



## Evaluating Active Managers: The Role of Belief Systems<sup>1</sup>

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*See the related article by John Minahan, [Do Cultural Biases Inhibit Performance?: The Case of Style Boxes](#)*

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When I evaluate an active investment manager, I usually try to uncover what I can about the manager's belief system, for two reasons. First, an active investment process is designed to exploit a manager's beliefs about how superior performance is generated, so understanding the manager's beliefs is central to judging the manager's investment process. Second, I want to know how proactive the manager is about using the available tools to self-assess his or her investment process and beliefs. At the very least I want to see managers with adaptive belief systems, and if they are proactive, all the better. While I don't have any hard evidence that adaptive or proactive belief systems affect performance – perhaps some data gathering is appropriate here – I have more confidence in managers that actively wrestle with learning and improving using whatever tools they can get their hands on, formal or improvised.

Talking about beliefs is difficult. Most managers are not accustomed to doing it in a substantive way. Consequently, approaching the topic directly ("So, what are your investment beliefs?") will likely generate superficial responses. It is better to let managers tell their story on their own terms, and then seek opportunities to ask follow-up questions which flow from the manager's story, but which also serve the purpose of shedding light on the manager's belief system. Often, simple questions such as "why do you think that?" or "why do you expect that to continue?" can go a long way to uncovering a manager's beliefs. Other times using concepts from capital market theory to frame one's questions increases the mileage of the inquiry.

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<sup>1</sup> Some of the material in this section first appeared in Minahan (2006).



However the conversation goes, in the end I would like to have a sense for the content of the manager's beliefs and for the process by which the manager manages their beliefs. Let me discuss each:

### **Evaluating belief content.**

Every now and then I meet a manager whose beliefs seem to violate bedrock theory. For example, some managers pursuing a high dividend yield strategy highlight the "compounding power of reinvested dividends" as a reason for hiring them, as if dividends somehow compounded more effectively than capital gains. As Alfred Rappaport (2006) has so eloquently pointed out, as a purely mathematical matter, it is total returns that compound; the division of returns between capital gains and dividends, all other things equal, has no impact on how returns compound over time.<sup>2</sup>

So when I listen to a manager making their case, one of the questions I am alert to is, "does the manager's case seem to rest on any violations of bedrock theory?" If it does, after making sure I haven't misunderstood the manager, I usually dismiss these managers without a second thought. Of course there is always the possibility that it is merely the marketing pitch that violates the bedrock, and that I may reject a good manager because of poor marketing. But I am not worried about this. Having a marketing strategy that is at odds with what the manager actually does is itself a sign that something is wrong with the organization. No point in wasting time – on to the next manager.

With managers that get past the "no-bedrock violations" screen, I would like to have a sense of the managers' beliefs on the following:

- Where do superior opportunities come from? What is it about the workings of capital markets that cause some opportunities to be available for less than they are worth?
- What is it about the manager that allows them to pick up these opportunities before someone else bids the price up?
- How does the opportunity set change over time? What are the underlying causes of opportunities changing over time? What is the manager's view on their own possible need to change in response to a changing opportunity set?

I find efficient market theory extremely helpful in guiding an interview so as to uncover answers to these questions (assuming the manager has answers). More specifically, I find *inverted* efficient market theory helpful.

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<sup>2</sup> There may indeed be reasons to like stocks with a high dividend yield, but compounding power is not one of them.



Although there are several variants of efficient market theory, the basic idea is that the process of trading on information or a point of view causes that information or view to be reflected in asset prices, and once reflected in prices, the information can no longer be used to generate superior returns. The inverse of this statement is this: “If a manager is to generate superior returns they must be able to trade on value-relevant information or perspectives before that information becomes reflected in price.” This is the value of efficient market theory as a logical construct. It simplifies all the possible reasons for superior performance into one focused question: how does the manager trade before their perspective or information is reflected in prices?

Ultimately, every coherent belief about how to generate superior returns ought to be able to be translated into a reason why the manager can trade before their information or perspective is reflected in prices<sup>3</sup>. If the manager cannot make this translation, I am inclined to assume the manager doesn't have a coherent belief system<sup>4</sup>. On the other hand, when dealing with a manager who does have coherent beliefs, this question can open a window into the manager's thought process and game plan for adding value.

Sadly, most traditional managers I interview are unable to credibly explain how they trade before their perspective gets into prices. Many managers appear to not even think in these terms, but instead focus on exploiting past patterns (e.g. "low price-book always works in the long-run") or buying "Mom and apple pie" stocks (e.g. "we only buy the highest quality companies, the companies that made America great"). There is nothing necessarily wrong with attempting to exploit past patterns or with buying quality companies, but unless a manager can explain why their perspective is not reflected in the prices of what they buy and sell, there is no reason to expect they will outperform in the future.<sup>5 6</sup>

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<sup>3</sup> Most reasons for being able to trade before price reflects one's perspective fall into one or more of three categories: the manager has an information gathering advantage; the manager is able to make more accurate predictions with the same information; or the manager is able to react more quickly when circumstances are changing rapidly and prices have not yet found an equilibrium.

<sup>4</sup> I am often challenged on this point. Critics say that it is not uncommon for talented managers to be inarticulate, so one doesn't know what to conclude if a manager can't explain himself. I think there is merit to this point of view if one is talking about an individual. However, investment management firms put enormous effort and expense into articulating their stories. If, despite this, they can't explain something as basic as how they view and exploit the opportunity set, I don't see how one can come to any conclusion other than the firm doesn't have a coherent view of how they generate value for their clients. Another challenge I receive is that some managers don't wish to reveal how they generate superior returns. I think this is a legitimate issue, but it doesn't really come up that much in practice. Most managers want to provide consultants with whatever it will take for the consultant to get comfortable with their process.

<sup>5</sup> It is important to note that not all managers fail this test. Some managers understand that trading ahead of price is *the* central issue, and are very good at explaining how the opportunity arises and how they exploit



## Evaluating belief management

The key questions I have regarding a manager's belief management are:

- How does the manager self-evaluate their investment process? What evidence does the manager look at to do this?
- Does the firm's culture support or retard greater awareness of potentially unconscious beliefs?

I will discuss each in turn:

### How does the manager self-evaluate?

The fundamental problem of performance evaluation is that returns have a substantial random element. This makes it difficult for an evaluator to conclude that good performance derives from successful execution of a sound investment strategy. This is obviously true for an external evaluator such as me, but an internal evaluator faces the same problem.

Some managers don't put much thought into self-evaluation. If performance relative to a benchmark or peer universe is good, they stop there. If performance is poor they may put more effort into analysis so as to craft a favorable spin on the situation. These are not the managers I want to hire.

I prefer to hire a manager who is driven to make honest and careful assessments of their investment process in good times and bad, and who understands that good performance can occur for reasons other than successful execution of the investment strategy. That is, I prefer a manager with a proactive belief system with respect to self-evaluation of their investment process. There are two things such a manager can do to partially mitigate the fundamental problem of performance evaluation:

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it. I have had somewhat better experience with alternatives managers than traditional managers in this regard, but in both camps there are managers who do this very well.

<sup>6</sup> Even when a manager can offer a *plausible* reason for superior performance, there remains the question as to whether there is any evidence that the plausible reason is the actual reason. It can be very difficult to generate such evidence, but as an evaluator I want to see that the manager has tried. Any manager that is seriously attempting to outperform realizes that he has as much at stake as anyone in understanding whether good performance actually derived from the manager's strategy or just good fortune.



- **Get the benchmark right.**<sup>7</sup> This ought to go without saying. Yet the overwhelming majority of managers I review use a benchmark that is not meaningfully connected to either the investment process or a reasonably specified passive alternative. The simplest example of this is a manager that selects securities from a universe materially different than the index to which the manager is compared. Externally, they may have no choice about their benchmark. Internally, they can use whatever they find most useful. If they are not careful about this choice that tells me they are not serious about self-assessment.
- **Supplement performance data with non-performance indicators of process success.** A manager with a proactive belief system wants to know if their process is working, and recognizes that good performance (even relative to a good benchmark) is not sufficient to come to that conclusion. Therefore, these managers seek additional indicators that the process is working. For example:
  - A manager who predicts earnings can track the accuracy of these predictions.
  - A manager who predicts bond upgrades and downgrades can track those predictions.
  - A manager who develops a fundamental view of the future can confirm whether the future actually plays out as predicted.

The key is that a manager recognizes there is a wide variety of data that can bear on self-evaluation, and proactively seeks out and uses the data available. If a manager does not do this, it seems fair to conclude that it is not important to the manager to improve over time.

**Does the firm culture support or retard greater awareness of beliefs?** A strong culture is usually viewed as a good thing. However, since all the members of a culture by definition share a set of unconscious assumptions, a risk of a strong culture is a weak capability for surfacing beliefs. Below I give you two examples of how firms have dealt with this, one where culture is used to enhance awareness and one where it seemed to reduce awareness.

- **Using subcultures to enhance awareness.** I once reviewed a manager whose investment process had two independent sub-processes, one quantitative and one fundamental. Each sub-process was run separately, but then each group critiqued the other's stock picks, and where they

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<sup>7</sup> Benchmarks are essential. As Waring and Siegel (2006) have argued, the universal goal of all active management is to add value over a benchmark. "Benchmark-free" investing is more a matter of not being clear about what the benchmark should be than it is an actual style of investing.



disagreed, each had to explain what they thought the other was missing. These debates were used to identify blind spots in both sub-process, and to improve them over time.

- **Hiring practices and culture.** Another manager I once reviewed emphasized that they always hired inexperienced analysts and then trained them in their way of doing things. All of the senior investment people in the firm started as junior analysts. They considered this to be a positive thing, as it ensured consistency in their approach. However, it raised concerns about inbreeding. So I asked for clarification: did they *never* hire experienced analysts or was it just uncommon? They responded that a few times they hired experienced analysts but they never worked out. Their thinking had been too “contaminated” by the outside world and could not adjust to the culture of this firm. So they “learned” from this experience that they shouldn’t hire experienced analysts. I came to a different conclusion.

A manager who is serious about generating superior performance ought to be serious about self-assessment. Such a manager should be *driven* to find tools and data which will enable objective self-assessment. At the very least, they should benchmark themselves right. If they don’t it is hard to take seriously any claims they make about how they generate superior performance.



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