Track Record and Asset Manager Selection

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Being specialized in the development of quantitative investment strategies, we regularly do performance evaluations and due diligence on a wide array of asset managers. Though the majority of those managers are in the quantitative/systematic space, some are also "normal" discretionary managers. This article presents an overview of the most critical steps involved in this process with a particular focus on quantitative managers and in particular with regard to the track record.

The relevance of the track record

The world is full of highly intelligent and charming people with great strategies for how to manage your assets – all for a fee, naturally. Nevertheless, as Winston Churchill once noted: "However beautiful the strategy, you should occasionally look at the results."

The first step is to establish whether a proper track record exists. Not long ago a client was approached from a tier-1 UK bank promoting an investment product. The performance charts looked excellent and the fund was led by a highly skilled management team. However, written in what was clearly the smallest font size available, it also said that all results were "hypothetical and based on simulations". To be clear, this is not a track record. Yet it is surprising how many people still give at least *some* weight to a simulation or "back-test". To illustrate why this is a mistake, please consider the performance in the chart. This very liquid S&P 500 strategy outperforms all major benchmarks by a wide margin with annualized returns of 15% since 1999 and an attractive risk profile with just a 20% maximum drawdown vs. the 51% drawdown of the S&P 500.

The time invested to design the strategy was exactly 17 minutes. It was done using a commercially available product (costing less than $500) instead of a proprietary advanced backtesting framework to demonstrate how readily available it is to anyone. No programming skills were required and only out-of-the-box trading signals were used. A 3-minute optimization of the parameters yielded over 32,000 NAV curves to pick and choose from. The result is an impressive looking curve-fitted fantasy of no real value at all.

A real track record thus implies evidence of actual investment results and ideally it a) has been independently audited and administered, b) covers an extensive time period, c) covers different market conditions and d) is the manager's exclusive track record.

The track record needs to have been audited by a reputable auditing firm and any fund accounting done by a top-tier fund administrator. Incidentally, none of this was the case with Madoff. Preferably neither the auditor nor the fund administrator have changed since inception, since such professionals will only accept responsibility from the time of the handover. It is quite common though for smaller funds to upgrade from a cheaper service provider to a better known name as the assets grow. This is understandable due to economic reasons and not necessarily an indication of any problem with the track record. Be aware of the limitations of a statutory annual audit in contrast to a full performance audit.

The track record not only needs to cover an extensive period of time, but also include a variety of market conditions. It is advisable not to invest in funds with track records shorter than 5 years. The time requirement ensures that the manager has a certain structural stability and staying power, even more so, if the market conditions have been difficult. The track record needs to give some indication that the manager can handle not only one market condition. Multi-year one-way markets have been very common over the last 20 years. A manager with an excellent audited track record over many years to 2000 is of limited use, since during this time it was a one-direction market and any reasonable bullish strategy would have yielded very good results. Currently the situation is similar with the many funds that launched at or just after the bottom of the financial crisis, i.e. March 2009. For a manager investing in virtually any asset class, except perhaps commodities, it has been rather difficult to fail since then. Essentially such managers made a very good timing decision of when to launch the fund – or were lucky – and have been able to profit from a roaring bull market in their asset class. How they would have performed during a different market environment is impossible to say. Clearly, a track record spanning at least a part of a financial crisis is more valuable.

The multiple track record

The track record also needs to be *exclusive*, in the sense that this was the manager's main line of activity and not one of several. Let us for a moment imagine a manager running 10 investment strategies in parallel. All are properly audited and spanning a reasonable length of time. He can now pick and choose the track record that is best

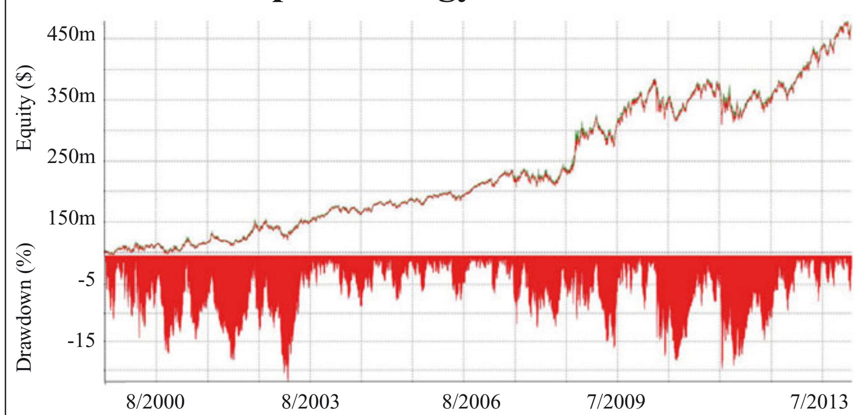
from a marketing perspective. The value of this track record is limited as it is likely the result of luck rather than investment competence. Even a blind squirrel finds a nut once in a while. It is no coincidence that the sales agents at the major financial institutions always seem to have a high-performing product to sell you. To explore whether a manager has marketed other now-defunct strategies, share classes, products etc. historically, a surprisingly useful tool is the Web Archive (http://web.archive.org) which contains historical snapshots of web pages. It is a gold mine for information that a manager would rather not talk about.

The "multiple track records" problem is even worse in relation to managed accounts, which is a common form of track record among managers seeking to launch a fund. The managed account track record will be audited as well, but it is impossible to say how many accounts the manager was running in parallel trying out any number of wild ideas, of which some are bound to work out by pure luck.

Track record sustainability

Will an excellent proven track record translate into further future gains? To answer this it is essential to understand *who* created the track record and *how*. Therefore the due diligence focus is on key personnel, signs of capacity constraints and manager adaptability.

With every investment manager there are typically one or two persons that either directly or indirectly are key to the success of the firm. As an investor you need to know who these people are and that they are still highly involved in the business on a day-to-day basis. A common misconception is that there is a substantial difference between discretionary and systematic managers in this respect, as the strategies can continue to operate automatically anyhow. However, this is only true for a limited time as all strategies need regular review followed by adequate adaptations. This is not an automated task, but rather one that only a very experienced system developer can perform. Potential investors should insist on meeting these persons at least once a year to gauge their level of involvement.



In a previous article in PRIVATE (5/2012) I discussed the capacity constraints of strategies. Every strategy has a capacity constraint, whether it is a fund of $10 million or $1 billion. At some point the cost of execution, i.e. slippage, becomes so high that it effectively kills the performance. The manager needs to prove convincingly that he will be able to repeat the track record with considerably more assets under management in the future. It is a common mistake to believe that large funds are any safer in this regard than smaller funds. There is no guarantee whatsoever that a large fund has not reached its capacity ceiling just when you are about to invest. On the contrary, capacity ceiling issues are generally more difficult to overcome when the fund is already large.

Managers – and in particular systematic managers – are typically secretive about strategy details and for good reasons. However, they should still be able to provide actual trade execution details that will give some confidence regarding the capacity ceiling. They need to give evidence of exactly how the execution is done, i.e. time of day, order type, duration and the instruments traded. Ask for a real execution track record over a 1-month period within the last 6 months, where the date and price fields are removed and the order of trades randomized. Another field should contain the effective slippage expressed in percent, i.e. the difference between the price at the time the order is placed and the final execution price. The disclosure risk for such information is minimal and the investor should not accept this excuse by the manager to hold back information. The manager should also be able to provide trade frequency numbers, average trade percents, losing trades percents, winning trades percents and percents of winners.

Based on the above information, it should be possible to form an informed opinion about the likely capacity constraints based on the relationship between the volume traded in the market typically at that time of day and the size of the manager's orders. Also it would be helpful to request a historical slippage chart expressed in percentage per trade. As this information is provided by the manager, it is advisable to sit down and discuss which parts could be independently verified by either the administrator or the auditor. A good administrator can supply much information as they likely already have the reports in their systems. There might be a cost involved, but depending on the amounts involved it can be money well spent.

Inquire about changes in investment strategy over time. It is only to be expected that there have been changes. As an investor you will want to see a number of strategy progressions and adaptations over the years, rather than a manager reluctant or afraid to introduce changes. The managers who have proven that they were able to adapt to changing market environments and who also communicate these strategy changes in an open and transparent fashion are the ones that you want to look at more closely.

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