Manager Selection:

Manager selection[1]

Virtually all nonprofit investment committees hire at least one outside investment advisor to manage their assets with a majority hiring multiple managers.

Many committees don't make this decision on their own. In general, there are three approaches to manager selection:

- *Hiring an outside consultant to make the decision for you*
- *Hiring a consultant to identify several candidates and letting your committee make the final decision*
- *Hiring a manager directly*

Before hiring a manager, you should be convinced that his or her investment philosophy fits within the role you expect it to play in your portfolio. Selecting someone whose investment approach is inconsistent with your portfolio requirements can jeopardize the ultimate success of your organization.

Fiduciaries face a number of vexing challenges during the manager selection process. Investment committees should clearly spell out guidelines in the investment policy statement (IPS) governing the selection, compensation, evaluation, and termination of their managers. Fiduciaries should also identify mandates that prospective managers will be expected to fulfill in administering various portions of their portfolio.

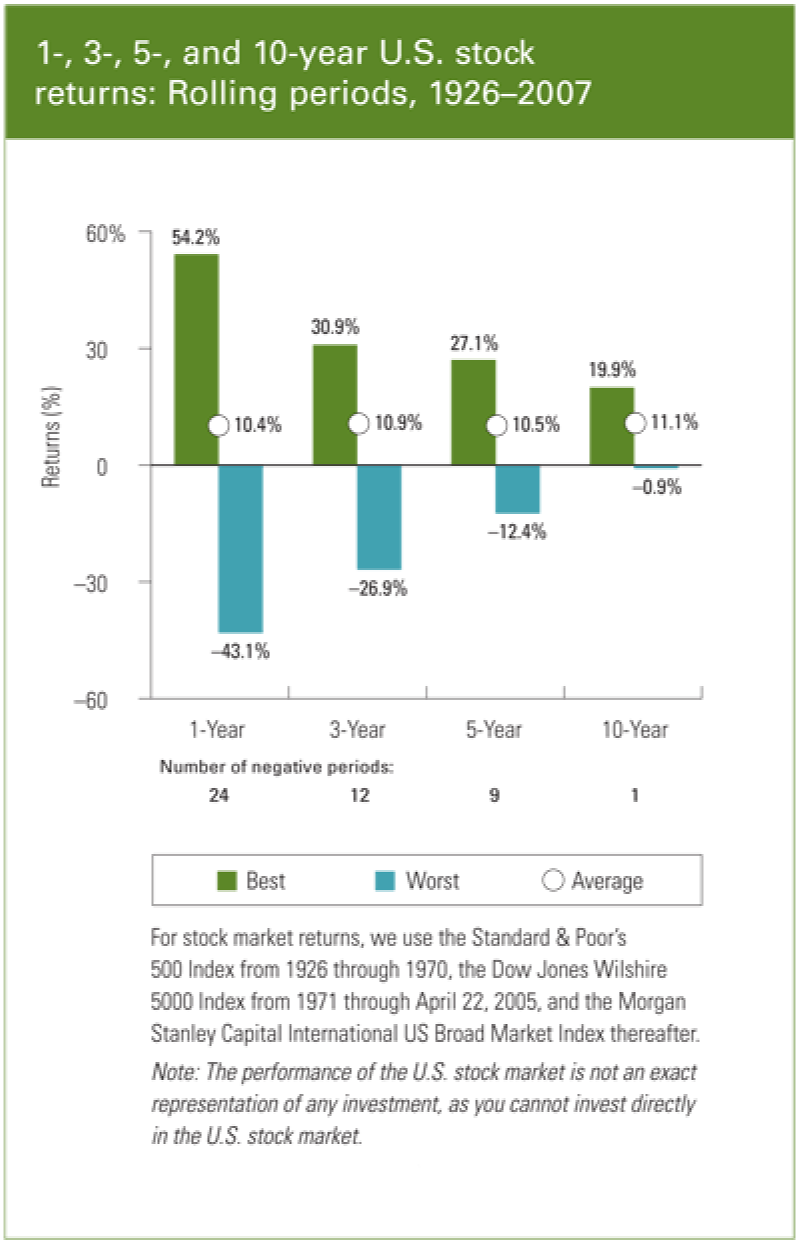
Nonprofits should base their selection of investment managers on multidimensional criteria rather than on a single factor. Investment committees too often overemphasize past performance at the exclusion of other important criteria. This approach can be problematic because past performance is often time-period dependent and has little to do with investor skill.

As mentioned in Vanguard's white paper, Evaluating managers: Are we sending the right messages?, the most widely used data for evaluating manager performance is generally short-term returns, which may not be meaningful. Because of the wide availability of this return data, it is not unusual for an investment committee to have a bias toward using it to frame its view of a manager.

The widespread reliance on short-term data also makes investors vulnerable to making mistakes based on loss aversion. The likelihood of experiencing negative returns from stocks has been high over shorter periods of time, but

[1] "Manager Selection." *Vanguard*, The Vanguard Group, Inc., institutional.vanguard.com/VGApp/iip/site/institutional/clientsolutions/endowmentfoundation/NPResourceCenter/managerselection.

much lower over longer time frames. Since 1926, stocks have experienced negative total returns in just one rolling ten-year period and nine rolling five-year periods. Over one-year periods, however, stock returns were negative in 24 of 82 periods (see figure below).



Source: Vanguard Investment Counseling & Research, 2006, Evaluating managers: Are we sending the right messages?

Regular review of short-term data, which increases the likelihood that investors will be confronting negative performance, may put pressure on investment committees to take dramatic action, such as changing managers or strategies in response to the bad news. In many cases, the most appropriate response is to stick with your original strategy.

The best committees look beyond statistics and test manager credibility by speaking with both current and former clients. Other aspects of a manager's record that should be assessed include his or her compliance history with regulators and any potential conflicts of interest, such as prior relationships with members of the investment committee.

We recommend the following four best practices in evaluating a potential investment advisor:

- *Understand each investment manager's investment process, which should be consistent over time and reflect your organization's philosophy.*
- *Analyze the nature of a manager's investment team and firm.*
- *Review the firm's long-term performance in light of its philosophy and process.*
- *Align manager's fees to your organization's goals.*

Manager selection criteria

Firm	People	Philosophy	Process	Portfolio	Performance
Ethics Stability Ownership Account and asset trends Client list Incentives	Deep investment team Succession/contingency Limited turnover of key professionals Tenure and experience Proven expertise in subject matter Demonstrated ability to handle large mandates	Shared by investment professionals Enduring Easily articulated	Understandable Stable/proven Generates a portfolio consistent with philosophy	Clear reflection of philosophy and process Consistent characteristics over time Indication of willingness to take risks	History of competitive results versus benchmarkets and peers Demonstrated success in different environments

Source: Vanguard Investment Counseling & Research, 2006, Evaluating managers: Are we sending the right messages?

Excessive investment advisor fees can eat into a nonprofit's investment return over time. According to industry averages, an organization with a $7.5 million annual distribution can lose more than 1% of a nonprofit's value to manager expenses (see table below). This can seriously damage an institution's ability to fulfill its mission. Over a period of several decades, the inability to control manager fees and expenses can mean inadequate funding for dozens of scholarships at a university, a multiyear delay or even cancellation of a new hospital wing, or insufficient resources to provide enough vaccines to cure an infectious disease in the underdeveloped world.

Manager expenses can impact nonprofit funding	
Initial Portfolio Value	$150,000,000
Spending/Distribution (5.0%)	$7,500,000
Investment Management/Custody Fees (0.3%–1.0%)	$450,000 to $1,500,000
Nonrecurring Expenses (0.0%–0.8%)	$0 to $1,200,000
Total Expenses	$7,950,000 to $10,200,000
Residual Portfolio Value (accounting for spending and expenses)	$142,050,000 to $139,800,000
Difference	$2,250,000

Source: Vanguard.

Fiduciaries also should ensure that a manager's fee structure is aligned with your portfolio's goals and time horizon. Applying a short timeframe to analyze a portfolio positioned for long-term results can end in poor investment decisions that compromise the ability to meet established objectives. Fees for an active equity manager, whose investment returns can vary significantly over short periods, should be based on performance of at least three years. Longer timeframes should be used to evaluate more specialized strategies, such as hedge funds, real estate, private equity, and other absolute return investments.

Conduct manager reviews

The appropriate timeframe for performance review depends on the asset classes involved. While assets in particularly efficient markets, such as certain money market and fixed income products, may require less time to assess investor skill, performance of assets in less efficient markets, such as equities and various alternatives, should be evaluated over a longer timeframe, a three- to five-year period, for example.

More frequent evaluations or a termination may be necessary should a substantial change occur in the mission of the manager's firm, its people, or philosophy.

A manager change may be warranted if the committee determines, over a sufficient timeframe, that manager performance is not up to par and is unlikely to improve in the foreseeable future.

Once you have hired a manager, Vanguard recommends establishing an ongoing managerial review process. Fiduciaries should regularly revisit the premises on which their original hiring decisions were made, periodically reviewing initial assumptions and subsequent behavior.