



## How to Squander \$170 Billion

By Robert Huebscher

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Some of the managers supposed to be among the sharpest have cost their clients \$170 billion dollars over the last two decades. I'm referring to "plan sponsors" who handle pension funds, endowments, and foundations, and Scott Stewart, a former money manager who now teaches finance at Boston University, has documented their value destruction in a study, [Absence of Value: An Analysis of Investment Allocation Decisions by Institutional Plan Sponsors](#), which appeared in the Financial Analysts Journal late last year.

When we initially [wrote](#) about Stewart's research two years ago, he had examined data only through 2001. Since then, he has expanded his analysis to incorporate data from a longer time period, from 1984 to 2007, and across a wider range of asset classes, including equities and fixed income for US and non-US markets.

Plan sponsors destroy value through their selection of active managers – most problematic is their proclivity to fire managers because of poor short-term performance, Stewart says.

Stewart used the PSN database from Informa Investment Solutions, which consisted primarily of separately managed accounts. As of December 2006, PSN held approximately \$13.5 trillion in assets – a very large sample, roughly twice the size of the assets held in the top 1,000 US pension plans at that time, according to *Pensions & Investments*. He ruled out any effects that might reflect survivorship bias.

Stewart focused his analysis on fund flows representing the decisions of plan sponsors to hire or fire a manager. He measured performance against what it would have been under a buy-and-hold scenario – if the manager had not been hired or fired.

Using the most conservative approach for interpreting his results, Stewart concluded that plan sponsors had collectively squandered \$170 billion in value over the two-plus decades he studied. That translates to approximately 112 basis points per year, based on fund flows. That is, a plan sponsor with a 100% annual turnover of managers will lose 112 basis points annually on those assets.



Stewart's results changed little if he included index funds in his analysis or if he did not. The value destruction came from the active side, cycling between active managers.

Value destruction persists for three years following a decision to change managers; only in years four and five does the value destruction decay to zero.

"Plan sponsors never make their money back," Stewart told me. "If they simply went on vacation, they could save their clients \$170 billion – and that doesn't count transaction costs."

More volatile asset classes experienced greater value destruction. Domestic growth and international equities were among those generating the greatest loss. Domestic fixed income had the smallest loss, which is not surprising, given that it does not offer the same opportunities for excess returns as do more volatile asset classes.

Plan sponsors are, of course, not unique in their ability to destroy value in this manner. Numerous studies, including those by Dalbar and Morningstar, have documented that individual investors, for example, buy mutual funds more heavily at the market peak and tend to sell them at the market bottom.

Plan sponsors should be more sophisticated than individual investors and, according to Stewart, they are. "Although they behave like retail investors," he said, "the amount of value they destroy is a fraction of that destroyed by individuals."

Stewart also examined fund flows at the account level, and he showed that value destruction is more severe when plan sponsors remove all assets from a particular manager, as opposed to merely cutting back their commitment to that manager. Weighting the flows by dollar value resulted in 112 basis points of value destruction, but weighting them by account size resulted in 217 basis points of destruction. Performance is about twice as bad when a manager is completely fired.

"When you fire a manager, your patience has totally run out, because performance was really bad," Stewart said. "When that happens, performance of the fired manager reverses even more than for your average manager who you don't like and just cut back."

"If everyone wants you to fire a manager, ask yourself if you are selling at the bottom," he said.



Advisors can take away other valuable lessons from Stewart's research. "This confirms that the toughest thing to do is to pick an active manager," he said, and advisors should carefully avoid bias driven by past performance. Screening managers by prior one-, three- or five-year performance records – prior to due diligence on those managers – is a prime example of that bias.

Cyclicity of performance, Stewart said, means that those outperforming managers will inevitably revert to the mean. Instead of relying on short-term performance, he says, advisors should look for "nice patterns" of returns – managers who consistently outperform on a quarterly basis, for example – as a way to avoid being biased by short-term results. Only then should advisors undertake due diligence on managers.

"Everyone knows that focusing on short-term results is wrong," Stewart said. "Nobody wants to hire a manager who has done poorly recently – but that's exactly what you want to do."

Advisors should look within asset subclasses when analyzing performance. Basing a decision, for example, on whether a value manager under-performed can be misguided. Instead, advisors must examine whether that manager was a deep-value or a relative-value manager.

Conversely, asset managers should be aware if their clients are selecting them because of short-term results, and they should manage client expectations. "The key is to develop a good relationship with your clients," he said. "When you get in trouble, you can show that you have a process and a track record that demonstrates that, when things look bad, they tend to reverse." This might get you a couple of quarters, which Stewart said is all that managers typically need.

Stewart's latest research project looks at whether organizations that believe they are more functionally proficient – and are better at making decisions – are better investment managers. He is analyzing the results of questionnaires completed by asset managers to answer this question.

His preliminary results show that an organization's self assessment of their decision-making capabilities does not correlate with their performance track records. Organizations who consider themselves to be an effective group tend to turn their portfolios over more frequently and have worse returns.

"Just because you think you are good at making decisions," Stewart said, "doesn't mean you are making the right ones."



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