

Does Blame Predict Performance?

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As an econometrician and a fund-of-funds portfolio manager, I spend much time researching quantifiable metrics to help me identify managers who can outperform consistently. There is, in fact, a rich body of literature exploring different manager selection criteria. Academic papers have considered portfolio manager attributes, such as tenure, the CFA designation, advanced degrees, and even SAT scores; they have also examined fund characteristics, such as portfolio turnover, expense ratios, and assets under management. Practitioners, especially investment consultants, have additionally focused on more nuanced and qualitative elements such as investment philosophy, compensation scheme, turnover of key professionals, ownership structure, and succession planning.

Ironically, perhaps, most people have given up on the hope that past positive alpha can predict future outperformance with any reliability.¹ Some might even go as far as asserting that manager outperformance is mean-reverting due to cyclicalities in styles and “luck.”

Some of the above-mentioned attributes may provide very incremental information on the true quality of the manager. However, most econometricians, asset owners, and investment consultants confess (although not all publicly) that effective methods for picking top quartile performers remain elusive. As one of my friends at a large Middle Eastern sovereign wealth fund famously proclaimed, “We are convinced that managers who can consistently deliver alpha exist. We are, however, also convinced that we do not know how to find them.” Perhaps, then, the science of manager selection really is about winning what Charley Ellis calls “the loser’s game.”

As my high school basketball coach was fond of reminding me, “If you can’t improve your shooting mechanics, you can still improve your field goal percentage by not forcing bad shots.” His advice is equally relevant to the investment industry: To improve your odds of outperforming, screen out the negative alpha managers. If an investor focuses on eliminating the lower quality managers from his selection universe, the odds for achieving outperformance, in the long run, would be much improved—even if hiring the best managers from the screened short list is still a crapshoot.

So, how does one win in a loser’s game? In this article, I argue that you can significantly improve your odds by employing simple rules for identifying and eliminating underperforming managers.

Predicting Long-Term Underperformance

First of all, we already know quite a bit about the predictors of poor long-term investment performance. High portfolio turnover, high expense ratios, and low active weights (Cremers and Petajisto, 2009; Sebastian, 2013) are quantifiable metrics that tend to predict underperformance in the long run. Qualitatively, anecdotes suggest that high turnover in the professional ranks, lack of organizational alignment due to poor compensation design, or deficient inter-generational transition planning also hurt long-term investment results. Both finance academics and investment consultants have been working hard on identifying quantitative and qualitative attributes which might predict underperformance.

However, given the reported negative median and average underperformance for active managers, investors will have to work much harder in screening out low quality funds and managers just to get the expected alpha for the screened universe up to zero. For example, the average mutual fund underperforms by 1.6% net of fees; screening out high fee funds merely brings the average active return above –1%. Additionally, many low quality investment organizations are savvy enough to respond to RFPs and interviews carefully so as to tick most of the boxes on a consultant’s due diligence report. The cynical perspective is that asset managers are far more adept at solving the challenge of gathering assets from asset owners than solving the challenge of producing alpha for asset owners.

Importance of Culture

So, how do we spot the lower quality asset managers who fly the colors of high quality managers? Are there other attributes predictive of long-term underperformance that cannot so easily be masked? I believe there

are.

Over the past five years, Research Affiliates has engaged outside experts to learn about the transformative power of a positive and healthy corporate culture.² As a quant, I initially approached this new age touchy-feely voodoo magic with a great deal of suspicion. Over the years, I have come to understand and deeply appreciate the enormous impact that culture can have on the individuals who come together as a collective to drive organizational success. As I interact with different organizations and manage my own team, I have discovered that one of the most toxic culture elements for investment management organizations is the culture of blame.

Blame has many brothers, including fear, defensiveness, and self-righteousness. When the four horsemen are present, personal accountability, creativity, openness, and learning go into exile. From what I have heard and seen, when blame lives in an investment organization, professionals take joy in second-guessing investment decisions after poor short-term performance. Whether it is the board blaming the investment staff at a pension fund, or the client facing team blaming the portfolio management group at an asset management firm—the *modus operandi* is often righteous indignation seeking to assign fault. The logical moves for the investment professionals, in this environment, are either to get defensive and deflect blame onto others or to proactively hide poor results.

Most academics are bewildered by the existence of year-end and quarter-end window dressing of portfolios—it seems too absurd to believe that such ridiculous behavior could persist in the investment industry, where delivering alpha is the only thing that supposedly matters. But to practitioners, buying popular winners at high prices and selling the cheap beleaguered dogs are as natural as can be when one has to deal with reproachful board members or client account managers. When Apple is trading at \$800 a share, they question why the portfolio manager did not buy the stock; everyone knows that Apple will take over the world. And when Apple craters to \$400 a share, they proclaim that any fool knows the company is only half its former self without Steve Jobs.

Similarly, cases studies have questioned why pension funds and portfolio managers do not rebalance into risk assets after large price declines, given the documented long-term price mean-reversion pattern (Ang and Kjaer, 2011). Most practitioners would readily acknowledge that the driver of this behavior is based in organizational politics rather than investment conviction. In 2009, the *ex ante* sensible investment decision to rebalance into financial stocks and high yield bonds simply carried too much risk of *ex post* blame.

When blame prevails, toxic fear becomes the main motivator of behavior. In that culture, people tend to hide problems and/or to be uninvolved, unaware, and unaccountable with regard to anything that might look like a problem. They will not be identifying or solving problems. And a special few might just be too willing to point fingers with righteousness and, of course, with hindsight. It is difficult to imagine long-term investment success from an organization rooted in blame. On the other hand, we would believe that superior long-term investment results can be produced by an organization which (1) unflinchingly identifies problems, (2) debates them with openness and without blame, (3) emphasizes fixing them, and (4) focuses on learning to avoid similar mistakes in the future.

Investment Organization and the Blame Game

The investment management industry, for better or for worse, is one where the short-term investment results experienced by clients provide little or no information on the true quality of the product. This might be especially true in volatile asset classes like equities where noise is especially prevalent. Given the dearth of actionable information contained in short-term performance, it is simply mind-boggling that so much acclaim and blame can be apportioned on the basis of short-term performance.

A culture of blame in an environment where outcomes are random can only lead to the most perverse behavior. When the organization's sport is to blame, it hardly matters that the assignment of fault is based on a metric (short-term performance) with no actual informational content. Whatever ceremonial committee meetings occur to conduct the *post mortem*, proclaim the faults, and distil the supposed lessons—the actual learning can only be naught. After all, how can someone take true responsibility for a random bad outcome and improve his investment process to assure positive random draws in the future?

Learning agility is the most valuable currency for long-term organizational performance in a dynamic environment where new facts are constantly being discovered and new theories are proposed to account for them. However, organizations plagued with fault-finding will often perceive “needing to be right” as more important than learning. Indeed, perhaps we blame others precisely to satisfy the ego's need to be right. Research finds that the highly intelligent and competitive people often have the greatest need to be right. The investment industry certainly has no shortage of smart, highly competitive people. When investment professionals debate in order to prove themselves right and others wrong, it eliminates the possibility for learning and so the possibility for improvement. When research analysts and portfolio managers focus on appearing to have the truth, they are implicitly committed not to seek the truth but merely to look for

confirming evidence.

In my experience, a blame-oriented organization is often one that demands accountability for randomly unfavorable short-term outcomes. A by-product is wasting resources on developing skills to improve the odds of flipping heads on a fair coin. Prolonged exposure to this culture may eliminate creativity and true personal responsibility and replace them with a cynical commitment to the art of covering one's arse. When an organization's energy is devoted to CYA instead of creating value, it is difficult to imagine that it could deliver superior long-term investment results. Thoughtful people who build organizations for the long-term don't tolerate a culture of blame.

Conclusion

In the end, I am an economist, not an organization behavior researcher. My biggest issue with blame in an investment organization is that it seems to be strongly positively correlated with a genuine lack of comprehension for statistics at the most senior level. Blame-oriented investment organizations revel in the drama of short-term performance—there is always something to “hold someone accountable for” (code word: blame) the next quarter. It is difficult to imagine that using short-term results to direct organizational energy and resources would create outputs of substance. If an investment management organization is dominated by people who aren't wise enough to understand that short-term results are largely random, there can be no hope that this particular organization will be winning the loser's game.

My advice is to avoid investment organizations with a culture of blame. They are likely very bad at statistics.

Endnotes

1. Paradoxically, many asset managers continue to be hired and fired based on recent three-year performance, despite all evidence pointing to the harm of such a practice. See Towers Watson's (2011).
2. We have been working with Jim Dethmer's Conscious Leadership for the past five years on learning and building a strong corporate culture.

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