Does Past Performance Matter in Investment Manager Selection?

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Dating back to Jensen [1968], the immense literature on investment performance has focused on determining if managers possess stock-picking or market-timing talent that enables them to consistently produce positive factor-adjusted results. The extensive early literature, up through Carhart [1997] and Wermers [2000], found little evidence that managers could consistently outperform the market on a factor-model-adjusted basis. While this outcome is disheartening to the individuals engaged in manager selection, it is perhaps unsurprising. The fierce, relentless competition among smart active managers would suggest that there are few opportunities for a free lunch. Additionally, rational active managers presumably extract the full rent of their talent, given that alpha skill is scarce and capital is plenty. Investors would be naïve if they did not expect managers to gather sufficient assets and charge adequate fees to effectively capture the better part of the dollar alphas they generate (Berk and Green [2004]).

December 2015 data from Morningstar Direct shows that, for better or worse, investors choose to allocate twice as many assets toward actively managed strategies than toward passively managed ones. Moreover, many trillions of dollars in pension assets are delegated to active managers through a beauty contest process that focuses substantially on the recent three-year simple outperformance against the stated benchmark (Goyal and Wahal [2008]). Academic discussions of manager skill and measurements of manager outperformance generally ignore the reality that manager selection is based largely on recent excess performance against a specified benchmark. For example, the mandated benchmark for most institutional managers running U.S. large-capitalization equities is the S&P 500 Index; managers would be considered to have outperformed if they produced excess return against the S&P 500 over the evaluation period while staying within the client’s tracking error tolerance.

Few if any pension trustees, investment officers, or their consultants measure the manager’s capital asset pricing model (CAPM) or Fama–French alpha in making hiring and firing decisions. Additionally, a performance fee, if there is any, is almost always based on the simple excess return over the benchmark, subject to a high watermark. Thus, by revealed preference, institutional investors have already made up their minds regarding the possibility of outperformance, the kind of outperformance they value and would pay for, and the method for selecting investment managers. Given modern manager selection policies, it is less relevant to ask whether managers can outperform net of fees using an advanced factor model. Instead, we argue that it is more appropriate...
to examine whether selecting managers based on recent simple outperformance against the stated benchmark (the dominant manager selection heuristic) can lead to subsequent simple outperformance against the benchmark (the desired outcome for most institutional investors).

Because our article focuses on the implications of the modern investment manager selection heuristic employed by industry practitioners, we follow industry practice and define performance as excess return over a stated benchmark.1 We are specifically interested in determining whether the common manager selection methodology based on recent excess returns over the chosen benchmark leads to future outperformance against the same benchmark. To anticipate our conclusions, we find that the common selection methodology turns out to be a detriment to performance.

RELATED LITERATURE AND RESEARCH

The literature on investment fund flows suggests that investors, both institutional (pension funds and sovereign wealth funds) and retail, often employ a simple algorithm—they usually focus only on recent performance. Retail investors have a substantially shorter horizon in which they review and trade funds every 6 to 12 months. Institutional investors generally have a longer but still short assessment horizon of two to three years. Papers including Chevalier and Ellison [1997], Sirri and Tufano [1998], Wermers [2003], and Frazzini and Lamont [2008] all report that flows are positively correlated with past performance.

Anecdotally, investment consultants and fiduciaries acknowledge that past outperformance is one of the dominant manager selection criteria, if not the only criterion, because it is intuitive and thus defensible to plan sponsors—even if all reported manager performance results are labelled with the statistically honest but small-font disclosure that past performance is not indicative of future performance. From the standpoint of investment consultants, hiring managers with superior recent performance and firing managers with poor recent performance is preferred because doing the opposite would be counterintuitive and therefore unacceptable to the layperson trustee board overseeing the pension fund. As noted previously, the performance measure employed is almost exclusively the simple return over the stated benchmark without risk adjustment. This is because the pension fund trustee boards generally consist of union leaders and active public servants such as schoolteachers and police officers, who represent the pension beneficiaries, as well as local statesmen and political appointees; most of them have little or no quantitative investment experience. When pensions’ investment staffs and consultants struggle to assist the board on issues such as proper asset allocation and pension underfunding, they are averse to wading into complex (and potentially less important) topics such as factor models for measuring manager skill.2 Furthermore, from a legal perspective, it has been argued that in the event of a dispute between a plan sponsor and its pension consultant or a plan sponsor and its beneficiary, a selection criteria dominated by simple recent performance is the most defensible.3

Although we are sympathetic to the reasons for selecting investment managers based on recent outperformance over the respective benchmarks, we have heard repeatedly from pension consultants and investment staff members about the lack of success from this approach. A question that we believe is worthy of careful empirical examination is, Could managers with better recent outperformance be more likely to underperform over the standard investment evaluation horizon? Intuitively, if there is mean reversion over the assessment horizon, which is roughly three years for the average institutional investor,4 the standard hiring/firing practice could possibly lead to a worse outcome than an apparently paradoxical strategy of investing in managers with poor recent performance and firing the recently successful ones!

Although a contrarian approach to manager selection might seem ridiculous at first blush, under the assumption that there are decreasing returns to scale in active portfolio management (Berk and Green [2004]) and that managers put fresh capital to work in existing positions (Khan, Kogan, and Serafeim [2012] and Lou [2012]), we maintain that it could actually be sensible. Our argument is related to Woolley and Vayanos’ [2012] theory of asset mispricing. The authors show that performance-chasing flows will create short-term momentum in the performance of winner managers, but also reversal when the flows turn around to chase the next winner strategy a few quarters hence. Exhibit 1 illustrates this “spiral effect” phenomenon.

Our argument is also supported by mean reversion effects that have been empirically documented in many of the common factors in stock returns.5 There is evidence that managers employ “factor strategies” to
augment returns (Chen, Jegadeesh, and Wermers [2000] and Grinblatt, Titman, and Wermers [1995]). If manager performance is the result of the manager following a particular “factor strategy,” and if such strategies mean revert, then choosing managers who have performed well in the past can actually lead to worse future performance. All of this suggests the possibility that a good recent track record may be a predictor of inferior future performance. The remainder of our article is devoted to an empirical analysis of performance-based manager selection strategies.

METHODOLOGY AND DATA

To simulate the impact of the popular manager selection heuristic, we compare the performance of hypothetical pension portfolios that follow policies that mandate investing in products based on recent benchmark-adjusted returns. Specifically, we start with the commonly employed “winner strategy,” defined as follows. At the beginning of each three-year period, investors purchase equal positions in products that rank in the top decile of benchmark-adjusted returns. At the end of three years, the monies are reallocated to a new portfolio that is once again equal weighted among the top-decile performers.

We compare the investment results of this “winner strategy” with those of a “median strategy” whose three-year asset allocation policy is to invest in products that rank between the 45th and 55th percentile of benchmark-adjusted returns. Finally, we also examine a “loser strategy” that follows the same procedure but invests in products that rank in the bottom decile of benchmark-adjusted returns. The winner-strategy bucket would generally consist of managers that investment consultants would recommend to their pension clients. Managers in the “loser strategy” bucket would generally be put on the “watch list” and actively replaced in client portfolios by managers on the recommended list.

We also compare the investment performance produced by an unorthodox strategy of investing in products that underperformed their benchmark by more than 1% per year and the even more extreme case of investing in products that underperformed their benchmark by more than 3% per year. These portfolios, which allocate to recently underperforming products, help us understand the impact of the common manager firing heuristic. When we “de-select” a manager who has recently underperformed by 3% per annum, are we really eliminating a source of bad future performance from our portfolio?

Given our primary interest in examining the efficacy of the institutional investor manager selection heuristic, we ideally need to apply these decision rules to products offered by asset managers who provide investment services to pensions. Unfortunately, no database tracking the returns offered by such institutional managers is free from survivor bias. For this reason, we use Morningstar Direct’s survivor-bias–free United States Mutual Funds database to proxy for institutional manager performance. Fortunately, many mutual fund managers also offer the exact same portfolio in vehicles designed
for pensions and other institutional asset owners. As it turns out, most large mutual fund managers also have a meaningful business managing assets for pension funds and other institutions. Through examining the products offered by large mutual fund managers, we are able to construct proxies for those to which the institutional investors also allocate.

More specifically, our empirical analysis proceeds as follows. For every 36 months, between January 1994 and December 2015, we truncated our cross section of actively managed U.S. equity mutual fund portfolios to include only those that (1) had at least a billion dollars in total net assets (TNA) as of the end of the previous month and (2) did not rank in the top decile of expense ratio in the prior year. We made these eliminations because small funds and those with high fees generally do not have much of an institutional presence. Additionally, prior research shows that expensive mutual funds tend to be persistent underperformers because of costs (Barber, Odean, and Zheng [2005] and Nanigian [2016]). Eliminating them from the universe allowed us to investigate transient versus persistent underperformance in a manner that is more clearly related to skill and portfolio exposures. Expense ratios and net-of-expense returns on share classes were aggregated to the fund portfolio level by weighting them by their TNA as of the end of the previous month.

We calculated the average benchmark-adjusted returns over the previous 36 months for each remaining fund in our universe. The benchmark was based on the “Primary Prospectus Benchmark” and “Secondary Prospectus Benchmark” data points in Morningstar Direct. If Morningstar Direct had a continuous time series of 36 monthly returns on both a fund’s primary and secondary prospectus benchmark indexes, we chose as the benchmark the one that produced lower tracking error volatility. If Morningstar Direct had a continuous time series of 36 monthly returns on only one of the two prospectus benchmarks, then we used that benchmark.

Next, we simulated investing equal amounts of capital in funds whose benchmark-adjusted returns were consistent with the aforementioned investment policies. We held the funds in each portfolio for 36 months. This matches the standard “tolerance/review horizon” for institutional investors. For simplicity, during the 36-month holding period, we rebalanced the portfolios monthly to maintain equal weights across strategies. If a fund disappeared from our dataset, the capital invested in it was equally allocated among the remaining funds.

At the end of the 36-month period, we repeated the evaluation process and reconstituted the portfolios based on updated information on expenses, TNA, and benchmark-adjusted returns.

We also performed a battery of robustness tests to examine whether using 24-month holding and evaluation periods, using fund portfolios of any size, and using only institutional share classes—rather than only fund portfolios with at least a billion dollars in TNA—affected the results. Finally, we reported results for each decile of the distribution of benchmark-adjusted returns.

**EMPIRICAL RESULTS**

Exhibit 2 shows the results for winner, median, and loser portfolios. Surprisingly, the average benchmark-adjusted return for the median strategy exceeds that of the winner strategy by 1.32 percentage points per year. The median strategy also outperforms the winner strategy across all other performance metrics commonly employed in academic studies, in addition to benchmark-adjusted returns. For example, the Sharpe ratio of the median strategy is 0.42 versus 0.25 for the winner strategy. This implies that investors can nearly double their mean–variance efficiency simply by switching from chasing winners to investing in funds that have demonstrated a median level of recent performance.

Furthermore, the CAPM alpha generated by the median strategy exceeds that of the winner strategy by 2.76 percentage points per year. The alpha from the

**EXHIBIT 2**

<table>
<thead>
<tr>
<th>Winner Strategy</th>
<th>Median Strategy</th>
<th>Loser Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benchmark-Adjusted Return</td>
<td>–2.39%</td>
<td>–1.07%</td>
</tr>
<tr>
<td>Raw Return</td>
<td>7.43%</td>
<td>8.89%</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>0.25</td>
<td>0.42</td>
</tr>
<tr>
<td>CAPM Alpha</td>
<td>–3.61%</td>
<td>–0.85%</td>
</tr>
<tr>
<td>CAPM Alpha t-Stat</td>
<td>–2.20</td>
<td>–1.70</td>
</tr>
<tr>
<td>Carhart Four-Factor Model Alpha</td>
<td>–3.19%</td>
<td>–1.16%</td>
</tr>
<tr>
<td>Carhart Four-Factor Model Alpha t-Stat</td>
<td>–3.09</td>
<td>–2.57</td>
</tr>
</tbody>
</table>

*Source: Morningstar Direct.*
Carhart four-factor model, which controls for the market, size, value, and momentum factors in stock returns, is also meaningfully higher for the median strategy than for the winner strategy.7 This implies that the winner strategy underperforms for reasons that go beyond the familiar factor exposures. Institutional investors who adopt the traditional manager selection heuristic do not earn a lower return because they avoid certain factor risks. Instead, they appear to earn low returns without potentially redeeming investment benefits.

The foregoing results suggest that outperformance is mean reverting. If so, it is possible that past losers perform the best of all, as DeBondt and Thaler [1985] found in the case of individual stocks. The simulated investment results of the loser strategy reported in Exhibit 2 support this conjecture: The performance of the loser strategy consistently exceeds not only that of the winner strategy but also that of the median strategy. For example, while the average benchmark-adjusted return generated by the median strategy exceeds that of the winner strategy by 1.32 percentage points per year, the average benchmark-adjusted return produced by the loser strategy exceeds that of the winner strategy by an additional 0.96 percentage points—a total performance differential of 2.28 percentage points per year. The observed pattern in which the loser strategy outperforms the median strategy which in turn outperforms the winner strategy holds across all the performance metrics, including the raw returns, Sharpe ratios, alphas, and t-statistics associated with the alphas.

Hsu, Myers, and Whitby [2016] suggest that the large gaps between the dollar-weighted returns experienced by investors and the buy-and-hold returns reported by managers is driven by the modern manager selection heuristic of engaging the hot managers, only to experience subsequent underperformance due to mean reversion. Our results offer empirical support for their explanation for the “return gap.”

To assess the robustness of our findings, we extend our analysis to examine the efficacy of hypothetical manager firing rules based on the level of underperformance relative to the benchmark index. To do this, we calculated the performance of portfolios constructed from funds that have underperformed their benchmarks by 1% per annum and by 3% per annum for the past three years. Such funds are usually dropped by pensions on the recommendation of their investment consultants. We compared these to the performance of the “complement” portfolios, which contain the funds that have not underperformed their benchmarks by more than 1% or 3% per annum over the past three years. If these funds were currently included in an investor’s portfolio, they were not dropped.

Exhibit 3 displays the results for these “fired” and “kept” funds. At the 3% threshold, the fired funds outperform the kept funds by over one percentage point per year based on benchmark-adjusted return, raw return, CAPM alpha, and Carhart four-factor model alpha. The Sharpe ratios indicate that the fired funds also exhibit greater mean–variance efficiency than their counterparts. The results are largely similar when we use a 1% threshold in place of the 3% threshold. Once again, the fired funds outperform the kept funds across all performance metrics.

**E X H I B I T  3**


<table>
<thead>
<tr>
<th></th>
<th>Underperformed by More Than 1%</th>
<th>Did Not Underperform by 1% or More</th>
<th>Underperformed by More Than 3%</th>
<th>Did Not Underperform by 3% or More</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benchmark-Adjusted Return</td>
<td>−0.67%</td>
<td>−1.31%</td>
<td>−0.30%</td>
<td>−1.33%</td>
</tr>
<tr>
<td>Raw Return</td>
<td>9.33%</td>
<td>8.40%</td>
<td>9.69%</td>
<td>8.52%</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>0.45</td>
<td>0.35</td>
<td>0.46</td>
<td>0.37</td>
</tr>
<tr>
<td>CAPM Alpha</td>
<td>−0.37%</td>
<td>−1.87%</td>
<td>−0.13%</td>
<td>−1.59%</td>
</tr>
<tr>
<td>CAPM Alpha t-Stat</td>
<td>−0.67</td>
<td>−2.52</td>
<td>−0.19</td>
<td>−2.80</td>
</tr>
<tr>
<td>Carhart Four-Factor Model Alpha</td>
<td>−0.69%</td>
<td>−1.88%</td>
<td>−0.48%</td>
<td>−1.64%</td>
</tr>
<tr>
<td>Carhart Four-Factor Model Alpha t-Stat</td>
<td>−1.43</td>
<td>−3.64</td>
<td>−0.79</td>
<td>−3.80</td>
</tr>
</tbody>
</table>

*Source: Morningstar Direct.*
To evaluate the impact of the assumed measurement period, we repeat our analysis three times—using two-year holding and evaluation periods, using fund portfolios of any size, and using only institutional share classes rather than only fund portfolios with at least a billion dollars in TNA. Exhibits 4 and 5 present our findings pertaining to the use of the two-year holding and evaluation periods. Exhibits 6 and 7 show the results of our analysis involving fund portfolios of any size.

Exhibits 8 and 9 present the results from our analysis using only institutional share classes, rather than only fund portfolios with at least a billion dollars in TNA. The results are little changed by switching to a shorter interval, dropping the TNA proxy for institutional presence, or replacing it with a share-class-based proxy.

Most importantly, the two main phenomena that we observed with the baseline specification persist. First, the loser strategy outperforms the median strategy,
which in turn outperforms the winner strategy. Second, the portfolios composed of funds that meaningfully underperformed their benchmarks wound up outperforming those that did not. As we observed with the baseline specification, these phenomena were consistent across all performance metrics.

To extend our results to a larger cross section, we sorted funds into portfolios based on decile rank of benchmark-adjusted return. Exhibit 10 displays the results for each of these 10 portfolios. This exhibit further demonstrates that a negative relationship exists between past benchmark-adjusted return and future performance, regardless of the particular metric of future performance.

Of course, plan sponsors and the consultants they employ do not select managers solely based on their recent performance. Investment consultants and financial advisors also grade investment managers and funds based on various other softer dimensions—including stewardship, governance, manager tenure, and incentive alignment. Research has found a linkage between these attributes and long-term manager performance. It is interesting to ask whether these other potentially informative characteristics might be enough to overcome the negative effect of using recent outperformance as a selection criterion. More importantly, it is useful to examine whether the truly skilled managers exhibit mean reversion in their benchmark-adjusted return.

To study this possibility, we create a stark example. In our analysis, on each manager selection date, we began with fund portfolios that had at least a billion dollars in TNA as of the end of the previous month and did not rank in the top decile of expense ratio in the prior year. Within this universe, we then calculated each manager’s average benchmark-adjusted return over all future fund-month return observations. By using data over the full sample period, we effectively assume that plan sponsors are able to identify managers that do,

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**EXHIBIT 8**


<table>
<thead>
<tr>
<th>Decile</th>
<th>Benchmark-Adjusted Return</th>
<th>Raw Return</th>
<th>Sharpe Ratio</th>
<th>CAPM Alpha</th>
<th>CAPM Alpha t-Stat</th>
<th>Carhart Four-Factor Model Alpha</th>
<th>Carhart Four-Factor Model Alpha t-Stat</th>
</tr>
</thead>
<tbody>
<tr>
<td>Winner</td>
<td>-0.39%</td>
<td>10.05%</td>
<td>0.49%</td>
<td>-0.08%</td>
<td>-0.93%</td>
<td>-2.63%</td>
<td>-0.30%</td>
</tr>
<tr>
<td>9</td>
<td>-0.46%</td>
<td>10.05%</td>
<td>0.49%</td>
<td>-0.08%</td>
<td>-0.93%</td>
<td>-2.63%</td>
<td>-0.30%</td>
</tr>
<tr>
<td>8</td>
<td>-1.04%</td>
<td>10.05%</td>
<td>0.49%</td>
<td>-0.08%</td>
<td>-0.93%</td>
<td>-2.63%</td>
<td>-0.30%</td>
</tr>
<tr>
<td>7</td>
<td>-1.24%</td>
<td>10.05%</td>
<td>0.49%</td>
<td>-0.08%</td>
<td>-0.93%</td>
<td>-2.63%</td>
<td>-0.30%</td>
</tr>
<tr>
<td>6</td>
<td>-1.50%</td>
<td>10.05%</td>
<td>0.49%</td>
<td>-0.08%</td>
<td>-0.93%</td>
<td>-2.63%</td>
<td>-0.30%</td>
</tr>
<tr>
<td>5</td>
<td>-1.82%</td>
<td>10.05%</td>
<td>0.49%</td>
<td>-0.08%</td>
<td>-0.93%</td>
<td>-2.63%</td>
<td>-0.30%</td>
</tr>
<tr>
<td>4</td>
<td>-2.14%</td>
<td>10.05%</td>
<td>0.49%</td>
<td>-0.08%</td>
<td>-0.93%</td>
<td>-2.63%</td>
<td>-0.30%</td>
</tr>
<tr>
<td>3</td>
<td>-2.46%</td>
<td>10.05%</td>
<td>0.49%</td>
<td>-0.08%</td>
<td>-0.93%</td>
<td>-2.63%</td>
<td>-0.30%</td>
</tr>
<tr>
<td>2</td>
<td>-2.78%</td>
<td>10.05%</td>
<td>0.49%</td>
<td>-0.08%</td>
<td>-0.93%</td>
<td>-2.63%</td>
<td>-0.30%</td>
</tr>
<tr>
<td>Loser</td>
<td>-3.00%</td>
<td>10.05%</td>
<td>0.49%</td>
<td>-0.08%</td>
<td>-0.93%</td>
<td>-2.63%</td>
<td>-0.30%</td>
</tr>
</tbody>
</table>

Source: Morningstar Direct.
in fact, outperform ex post. From the group of superior performers, we then examine the impact of screening funds based on recent performance.

In Exhibit 11, not surprisingly, we see that having future performance information would be incredibly valuable for selecting funds. A portfolio that allocates equally to the top 25% of managers by future performance every 36 months would outperform the median strategy portfolio by 3.54 percentage points per annum (performance improves from −1.07% to 2.47%), based on benchmark-adjusted return. However, if we further select from these top future performers the top 10% by the past 36-month performance, the performance actually declines by 0.65 percentage points (from 2.47% to 1.82%). In addition, it remains the case that selecting losers improves performance. When the recent losers are selected from the universe of top future performers, the benchmark-adjusted returns rise by nearly a full percentage point (from 2.47% to 3.46%) and all the risk-adjusted measures of return improve. This suggests that focusing on recent performance in manager selection could substantially reduce the information advantage an investor gains from other manager selection analysis. It also shows that even the “superior” managers, defined ex post, exhibit mean reversion in their future performance against their stated benchmark.

Imagine a situation in which an investment consultant suggests that her clients consider a set of managers who she identified based on her evaluation of characteristics that prior research have found to be predictive of future performance. One could reasonably expect that these managers would indeed outperform if held for the long term. However, we find that if clients then choose from that set of managers those who had the best recent performance, this additional step meaningfully destroys value. Put simply, even if investors start with a well-constructed list of managers, using strong recent performance as an additional selection criterion is a harmful practice.

**INVESTMENT IMPLICATIONS**

The purpose of our article was to empirically investigate the performance of commonly used fund-manager selection strategies that involve hiring outperforming managers and firing underperforming managers. Based on portfolios held and evaluated over typical three-year periods, we found that the performance of hypothetical plan sponsors who chose funds with poor recent performance was higher than the performance of those who chose funds with superior recent performance. The greater benchmark-adjusted return to investing in “loser funds” over “winner funds” is statistically and economically large and is robust to reasonable variations in the evaluation and holding periods, as well as to standard risk adjustments. We also found that the standard practice of firing managers who have recently underperformed actually eliminates those managers that are more likely to outperform in the future. Finally, we found that even if investors are able to narrow the universe to a short list of managers who outperform in the long run, using past outperformance as an additional selection criterion substantially reduces performance.
Our study has a key implication for plan sponsors. A policy of hiring recently outperforming managers and firing recently underperforming managers is 180 degrees wrong. Because of the mean reversion in manager performance, a strategy of hiring managers with mediocre track records outperforms one of hiring past winners and a strategy of hiring past losers turns out to be the best of all.

Our results pose a challenge for asset owners. If the results are accepted at face value, and if past performance is used at all for hiring and firing managers, the best-performing managers should be replaced with those who have performed more poorly. Despite our findings, a policy of firing successful managers and replacing them with poor performers is unlikely to gain widespread acceptance. Instead, the practical implication of our article is that asset owners should focus on factors other than past performance when selecting managers.

Most saliently, as Cornell [2011] argues, the theoretical soundness of the “investment thesis” that drives a fund’s portfolio management strategy should be a key criterion for consideration. Recent research also points to a variety of signals of incentive alignment that predict future performance. These include the presence of performance-linked bonuses in fund manager compensation packages (Ma, Tang, and Gómez [2012]), a high level of fund manager ownership (Khorana, Servaes, and Wedge [2007]), board of director ownership (Cremers et al. [2009]), and lack of affiliation with an investment bank (Hao and Yan [2012]). Other characteristics that predict superior performance include the following:

- a high active share (Cremers and Petajisto [2009], Amihud and Goyenko [2013])
- outsourced execution of shareholder services (Sorhage [2015])
- the presence of a short-term redemption fee (Finke, Nanigian, and Waller [2015])
- having PhDs in key portfolio roles (Chaudhuri et al. [2013])
- having a strong positive firm culture (Heisinger, Hsu, and Ware [2015])

Evaluating a manager’s strategy ex ante and taking account of the characteristics of the investment management firm may be more difficult than making decisions based on historical performance. Nonetheless, our research implies that it is a better approach to delegated portfolio management.

ENDNOTES

We would like to thank Philip Lawton and Travis Meister for their editorial assistance.

1See Hsu, Myers, and Whitby [2016] for a discussion of the difference between the practitioner’s and the academic’s definition of outperformance.

2See Cornell and Hsu [2016] for a discussion of the investment ecosystem and the knowledge level of average individual investors and their fiduciaries.

3ERISA (the 1974 Employee Retirement Income Security Act) and UPIA (the 1994 Uniform Prudent Investor Act) require that pension fiduciaries follow a “prudent man” approach, which has come to be understood as “the common practice adopted by one’s peers.” Because firing managers with poor recent performance and hiring managers with good recent performance has become the industry norm, this heuristic is also interpreted as “safe harbor” behavior—what a reasonable prudent man would do. In the same vein, Goyal and Wahal [2008] argue that pension sponsors tend to terminate managers for recent poor performance to avoid headline risk.

4From Research Affiliates’ anecdotal survey of institutional consultants, performance over the past three years is one of the most important statistics for firing managers and is critical in the hiring decisions as well. This is also consistent with the algorithm behind the Morningstar star rating, which gives the heaviest weight to performance over the past three years (see methodology paper: http://corporate.morningstar.com/cf/documents/MethodologyDocuments/MethodologyPapers/MorningstarFundRating_Methodology.pdf). Goyal and Wahal [2008] find evidence that pension sponsors tend to invest with managers with high past three-year performance. An anonymous investment consultant revealed that, “When you get to three years of underperformance, we either fire the manager or be fired ourselves.”

5Campbell and Shiller [1998] and Cochrane [2008] find that market beta can be timed. Asness et al. [2000] find that the value premium can be timed. Daniel and Moskowitz [2013] find that momentum crashes can be timed. Garcia-Feijóo et al. [2015] find that the low-volatility premium can be timed.

6Expense ratios are collected from annual reports.

7Asset pricing model factors are gathered from Kenneth French’s website. For details on the construction of these factors, see mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/f-f_factors.html. We are grateful to Kenneth French for providing this data.
REFERENCES


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