"HOW WE INVEST" WHITE PAPER

INVESTMENT MANAGER SKILL

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SEPTEMBER 2014

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PREFACE

This paper is a summary of one of a series of internal Guardians discussion workshops. We'd found ourselves having discussions about a specific investment where what we were really debating was a much more fundamental investment issue. The workshops were designed to explore team members' views, and understand the basis of internal agreement and disagreement, on a range of these fundamental issues. We knew that we were not necessarily going to resolve all of these issues, but we would come away with a better understanding of the key differences in opinion. Most importantly, we also considered the implications of each issue for how we construct our investment portfolio.

Holding the workshops, and developing these papers, has helped us provide a consistent vision to staff, to focus our time and resources appropriately and to avoid re-litigating some of the fundamental investment questions that investors deal with on an ongoing basis. I hope they also enhance your understanding of how we go about investing the NZ Super Fund.

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WHAT IS IT?

No conversation about investment skill gets very far without a shared understanding about what it actually is. We've thought a lot about this and have found the most useful place to start when defining skill, is to establish what it is **not**. If you consider the ingredients of extra investment returns ('alpha'), then skill is not:

- Beta (the market return);
- Risk factors (for example, harvesting a value or growth premium); or
- Luck.

Through properly analysing a series of investment manager returns, it is possible to identify the presence and significance of beta and risk factors.

You can then construct an appropriate benchmark to ensure that market movement driven by any of those factors is captured within the benchmark, and not attributed to the manager's ability to generate extra returns. This makes the benchmark harder to beat (as a benchmark should be) and also means you should not pay an extra return premium, through performance fees, for what is not actually an extra return.

Isolating skill from luck is more difficult and because of that it is not possible to create a benchmarking solution. We have agreed, however, that the best 'centrifuge' for separating skill from luck, is time. This is based on luck being, by definition, random, and skill being deliberate action and therefore, theoretically, repeatable.

Finally, there are many skills which an investment manager may bring to bear on an investment, such as analytical skill, information-gathering skill and negotiation skill. The key is to identify which of those skills (if any) is the cause of extra returns generated (i.e. those which are not the result of beta, risk factors or luck).

Combining all of these pieces, then, we arrive with a definition of skill which is:

Skill is the ability to persistently outperform an appropriate benchmark.

We also note that some markets are conducive to manager skill. Typically, a conducive market is one where, if you look at a group of managers accessing the same opportunity, a selection of that group will persistently achieve outperformance relative to the remainder of the group (the New Zealand equity market is a good example of this).

A market can be conducive to manager skill because it takes effort to acquire information about how it works and the behaviour of its participants. Alternatively, it may be conducive to manager skill because some participants are in the market for reasons other than maximising investment returns. We like markets that are conducive to manager skill because, to use a fishing allegory, we are more likely to find a successful fisher if we first find a productive pond.

IS SKILL ALWAYS NECESSARY?

To generate extra returns over an appropriate benchmark, yes, skill is necessary. We also have passive managers tasked with achieving benchmark returns, and who charge lower fees as a result. There is clearly skill in this (again, in the sense of capability). But for the purposes of useful distinction, we re-classify this as *competence* – the ability to deliver (not outperform) an appropriate benchmark return.

Even when we are confident that we have located skill, we cannot be confident that we will benefit from it. Why?

- because the benefits can be eroded by what we pay for it;
- because our own processes might be insufficient to ensure we capture all of the potential benefits; and
- because there is insufficient alignment between us and the manager.

HOW DO WE GET CONFIDENT THAT WHEN WE FIND SKILL, WE WILL BENEFIT FROM IT?

Our response to these challenges is two-fold.

First, we believe it is important to identify the *source* of a manager's skill. We agree, as do most researchers on this topic, that it is some combination of a manager's experience, strategy, discipline, processes and execution capabilities. All of these are tangible, measurable factors which are useful to our ability to form a view as to the likelihood of the manager's skill being repeatable. Plus, in identifying something tangible, it is simpler to identify what might threaten that quality (and therefore what we should seek to preserve in the legal arrangements with the manager, and to include in our monitoring programme for that manager).

Second, even where we identify skill in a manager and believe we have a good handle on its source, we must be able to access it in a way which maximises the alignment between the manager and ourselves. For example:

- fees which do not erode or even eliminate extra returns;
- reporting which gives us optimal visibility into what the manager is doing and its broader organisational issues; and
- structures which protect us against changes in strategy, ownership or key personnel.

If we cannot align ourselves to the skill we have found, then we can still walk away – we have not *captured* the skill.

DO WE NEED SKILL TO CHOOSE INVESTMENT MANAGERS?

Yes, we believe that skill is hard to identify and capture. Because of that, and because of the financial and reputational consequences of getting it wrong, our manager selection competency is at least as important as the investment manager's skill in generating extra returns. The best way for us to assess our own competency in this regard is ongoing monitoring of the performance of the managers we choose, relative to other managers we could have chosen and did not.

For more information see
https://www.nzsuperfund.co.nz/how-we-invest/investment-managers