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What matters most? An analysis of investment committee hire/fire decisions

Vanguard research

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Executive summary. Seventy-five percent of investment committees in our survey hired or fired an investment manager over the past three years, averaging about one manager change per year over the period. Performance was clearly rated as the most important factor driving the hire/fire decision. However, factors such as manager consistency, fees, and external committee pressures also affected manager turnover rates among committees.

Hire/fire behavior. While three-quarters of committees made one or more changes to their investment managers in the past three years, slightly more committees hired managers than fired managers. In addition, respondents found hiring more difficult than firing—perhaps because it takes more resources to hire than to fire.

Drivers of turnover. Most committee members cite performance as the most important factor affecting investment manager hire/fire decisions. Factors such as manager consistency, fees, and external committee pressure explain more of the differences in manager turnover rates among committees.

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Behavioral biases. We found that the committees represented in our survey exhibit a tendency toward group polarization—that is, as committees, they tend to make more conservative decisions than individual committee members would make on their own. Overconfidence is also an issue; for example, more than 80% of respondents rated their committees' investment knowledge as above average and more than 60% indicated that their committees seldom make mistakes. Overconfidence is associated with higher levels of manager turnover in our survey.

Implications. Our results indicate that investment committees generally use a reasoned approach that takes several factors into account when making hire/fire decisions. The results also suggest some areas of potential improvement in the decision-making process. The drivers of turnover—performance, manager consistency, and fees—are proper factors to consider in the hire/fire decision. However, investment committees should be aware of several behavioral biases such as group polarization, confirmation bias, and overconfidence that could derail their hire/fire decisions.

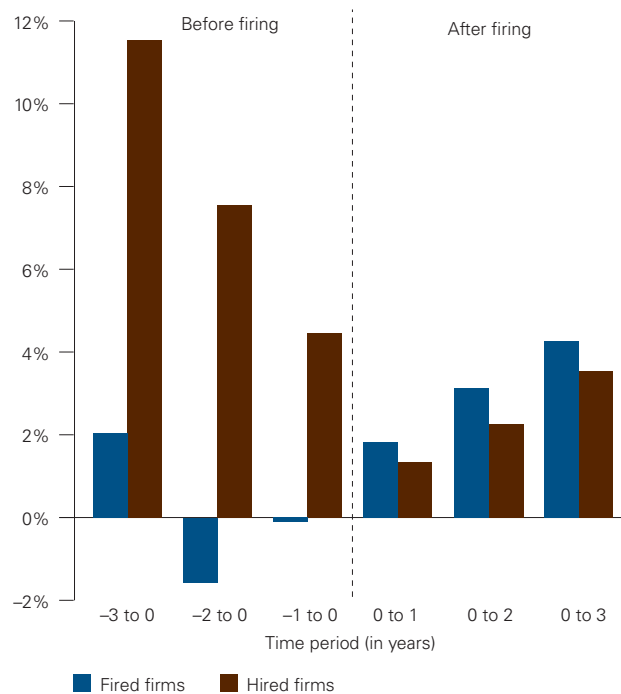
Introduction

Investment committee members exercise discretion or control over investment portfolios or investment lineups and act as fiduciaries for those assets.¹ There are federal and state laws that govern fiduciary standards of care—these include the Employee Retirement Income Security Act of 1974 (ERISA) for defined benefit and defined contribution plans and the Uniform Prudent Investor Act (UPIA) for many endowments and foundations. The process for conducting this due diligence function includes “evaluating the investments against their stated objective for consistency, analyzing relative performance against relevant benchmarks and peer groups, and looking at plan fees and expenses for reasonableness” (Department of Labor, 2010). As such, good fiduciary conduct includes acting as an experienced or knowledgeable expert to select and monitor investments and to add or remove investments when warranted.²

Yet little is known about how investment committees actually handle the hiring and firing of investment managers. One of the few studies on this topic examined the investment manager hire/fire decisions of 3,400 plan sponsors, and the results of the study underscore the difficulty of hire/fire decisions.³ These researchers found that sponsors tended to hire managers who had realized large positive excess returns, but that once hired, the new managers’ returns did not differ statistically from the fired managers’ returns. In fact, the fired managers’ returns were greater than the hired managers’ returns, although not significantly so (Figure 1). This study highlights the fact that investment committees, like individuals, may be susceptible to a host of group decision-making biases as well as group dynamics that can influence committees’ decisions about hiring, firing, and retaining managers.

To better understand the hire/fire decision-making process and group decision-making biases, we conducted an online survey in November and December 2009 of investment committee members.

Figure 1. Pre and post excess returns for fired and hired investment managers



Source: Goyal and Wahal (2008).

Note: All of the differences between fired and hired managers before the firing are significant. None of the differences between fired and hired managers after the firing are significant.

Our sample was drawn from prospective and current institutional clients at Vanguard. We received survey responses from 113 respondents.⁴

In terms of sample composition, 21% of the respondents represent defined benefit investment committees, 29% represent defined contribution committees, and 50% represent endowment and foundation investment committees. Two-thirds of the respondents’ portfolios had assets under management of \$250 million or less. The average committee’s size was slightly fewer than seven members. Committee members were largely nonminority (90.5%) and male (82.5%). Consistent with other industry findings, 79% of investment committees used one or more external consultants.⁵

1 Investment decision-making groups can range from large, diverse boards, to a finance committee, staff, or other supervisory entity. For the purposes of this study, we will refer to all such groups as investment committees.

2 See Gordon and LaBarge (2010) for more information.

3 See Goyal and Wahal (2008) for more information.

4 Top-line survey results have a +/- 7% sampling error at a 90% confidence level; statistically significant differences are noted where appropriate.

5 Although the majority of our survey respondents serve on committees for smaller portfolios, many of our findings are consistent with those of other surveys which focus on larger portfolios.

We begin by providing some descriptive statistics on the hire/fire process and exploring the drivers of investment manager turnover. We then examine psychological and behavioral biases that can affect the hire/fire decision, and we conclude with a look at committee member satisfaction with the hire/fire process.

Hire/fire behavior

Over the past three years, three-quarters of the surveyed investment committees hired and/or fired an investment manager (Figure 2, Panel A).⁶ The average number of manager changes was 2.6, with more than 40% of plans making two or fewer changes. Among the three-quarters of committees making changes, the average number of manager changes was 3.5—or a little more than one change per year. Further, only about one-third of respondents reported five or more investment manager changes (Figure 2, Panel B). Average manager tenure for the committees surveyed was 5.8 years.

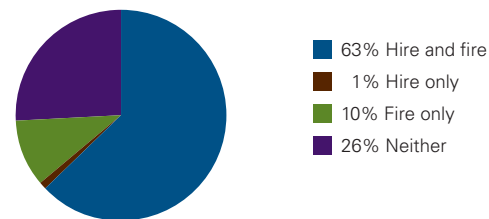
Is an average of one manager change per year a reasonable level of manager turnover? There is no definitive answer to this question. Investment manager turnover will depend on a number of factors such as the type of investment being managed, the number of managers used, the size of the mandate, the objective of the portfolio, and the investment environment.

Difficulty of the hire/fire decision. Committee members do not find the hire/fire responsibilities to be easy. Two-thirds of the committee members surveyed found the manager evaluation process difficult, and committees that found it difficult engaged in statistically significant lower levels of turnover than committees that did not find it difficult. For example, the committees of the respondents that rated hiring and firing of investment managers as difficult averaged 1.7 manager changes over three years compared with 3.5 for the committees of respondents that did not find the hire/fire process difficult.

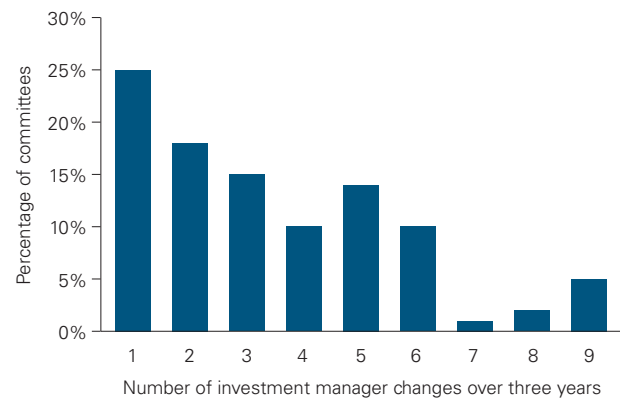
Respondents rated the hiring of managers significantly more difficult than the firing of managers. This finding is understandable. Effective manager evaluation requires the gathering and analysis of a wide array

Figure 2. Frequency of hiring and firing behavior (3 years ended October 2009)

Panel A: Hire and fire activity



Panel B: Investment manager changes



Source: Vanguard, 2010.

of information on the investment manager to confirm consistency of people, business, and portfolio style.

The evaluation process for new managers is particularly time-consuming.⁷ In terms of firings, managers are fired for a variety of often specific reasons, including style drift, organizational instability, changes in philosophy/process, and past performance, as well as changes to the plan's or the portfolio's strategic asset allocation.⁸ The greater resource requirements for the hire decision relative to the fire decision may well be driving the differences in stated difficulty.

Last, although a majority of the investment committees used a consultant, we found no significant relationship between the use of a consultant and the ease of the hire/fire process. Since investment committees often use consultants for new manager searches, this was a somewhat surprising result.⁹

6 This and other findings of our survey are consistent with several other recent surveys. See Arnoff (2009) for a description of some defined benefit plan survey results; Spectrem Group (2009) and NACUBO (2010) for endowments and foundations; and Greenwich Associates (2008), Adams (2009), and Moore (2010) for defined contribution plans.

7 After screening for investment managers who have an investment style that satisfies the desired mandate (e.g. small-cap equity growth), a request for proposal (RFP) is sent to candidate firms. This is followed by selective manager presentations and, finally, a decision by the investment committee.

8 Goyal and Wahal (2008) report that "[e]xcess returns prior to firing are negative for performance-based terminations but not for others."

9 Stockton (2009) also found that the use of a consultant did not significantly affect investment committee performance ratings.

Drivers of manager turnover

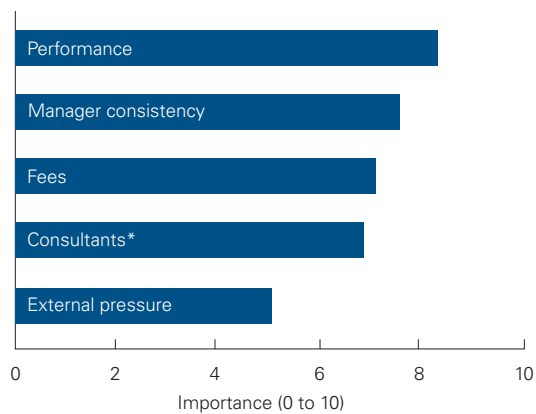
Stated preferences. Investment committees consider various factors during their evaluation of current and prospective managers. We asked survey respondents to rank by importance various factors in their decision-making. As shown in Figure 3, performance topped the list of important factors shaping manager turnover, which is not surprising given that committees spend 40% of their time, on average, reviewing the past performance of their investments.¹⁰

In keeping with the due diligence required by fiduciary standards, performance was not the only variable of value. Manager consistency—a combination variable composed of consistency in portfolio style as well as the manager’s staff and business—and fees were also key considerations. Pressure from external sources—a combination variable reflecting the importance of senior management recommendations and peer group influences—had the lowest rankings of these five factors.¹¹

Derived preferences. One limitation of any survey is that stated levels of importance can vary from actual importance. One method of addressing this limitation is to examine the relationship between attitudes and behavior statistically using regression analysis. In particular we examined whether the variables that respondents said were important in the hire/fire decision were actually related to investment manager turnover rates.

Manager consistency has the biggest impact on the actual manager turnover rate (Figure 4). An increase of 10% in the importance that a committee places on manager consistency translated into a nearly 7% increase in manager turnover.¹² Fees also play an important role, but they have a tempering effect on turnover. For every increase of 10% in the importance a committee places on fees, turnover decreased by 5%. In other words, committees that believe fees are important change managers less frequently.¹³

Figure 3. Committee’s stated importance of factors impacting turnover^a

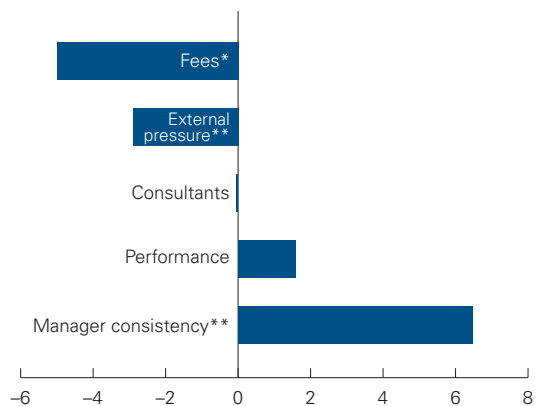


Source: Vanguard, 2010.

a: Turnover is defined as number of times an investment manager was hired or fired in 3-year period.

* Note: Ranking applies only to the subset of respondents using a consultant.

Figure 4. Factors related to investment manager turnover



Source: Vanguard, 2010.

* Indicates variable is significant at the .05 level.

** Indicates variable is significant at the .10 level.

External pressure on investment committees also tempers turnover rates—lowering it by 3% for every increase of 10% in stated importance—although the reason for this relationship is less clear. Perhaps committees that rely heavily on outside input from senior management and peer groups are less likely

10 Stockton (2009) argues that committees may be spending too much time discussing performance and not enough time discussing factors they can control such as risk assessment and portfolio construction.

11 The combination variables were created by averaging the scores from two survey questions.

12 Regression coefficients are reported as elasticities (see Pindyke and Rubinfeld, 1997).

13 One corollary to the fee-turnover discussion is the possibility that fee-conscious committees may be more likely to use passive index funds. Since disappointing relative performance is less likely with index managers, turnover is likely to be lower as well.

to make changes because they do not have full autonomy to act on their own. Consultants have no effect on the turnover rate, and perhaps most interestingly, performance is not significantly related to turnover—although this is not to say that performance is not important.

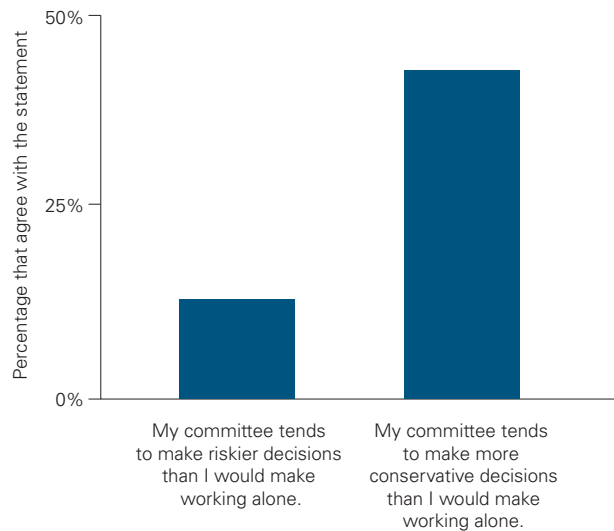
As already discussed, performance was ranked as the most important stated factor. There is almost universal agreement that it is important, and as a result, performance is not linked to differences among committees in manager turnover.¹⁴ As just discussed, Figure 4 shows that some factors increase turnover and some factors decrease turnover. A reasonable level of turnover is likely necessary for investment committees to meet their fiduciary obligations in selecting and monitoring portfolio investments. However, committees should keep in mind that investment manager changes involve transition costs that can be quite expensive. Estimates of transition costs range from 2% to 5% of the portfolio; so it is important that investment committees are sensitive to factors that can unnecessarily drive up manager turnover and, consequently, investment management costs.¹⁵

Behavioral biases

Social psychological research suggests that groups, like individuals, are susceptible to a host of decision-making biases and group dynamics that can influence their decisions. We explored the relationship between some behavioral biases and investment committee hire/fire decisions and found some interesting results.

Group polarization. According to the group polarization hypothesis, groups will render more extreme decisions than individuals—both in the cautious and risky directions. However, the direction of the shift is determined by the group members' initial views. Groups whose members hold initially cautious views are apt to make a more cautious decision than the individual members' prediscussion views would suggest. Similarly, groups whose members have initially riskier views are likely to

Figure 5. Group polarization effects



Source: Vanguard, 2010.

make a riskier decision.¹⁶ Given this tendency of groups toward more extreme decisions and the obvious implications of this bias for investment committees, we queried the survey respondents about whether their committees' decisions were riskier or more conservative than decisions they would have made acting alone.

Our results suggest that group polarization effects could be occurring and that investment committee decisions could be shifting toward the conservative end of the spectrum. For example, only 12% of respondents agreed with the statement that "My committee tends to make riskier decisions than I would make working alone." However, nearly half of the respondents (42%) agreed with the statement that "My committee tends to make more conservative decisions than I would make working alone" (Figure 5).¹⁷ So, there appears to be a shift in the conservative direction—a finding consistent with Stockton (2009), who also found a significant minority of committees shifting toward more conservative decisions. While the tendency toward more conservative investments could be driven by the

14 Performance had the smallest standard deviation of the importance factors and 75% of the responses were greater than or equal to 7 on a 0-to-10 rating scale.

15 See Goyal and Wahal (2008) for more information.

16 See Mottola and Utkus (2009) for an in-depth discussion of behavioral biases and investment committee behavior.

17 These variables were measured on an 11-point scale where 0 was strongly disagree, 5 was neutral, and 10 was strongly agree. Respondents were coded as agreeing with the statement if they were 6 or higher on the scale.

current market environment, the fact remains that groups are moving in the conservative direction more aggressively than individuals—which is the essence of group polarization.

This finding has implications for investment manager hire/fire decisions. For example, committees that contain a majority of members who are, initially, reluctant to change managers could become even more reluctant to change managers after discussing the issue as a group. That is, group discussion could result in a position that is more cautious than any of the individuals' prediscussion positions—thus making manager change very unlikely.

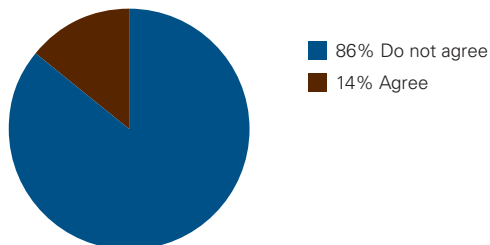
Overconfidence. There is evidence that investment committees are overconfident in their abilities. When asked to rate the collective investment knowledge of their investment committees, 83% of respondents indicated that their collective knowledge was above average and 1 in 5 respondents rated their committees the highest score, a 10 on a scale of 0 to 10. In addition, 61% of respondents indicated that their investment committees seldom make mistakes—an overly optimistic assessment of decision-making skill by any measure.

In the realm of investment committees, overconfidence could lead to higher turnover rates as well as the type of performance chasing documented in Figure 1. In fact, we found a significant correlation of +.26 between self-reported committee investment knowledge (an indirect measure of overconfidence) and turnover, suggesting that overconfident investment committees could be turning over investment managers at a higher rate than investment committees that are not overconfident.

Overconfidence can also lead to confirmation bias, which is the tendency to seek out information that confirms the group's preconceived notions. Although we did not find a significant relationship between our measure of overconfidence (i.e., ratings of

Figure 6. Action bias

My committee sometimes makes investment manager changes primarily because the committee feels like we have to take some action.



Source: Vanguard, 2010.

investment knowledge) and confirmation bias, nearly 4 in 10 respondents indicated that their committees exhibit some level of confirmation bias—that is, they seek out information that confirms their preconceptions.¹⁸ A closer investigation of this relationship could bear insights in the future.

Action bias. The psychology literature suggests that, generally, people are biased toward inaction. However, when action is the norm (or expected) behavior, people may be biased toward action and act even when it is not in their best interests.¹⁹ This phenomenon is known as action bias. Because investment committees are often expected to address investment manager problems with some type of activity, we explored whether investment manager turnover was driven, at least in part, by action bias.

As Figure 6 shows, our committees did not feel compelled to make investment manager changes simply because they had to do something. In fact, we found just the opposite. Only 14% of respondents felt that their committees made investment manager changes because they felt compelled to act. In other words, investment committees did not appear to fall prey to action bias.

¹⁸ Stockton (2009) also found that investment committees engage in confirmation bias.

¹⁹ See Anderson (2003) and Bar-Eli, Azar, Ritov, Keidar-Levin, and Schein (2007) for more on this topic.

Satisfaction with the process

One overlooked aspect of investment committee behavior is satisfaction. There is substantial interest in investment committee performance, but relatively little interest or research on committee member satisfaction. While psychology-based research on the relationship between job satisfaction and job performance is mixed, some research suggests that satisfaction is related to absenteeism and turnover. Since committee member attendance at meetings is important and continuity of membership on the committee is also important, further examination of this issue may be warranted.

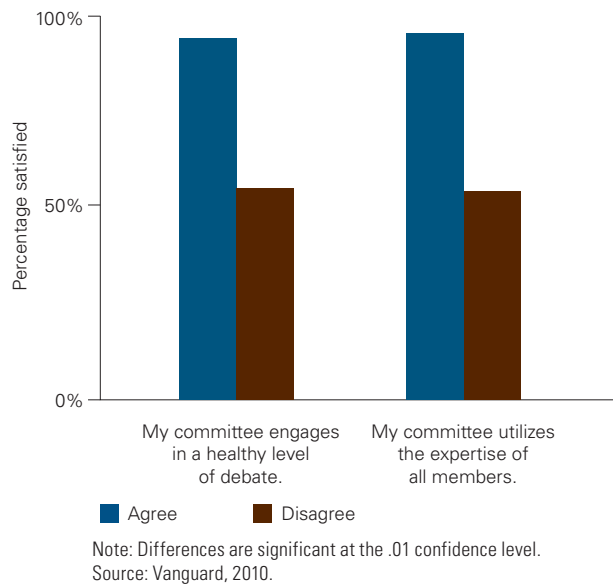
Our survey inquired about investment committee member satisfaction with the hire/fire decision-making process. Overall, investment committee members are quite happy, with nearly 90% of the survey respondents indicating that they were satisfied with their process.

In addition, some aspects of group dynamics appear to influence the satisfaction level of committee members. We examined the relationship between a host of group dynamic variables and satisfaction with the hire/fire decision-making process, and while many of the variables were not related to satisfaction, two variables appear to play an important role.

Committees that engage in a healthy level of debate have higher satisfaction ratings (Figure 7). Nearly all (92%) of respondents that agree with the statement “My committee engages in a healthy level of debate before making decisions” are satisfied with the hire/fire decision-making process. Conversely, only about half (54%) of respondents that do not agree with this statement are satisfied.

Committees that tap into the expertise of all committee members also increase satisfaction with the investment manager decision-making process. Again, nearly all respondents (94%) who agreed with the statement “My committee utilizes the expertise of all committee members” were satisfied with their hire/fire decision-making process compared with 53% of respondents that did not agree with this statement.²⁰

Figure 7. Group decision-making environment and committee satisfaction



Implications

What matters most when investment committees make hire/fire decisions? Consistent with good fiduciary conduct, investment committees *do* evaluate managers for organizational and style consistency, for reasonableness of fees, and for long-term relative performance against relevant peer groups and benchmarks. Long-term relative performance consistent with expectations is essential. Beyond performance, the importance investment committees place on management consistency and fees significantly affects investment manager turnover rates.

Committees should be aware of several behavioral hurdles that could affect their hire/fire decision-making. First, investment committees are vulnerable to group polarization—resulting in overly conservative (or overly risky) decisions. Second, committees should be wary of overconfidence, because our research suggests that investment committees are, indeed, overconfident and that overconfidence is likely associated with higher levels of investment manager turnover. In addition, 4 in 10 investment committees in our survey confess to falling prey to confirmation bias, which like the aforementioned behavioral issues can lead to poor decision-making.

²⁰ These differences are significant at the .01 level using a standard chi-square test.

Investment committees can mitigate the harmful effects of these behavioral biases by using several techniques. First, committees should encourage healthy debate and healthy dissent among committee members by using a devil's advocate to champion less popular ideas, having outside experts (such as consultants or academics) attend meetings, and ensuring the committee has a diverse membership. Second, committees can use decision-making techniques such as creating lists of pros and cons and conducting "what-if" scenarios. Last, committee members should simply be made aware of the decision-making biases that can impact their group's performance. If members begin to recognize some of the pitfalls of group decision-making, they can begin to remedy them.

Further, committee chairs may also want to consider their members' satisfaction with their hire/fire decision-making process since job satisfaction has been associated with behaviors that could improve committee performance—such as reduced absenteeism and turnover. To that end, our research suggests that committee chairs could improve satisfaction by encouraging healthy debate among the committee members and utilizing the expertise of each committee member.

Taken together, these results indicate that investment committees generally use a reasoned approach that takes several factors into account when making hire/fire decisions. The results also suggest some areas of potential improvement in the decision-making process. The drivers of turnover—performance, manager consistency, and fees—are appropriate factors to consider in the hire/fire decision. In addition, satisfaction with the hire/fire decision-making process is high, which could have positive repercussions. However, investment committees should be aware of several behavioral biases such as group polarization, confirmation bias, and overconfidence. The good news is that these biases can be mitigated by creating a healthy decision-making environment in which healthy debate can flourish and diverse opinions are shared freely.

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