DISCIPLINE AND PATIENCE—KEYS TO MANAGER SELECTION

In picking fund managers, past performance isn't predictive of future results. Past performance is useful only as a tool for screening funds to identify those worthy of further research. We believe it's more important to identify why a fund performed well in the past, determine whether the portfolio management team has an identifiable edge (i.e., was past performance due to luck or skill?), and assess whether the edge is sustainable. To answer these questions requires intensive research of fund managers and their research teams. Focusing on past performance sets up short-term thinking, unrealistic expectations, and poor decision making. This is confirmed by Dalbar investor studies on retail shareholder performance vs. manager performance, as well as in studies of institutional plan sponsors who continuously make poor decisions by choosing funds to invest in based on historical track records (the best records), only to see them go on to deliver poorer performance over a shorter-term holding period. They then sell that manager when they're down and replace them with another outperforming manager who goes on to do the same. All the while, the original manager they sold, if they had skill and stuck to their process, would have done better over the longer term. A different kind of analysis must be done to understand what funds are owned, in order to reap long-term benefits for our clients.

Deeper Dive
Every fund manager claims to have "a disciplined and repeatable" approach, so the claim cannot be accepted at face-value. Our job is to understand how managers think and how they make decisions. Inevitably, every manager will underperform for some period of time, sometimes meaningfully. Unless there is a thorough understanding of the discipline of their investment process, when underperformance happens it becomes a guessing-game whether to stick with the fund or sell. What differentiates our approach is that by understanding why the underperformance is happening, we can surgically dig into mistakes and confidently assess whether a manager's investment process is breaking down.

We are always monitoring and looking for portfolio managers who have an identifiable, sustainable investment edge, but very few make the cut. As such, there is no standard timetable for how often or how many managers are chosen. The same is true for firing managers. We don't look at performance only when evaluating whether to sell a fund. When buying a fund, there is no predetermined holding period. Changes that occur at a management firm are the most common trigger for a drop in our confidence in a manager. Here are some changes that might lead to the removal of a manager:

- ***Changes in personnel***: When key people leave, it is often difficult to know how successful the firm will be in filling their roles. While not always true, departures are sometimes indicative of cultural problems at the firm.

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- ***Excessive growth or poorly managed firm growth***: This can negatively impact our confidence in a variety of ways including the possibility of reduced flexibility, reduced focus due to management distractions, delegation of key duties to potentially less capable team members, and reduced motivation to succeed that can come with increased wealth. Risk that comes from substantial growth and size is something that we increasingly attempt to assess, though admittedly this is very hard to do.
- ***Loss of focus***: This can be due to burnout or the development of other interests.
- ***Discipline slips***: At times a manager who was previously successful strays from discipline and makes decisions without the analytical basis we expect.
- ***Business risk***: Sometimes various factors lead to a loss of assets and team members at a firm. This raises concerns about risk to their business and their capabilities.

The significant effort put in to manager due diligence allows us to be patient with managers who go through a slump, as they all do eventually. If one of our selected funds underperforms, we circle back, try to understand what is going on and assess if something significant has changed with the team or process, or determine whether we missed something in our initial analysis. If none of the reasons for initially selecting the fund have changed, then we have the confidence to stick with a manager who is underperforming for a while, or whose style of investing is temporarily out of favor.