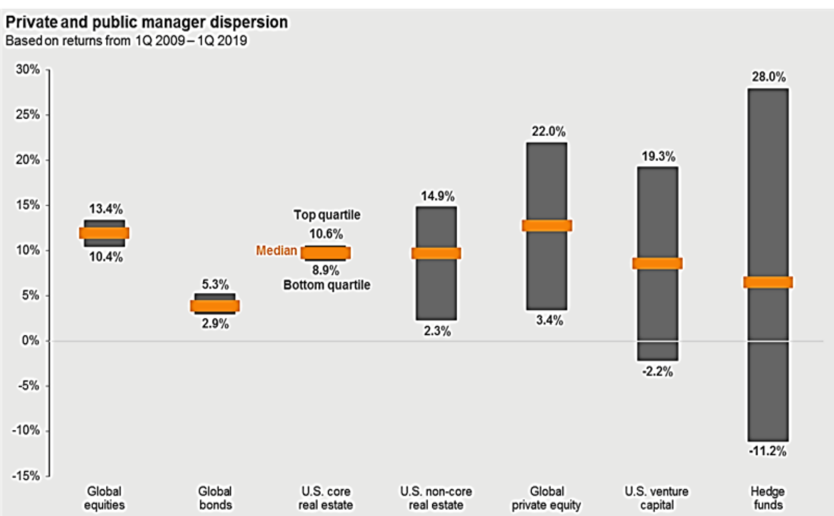
Alternative Manager Selection—Themes & Myths

Antonis Mistras, Managing Director, Alternative Investments

Manager selection in alternatives investing is critical. As the table below demonstrates, manager return dispersion in the alternative asset classes is considerably wider than that in the traditional stock and bond asset classes. This has the potential to swamp the impact of the asset class allocation decision.

Manager selection is such a broad subject that entire books have been written on it. The goal of this paper is not to present a comprehensive guide to manager selection, but to instead describe some themes in DCM's alternative manager selection process, as well as discuss several prevalent myths in the market.



As of 8/31/2019
Source: Lipper, NCREIF, Cambridge Associates, HFRI, J.P. Morgan Asset Management

Themes

1. **Manager organizational life-cycle.** An important principle in DCM's manager selection process for alternatives portfolios is the alignment of interest between manager and investor. The organizational lifecycle of a manager has a significant influence on the motivational drivers that determine this interest alignment. As a value investor, DCM typically looks for managers in the "sweet spot" between early growth and maturity. This provides enough experience and track record to support effective due diligence but allows sufficient runway for growth and hunger for success. As an example, closed-end private equity fund GPs often launch series of funds of increasing size. It is quite common for DCM to invest in funds III and IV of a series and disengage from later funds. While this is an oversimplification and by no means a rule, it is possible that a manager's track record may not provide enough depth for the due diligence process for funds I and II. Conversely, by the time funds V and beyond are launched, the funds' target size may have grown to a level inconsistent with the investment team's capacity and the historical deal size on which the track record is based.

2. **Style drift.** DCM focuses on identifying style drift in its selection process for both hedge funds and private market managers. Style drift is concerning for two reasons. First, it indicates a manager's lack of discipline and potential tendency to treat guidelines and commitments with less than the required attention. Not adhering to a communicated investment mandate is one thing but it could also reflect a lack of care in more troubling areas. These potential areas may include compliance, which is critical to the viability of a firm.

The second reason is performance-related. Any style drift reflected in a manager's track record may have significantly influenced performance. Taken to the extreme, performance results that made a strategy attractive in the first place, may not be repeatable. It is relatively difficult to identify past instances of style drift. However, it can be done through interviews with a manager's staff, centered around past investments. Style drift can be more readily identified in ongoing due diligence, in which it can be a useful tool in a manager termination decision. Style drift does not need to be associated with negative performance only. In fact, it is important to recognize style drift even if it results in positive returns. Conversely, negative performance may be better tolerated if it happens in the context of a manager's style and expected behavior.

As an example, DCM tolerated an emerging market-focused, global macro hedge fund's significant losses in the recent Argentina meltdown, as these losses were consistent with the manager's style of taking directional, concentrated positions in sovereign credit. On the other hand, DCM terminated an investment in a fixed income arbitrage fund, expected to make diversified, relative-value, and risk-controlled trades, as a result of an outsized directional position in Italian government bonds.

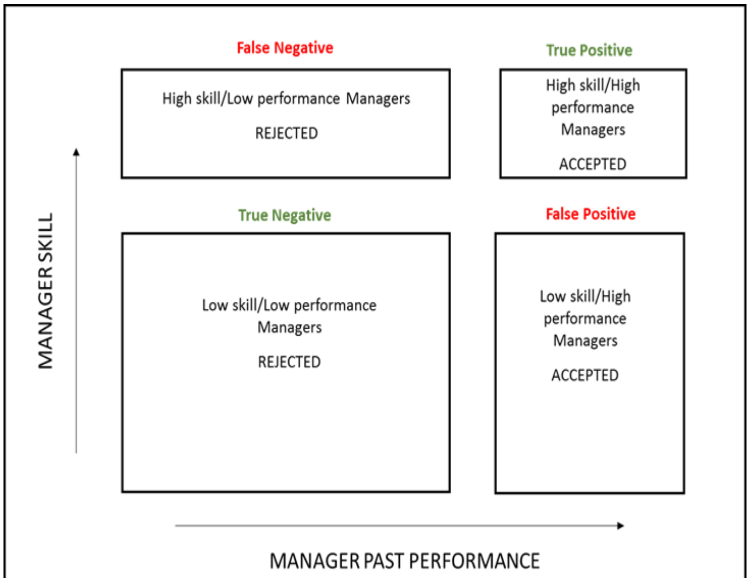
3. **Surviving crises**. Analyzing periods of negative returns or drawdowns is instrumental in determining a manager's ability to generate consistent and repeatable performance. While negative returns should be typically seen poorly in the context of due diligence, sometimes there are mitigating circumstances. An example is the 2008 great financial crisis. Excessively negative returns during that time do not necessarily indicate inferior manager quality, especially if they resulted from forced asset sales caused by outsized investor withdrawals.

An additional silver lining to a manager experiencing a crisis like 2008, is that surviving a "near death" experience could strengthen the manager as an organization and prepare them for future crises. On the other hand, positive outsized returns during a time of crisis, while certainly a great accomplishment, may not always indicate a repeatable process. For example, large short positions in mortgages before the 2008 selloff, while illustrative of the manager's sound investment decision making, may not constitute proof of a repeatable investment process. Who knows if the manager will make an equally successful macro decision during the next bubble?

Myths

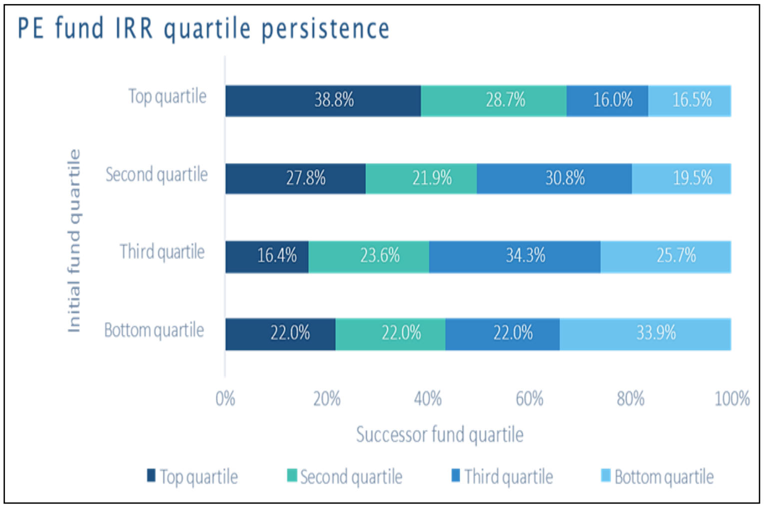
1. Past performance is not indicative of future performance. While this statement is generally accurate, a manager's track record is one of the most tangible pieces of evidence in investment due diligence. The main arguments against relying on past performance are the possibility that it is the product of luck rather than skill, and the well-documented reversion to the mean of managers' outperformance over time. The following chart provides a stylized representation of a performance-based manager selection process.

The challenge to investors is to use the qualitative part of the investment due diligence to filter out the false positives and "reclaim" the false negatives. This may be achieved by analyzing the managers' investment process to determine the level of repeatability of past success and the potential temporal nature of past failures. While acknowledging the well-publicized shortcomings of reliance on manager past performance, DCM believes that track record is the most important first step in manager selection, when combined with strong qualitative investment due diligence.



For illustrative purposes only.

In Private Equity, there is evidence that both positive and negative performance is persistent across consecutive funds of the same GP. The following chart shows Pitchbook's findings demonstrating the trend, based on an analysis of funds in its database.



Source: Pitchbook. Based on 669 PE funds in Pitchbook's database from 2000 to September 2017.

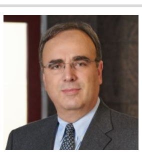
2. **Greater liquidity terms are always better**. Generally, investors welcome flexible liquidity provisions, especially withdrawal terms, in open-end funds. While the positives of liquidity are obvious, in some cases excessively permissive liquidity may work to the detriment of investors. Instead, a more appropriate approach to liquidity terms should match the horizon of the underlying traded assets to the allowable timing of subscriptions and withdrawals. In times of heightened volatility, too liberal terms may lead to withdrawal spikes. In effect, investors are forced to play a game of musical chairs, potentially hurting the fund and its remaining investors.

3. More transparency is always better than less. In due diligence, investors often strive to obtain as much information about managers as possible. While more information is generally helpful, a thoughtful approach to collecting data should match the type of information collected with an investor's ability to process it. An example, applicable within hedge funds, is position-level transparency. Holdings data could be effectively used as an input to a risk model to estimate portfolio exposures to various risk factors. However, obtaining information with no specific purpose or for an anecdotal or superficial use may be unproductive. First, from a manager's perspective, reporting such data raises administrative burden and increases the likelihood of proprietary information leakage. From an investor's perspective, it may provide a sense of false security. So, while obtaining more information may appear to always have an obvious benefit, it's important to remember that it generally carries a cost as well.

4. **Overdiversification can lower returns.** A common myth is that a high number of managers can cause a portfolio to be overdiversified to the detriment of returns. The implied reasoning is that a concentrated portfolio of superior managers will outperform a more diversified one with a broader set of managers. The logic continues that an increased number of managers could drag portfolio performance down to a mediocre mean. However, this argument is based on the dubious assumption that a small set of superior managers can be readily identifiable ex ante with a high level of certainty. On the other hand, portfolio construction, emphasizing low correlation across managers, can have a powerful impact on a portfolio's returns and its Sharpe ratio. DCM believes that correlation is easier to forecast than manager alpha. Sacrificing diversification for a narrow set of managers with higher return expectations may or may not produce strong returns. However, over time, such a portfolio, because of its reduced diversification, will likely have higher volatility and lower Sharpe ratio. We recognize that investors' ultimate goal is higher returns, not Sharpe ratios. However, lower Sharpe ratios, and therefore higher volatility, tend to lower returns. Finally, higher return consistency allows investors to efficiently raise risk in other portfolio areas and increase overall returns.

5. **Trades versus process.** In manager due diligence, whether initial or ongoing, it is tempting to focus on portfolio positions and trades as the principal means of evaluating a manager's quality. DCM believes that comprehending trades and the motivation behind them is a critical part of due diligence. However, its main role is in understanding the investment philosophy and process of a manager and is not a goal in itself. Investors commonly make the mistake of evaluating positions and trades in the context of their own investment views. For instance, the view of a global macro manager about the economy may differ from that of the investor. This is not necessarily an indication of an inferior investment process.

Navigating manager selection in alternative investments requires a high level of expertise. DCM's value-based manager selection process is characterized by a focus on track record analysis, manager alignment, and diversification. We make informed decisions by familiarizing ourselves with a firm's investing process, analyzing all of the data, and asking the right questions. Our in-depth approach helps us identify clues others may miss.



Antonis Mistras, CFA, Managing Director, Alternative Investments – Mr. Mistras is responsible for Private Equity, Private Credit, Private Real Estate, Hedge Funds, and Stable Value investments. Prior to joining DuPont Capital in 1992, he served as Manager of Production at BARRA. He joined the financial services industry in 1990. Mr. Mistras holds a B.S. in Forestry, concentration in Forest Engineering from Aristotelian University of Thessaloniki, Greece; an M.S. in Wood Science and Technology from the University of California at Berkeley; and an M.B.A. from the University of California at Berkeley. He is also a CFA charterholder.