

The Bed We Made...

Procrustes, a highway robber in ancient Greece, made his victims “fit” an iron bed, chopping off their legs if they were too tall or stretching them on a rack if they were too short. Theseus killed him on the same bed, but the heirs of Procrustes continue to practice his craft in today’s investment world. They are called consultants.

Investors hire consultants to select good managers. To evaluate a manager, consultants compare her portfolio to a benchmark index – for example, the Standard and Poor’s 500 index can be a benchmark for a manager of large U.S. stocks. The consultants apply a set of quantitative tools to compare various characteristics of the manager’s portfolio to the benchmark’s characteristics – for example, the size of the companies held, their valuations, growth rates, etc. This helps the consultants to compare competing managers and, perhaps more important, to wow clients and prospects with their expertise and sophistication. Too often, however, consultants use the tools as a Procrustean bed, penalizing investment managers for what may be desirable behavior and forcing a mindless conformity among managers fearing criticism.

In the interest of full disclosure, many consider us to be consultants, although we usually act as a discretionary manager of managers rather than just providing advice. We also hope to convince you that we use our analytical tools in a more sensible manner than many in our industry. Listen to consultants talk for awhile, and it becomes clear that their idea of perfection is a portfolio that matches every characteristic of the benchmark but significantly outperforms the benchmark. To the extent a manager’s portfolio is different from the benchmark, the manager risks the consultants accusing her of “style drift,” a pejorative description of varying from the benchmark. But the consultant’s ideal portfolio is impossible to achieve in practice – the only way to beat the performance of a benchmark is to have investments that vary from the benchmark. Every active investment manager is engaged in some form of “style drift” – the only questions are how much, in what direction and (most importantly) to what end?

Imagine three value managers that have a rule of only buying stocks selling at less than 12 times earnings. Due to market conditions, they have trouble finding stocks that meet their rule in the traditional “value” industries. They can find stocks, though, at under 12 times earnings in “growth” industries.

The first manager sticks to his rule and traditional industry focus and holds some cash rather than investing in stocks that do not meet his rule. The second manager sticks to his rule but is willing to apply it to the “growth” industries. The third manager loosens his criteria to buy stocks under 20 times earnings rather than 12, but sticks to his traditional industries. Many consultants would fire the first manager – “we didn’t hire you to manage cash.” Many would also fire the second manager for style drift, since he is now buying what they perceive to be growth stocks. The third manager is unlikely to broadcast that he changed his previous buy rule, so the consultants may continue to favor him. It appears he is “sticking to his discipline” – even though he is not. Managers know the way consultants think, and since consultants bring them clients, managers may “cheat” rather than do what they truly believe is right.

Not all consultants enforce conformity to arbitrary standards, but many do. This is not the way the investment world used to be. Manager selection used to be the process of finding smart people to manage your money and then letting them apply their smarts. If they liked growth stocks one year and value stocks the next, or are nervous about the market, sell stocks and hold cash, well, that was what they were supposed to do.

*Investing is dead, and we
(consultants) have killed it.*

Comparing a manager to a benchmark can be a valuable analytical tool, but it is no excuse for failing to use common sense. If we hire a manager who follows a particular style, and she is having trouble finding candidates to buy, we hope her fiduciary sense leads her to hold cash rather than stray from her expertise – we believe that is what she is supposed to do. We excluded “value” managers who bought technology stocks in 1999 or 2000, when everyone in the world was in love with that sector, but we are intrigued when we see value managers buy beaten-up tech stocks after the bear market. Terms such as “growth” and “value” are not precise. We are not the only ones having troubles with the definitions – Vanguard recently changed the benchmarks for several of their index mutual funds due to concerns over the definitions of “growth” and “value.”

In last month’s newsletter, we criticized investor perceptions of the hedge fund industry, but you can see the attractiveness of hedge funds for investment managers. What would happen to the managers fired for holding cash and buying growth stocks if they called themselves “hedge fund” managers? Hedge funds are supposed to hold cash rather than make questionable investments, to go where the opportunities are, to do anything “smart” to make money for their clients, just like all managers before the reign of consultants. Consultants may fire a mutual fund manager for the same activity that would lead them to praise a hedge fund manager. The amorphous definition of hedge funds, the inability of anyone to really pin down what they are, shields the managers from meddling by investment consultants. Unfortunately, lust for high fees and avoiding hassle are enticing to bad managers as well as good, so the hedge fund “advantage” does not necessarily accrue to the clients. Consultants are starting to ply their craft in the hedge fund industry as well, so the “advantage” for managers may be ephemeral.

Rather than micro-analyzing short term performance or worrying over a slight variance from a hypothetical and somewhat arbitrary Procrustean benchmark, we look for managers that are consistent and ethical, managers who follow an approach we can understand. If you would like investment help from a firm that focuses on trying to apply common sense in a rapidly changing world, check us on the web at www.sigmainvestment.com or call us at 503-419-3938.