# Dealing with Underperformance: Wisdoms and Pitfalls of Replacing Trailing Managers

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DeMarche

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## Point of Discussion

**01** Fear of missing out

**02** Peer benchmarking

**03** Odds of recovery

**04** Leading indicators


## Abstract

Your active manager underperformed their benchmark over the latest three years, and ranks near the bottom of their peer universe. Is it time to replace them? How should you evaluate whether they can recover the lost ground, and perhaps be a winner going forward?


For more information on this study and manager performance, please contact your DeMarche Consultant.

## Mind the gap

Among the most common questions clients ask is how do you determine whether or not to replace an underperforming manager, and when? Often, market-capitalization weighted indexes can be dominated by a narrow group of winning stocks, or by factors such as growth and momentum. This gap can widen and persist for a few years, but often is followed by periods of exceptional recovery and outperformance by the same active managers that once trailed. It can be rather costly to miss out on that subsequent return, and it can be just as costly to wait too long to dismiss a manager that fails to get their mojo back.

> *"Humans also have an inherent "fear of loss." Psychologists tell us that due to living at subsistent levels (poverty) for thousands of years, we value losses 2:1 over gains. In other words, it feels twice as bad when we lose $1 as it feels good to gain $1."*
>
> ***- Coleen D. Trimble***

## Wisdoms and pitfalls of replacing trailing managers

Professional advisors and investors generally agree: it can be harmful to apply a common "rule of thumb" to every occasion. We decided to review the data from a few periods in time where large numbers of managers were trailing benchmarks. Such times generally find the index's return in the top quartile of a peer universe review.

We examined two periods of index leadership, the three years ended December 31, 2010, and the three years ended December 31, 2016.

At the end of 2010, over 51% of all domestic equity funds were outperformed by benchmarks, but in Small Cap Growth, over 83% were behind the style index, per Standard & Poor's. Small Value managers fared better, with about 53% delivering less than their index.[1] Even more astonishingly, 93% of Small Value and 98% of Small Growth managers were outperformed by their style indexes in the three years ended 2016.

Were these years seeing similar trends elsewhere in the global marketplace? We studied the manager universes for International Large Cap (versus the MSCI EAFE Index) and Emerging Market Large Cap Equities (versus the MSCI EM Index) as well for the same investment horizon, using eVestment Alliance's database. While other snapshots in time may have favored these non-US indexes, institutional investors with

[1]SPIVA U.S. Report, Year-End 2010 and 2016. Standard & Poor's, CRSP.

active management fared relatively well in comparison. For the three year period ended December 2010, only 30% of the active EAFE Large managers and 36% of all active EM Large managers were outperformed by their benchmark index. Similarly, at the end of 2016 only 24% of active managers in EAFE Large and 35% in EM Large were bested by their index.

## Retain or replace?

Let's look in some detail at the Small Cap Growth manager universe. At the end of 2010, those managers whose annualized return (gross of fees) was at least 100 basis points lower than their benchmark averaged a universe percentile rank of 82nd, and trailed by an average of 421 bps. How did this group do over the following three years? As a group, they improved into the second quartile, averaging a percentile rank of 42nd, and outperformed the benchmark by an average of 94 bps. The recovery was more pronounced by the worst performers as of Dec. 2010. Those trailed the index by more than 300 bps, and as a group ranked in the bottom decile (92nd), but when held over the next three years, outperformed by 155 bps to rank 37th on average. This did not necessarily recover all of the prior underperformance, but termination of all trailing managers, en masse, was not statistically a winning solution.

### Exhibit 1

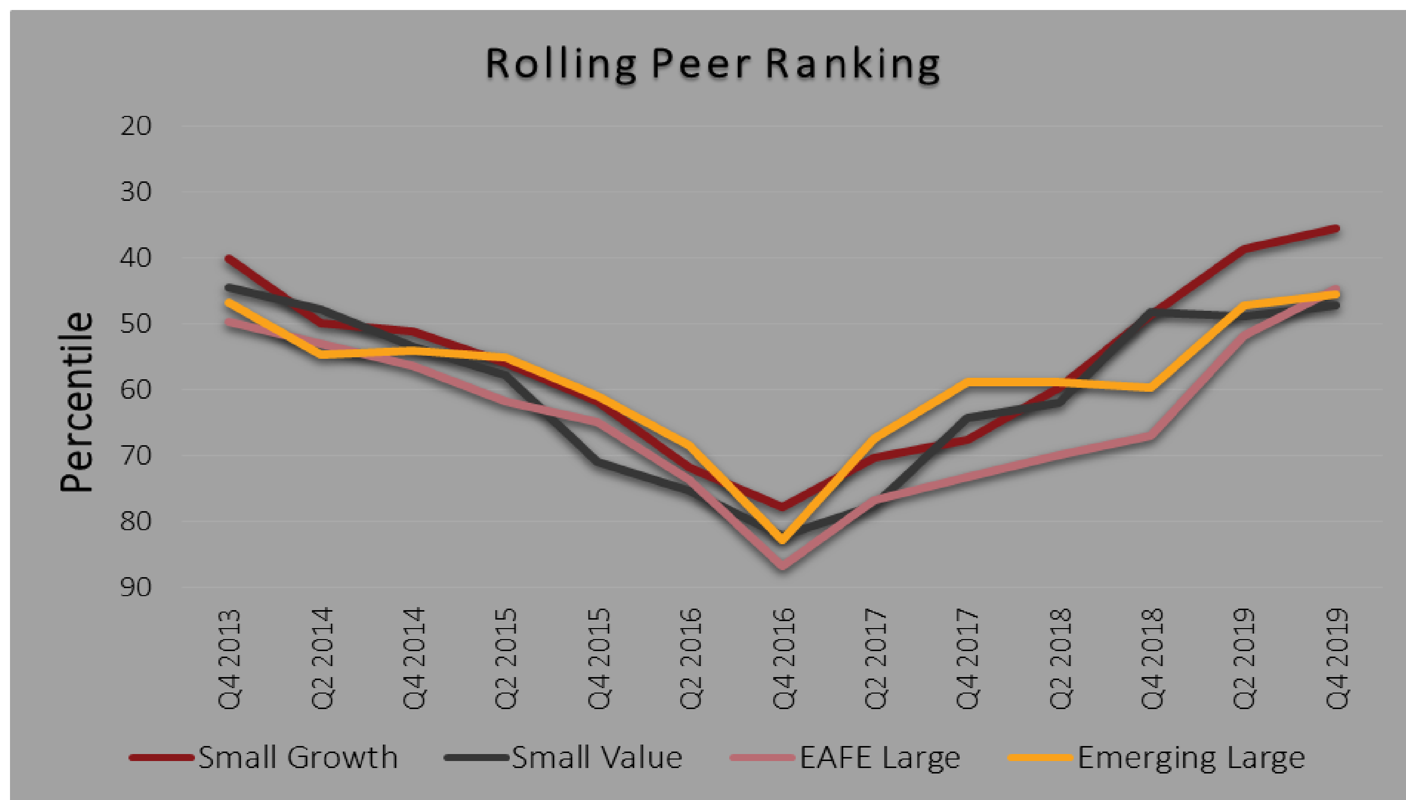



Exhibit 1 illustrates the path of weak performance and recovery for the groups found to be trailing at the end of 2016. Small Growth managers trailing over the prior three years, shown in the maroon line on the chart, had dipped over time from above median peer ranking, but as a group were steadily recovering back toward median ranking over the subsequent three years. The exhibit illustrates a common pattern for the other three manager universes in this study.[2]

We learned that recovery from relative underperformance did not go as well for International and Emerging Market managers in the 2010 study. On average, the trailing active managers only recovered to median and did not outperform the index in the

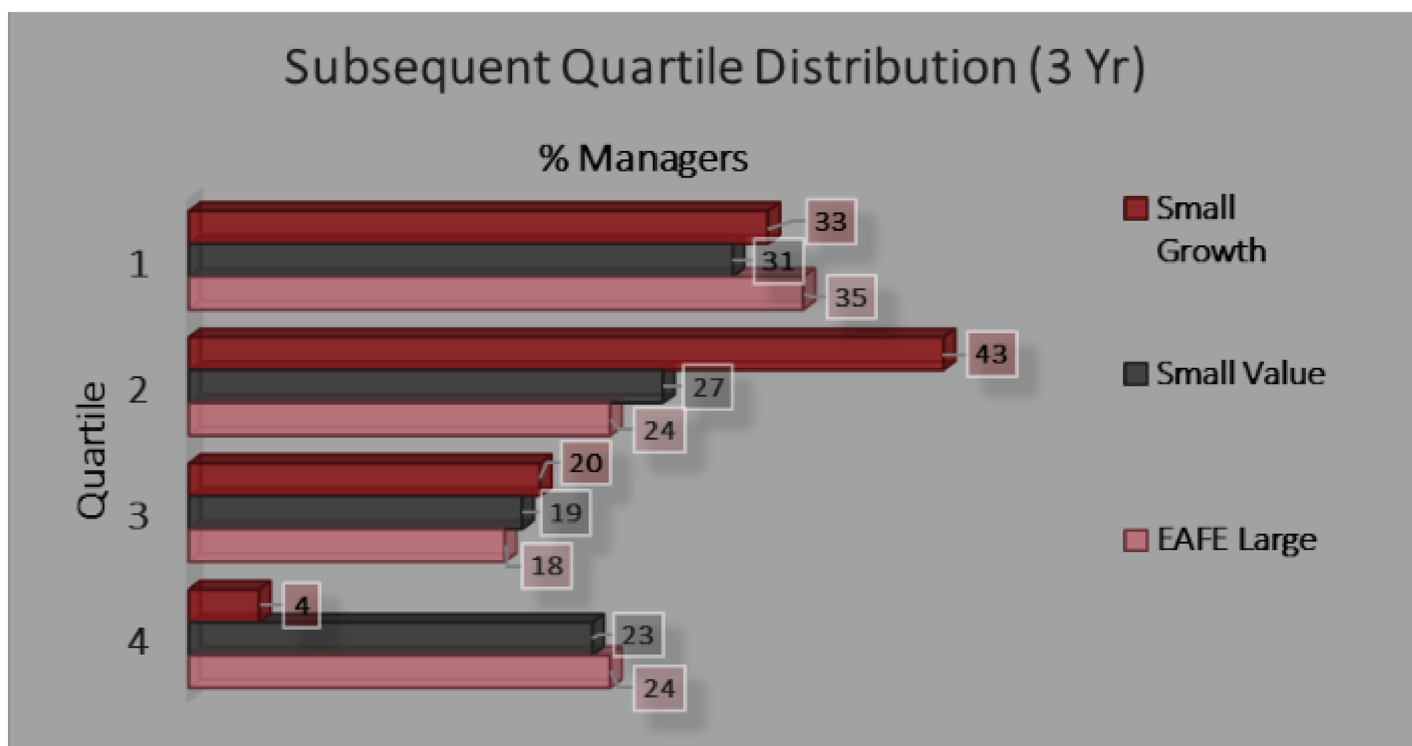
[2] Manager peer groups defined by eVestment Alliance database. Groups include managers that underperformed by at least 100 basis points, gross of fees, as of 12/31/2016.

subsequent three years. In the 2016 study, Emerging Market managers had similar results to the 2010 study, but International equity managers had better results versus peers and generated a 120 basis points premium to the index. Endpoint selection serves as one possible explanation for the differing outcomes between domestic and international managers, as international active manager premiums in the time periods examined far outpaced those of domestic managers.

## What are the odds?

In our study, the underperforming managers improved over the subsequent three years, on average, but we were also curious about how many successfully climbed into the top quartile or two of their peer group. Exhibit 2 illustrates the distribution of the 2016 underperforming managers group among the full peer universe, by quartile, based upon their subsequent three year annualized return. For the full universe, each quartile contains 25% of the members. The recovery from the underperforming groups exceeded that, with over 30% of each group ranking in the top quartile. For EAFE and Small Value managers, however, one-fourth of managers were ranked in the bottom quartile, extending the 'suffering' for their long-term investors. Having one-fourth of a manager universe in the bottom quartile is statistically perfectly normal, but after a starting point of three earlier years of underperformance, that brings an element of 'pain.'

## Exhibit 2



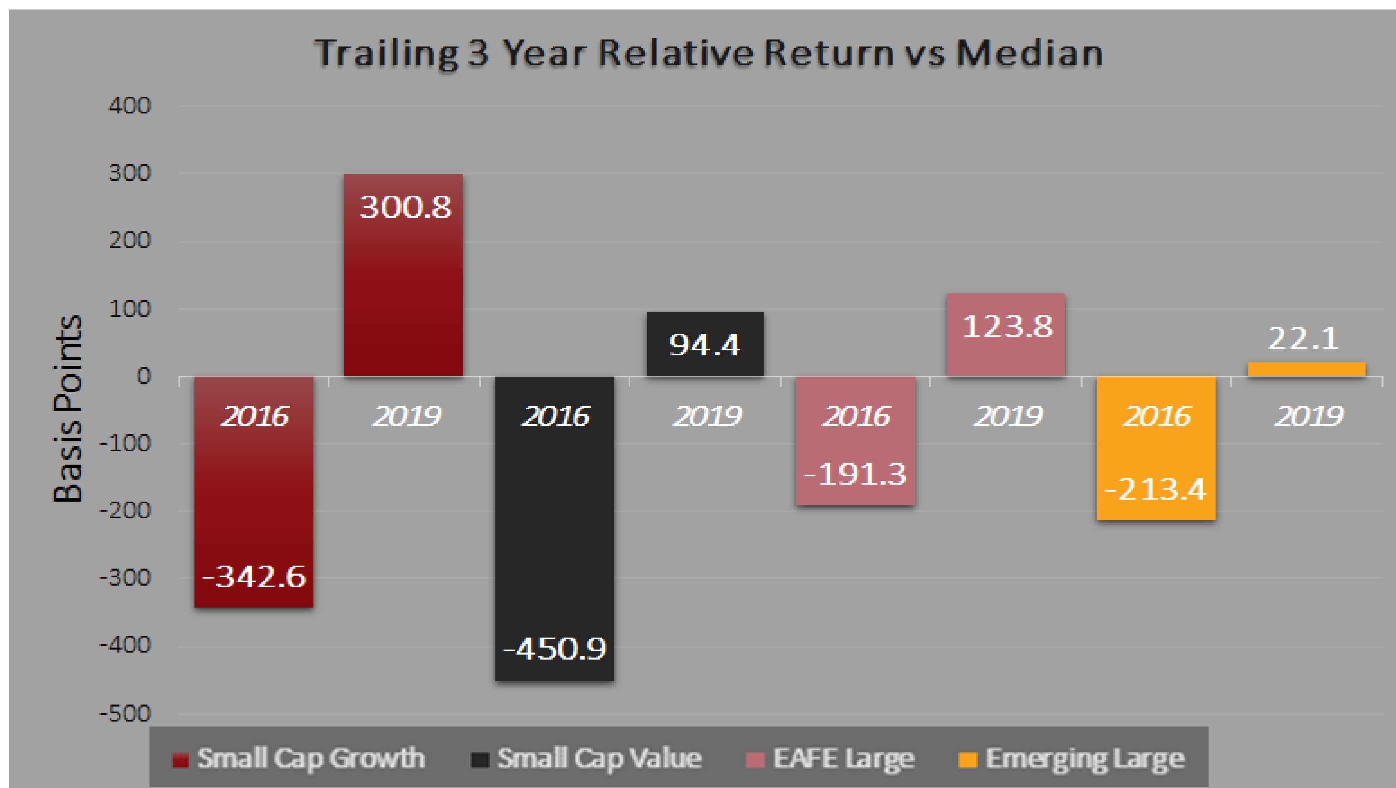

*Emerging Markets were excluded from Exhibit 2. The observed managers were too modest in number, and differences in relative performance too unevenly distributed, to demonstrate relevance when assigned into quartiles over the subsequent period.*

## Sunk cost

We commonly hear investors base their satisfaction with a manager's recovery on the degree to which prior underperformance was recovered in full. While that is behaviorally normal, an impartial voice might remind us that what matters is whether the potential outperformance from this point forward is a better outcome than a switch to another strategy. This is crucial, because the most common investor mistake is to "buy high" and "sell low." That said, our study looked into how much the underperforming managers recovered in the subsequent three years.

Exhibit 3 shows the results, on average, of the four sets of managers. The degree of subsequent outperformance happened to be strongest in Small Growth. The pairs of bars, each for a different peer group, compares the 2014-2016 period to the next three years, 2017-2019. It appears the investors in the Emerging Markets group would have had the least cause to celebrate a decision to hold on for a recovery, but perhaps could take some solace in that average underperformance for the group had ended.

## Exhibit 3




## Action plan

Because periods of underperformance can seem to last an uncomfortable amount of time, and a manager's recovery from a weak period can be rewarding for the patient investor, we encourage clients to emphasize their retain-or-replace analysis on what we call the "leading indicators" of future performance. These are: stability of the manager's firm, its ownership, and leadership; stability of the investment management team and their resources; continuity of the investment philosophy and process; and an appropriate growth/stability of the strategy's assets under management. Deterioration and/or increased uncertainty in these fundamentals reduces the odds of full recovery to having a winning strategy again.

*Sources Utilized:*

- *Behavioral Finance: The "Science" Behind Investor Decisions, white paper by Coleen D. Trimble, Senior Consultant, DeMarche*
- *eVestment Alliance database*
- *SPIVA, Standard & Poor's*

# Put Research To Work

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