FRONTIER ADVISORS

20 years

# Observations on Equities

## North American Research Trip

## April 2015


Frontier Advisors Pty Ltd

International Research Issue 12

Frontier regularly conducts international research trips to observe and understand more about international trends, and to meet and evaluate first hand a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high level assessment on the key areas and observations unearthed during this research venture. We would be pleased to meet with you in person to provide further detail on these observations.

**Our research team**

In April 2015, members of Frontier's Equities Research Team travelled to Canada and the US. A focus of this trip was to meet with global equity managers we either currently rate or which we could rate in the future. Discussions with managers covered a broad range of themes and gave us a variety of perspectives, providing us with a sense of the issues global equities managers are grappling with at the moment. While many issues are manager-specific, some are common across many managers. One theme that pervaded a disproportionate number of meetings is the subject of this International Research Issue: Performance and Sales oriented cultures.

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# Introduction – performance versus sales culture

Members of Frontier's equities team recently visited around 40 investment teams over a two-week period in North America. These days, we get more international managers visiting Australian than ever before, so it is reasonable to question why Frontier places such an emphasis on onsite visits. However, we think onsite visits provide numerous insights that help us identify managers that can outperform in the future.

One theme which became increasingly obvious during the research trip was the divide between investment managers which are driven to deliver performance and those that are driven to increase funds under management (FUM).

Our due diligence process is geared toward identifying those investment managers that are most driven to generate outperformance and we aim to avoid managers that are likely to prioritise business growth at the expense of performance.

Logic and our own experience indicate that managers with a strong performance culture are more likely to deliver strong returns than those where sales objectives take precedence, even if the incremental sales could damage future investment performance potential.

Meeting managers onsite is very helpful in assessing cultural differences as:

1. we can see who is brought to the meeting (i.e. how many sales people attend),
2. we can hear what ultimately motivates the firm's leaders (performance or asset growth);
3. we can gauge the working environment from meeting multiple team members, including the level of intensity and hunger for delivery of superior investment performance.

This report outlines examples from meetings which are indicative of a strong performance culture and other examples where we feel sales efforts are in conflict with delivery of future investment performance.

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# Performance oriented cultures

### Accountability

One feature of a strong performance culture is accountability, both at the individual and team level. We tend to find all managers are willing to be accountable for periods of success, but we learn most about a manager when discussing accountability as it relates to the more challenging periods. We accept that some investments do not play out as planned and expect managers to be able to articulate where mistakes have been made, including identifying who ultimately made these mistakes.

One manager we met with during this trip has a regular and relatively frequent review process for investment team members which assesses their contribution to the team and areas for improvement. This regular program of individual performance assessment, feedback and review is a sign that investment performance is the basis of their employment. The staff members are acutely aware of the deal – work hard, generate superior investment performance and you justify your place and the lucrative rewards. There will, however, not be any passengers in this team's culture and underperformers are measured and moved on, if necessary.

By contrast, we met with other managers where accountability was murky.

Some managers found it difficult to attribute responsibility for stock recommendations or portfolio decisions to any particular team member (or team members), often suggesting decisions were the collective team's responsibility.

In many respects, this manifests itself as nobody feeling truly accountable. This has problems on two levels as team members do not learn from mistakes and, correspondingly, team members are not rewarded for their successes.

From our experience, it is surprising how often we see a lack of clarity in accountability, so we are naturally drawn to the examples of clear and firmly applied accountability structures.

### Intensity

The difference in intensity levels between managers with a strong performance culture versus those with weaker performance cultures is also evident from the onsite meetings.

We consider intensity levels to be correlated with success. We meet plenty of passionate people that love investing, but we meet far less that display determination, drive, work ethic and a hunger for success.

A comment made by one Boston-based manager helped to separate their intensity from the masses. The manager commented that it is easy to fall into "receive mode" and meet company management as they come through Boston. However, he sees this as a trap and encourages his team to travel to see companies onsite, where the environment is different, there is a broader range of people to meet and many other cultural aspects can be observed.

This was a good example of a manager not taking the easy option and recognising it needs to be generating insights and ideas rather than waiting for them to fall into its lap. These are essentially the same reasons that motivate Frontier, as manager researchers, to conduct our own onsite visits. We know we experience a far richer engagement with investment managers on their home turf, relative to their visits through Australia.


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# Performance oriented cultures

Another example of intensity was a (very successful) quantitative manager that described the evolution of its investment approach, with enhancements borne out of trying to stay ahead of its competitors. This manager assumed its competitive edge was continually at risk of erosion by other quantitative managers replicating its approach. It therefore continued to innovate and was willing to make material changes to its models in order to retain an edge.

We contrast this with other quant managers we met which seemed complacent in thinking their existing approach was highly effective, had inconsequential research agendas and were content to tinker around the edges of their models.

We regularly discuss remuneration structures with managers as they are an important part of any investment business. Ideally, remuneration structures promote clear accountability, as discussed earlier.

However, when it comes to potential future success, we think an appropriately aligned remuneration structure does not, on its own, lead to a performance-oriented culture. For superior longer-term performance, we look for evidence of human behaviours which we think are correlated with investment success. These can include determination, work ethic, a willingness to travel and meet companies (where that is relevant to the investment process), as well as a voracious appetite for learning.

Often, these less obvious human traits are only observable when meeting investment teams onsite.

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# Sales oriented cultures

While we are aware of investment managers that combine a successful performance-oriented investment culture with an effective sales culture, the ability for these cultures to coexist in the long-term is rare. More often, we find our onsite visits identify an unhealthily strong sales culture that threatens long-term performance generation.

### Product proliferation

An issue we are always on the lookout for is the expansion of a manager's product suite, motivated by an interest simply in growing assets under management.

We are very supportive of managers introducing new strategies where there are legitimate reasons (e.g. existing investment philosophy and process is expected to work well in a different universe of stocks or to give a valuable employee a portfolio management opportunity). However, we are conscious of instances where introducing a new product can negatively impact existing strategies by, for example, distracting portfolio managers or impinging on capacity for those strategies.

We question the motivations of one manager during the trip that has introduced a larger cap version of its flagship equity strategy under the guise of providing intellectual stimulation to existing investment team members.

When considered in the context of a four-fold increase in funds under management in four years, we came away with a view that this manager prioritises growth in funds under management ahead of focusing on performance.

Growth in assets and profits can be seductive and this investment manager is capitalising on its current popularity, without any great consideration of whether this is in the interests of long-term investment performance.

By contrast, we met with two other managers during this trip that have introduced small new strategies which are not expected to negatively impact other strategies.

In one case, the new strategy is a smaller market cap implementation of one of the manager's global equity themes. The manager has the expertise in place to offer this strategy, this product is motivating and exciting existing staff and there is the associated benefit of potential new ideas for the global equity strategy as the companies grow.

In a similar vein, the second manager has introduced a small strategy that invests in private companies (and has added a dedicated investment team to avoid distracting those managing the listed equity portfolios). The strategy is expected to generate returns in its own right, but also importantly can give the manager a head start in identifying potential holdings for the manager's listed equity strategies as these private companies are brought to market.

Given the manager invests heavily in innovative companies in technology and health care, we can see the potential benefit of taking this approach.

We consider these latter two examples to be logical extensions of an existing internal capability which have the potential to improve existing offerings, but more importantly, do not detract from existing offerings.

# Sales oriented cultures

### Lack of capacity clarity

Managers' willingness to grow funds invested in particular strategies without regard to capacity constraints is another indicator of prioritising fund growth as opposed to investment performance.

We expect managers to have conducted analysis which indicates a level of funds that can be managed in a strategy without the ability to trade positions or take positions in stocks at the smaller end of the universe being unduly impacted.

We have various concerns with managers we met on this trip in this regard. We found successful managers unwilling to stipulate their expected capacity limits, while others had already grown assets to levels that seem destined to materially impact future performance.

One "all cap" manager, in particular, (which has experienced rapid growth in funds under management over the last few years) essentially admitted it had grown its funds assuming it would remain invested in large caps for the foreseeable future. It noted that, if it were to find opportunities in smaller and mid-cap companies, it would need to change its approach by either investing in more stocks or by increasing its ownership stakes in individual companies.

This lack of effort in considering capacity and performance impact is indicative of the manager's overarching focus on continuing to build assets under management and showing scant regard for how such growth will impact the execution of its strategy.

While capacity limits may legitimately change over time, we expect managers to have an understanding of what the impact will be on the execution of the strategy at different levels of funds under management.

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# Conclusion

We think onsite meetings are very important when assessing investment managers. These onsite meetings enable us to see the true fabric of some of the investment organisations and the culture and conduct of the investment teams.

This is often less obvious when managers visit Australia with a pitch-book in hand.

A theme that was apparent during this trip was the stark divide between managers with investment performance as their primary objective and managers with sales as their primary focus. Our investment process is designed to identify those managers we expect to generate strong returns over a market cycle, which naturally guides us towards those managers which are structured to deliver performance, first and foremost.

That said, we acknowledge that investment managers are not altruistic entities.

The ability to increase funds under management to a level which helps attract and retain talent and ensure the stability of the organisation in the future is important. Therefore, we acknowledge we need to examine the interplay of a manager's investment culture with its sales culture.

Our preference, however, is that success in attracting funds follows from having established a strong performance culture as the backbone to the organisation, rather than a strong sales culture.

We think this is most easily discerned by spending time onsite with the investment managers.


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