A Manager Research Perspective on Risk Management

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In order to understand risk management from a manager research perspective, we first need to describe what we define as risk.

In the context of investments, we understand risk to be the dispersion of returns on an investment around the expected return. Risk is the probability of losing some or all of your investment, but can result in outperformance over the short-term i.e. taking excessive risk may lead to outperformance while putting your capital at excessive risk. In the context of manager research however, this identification of risk can be somewhat opaque as you may not know how much risk your asset manager is taking just by looking at past performance.

Placing managers on our "buy list" because we deem them as skilful, if in fact they are not, is one of the largest and most obvious risks. In addressing risk management in the context of manager research we have broken this down into three parts.

Risks relating to the quality of the managers that appear on our buy list, risks relating to the understanding of how managers are likely to perform in different market environments and risks relating to regulation and legislation, which has attracted a growing amount of focus over time. We touch on each one of these risks in turn in this article. It is also important to note upfront that these risks are not rewarded (unlike investing in assets), and the risk management process aims at avoiding or mitigating them completely.

Portfolio Management Risk

Including a manager in our portfolio on the basis of our view that the manager is a skilful one, only to have the manager persistently underperform will result in our portfolio not meeting its intended client objectives. The risk we face therefore from a manager research perspective is that of selecting poor quality managers for our "buy list", which will then be available to our portfolio management team for use in the portfolio construction process. We would define poor quality managers as those that have a weak investment philosophy and process, or a manager that has a poor track record of translating a good process and philosophy into a strong alpha profile. We therefore need to be able to separate skilful managers from those who are not. How we distinguish between these managers is the cornerstone of the manager research process and the magnitude of this risk should not be underestimated.

Our manager research investment due diligence process (operational due diligence is covered separately, and discussed in Sanusha's article) is the starting point for managing this risk. The starting point to minimising this risk is having a robust and rigorous process.

We subject managers to a process that entails due diligence questionnaires where we get information around their philosophy, their process, their people, and a range of other important factors like trading and compliance. An important point from this information gathering process is that it allows us the opportunity to make comparisons over time. We review each asset class or strategy on a two year cycle, and the consistency of a manager over time in terms of philosophy and process is very important

(I will touch on this further in the context of understanding the underlying managers in the next section).

Further to our due diligence questionnaire, we engage with managers at due diligence meetings, and this allows us to get an in depth understanding of how the manager thinks so we can get comfort around the depth of knowledge within the team.

Our manager research team also undertakes a large amount of desktop research as another layer of understanding the manager. This further enables us to put into context the investment decisions taken by the manager and how this has translated into performance over time. Essentially forming an understanding of whether this is evidence of luck or skill over time.

A second point to bear in mind is how we have organised ourselves as an investment team to make the decision of which managers are voted onto our "buy list". Our focus on leveraging of the collective wisdom of our investment team of fourteen investment professionals, allows us to view the underlying manager from various perspectives. A combination of diverse skills within our team makes for robust and thorough debates around managers, which reduces the likelihood of placing the manager in the wrong bucket i.e. buy versus sell.

Not having breadth of coverage in terms of managers that are available for our portfolio managers is also a risk. The risk here is that the portfolio management team would simply not have a comprehensive list of good quality managers available to choose from, either when initially creating the portfolio or later when looking to replace an existing manager.

Manager risk

Managers are included within a portfolio based on their investment philosophy and process (style), as they are expected to play a very specific role within the overall portfolio. It is important to state upfront, that we prefer managers that don't exhibit "dogmatic" styles but rather exploit as many sources of return (alpha drivers) as possible. So including a manager into a portfolio would imply that we have a good understanding of the manager's style and their potential delivery of alpha. A value manager, for example, would be expected to deliver a return profile in line with the value style. In some instances however a manager can deliver a return that is not in line with expectation. This is therefore a risk we face within the manager research function, of not fully understanding what we are likely to get from a manager in terms of the performance they deliver.

The ongoing review of the underlying portfolio holdings of manager mandates, to form an assessment of the alignment between the philosophy of the manager and the return they have delivered, is critical. It is also important to understand any significant divergence from expectation, even if the results are "deemed" favourable e.g. outperformance. A value manager investing in Naspers for example may seem quite out of kilter (out of balance). Understanding this in the context of the manager and their investment case would allow for a better understanding of the investment decision taken. From this we would be better positioned to understand if this is in line with the overall philosophy or if this is an indication of style drift or capitulation. In the instance of the latter, we would need a complete review of the manager. We like to review manager positions regularly to ensure this alignment, and to pick up any concerns quickly.

Additionally, not understanding the depth of the investment team within a manager and how they have organised themselves for decision making brings another manager risk. A recent example of this would be the change within the investment team at Prudential Investment Managers which saw Mark Beckenstrater move from the South African based Chief Investment Officer role at Prudential to take up a Portfolio Manager role at M&G, the parent company of Prudential in the UK. This was a significant change within the manager, and may have resulted in the conclusion that such a significant change would warrant selling out of the manager. This would have resulted in portfolio turnover and additional costs associated with the selling out of a good manager, because of a lack of understanding of the underlying team and how it is organised.

Given our continuous engagement with managers which our manager research process enforces; we understood the organisation of the team; and their collaborative decision making culture which influenced our view that the change did not pose any significant concern for us. This then eliminated any rash decisions being made on the back of the announcement, saving our portfolio and clients unnecessary costs.

Regulatory risk

Regulatory risk is the last risk we will touch on and is one that has been emphasised increasingly over time. The duties imposed on trustees, as fiduciaries, as a result of Regulation 28 of the Pension Funds Act should highlight the level of responsibility and rigour of due diligence required to discharge these responsibilities before an investment can be made in a manager. A similar requirement exists in the retail market, where financial advisers are required to carry out due diligence on the underlying managers before advising clients to invest.

Our manager research engagements are extensive, and are structured to allow an in-depth understanding of the underlying manager. This is then subjected to a manager research committee meeting where the investment case for the manager is debated before inclusion on a buy, hold or sell list. The entire support for the basis for our decisions is documented and maintained, allowing the collateral to be used as evidence of the work carried out on behalf of our own funds, and for clients using our manager research service.

Additionally, with the growing emphasis placed on environmental, social and governance (ESG) issues, it has become important for us to understand how the manager addresses these responsibilities. Be it an inclusion or exclusion criteria, or part of the valuation process, or proxy voting, or shareholder activism, managers are required to consider ESG for assets managed for clients. Understanding how this is implemented forms part of our due diligence process and is a standing point on our agenda.

Conclusion

Risk management is entrenched within each level of the investment process within STANLIB Multi-Manager and this includes the manager research function. We are however cognisant of the fact that managers evolve, markets change and new aspects of risk reveal themselves over time.

This is why we are focused on continuous interaction with managers to ensure that we address these risks as they arise. We understand that continuous work needs to be done to ensure that adequate processes are in place to address risk at all levels of the manager research process and we are consistently conscious of this responsibility.

Ensuring that we address our responsibilities in terms of regulation and holding managers accountable for their responsibility in terms of ESG issues forms an additional layer in our risk management process.

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