Keep that revolving door

Rotating through set of managers could be the best way to achieve optimum investment performance

By **Douglas Appell**
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WELLESLEY, Mass. — You can love your portfolio managers, but you have to be prepared to leave them, according to Howard Present, president and chief executive officer of virtual multimanager portfolio provider F-Squared Investments LLC, Wellesley.

In a recent Journal of Indexes article, Mr. Present, former managing director of global product management and strategy for Evergreen Investments, and Ron Santangelo, a former manager of Merrill Lynch & Co.'s managed solutions and analytics group, argue that the inability of even top portfolio managers to deliver alpha consistently over a full market cycle makes "buy and hold" a second-best strategy for mutual fund investors.

Instead, Mr. Present said in a recent interview, "a proactive process for removing managers from the investment portfolio is required."

With research by Mr. Santangelo showing the performance of managers who delivered results in the top two quintiles for a rolling three-year period deteriorating in the following 12 to 18 months, an optimal portfolio of 10 managers for any given style-based approach, such as large-cap growth equities, could see two to four managers replaced in any given year, Mr. Present said.

F-Squared is poised to begin bringing a family of virtual multimanager products to market in the next month or two. The products first will be offered through separately managed accounts by financial advisers, to be followed by an institutional offering, Mr. Present said.

The products will rely on F-Squared's "portfolio reconstruction technology" analytic engine to construct portfolios of roughly 150 stocks that will replicate an index of 10 leading actively managed mutual funds selected by consultants partnering with F-Squared: Boston-based Kanon Bloch Carr; Raleigh, N.C.-based Klein Decisions LLC; and Chicago-based Mesirow Financial Holdings Inc. The portfolios will have an annualized tracking error vs. equally weighted indexes of those managers of well below 100 basis points, Mr. Present said.

The firm has portfolios for each Morningstar style box, and a range of industrial sectors. Without the need to pay management fees for publicly available information gleaned from the underlying managers, the products will provide "the highest retained investor returns possible," with an SMA fee for a full turnkey product of 55 basis points and an institutional fee of only 16 basis points, said Mr. Present.

That pricing advantage might not be compelling for the biggest, most sophisticated institutional investors, but for a $300 million plan, a 16-basis-point fee on a small cap growth or value portfolio should be very attractive, Mr. Present said. Even so, he predicts demand for F-Squared's products from high-net-worth investors should lead the way: "I expect most institutions are going to want to kick the tires a bit."

Competitors and consultants say they agree with F-Squared's logic regarding the ups and downs of manager returns and the gains investors can garner from a carefully selected group of complementary managers, but they part company when it comes to shuffling managers.

“Manager "alpha cycles' are a constant source of debate and discussion within our firm,” but if identifying skilled managers is notoriously hard, systematically timing entry and exit points is much harder, said Matthew Rice, principal and chief research officer with Chicago-based consulting firm DiMeo Schneider & Associates LLC.

No confidence

“I wouldn't be confident in our ability — or anyone's ability for that matter — to time cycles,” said Joseph Brennan, director of manager research with Malvern, Pa.-based Vanguard Group.

And the damage from bad timing can be substantial, said Mike Prus, a manager in Oaks, Pa.-based SEI Inc.'s investment management unit. By way of example, he noted that investors who missed the Standard & Poor's 500's 10 strongest sessions out of 2,519 for the decade ended Dec. 31, would see their annualized returns plunge to 1.19% from 5.89%.

While conceding that figuring out which managers will do best this year isn't an exact science, Messrs. Present and Santangelo argue the subject is attracting growing interest — and yielding results.

“I'm not saying we can pinpoint where in the cycle we are at a given time,” but a growing number of models are starting to look at issues of cycles and how investors can position themselves to take advantage of them, said Mr. Santangelo, in a separate interview. He runs consulting firm Santangelo Research & Investment Management and serves on F-Squared's board of advisers.

“We don't try to identify the alpha cycle specifically,” agreed Mr. Present. Instead, “we use 10 managers to create enough diversification at substrategy level to improve results” and “embed a default holding period of one year” to try to identify managers who are “out of phase with the current cycle” before too much time has passed, he said.

The industry's most successful people are those who have “the most intensive attribution analysis ... (figuring out) what's driving a manager, where returns are coming from,” said Mr. Santangelo. There's evidence that improving on a 50-50 coin flip to get those timing decisions right roughly two-thirds of the time would add 200 basis points to an equity portfolio's annual returns, he said.

Mr. Present argued that F-Squared's virtual portfolios have begun reaping some of those benefits. Of the 249 basis points of excess returns the firm's large-cap growth equity portfolio has enjoyed vs. its Russell 1000 growth benchmark over the past five years, roughly two-fifths has come from lower management fees while the remaining three-fifths has come from tactical changes in the portfolio's manager lineup, he said.

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