When the Chips Are Down: How Underperformance Changes Fund Manager Behavior

This study looks at the ways in which fund manager behavior changes after the experience of a period of substantial underperformance. A series of structured interviews with experienced investors was carried out. They revealed strong patterns in the changes in investment behavior that they observed. These changes were mainly regarded as unhelpful ones.

When investment performance is good, the job of managing money brings many rewards. In addition to financial rewards, fund managers get positive feedback from their clients, their peers, and the firm’s management, and they receive all the satisfaction that comes from success. But what happens when the manager suffers a period of substantial underperformance? This experience brings few rewards and any number of unwanted pressures. Does it change investment behavior, and if so, is it for the better or the worse? How effective are firms in supporting their fund managers through the tough times?

We investigated this area by carrying out structured interviews with 20 experienced investment professionals. All the participants had managed money and investment teams, and 11 were current or former chief investment officers (CIOs).

As might be expected with investors, we found plenty of differences in opinion. We also found, however, some strong patterns in the changes in investment behavior after long periods of underperformance that they had observed. These changes were mainly regarded as being unhelpful. The extent of these unhelpful changes suggests a strong motivation for firms to provide effective support for their money managers, but this support is not generally delivered.

METHOD

We held structured interviews in the second half of 2011. The interviewees ranged in investment experience from 14 to 40 years. All the participants were based in the United Kingdom at the time of interview, although they had a broad range of international experience. The firms that employed them managed, in total, assets of around £900 billion.

In the interviews, we asked participants to reflect on their experience over their investment career of how investment behavior changes following a period of substantial underperformance. We asked questions about whether they had observed significant changes across a range of investment behaviors. We asked about the direction of change of the behavior and whether its impact on subsequent investment on investment performance was typically helpful or unhelpful.

FIVE CHANGES TO LOOK OUT FOR

There were five changes in investment behavior that a majority of the participants had observed and considered to be unhelpful: shifts in risk appetite, shortened time horizons, increases in loss aversion, lowered levels of engagement with colleagues, and increases in confirmation bias.
1. Shifts in Risk Appetite  The appetite for taking investment risk seems to be significantly affected by the experience of substantial underperformance. Some 85% of the participants had observed changes in this aspect of fund manager behavior.

Figure 1 (and subsequent figures) shows how the participants’ observations of changes in behavior are split by the nature of the changes (shown by the bars) and their views on whether such changes were helpful or not (split by color within each bar).

A significant minority of the participants had observed changes in both directions, with some fund managers showing increased risk appetites and some, reduced risk appetites. As one participant commented, “Some swing harder, some go into their shells.”

A majority of the participants considered the changes to be mostly unhelpful. This opinion typically reflected the view that changes were often heavily influenced by the emotional response of the fund manager to a very difficult situation rather than being a considered response to a changing market environment.

2–Shortened Time Horizons  We found a clear pattern to the observations of how substantial underperformance affected fund managers’ time horizons.

As Figure 2 shows, participants generally observed a shortening of time horizons. This effect was associated with greater impatience on the part of investors for positive change. As one participant colorfully put it, “I need a stock to get me out of jail—fast.”

Shorter time horizons were also linked to the day-to-day pain of experiencing substantial underperformance. Fund managers are typically individuals who have experienced plenty of success in their lives. The experience of apparent “failure” can be a difficult one. One of the participants characterized it thus: “You have no spare alpha; every day gnaws at you.”

In addition, strong institutional pressures often push managers toward using a shorter time horizon. During a period of substantial underperformance, senior managers and the firm’s distribution arm may both give the message that the fund manager needs to “do something” to turn performance around. Even if this message isn’t given explicitly, a fund manager is likely to be well aware of the increased likelihood that he or she will be fired.

There was a high degree of consensus that these changes in time horizon tended to be unhelpful. This result is not surprising. The motivation for the shortening of the time horizon is typically the psychological state of the fund manager. Given this motivation, investing for a shorter time horizon than usual seems unlikely to increase the chance of adding value.

A fund manager may well seek to rationalize the use of shorter time horizons by stating that the market environment has changed so that the way to add alpha needs to change with it. In certain instances, this rationalization may be true, but more often, the main driver is likely to be the manager’s experience of substantial underperformance.
3–Increases in Loss Aversion The reluctance of investors to cut losing positions is well documented in the behavioral finance literature. This tendency appears to be primarily increased by the experience of substantial underperformance.

Figure 3 indicates that a majority of participants observed less enthusiasm for closing underperforming positions following underperformance—that is, greater loss aversion. The increase in loss aversion was ascribed to a variety of factors. When the performance of a fund is very poor, the potential for regret is greater should the position subsequently turn around. One aspect of this effect was characterized by a participant as follows: “What would I say to my boss if I sold it and it bounced?”

Another driver of an increase in loss aversion is the impact of what the fund manager has said to colleagues and clients about the positions in a fund. When investment performance is poor, fund managers generally have to do more in the way of explaining why the fund holds its current positions. This type of rationalization can make it all the harder later to acknowledge that a position needs to be closed. The observation from one of the participants about fund manager behavior was that “they get frozen in stocks that they have defended to their clients.”

A significant minority of participants, however, had observed fund managers whose enthusiasm for closing underperforming positions increased after underperformance. This result was typically linked to managers finding the pain of underperformance so acute that they reached the point of capitulation on losing positions.

A clear majority of participants viewed the changes in fund manager behavior as unhelpful. This view reflects the nature of the drivers of the changes. These drivers relate mostly to the pressures experienced by underperforming fund managers. There are no doubt fund managers whose increased loss aversion is a considered response to more attractive valuations on underperforming positions, but such managers appear to be in the minority.

The observations of greater loss aversion in times of underperformance are consistent with the research done by Frazzini (2006). Looking at U.S. mutual funds, Frazzini found that those funds that had the lowest returns in the previous year subsequently had the lowest proportion of realized losses.

4–Lowered Levels of Engagement with Colleagues Ware (undated) observed that the investment world has more than its share of introverts. The experience of substantial underperformance seems to accentuate this characteristic.
As Figure 4 shows, a majority of participants observed lower levels of engagement with colleagues following periods of underperformance. This lack of interaction was characterized as fund managers “going into their shell” and “becoming insular.” An important driver of this change was the emotional difficulty of dealing with the experience of substantial underperformance. Fund managers can easily feel less confident about sharing their views and investment thinking. Furthermore, they can become more resistant to challenges to their ideas and positions. This change was generally regarded as an unhelpful one. It is an important change because the interaction among professionals is a key part of the investment process in most investment firms. A common theme among the participants was the importance of trying to keep good levels of engagement and communication going when times are tough.

5–Increases in Confirmation Bias The inclination to seek out evidence that is supportive of one’s own views is a common feature of investor behavior. It can be easy for managers to focus on those elements of the information flow that fit well with an existing investment thesis or portfolio position and ignore disconfirming evidence. The degree of this “confirmation bias” does appear to change under the influence of investment underperformance.

A clear majority of participants observed an increase in confirmation bias, as Figure 5 shows. Unsurprisingly, they considered the change to be unhelpful.

When fund managers are experiencing a period of substantial underperformance, they are already getting plenty of feedback that their historical judgments have been “wrong” (or, at the least, unsuccessful). This feedback can make it all the more uncomfortable for them to acknowledge evidence suggesting that current views and positions may also turn out to be “wrong.” Like many of the adverse changes highlighted previously, this change is linked to a loss of confidence.

TWO POSITIVES
In two areas, participants typically observed helpful changes in investment behavior following a period of underperformance. Substantial underperformance generally led fund managers to look hard at their investment approach and at the sources of their historical performance.
Examining the investment approach A strong majority of participants had observed an increase in managers examining their investment approaches.

This change, as Figure 6 shows, was generally viewed as positive in light of two main factors. First, such an examination can highlight whether a significant shift has occurred in the way the investment approach has been applied and, if so, whether the shift is appropriate. For example, has a bottom-up stock-picking approach become more top down over time? Does this change play to the team’s competitive strengths?

Second, examination of the investment approach can highlight gaps or areas where the approach requires some evolution. Participants expressed plenty of caution, however, about this aspect. The pressures of underperformance can make it all too easy to carry out changes that are too substantial, rushed, or ill considered.

Understanding historical performance Substantial underperformance appears to act as a catalyst for many fund managers to look harder for insights from their own historical performance.

A common theme of participants’ responses was that fund managers often don’t fully understand the drivers of their historical performance and thus turn to fuller examination of these drivers. In particular, they may have failed to carry out structured analysis that looks for specific factors or patterns that could lie behind the underperformance. In this context, it is not surprising that the greater attention to understanding historical performance was mostly seen as a positive.

PROVISION OF SUPPORT BY THE FIRM

Given that substantial underperformance is associated with plenty of unhelpful changes in investment behavior, strong motivation should be present for a fund manager’s employer to provide support to counteract unhelpful changes. Apparently, however, such support is rarely provided. Effective ways of providing support were identified by participants, but firms were generally viewed as being poor or variable at applying these means.

How support can be given Numerous observations on how firms can help focused on supporting the fund manager’s investment thinking. This support would typically take the form of constructive challenge and questioning of both the approach taken to making investment decisions and specific individual decisions. This conversation could help reduce the potential negative changes in investment behavior and also deepen the
Figure 6. Observed changes in the level of examination by fund managers of the investment approach

Participants observing change (%)

Nature of changes

Figure 7. Observed changes in attention given by fund managers to understanding historical performance

Participants observing changes (%)

Nature of changes
fund manager’s own understanding of the investment approach, its strengths and limitations, and how to apply it most effectively.

The “constructive” nature of this challenge and questioning is important. When a fund manager hits a spell of substantial underperformance, a long queue of clients and colleagues will often readily point out the recent “failures” in the fund manager’s investment thinking and the impacts of it on performance. What fund managers need is help in carrying out thoughtful reflection on their investment approach and its application, not yet more need to defend and justify it.

The process of constructive challenge and questioning may well reveal some weaknesses in the way the fund manager has been making investment decisions. It may also reveal potential strengths, however, that may be underused. Questioning about this area can remind the fund manager of the skills that he or she does have. It can also help deal with the issue of loss of confidence, which lies at the root of many of the negative changes in investment behavior we have highlighted.

Obstacles to effective support Organizational structure and culture can both play an important role in whether support is given. In some organisational structures, there may be simply no individuals within the firm who see it as their role to provide support to a fund manager. This problem is particularly likely in organizations where the fund manager reports to an individual whose primary role is a business one rather than an investment one.

Furthermore, the organizational culture may not encourage the provision of support. This situation is particularly likely where results are expected over a short time frame or where the accepting of support in tough times would be regarded as a sign of weakness.

Obstacles remain even where an individual, such as the CIO, “owns” the role of providing support. The CIO may have neither the skills to provide effective support nor the time to do so. In addition, the CIO is typically a key decision maker in any decision to fire a fund manager. Thus, discussions about the fund manager’s weaknesses or historical decision making are likely to be less than frank. As one of the research participants put it, “They don’t want to admit weakness to a boss who will be deciding if they are for the chop.”

Two main alternatives were suggested to complement the support given by the firm’s management. First, an external coach, someone with broad investment experience, could be used. This approach has the advantage of providing an independent and confidential sounding board for the fund manager. Second, a peer with the relevant skills from within the firm could be sought as support giver. A peer can potentially elicit more open dialogue than when support is provided through the management structure.

CONCLUSION

The experience of substantial underperformance frequently changes the investment behavior of fund managers. Many of these changes—an increase in loss aversion, shortened time horizon, less engagement with colleagues, and greater confirmation bias—are likely to be harmful to a fund manager’s ability to generate alpha in the future.

Therefore, the danger is that a period substantial underperformance can lead to an increase in the likelihood of further underperformance. This danger in itself is costly to the firm and also increases the chances that the fund manager will be fired, with all those attendant costs and client risks.

Despite these high potential costs, firms often struggle to provide effective support to their fund managers through the tough times. Much can be achieved, however, by offering such support. It need not focus solely on mitigating the impacts of unhelpful changes in investment behavior; it could also encourage the investment manager to gain understanding from the experience. In the words of one of the participants, “Serious underperformance offers a real chance to learn, but few investors have the humility and confidence to take advantage.”

REFERENCES


Greg Richmond is an associate at Investit Ltd.
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