

# Evaluating Managers: Are We Sending the Right Messages?

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**Executive Summary** Investment managers are traditionally evaluated on quantitative measures of performance, including performance relative to a benchmark, portfolio attribution analysis, and statistical measures such as information ratios. But this method of evaluation can potentially lead to a misalignment of goals and objectives between portfolio managers and those charged with evaluating their performance. This paper reviews some common flaws in the current manager-assessment process: lack of awareness of our biases; misuse of good tools, overreliance on bad tools; and a short-term focus. After reviewing the flaws, the paper outlines a framework for manager evaluation that:

- Addresses shortcomings that keep us from sending the right message.
- Communicates the right message.
- Continually reemphasizes the right message.

## Introduction

The process of evaluating investment managers has evolved dramatically since the 1974 passage of the Employee Retirement Income Security Act (ERISA), the landmark retirement plan legislation that intensified plan sponsors' focus on their fiduciary duty to plan participants. Before ERISA, the process was largely qualitative. The typical standard of evaluation was whether a manager had outperformed the broad market over a full market cycle—a standard so vague as to be almost meaningless. What in the world is a market cycle?

After ERISA, regular, rigorous evaluation of investment managers came to be considered a fiduciary obligation. This renewed focus on manager performance coincided with revolutions in technology and investments that put sophisticated analytical tools and enormous

amounts of data in the hands of investment consultants and committees. From our experience and perspective, the manager-evaluation process today is overly dependent on quantitative approaches. Too often, fiduciary decisions are based primarily on an array of statistics and analytical tools that, to outward appearance, seem to offer objective judgments of manager ability. What's lost is a focus on the manager's investment process, the framework for decision-making that can distinguish superior managers from the crowd.

Quantitative tools *do* enhance our evaluation of managers, but in the 30-year shift from qualitative to quantitative evaluation, the pendulum has swung too far, to the point that data is treated as insight, rather than what it is—information. Quantitative tools provide insight

only when their context and limitations are understood. It's also equally important to understand people's own limitations as decision-makers. The emerging field of behavioral finance identifies behavioral biases that can lead to poor decision-making. It's also clear that many of these biases are exacerbated by the proliferation of data.

Lack of awareness about these behavioral biases and about the limits of quantitative tools has two adverse effects for managers and their clients. First, it can lead to bad decisions. More perversely, and at the same time, it can produce miscommunication that inadvertently leads managers to change their approach. As a form of communication, manager evaluation sends messages to the manager. In an evaluation based solely on quantitative tools, the messages are "think short-term," "stick to the benchmark." Clients may believe that they want managers to produce exceptional long-term performance, but managers heed the message delivered by quantitatively focused evaluations. Managers try to "win" by not lagging a benchmark on a short-term basis. Clients can end up losing as their implied message of "risk control" keeps managers from taking the types of risks that made them successful in the first place.

### **Vanguard's Expertise in Evaluating Managers**

The Vanguard Group has been selecting investment advisors to manage Vanguard portfolios over the past 25 years. In a single year, Vanguard's Portfolio Review Group might talk with up to 125 different advisory firms. Over time, we've developed an approach to manager evaluation that treats investing as a process, as an exercise in human judgment. In evaluating managers, we keep investment issues such as changes in strategy and in personnel in the foreground. We keep data in the background, believing that, while statistics are important, they should not be the only tools shaping our view of a manager.

We consider ourselves experts at manager evaluation, at least according to the standard set by German physicist Werner Heisenberg: "An expert is someone who knows some of the worst mistakes that can be made in his subject—and tries to avoid them."

### **Pitfalls in the Conventional Investment Review**

A good example of the pitfalls in the typical manager-evaluation process is the conventional investment review. In a single 30-minute session, the investment committee and manager review returns for the past quarter, the year to date, and trailing one-, three-, and five-year periods, with special emphasis on more recent results. They examine absolute returns and results relative to benchmarks and peer groups, relying on benchmark-based attribution sheets to explain why performance was good or bad. The discussion typically ends with a summary of recent purchases and sales and a few minutes devoted to the investment manager's outlook.

Although simple and seemingly rigorous, the process is an ineffective means for evaluating managers, because it increases a committee's vulnerability to the well-documented behavioral biases common to human beings. These biases lead us to view investment managers through flawed lenses.

#### **Flawed Lenses: Overconfidence, Representativeness, Availability Biases, Framing, Loss Aversion**

**Overconfidence.** Human beings tend to be overconfident about their ability to make good decisions. Academic literature documents examples of overconfidence in all areas of human activity, from driving (surveys show that most people, commonly as high as 90% of respondents, consider themselves to be above-average drivers) to investing (stocks bought by individual investors tend to do worse than the stocks sold by these same individuals). A typical investment committee may be especially susceptible

to overconfidence in its ability to select managers; its members are often people who have achieved noteworthy success in various fields of endeavor. It would be natural for these accomplished groups to think, “Sure, most people can’t pick good managers, but we can.”

*Representativeness.* Another behavioral bias arises from what researchers call the “representativeness heuristic”—our tendency to draw unwarranted conclusions about an investment manager from limited data. Human beings tend to ascribe logic to small, random samples of data. Consider coin flips. Someone flips a coin five times, and, in order, gets heads, heads, heads, heads, tails. In the next four flips, this same person gets heads, heads, heads, heads. Most people would guess that the next flip will be tails, because that’s the pattern they saw in the first series. Each flip is independent, however, and there’s a 50/50 chance that the next flip will be heads.

One manager has told Vanguard that his least favorite client meetings are those following a period of exceptionally good performance. He understands that investment returns always have some element of chance. In one period, the breaks may fall his way; in the next, they may not. This reality is hard to communicate to clients, who interpret a recent period of outstanding performance as a pattern that will persist in the future. But the manager knows that randomness will eventually work against him. When performance cools, clients will be disappointed. Just as they attributed unusually high returns to skill, they’ll see weak results as a measure of incompetence.

In evaluating managers, vulnerability to this representativeness bias can lead people to select new management firms with outstanding short-term records rather than longer-established advisors with good, but less impressive, long-term records. For example, an investment committee might evaluate two managers, one that has outperformed the benchmark in four of the last five years, and one that has

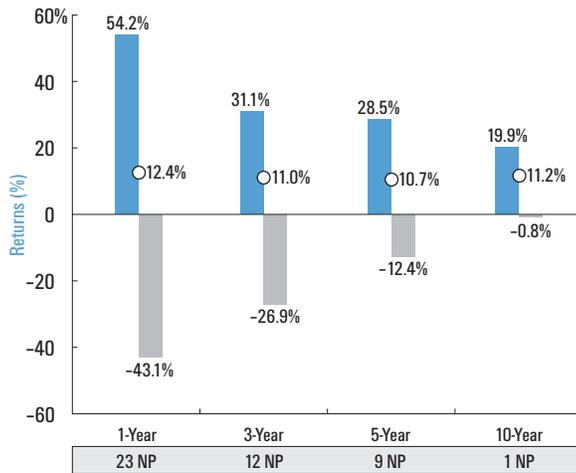
outperformed in six of the last ten years. An investment committee susceptible to “the human bias” would extrapolate these patterns and assume the first manager is likely to outperform 80% of the time, while the second should outperform only 60% of the time. A better approach would be to ask which time frame—five years or ten—presents a more meaningful picture of manager ability and to look at the outperformance in the context of the market environment.

A second question might be whether a series of yearly returns is the best way to assess managers. It is generally more useful to review returns over rolling periods, which can highlight when a management strategy tends to go in or out of favor. In any one period, a static snapshot of trailing returns can suggest that a manager is a genius or an incompetent. Neither is probably true, but our behavioral biases can lead us to draw these conclusions from what may be a very unrepresentative data set.

*Availability heuristic, framing, and loss aversion.* An additional set of biases can be especially counterproductive in the presence of short-term performance data. The first bias is the availability heuristic—our tendency to base decisions on any available information, whether or not it is meaningful. This data is then used to frame the way we evaluate managers. The most widely available data about an investment manager is generally short-term returns—information that, in Vanguard’s experience, is not very meaningful. Because the data exists, however, an investment committee has a bias toward using it to frame its view of a manager.

For example, a staple of manager evaluation is performance relative to a market benchmark. This information is available, and thus tends to be used. Outperformance relative to the benchmark is a success, while underperformance is a concern. In reality, the manager’s long-term objective may have no relation to the benchmark. In an endowment, for example, a manager’s charge might be to generate income on a

**Figure 1**  
**1-, 3-, 5-, and 10-Year U.S. Stock Returns:**  
**Rolling Periods, 1926-2003**



*Note: The performance of the U.S. stock market is not an exact representation of any investment, as you cannot invest directly in the U.S. stock market.*  
 Source: The Vanguard Group.

consistent basis. Although it wouldn't be difficult to develop quantitative measures of a manager's income-generating performance, such data are not readily available. Instead, performance is framed in terms of an available, though not necessarily appropriate, market benchmark such as the Standard & Poor's 500 Index. These biases lead to misunderstandings about the manager's performance and role.

The widespread reliance on short-term return data also makes investors vulnerable to mistakes based on loss aversion. Researchers have established that investors consider losses to be about 2.5 times as powerful as gains. The likelihood of experiencing negative returns from stocks has been high over shorter time periods, but low over long periods. As demonstrated in Figure 1, since 1926, stocks have experienced negative total returns in just 9 rolling five-year periods and 1 rolling ten-year period. Over one-year periods, however, stock returns were negative in 23 of the 78 periods. In quarterly periods, the incidence of loss is much higher. Regular review of short-term data, which increases the probability that investors will be confronting a loss, may put pressure on

investment committees to do something—such as change managers or modify a strategy—in response to the pain felt by losses. In many cases, however, the best response is to sit tight.

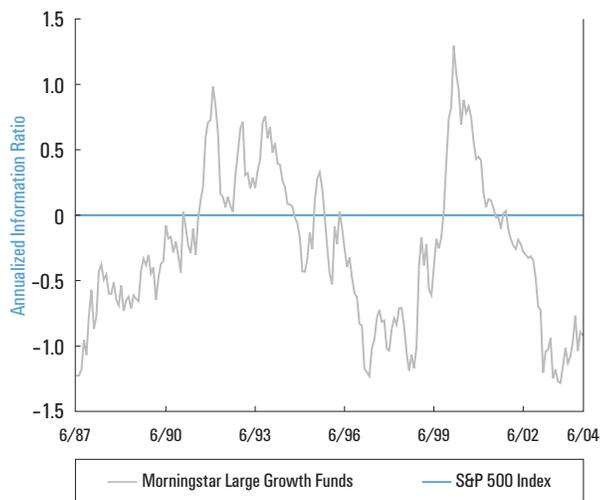
In short, extensive use of short-term performance data, when combined with behavioral biases such as the availability heuristic, framing, and loss aversion, gets in the way of good decision-making.

### Flawed Tools: Risk/Return Measures, Benchmarks, Peer Groups

**Information ratio.** If behavioral biases represent flawed lenses, a second pitfall in manager evaluation is the misuse of tools or overreliance on flawed tools. One widely used measure is the information ratio, a statistically sound measure of a manager's *historical* risk-adjusted return. The ratio is calculated as the manager's risk-adjusted excess return (alpha) versus a benchmark divided by the standard deviation of the excess returns (tracking error)—in essence, the extra return generated for a portfolio's variability from the benchmark. (Some observers might refer to this variability as "risk." But it's important to remember that investment risk is much more than absolute or relative variability.) Just as returns are dynamic (they change over time), alpha, too, is dynamic. Often historical returns, and subsequently alpha, are extrapolated into the future, when in fact there is no sensible reason to assume they will be static going forward.

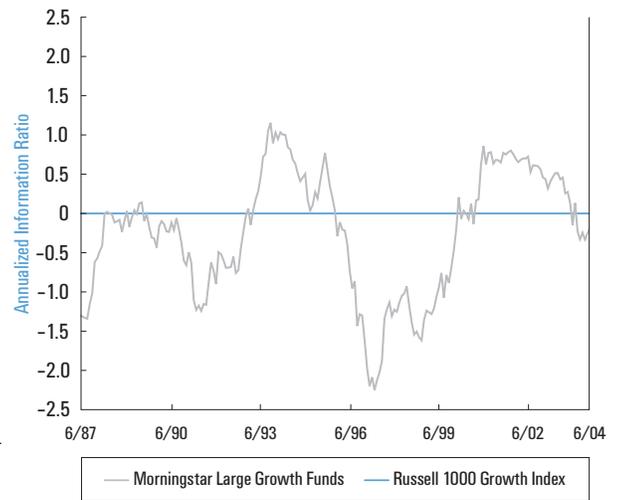
Figure 2 (see page 5) shows the information ratio of the average large-capitalization growth manager calculated relative to returns of the S&P 500 Index from July 1984 through June 2004. It has clearly been dynamic over time. For example, for the three years ended February 2000, the information ratio suggested that large-cap growth managers as a group displayed remarkable skill relative to the S&P 500. For the three years ended September 2003, by contrast, this same group of managers looked

**Figure 2**  
**Inconsistent Predictive Power of Information Ratios**  
**Versus S&P 500 Index: July 1984–June 2004**



*Note: Thirty-six-month rolling information ratio versus S&P 500 Index.*  
 Sources: The Vanguard Group and Zephyr Style Advisor.

**Figure 3**  
**Inconsistent Predictive Power of Information Ratios**  
**Versus Style Benchmark: July 1984–June 2004**



*Note: Thirty-six-month rolling information ratio versus Russell 1000 Growth Index.*  
 Sources: The Vanguard Group and Zephyr Style Advisor.

like incompetents. Neither was true, but short-term perspectives of the information ratio could support such conclusions.

The information ratio depends not only on the time period but also on the benchmark used to calculate the ratio. For example, in Figure 2, the S&P 500 Index isn't the best benchmark for large growth funds because the benchmark also contains stocks classified as value and as a result, in theory, is style neutral. We therefore measured the same large-cap growth managers against a more appropriate benchmark—the Russell 1000 Growth Index—but, as shown in Figure 3, the results raise new questions. Compared with the Russell 1000 Growth Index, large growth managers fared terribly in the late 1990s—about the same time that information ratios derived from the S&P 500 Index portrayed these managers as geniuses. At the start of 2000, after growth stocks collapsed, the managers' information ratios improved relative to the Russell index even as they declined relative to the S&P 500. Different time periods, different benchmarks, different information ratios.

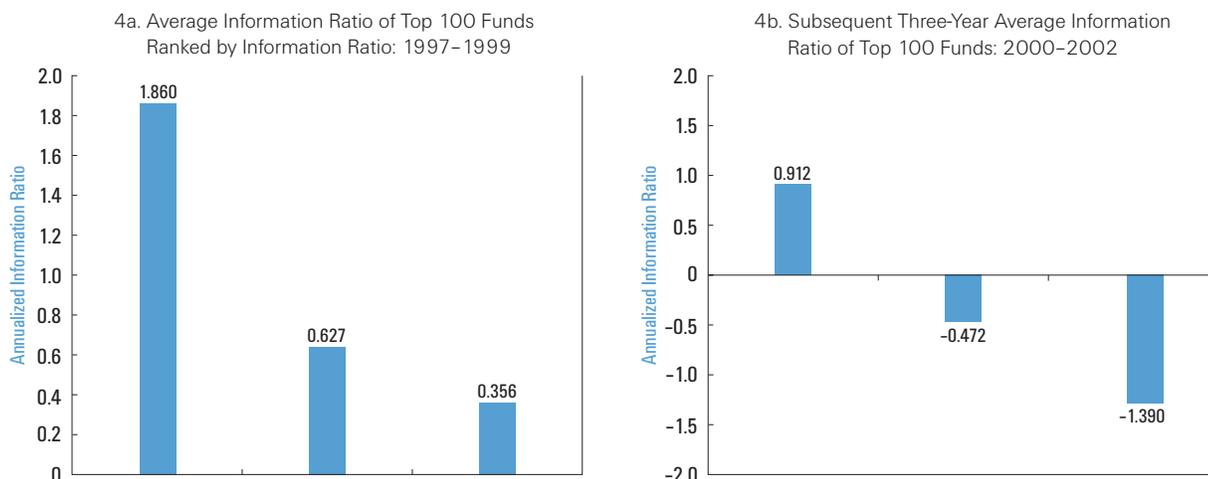
The ratio's appeal is obvious. People want to buy the "best," and for many purchases—cars, appliances—the best can be identified by simple

performance rankings. The same is not true of investment managers and information ratios. What many investors treat as an objective measure of some eternal truth about manager performance is in fact very context-dependent.

As another example, Figure 4 (see page 6) illustrates the information ratio's weakness as a predictor of absolute and relative performance. The left-hand side of the figure charts information ratios from those 100 funds that had the highest information ratios from 1997 through 1999. The highest ratio was 1.86, the lowest was 0.36, and the median of this "top 100" was 0.63. In the subsequent three years, 2000–2002 (right-hand side of the figure), the best ratio of those same 100 funds was just 0.91, the worst, –1.39, and the median, –0.47. As a measure of a manager's ability to generate return per unit of risk, historical measures were a poor guide to the future. The ratios were not stable.

The information ratio was also a poor predictor of a manager's performance relative to that of other managers (see Figure 5, page 7). The top 100 funds in the first period were not the same as the top 100 funds in the subsequent period. In the first period, these 100 funds generated the highest information ratios out of

**Figure 4**  
**Information Ratios Are Poor Predictors of Future *Absolute* Performance**



*Notes: Data based on 2,301 U.S. equity mutual funds covering a range of Lipper categories. All regressions are run versus the S&P 500 Index. The alpha used to compute the information ratio is based on actual historical data, using a single-factor regression equation. The information ratio, therefore, is computed by dividing the alpha by the standard error. Annualized information ratios are used, rather than ratios based on the monthly time intervals.*

Sources: The Vanguard Group and Lipper Inc.

a universe of 2,301 funds. The best performer was ranked 1st; the median performer, 50th; and the lowest of this premier set, obviously, 100th. In the subsequent three years, the new best performer from these former top-100 funds checked in at 239th. The new median, or 50th-ranked fund from this group, ranked 1,465th, the universe's bottom one-third. Of those elite 100 from the first period, the lowest performer in the second period placed 2,091st, lower than all but 9% of the 2,301 funds.

It's important to reiterate that these observations are not criticisms of the information ratio, but only of its misuse. It's not a criticism of a hammer to note that it does a poor job of cutting wood. The information ratio can convey information about the past, but it cannot be used to predict the future.

**Market indexes.** Market indexes are viewed as having the characteristics of a ruler; that is, as independent measuring devices with immutable properties. In reality, most indexes are unstable. Although a yardstick is always 36 inches long, the characteristics of market indexes change over time.

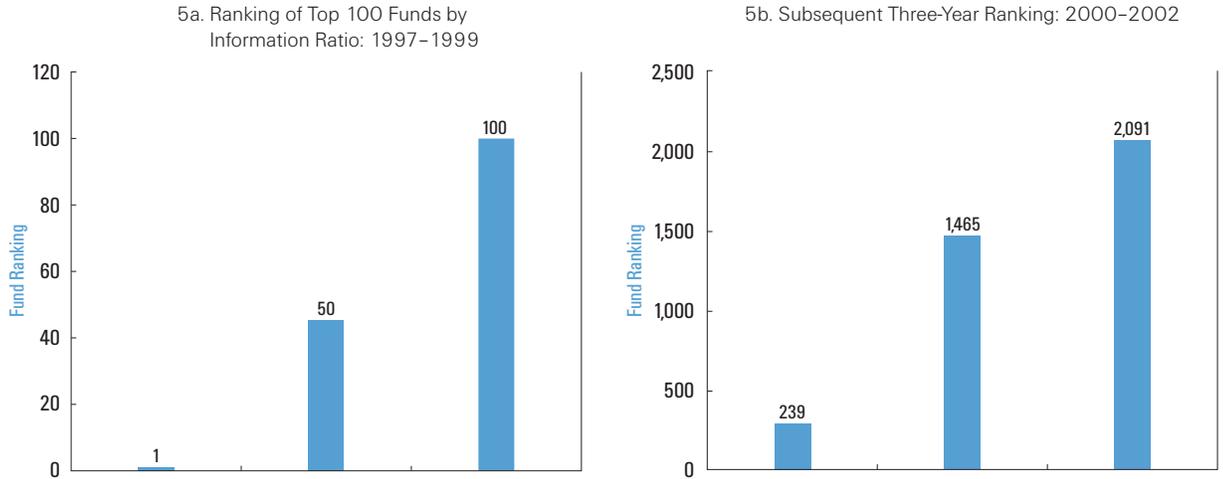
A classic example is that of the Morgan Stanley Capital International Europe, Australasia, Far East (MSCI EAFE) Index, a widely

followed benchmark of international stocks from developed markets. During the mid-to-late 1980s, it was very difficult for active managers to outperform the index (see Figure 6, page 8), primarily because Japanese stocks—at the time, the index's largest constituent—were outpacing those from every market around the globe. Japanese stocks came to represent about 70% of the Europe and Far East total market value, with Japanese banks alone accounting for up to 35% of the country's stock market value. Unless a manager was overweighted in Japanese stocks, particularly financials, he or she was almost doomed to underperform the benchmark during the Nikkei's bull market run.

Over the following decade, however, the Japanese stock market experienced a long, grinding decline, again led by financials, tumbling to about 20% of the index's value. During this period, active managers had a much easier time outperforming the index (see Figure 6). By underweighting Japan—the same approach that had led to poor relative returns in the late 1980s—managers were able to stay a few steps ahead of the index as Japanese stocks collapsed. Measures of relative performance thus told us more about changes in the benchmark than about the talents of managers.

**Figure 5**

**Information Ratios Are Poor Predictors of Future *Relative* Outperformance**



*Notes: Data based on 2,301 U.S. equity mutual funds covering a range of Lipper categories. All regressions are run versus the S&P 500 Index. The alpha used to compute the information ratio is based on actual historical data, using a single-factor regression equation. The information ratio, therefore, is computed by dividing the alpha by the standard error. Annualized information ratios are used, rather than ratios based on the monthly time intervals.*

Sources: The Vanguard Group and Lipper Inc.

Another example of indexes' mutability is the changes in growth and value benchmarks during the late 1990s. When these style indexes were first created, index providers felt that it was appropriate to divide the stock market in two, with each style (growth and value) accounting for half of the market's capitalization. Methodologies differed among benchmark providers, but one prominent provider—Standard & Poor's—used price/book value to determine whether a stock was classified as growth or value. Standard & Poor's then ranked stocks by price/book value and counted down the list until the aggregate market capitalization of all the higher-ranked stocks equaled 50% of the stock market's value.

As the returns of growth stocks soared during the late 1990s, it took fewer and fewer stocks to make up the growth half of the market's value (see Figure 8, page 9). Stocks long classified as growth stocks were now classified as value stocks, and the returns of traditional value managers were now being measured against a universe of securities that they had never before considered. Those who stuck to their investment disciplines paid a price in relative performance as these "mock-value" stocks were swept up in the growth rally, outperforming typical value fare.

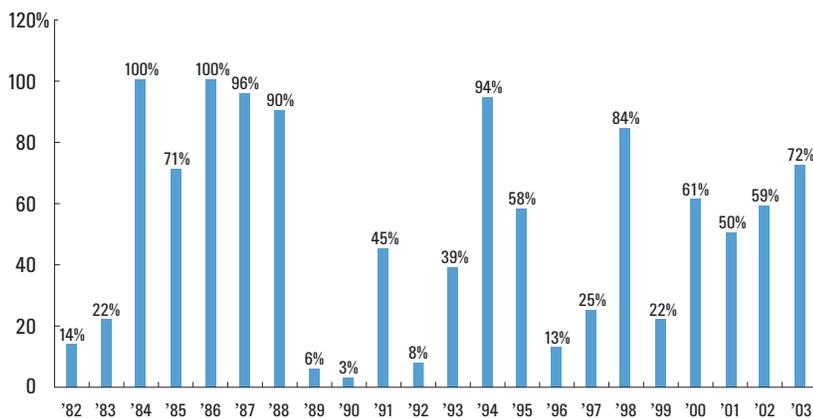
**Peer groups.** More flawed than benchmarks as a manager-evaluation tool—but also widely used in this regard—are peer groups. Investment research and consulting firms create and maintain groups of funds that follow similar investment styles—large growth, for example, or multi-cap value. Peer-group comparisons play an important role in manager evaluations, seemingly answering an important question: Is the manager doing better or worse than other managers that provide similar advisory services?

What isn't widely understood is that peer groups are fluid. Peer-group-based comparisons can be likened to playing a golf game in which the par changes after you play. You get a birdie on a par-5 hole. You feel good. At the end of the round, you go to the pro shop and are told, "Sorry, the hole just changed to a par 4." A silly example, maybe, but something very similar happens with peer groups.

For example, at the end of 1999, the average multi-cap growth fund had generated a 12-month return of 52.3%, according to data from Lipper. Four years later, at the end of 2003, the 1999 return for multi-cap growth funds was no longer 52.3%; it was now 68.3%, a 16-percentage-point revision of history. By July of 2004, this 1999 return was again dramatically modified, now registering 60.4%, an 8-point

**Figure 6**

Percentage of Diversified International Managers Outperformed by MSCI EAFE Index: 1982–2003



Note: International small-cap funds excluded from analysis.

Sources: Lipper Inc., Morgan Stanley Capital International, and The Vanguard Group.

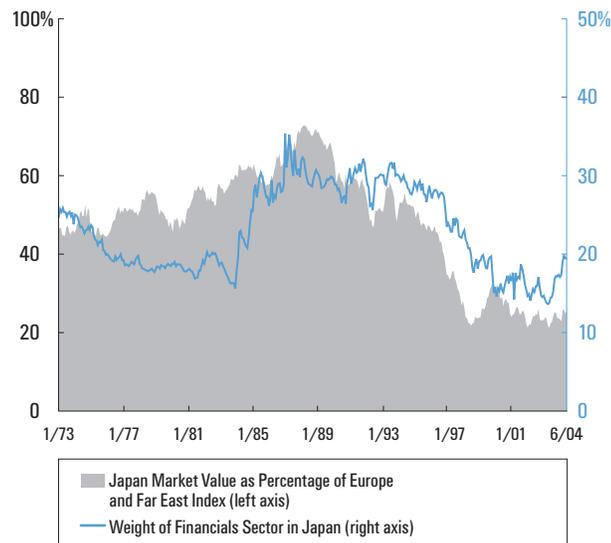
change in under a year. In 1999, a manager who had returned 60.3%, beating his or her peers by 8 percentage points, was a hero. Four years later, that same performance looked, in retrospect, like a failure—an 8 percentage point shortfall relative to the peer group—while after just another seven months, that manager appeared to be on par with the 1999 benchmark.

What happened? The turnover rates within the different Lipper categories have historically been 25% to 50% annually. When a fund moves from one category—multi-cap growth, for example, to multi-cap blend—the fund’s historical record follows. Returns that were previously included in multi-cap growth are now included in the multi-cap blend averages. History is rewritten.

This critical flaw in peer-group comparisons is impossible to discern from the statistics generally used in manager evaluations. Vanguard is aware of this flaw because we have historically tried to capture peer-group returns in real time. We then link the initially reported returns together in order to calculate long-term returns of peer groups as they existed when the returns were first recorded. Peer-group comparisons that instead calculate historical returns based on a peer group’s current membership are not necessarily fair, independent measures of a manager’s abilities relative to those of advisors practicing similar strategies.

**Figure 7**

Japan Market Cap and Japan Financials Sector as Percentages of Europe and Far East Market Cap: January 1973–June 2004

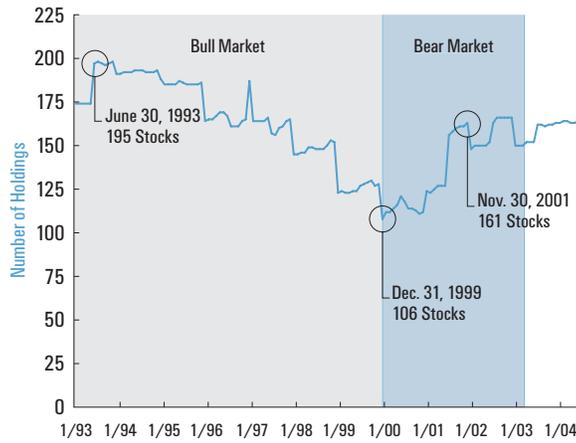


Sources: Thomson Financial Datastream and The Vanguard Group.

Capturing peer-group returns in real time also corrects for survivor bias. When a fund ceases operations, its record vanishes. Estimates by Malkiel (1995) and Carhart (1997) suggested that over periods of ten years or more, 18% to 33% of all mutual funds are liquidated or merged out of existence. These researchers found that, just as intuition would suggest, funds with the worst performance are the ones that disappear from the public record, thus inflating the average returns of peer groups.

A final weakness with peer-group comparisons is that they are defined very broadly. A peer group’s investment characteristics may not reflect the mandate you’ve given your manager. A “value” category can include managers that seek out stocks with low price/earnings (P/E) ratios as well as managers that emphasize dividend income. The returns of these two approaches can be very different, and a peer-group comparison that encompasses both won’t yield meaningful information. In 2003, for example, those managers pursuing low-P/E strategies generated excellent returns, while those emphasizing dividend-paying stocks trailed. (Non-dividend-paying stocks returned 45%; dividend-paying stocks were up just 30%,

**Figure 8**  
**S&P 500/Barra Growth Index Holdings:**  
**January 1993–June 2004**



Source: The Vanguard Group.

according to Bloomberg.) The average return of the broad peer group tells you very little about either investment approach.

### Flawed Lenses, Flawed Tools Deliver Flawed Messages

Our behavioral biases, bad data, and the flawed interpretation of good information can lead to miscommunication between clients and investment managers. The messages conveyed by an evaluation’s emphases on short-term returns and index and peer-group comparisons may inadvertently encourage managers to create portfolios that don’t reflect a manager’s expertise, philosophy, and convictions. Clients may believe that they want a manager to deliver long-term performance consistent with the unique strategy for which he or she was hired. But when the investment review is framed in terms of short-term performance, peer groups, and benchmarks, what the committee is inadvertently saying is, “Be consistent with the benchmarks and peers” and “Focus on the short term.”

Talented managers have strong convictions about the best way to deliver exceptional long-term performance. They also need to retain enough clients to stay in business. When investment committees deliver messages that implicitly tell managers to subordinate their convictions to business considerations, managers react in ways that deprive clients of their best efforts.

Following are actual quotes from discussions between Vanguard and various managers on their experiences. For obvious reasons, the sources must remain anonymous:

- “If I stay close to the benchmark, I keep my job.”
- “I’d love to [buy a stock that’s not in my benchmark], but the consultants would kill me.”
- “I can’t afford not to own [fill in the blank] even if I hate it. It’s 4% of my benchmark.”
- “The index is always at the back of my mind.”
- “After 1996, I took my tech weighting up at the wrong time. Eventually the job became inordinately stressful. The fear of getting too far away from the S&P 500 has haunted many people, myself included. I used to be more of an investor, but now I’m more focused on the short-term indexes.”

In each of these cases, relative risk and performance became objectives, not measures. The cost of short-term underperformance is too high—potentially the manager’s livelihood.

Like all economic actors, managers respond to the demands of the marketplace. An investment committee’s well-intentioned, but inappropriate, use of flawed tools and lack of appreciation for its own behavioral biases can help turn an investment manager into a functionary in the investment management business. Oddly enough, the physicist Werner Heisenberg introduced an idea that offers insight into this dynamic as well. Call it the “Heisenberg Principle of Manager Assessment,” a paraphrase of his famous uncertainty principle: “The act of observing a phenomenon changes it.” Heisenberg was referring to subatomic particles, but the same principle applies to manager evaluation. Or, in the words of one investment manager, “Messages about compensation and evaluation can and will be reflected in your portfolio.”

## A Different Framework for Manager Evaluation

Vanguard has identified the outlines of an evaluation framework that we believe facilitates productive communication with the investment manager. Broadly, this framework is an acknowledgment of the first Heisenberg principle: “An expert is someone who knows some of the worst mistakes that can be made in his subject—and tries to avoid them.” We know a number of the mistakes, and we try to evaluate managers in a way that minimizes our vulnerability to behavioral biases and bad judgments based on flawed tools. Our goal is not to create a formula for manager evaluation—formulas don’t work. When we evaluate managers, we review performance, but most of the discussion is directed toward issues in managing the portfolio. For instance, we might talk about changes in the rate of portfolio turnover. Does higher turnover indicate less conviction in the manager’s research process? What changes are taking place within the manager’s firm? New hires, recent departures? We keep issues that are fundamental to the investment strategy and to the firm in the foreground. Performance is in the background. The broad outlines of this approach to manager evaluation are to:

- Align interests properly.
- Define objectives properly.
- Recognize our biases and the flaws in our tools.
- Promote awareness both about biases and about the limits of quantitative tools among the investment committee and others charged with evaluating managers.

### Align Interests Properly

The time to ensure that the interests of the client and the manager are properly aligned is at the start of the relationship. Within the context of a client’s goals, the investment committee and the manager agree on the benchmarks and time periods used for evaluation and on the incentives that will keep the manager focused on delivering investment results, not simply on

trying to retain client assets. We approach this conversation with awareness that there are many ways to run money. We try to find out what kind of market environments are most favorable to a particular manager’s approach, and when performance is likely to take a hit. Benchmarks—standards of evaluation—are part of the conversation, but they’re secondary considerations. The primary focus is on the manager’s strategy and the client’s long-term goals.

### Define Objectives Properly

When defining an objective, the client and manager need to make sure that the client’s investment goal is wholly consistent with that manager’s strategy. It’s unproductive to ask a manager who has demonstrated talent in managing concentrated portfolios to provide your institution with broadly diversified exposure to a market benchmark. After we determine that a manager is an appropriate choice for a particular mandate, we spend substantial time ensuring that the manager’s objectives are defined properly. Our parameters are much more nuanced than the typical definitions of, for example, *growth* and *value*. A conventional approach might be to stipulate that a portfolio must always have a P/E ratio less than 75% of the market’s P/E ratio. That guideline is interesting, but it’s not flexible enough to allow a manager to pursue his or her investment convictions in the real world of dynamic markets. Instead, we have a wide-ranging discussion about the investment characteristics we want—broad guidelines with regard to income, volatility, diversification, correlation with various yardsticks, and so on. We try to give the manager a multidimensional picture of the performance we expect, all within the context of how the manager makes decisions. We recognize that portfolio management is a dynamic process, not painting-by-numbers. We don’t want managers to put together a basket of stocks simply to get a P/E ratio equal to X and a yield equal to Y.

### Recognize Biases and Flaws

To evaluate managers effectively, it's critical to be aware of our own limitations. Like most human beings, we approach the evaluation process with built-in behavioral biases. Simple awareness of these biases can minimize their impact on our decision-making. It's equally critical to be aware of the flaws and biases built in to the industry's widely used analytical tools. This process is ongoing. Just as statistical benchmarks such as market indexes and peer groups are not the constants they may seem, neither are their flaws. In one period, a benchmark's most pronounced weakness might be an unusual under- or overweighting in a particular market; in another period, it might be something else. An important part of evaluating managers is subjecting the analytical tools used in this process to equally intense scrutiny. A process and infrastructure for doing so should be a core competency for those evaluating investment managers.

### Promote Awareness

Finally, investment committees and the consultants and analysts who work with them need to raise awareness of the shortcomings in the conventional evaluation process. This may be the most difficult challenge. It puts you in conflict with the popular idea that we can learn everything we need to know about managers from a quick review of the latest statistics. By advocating a more qualitative approach, you risk being labeled a Luddite—even though awareness of statistics' limitations actually reflects a deeper understanding of the quantitative techniques, not a fear of them. Like any change in the status quo, implementing a new approach to manager evaluation will require persistence and leadership.

## ... Then Our Managers Can Deliver Their Best

This critique of the traditional approach to manager evaluation helps establish what it means to be an “expert” in manager evaluation—namely, someone who is aware of the behavioral biases and the flaws in the tools that can lead to bad decision-making and to miscommunication between clients and managers. This awareness allows managers and the people who make decisions about hiring or retaining those managers to develop a more productive and rewarding relationship. When investment committees and managers establish a common understanding of their goal, one much broader than the short-term index-based definitions used today, managers will be able to ignore the noise. They will invest based on their convictions, rather than on the composition of an index or the holdings of their peers. They won't be distracted by benchmarks that have little to do with their investment process. And at the end of the day, they will be able to tell their clients that a portfolio is structured in a particular way “because this is the right way to manage these assets.” When a talented manager can operate with this kind of conviction, clients are the winners.

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