FPPTA · CEU SESSION

# Hiring, Keeping and Replacing Investment Managers

A framework for selection, retention and termination decisions

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01

# The fiduciary frame

Why process matters more than outcomes

# Prudence is judged on what was known at the time of the decision, not by hindsight.

Pension boards must use care in selecting the manager, setting the terms of the mandate and periodically reviewing the manager's performance.

# Why a disciplined process pays

Hiring after strong returns and firing after weak ones has, generally, not paid off for plan sponsors.

**Return chasing doesn't pay**

**Value lost to reallocation**

**Transition costs**

# The manager lifecycle

1
**Define the mandate**

Role, benchmark, risk and fee budget

2
**Search and screen**

Build a long list; screen on objective criteria

3
**Due diligence**

Investment and operational review, on site if possible

4
**Hire and fund**

Negotiate terms; move assets efficiently

5
**Monitor**

At least annual review of results and compliance

6
**Retain, watch or replace**

Decide using the criteria set at step 1

The criteria written at step 1 becomes the yardstick at step 6. That link is what makes a decision defensible.

02

# Selecting a manager

What to evaluate before the first dollar moves

SELECTION

# Define the job before interviewing candidates

| | |
|---|---|
| **Role in the portfolio** | Judge each mandate by its role in the whole portfolio's risk and return goals. |
| **Benchmark** | The yardstick the manager will be judged against, written into the mandate. |
| **Risk parameters** | The constraints on the strategy and the risk limits it must stay within. |
| **Fees** | How all fees will be calculated and paid, set before the contract is signed. |
| **Vehicle and valuation** | Separate account or commingled fund and how the assets will be valued. |

SELECTION

# Six lenses for evaluating a manager

### People

Experience of key personnel, reasons for recent staffing changes and turnover.

### Philosophy

The firm's investment philosophy and the competitive advantage it claims.

### Process

Research and portfolio management that are disciplined and consistent, yet adaptive.

### Performance

Results against appropriate benchmarks and peers over 1, 5 and 10 years, net of fees.

### Fees

All fees and compensation disclosed and judged against expected returns.

### Operations

Risk controls, back office, disaster recovery or similar operations.

SELECTION

# People and organization

## What to look for

- Experienced key personnel in managing institutional assets
- Staffing changes and turnover over at least three years
- Evidence of the firm's financial stability
- Assets and number of clients in the strategy
- Clients gained and lost over the past three years
- Contract terms requiring notice of ownership or key-staff changes

## Red flags

- Departures of key investment staff without a planned transition
- A pending change in firm ownership
- Asset growth that erodes returns, especially in small caps
- Past or pending litigation, or SEC discipline
- Prior data breaches

SELECTION

# Philosophy and process

THE EDGE

## Is it real?

What competitive or strategic investment advantage does the firm claim, and is it credible?

THE PROCESS

## Is it repeatable?

Is research and portfolio management disciplined and consistent in strategy?  Is it adaptable to changing markets?

RISK CONTROL

## Is it disciplined?

What risk management safeguards and investment policy compliance controls are in place?

SELECTION

# Performance: read the record in context

| | |
|---|---|
| **Track record length** | Trailing 1-, 5- and 10-year results; compare net returns over a full market cycle. |
| **Right comparison** | Against appropriate benchmarks and peers, not just the broad market. |
| **Style fit** | The actual portfolio's style parameters match what the manager describes. |
| **Consistency** | Even long-term winners have spent years trailing; see how deep and how long. |
| **Net of fees** | Compare approaches on net returns: what the plan actually receives. |

SELECTION

# Fees and terms

Fees are certain.
Excess returns are not.

**Fee versus expected return**

**Fee structure**

**Performance fees**

**Terms**

SELECTION

# Operational due diligence is a pass/fail gate

- Custody and asset safeguards
- Independent valuation
- SEC registration
- Risk and compliance controls
- Data breaches and disaster recovery
- Liability insurance and litigation
- Form ADV and Conflicts of interest

SELECTION

# Considerations specific to public plans

| | | |
|---|---|---|
| Pay-to-play rule | Third-party solicitors | Procurement rules |
| Conflicts of interest | State law and local preferences | Gift, Meal and Entertainment Rules |

SELECTION

# An illustrative selection scorecard

| Criterion | Weight | What earns a high score |
|---|---|---|
| People and team | 25% | Experienced and consistent leadership; aligned compensation |
| Philosophy and process | 25% | Clear edge, applied consistently, with disciplined risk control |
| Fees and terms | 20% | Fair share of expected alpha; favorable liquidity and terms |
| Performance | 15% | Consistent with process, net of fees, over a full cycle |
| Organization | 15% | Sound ownership, manageable growth, focus on the strategy |
| Operations | Pass / fail | Clean operational review, required before any hire |

For illustrative purposes only. These weightings should align with the Plan's specific Investment Policy Statement. Adapt them to your specific Investment Policy Statement.

03

# When performance disappoints

How to tell a bad stretch from a broken manager

# Even skilled managers can fall behind

Take a manager with a top quartile information ratio.

A simple model says it will still trail often, and real long-term stars have spent years on watch lists.

**31%**

modeled chance of trailing in any single year

**19%**

modeled chance of trailing over three years

**>1/3**

of the time on watch for funds that beat the market by 2%+ a year for decades

**23 qtrs**

longest unbroken watch-list stretch for one of those funds

Sources: Grinold and Kahn, Active Portfolio Management, 2nd ed. (2000), p. 114; West and Ko, "Hiring Good Managers Is Hard? Ha! Try Keeping Them," Research Affiliates (2014).
Top row: model estimates assuming normally distributed excess returns, probability of trailing = N(−IR × √years). Bottom row: historical fund data.

WHEN PERFORMANCE DISAPPOINTS

# Judge the process first, then the returns

| | Returns strong | Returns weak |
|---|---|---|
| **Process intact** | **Retain**<br>Keep watching for complacency, asset bloat and fee creep. | **Usually retain**<br>The lag can reflect style, not failure. Confirm the thesis still holds; consider rebalancing back to target. |
| **Process broken** | **Investigate**<br>Good results for the wrong reasons are not repeatable. Find out what changed. | **Replace**<br>Nothing is left to wait for. Begin replacement and transition planning. |

# Questions to ask when a manager lags

## About the market

- Has the manager's style been out of favor?
- Are style-matched peers lagging too?
- Is the benchmark a fair yardstick for this period?

## About the manager

- Did they do what they said they would do?
- Is risk within the range we expected at hiring?
- Any unplanned change in team, ownership, assets or process?
- Does the portfolio still match its stated style?

# A watch list is a diagnostic tool, not a countdown

## Typical objective triggers

- Trailing 3-year return below benchmark, reviewed quarterly (a common rule)
- Rolling returns versus peers, e.g. in bottom quartile
- Qualitative concerns: team, ownership, compliance, process

## What placement means

- Managers on the list are closely monitored
- No new contributions or rebalancing without committee approval
- A documented quarterly decision on each manager

# Behavioral traps for boards

| | | |
|---|---|---|
| **Recency bias** | **Chasing returns** | **Action bias** |
| **Sunk cost** | **Herding** | **Groupthink** |

Real case: a committee fired a manager against its consultant's advice simply because it was on the watch list.

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# When to replace a manager

Clear triggers, a high bar and a plan for the transition

# Reasons to replace, with or without poor returns

## Qualitative triggers

Can justify action on their own, even with good returns

- Unplanned departure of key personnel
- Drift from the stated strategy or investment policy
- SEC violation, discipline or other legal breach
- A change in firm ownership
- Asset growth beyond what the strategy can absorb
- A failed operational review or data breach
- The plan no longer needs the mandate

## Performance triggers

Only after diagnosis and a watch-list review

- Sustained underperformance not explained by style or market
- Results persistently outside the mandate's risk parameters
- No improvement after a watch-list review
- A better net-of-fee option for the same role

# Before you replace, clear the higher bar

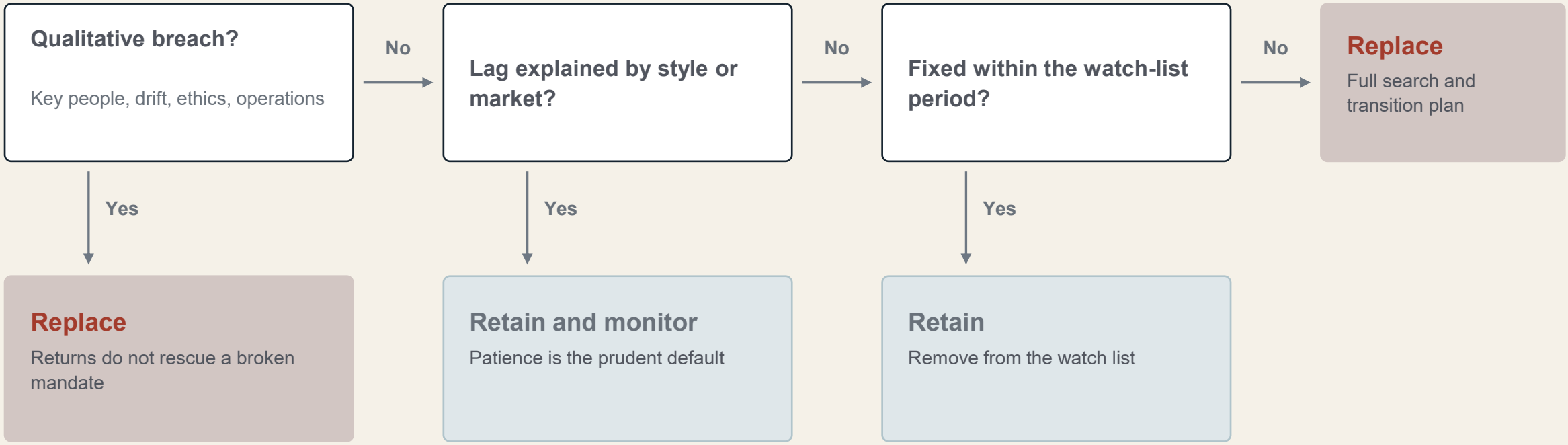
A replacement must be expected to do better, net of fees and transition costs…not merely differently.

**Transition costs**

**No shortcuts**

**Interim plan**

# Putting it together: a decision path



05

# Governance

Clear roles, written criteria and the discipline to follow them

# Who does what

| Decision | Board | Staff | Consultant |
|---|---|---|---|
| Policy and criteria (IPS) | Approves | Drafts | Advises |
| Search and due diligence | Oversees | Leads | Screens, supports |
| Hiring decision | Approves or delegates | Recommends | Recommends |
| Ongoing monitoring | Reviews reports | Monitors | Reports |
| Watch list and termination | Decides or delegates | Recommends | Independent view |

Delegating is not abdicating: the board must still select agents carefully, set the terms and review their work.

Sources: Becker and Comstock (Aon), "Mastering Governance: Who Should Make Decisions About Manager Selection?", NCPERS; Uniform Prudent Investor Act §9; GFOA (2025).
About half of the 50 largest U.S. public pension funds delegate manager selection in some form (Aon). Role split above is illustrative.

# Five things to remember

1. Define the mandate first; it sets the yardstick for every later decision.
2. Weight people, process and operations above past returns.
3. Expect underperformance and diagnose before you decide.
4. Replace for a broken process and only when the alternative clears the cost of switching.
5. Document the criteria in advance and the rationale at every step.