# Selecting Money Managers – Qualitative versus Quantitative

Putting together a robust, diversified portfolio

*Most investors select potential investments or investment managers using various forms of quantitative information. Everything from returns, risk rankings and return-to-risk ratios might be brought in to help in the selection process. But quantitative processes often fail to ask and answer some basic questions that influence the long-term viability of a portfolio. My experience with qualitative and quantitative approaches suggests that including qualitative selection processes should provide a more robust, diversified portfolio.*

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## Introduction:

For 24 years in the money management business, I've watched our clients screen the investment universe for the "10 Best" of this or that, but I have not seen them generally end up with robust, diversified portfolios. Quantitative approaches for assembling portfolios tend to concentrate risks in a few areas that have recently performed well. Over time, these same investments typically do not keep up with their recent good performance, disappointing the clients.

When Trendstat started work on the Trendstat Timing Opportunities Fund (TTOF), a fund of funds that would hire some of the best mutual fund allocators, sector specialists, market timers and bond timers, I vowed to not fall into the same quantitative trap when selecting managers.

## Qualitative due diligence:

It's very easy to type a few commands into a computer and get the 10 best Sharpe ratios, the 10 best returns for the last year or the 10 least risky investment strategies. Yet, using these standards to put together a diversified portfolio is rarely successful, in my opinion. Since many managers have similarities, they may all have exceptional performance at the same time or all lose money at the same time. Technology stocks dominated the portfolios of the top performing mutual funds at the end of the 1990s. When many of these stocks cratered, so did the performance of the fund companies. Diversifying among the top ten performers did not reduce risk.

Relying on historical correlations to diversify investments is also vulnerable to changing market conditions. In the chaotic financial markets of 2000, many strategies that were not considered highly correlated have ended up being correlated to the downside. Dogma says you diversify a portfolio between stocks and bonds, because these two investment categories have a low correlation and often move inversely. Global investments are said to diversify the risk of U.S. investments. Neither has been true in the last five years.

Using quantitative approaches to select managers is similar to analyzing the last battle in order to find out what worked and what didn't. The logic is that this helps you fight the next battle. That

approach might be helpful, but runs the risk of using antiquated techniques to fight the next battle. The British learned that lining up in formation in red uniforms was not necessarily a great way to counter militia hiding behind bushes and rocks, even though that strategy had helped them dominate the world in the 1700's.

A better strategy is to concentrate on what you want to end up with and figure out a way to get there. Assuming our goal is a diversified portfolio that performs well across a variety of market conditions, we want:

- A variety of markets.

  Markets cycle. Small cap stocks were the top performers from 1991 through the first part of 1994. Since mid 1995, large caps have dominated the list of top performers. International markets have lagged the U.S. recently, but hold tremendous potential. By investing across a variety of markets, investors have profit opportunities when one or more markets are in a downturn.
- Different management styles.

  Value investing is a classic example of a management style that has produced superb returns in the past, but has lagged growth management styles the majority of the 1990s. Market timing historically has outperformed more passive strategies during market downturns, but tends to lag performance during bull markets. We would argue that a variety of management styles adds balance to a portfolio.
- Diversified time frames.

  How long does the portfolio manager hold a position?

Some examples of the questions an investor might ask are:

- What is your style of trading?
- What markets do you trade?
- What funds do you use as investment vehicles for clients?
- When clients add/withdraw money from the portfolio, how do you handle the change in trading amount?
- How have you matched your trading style to your skills/capabilities/personality?

- What do you believe your edge is in producing a profit?
- What situations/scenarios could cause large losses?
- What makes you unique versus other managers?
- How many round turns of the portfolio would you do in a typical year?

## Analyzing 33 Managers on a Qualitative Basis

In Trendstat's case, we wanted an allocation model that I could hold constant across all manager selection cases. Over the years, Trendstat has developed an allocation model based on extreme volatility. It measures the highest volatility exhibited during a 20-day period in a manager's history. Simply described, if Manager A has twice the extreme volatility as Manager B, then Manager A gets half as much of the portfolio as Manager B. This allows both managers to contribute meaningfully to the portfolio when they are in extreme periods. We have found this very robust in actual use over the years at Trendstat, so I used this model across all the manager selection cases shown in this research.

The first sample group I analyzed was the universe of all the track records of 33 managers we had individually interviewed. This allowed me to set a base for testing various allocation alternatives. Next, I used two frequently selected standards of quantitative screening. I took the top 10 performers for 1999 and the top 10 lowest risk managers. Simple returns for the calendar year were used for the high performance group and the lowest average loss in all losing months was used as a measure of low risk sample group.

Last, I used a strictly qualitative approach to select 18 candidates for the fund that gave me diversity by:

- Strategy,
- Markets traded,
- Bear market risk and
- Trading frequency.

All of these managers convinced me that their businesses were sound and their techniques disciplined. All had developed their investment strategies by themselves and most had been

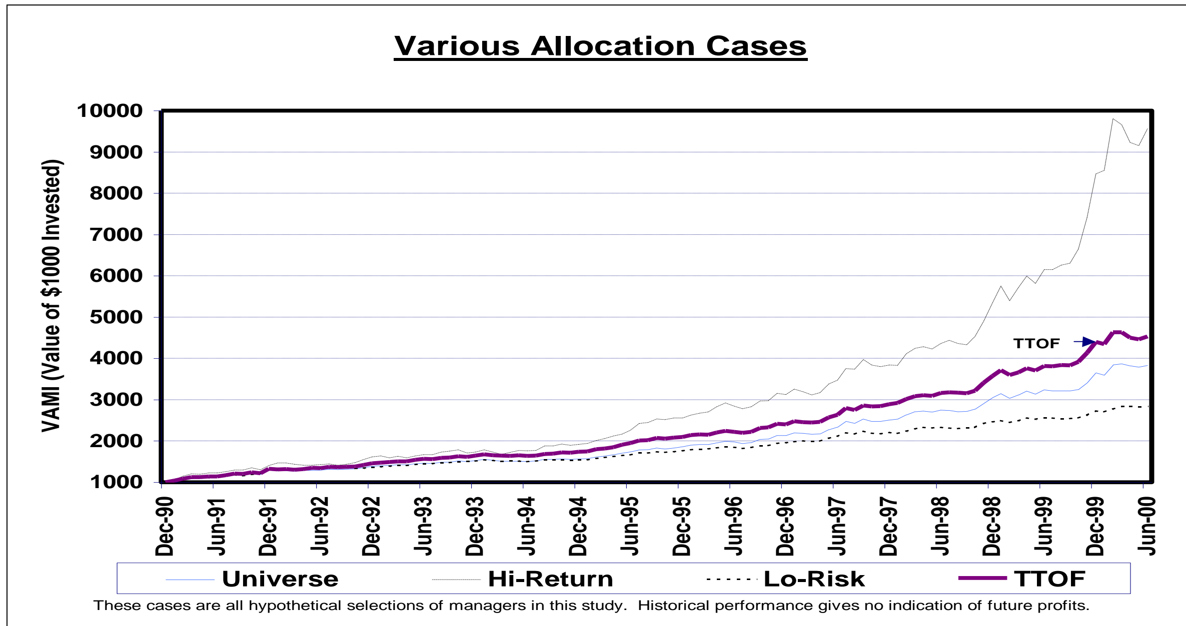
managing money for a number of years. Table 1 shows a quantitative analysis of the four sample groups.

## Table 1 – Various Allocation Groups

| | Universe of 33 Managers | High-Return Managers | Low-Risk Managers | 18 Selected Managers |
|---|---|---|---|---|
| **Annual Return** | +15.05% | +26.57% | +11.57% | +17.07% |
| **Maximum Drawdown** | -3.92% | -6.65% | -2.97% | -3.66% |
| **# of Drawdown Days** | 273 | 304 | 393 | 212 |
| **Best 12-Month Return** | +29.25% | +81.71 | +29.99% | +32.46% |
| **Worst 12-Month Return** | +0.77% | +2.97% | -0.34% | +3.52% |
| **Return/Maximum Drawdown** | 3.84 | 4.00 | 3.89 | 4.66 |
| **Sharpe Ratio** | 1.63 | 1.40 | 1.26 | 1.93 |

The universe of all 33 managers posted a positive return of +15.05% for the period that we had comparable data (12/31/90 to 6/30/00), almost 10 years. The top 10 performers came in with a much higher +26.6%, while the 10 lowest risk managers produced an 11.6% return for the period. The qualitative selections came in between the two extremes and generally had a *higher return and lower risk* than the universe. This group also had the highest Sharpe ratio, which some allocators use to measure return to risk of a manager. Another measure of risk, the return/maximum drawdown ratio, also showed the qualitative selection case as best over the period. The performance profile of all four cases is shown below in Figure A.

# Figure A




## Graphically Showing the Manager Profiles:

Table 1 shows a quantitative analysis of the managers. But now we need a way to look at the managers on the basis of the four qualitative variables we defined earlier (1) strategy, (2) markets traded, (3) bear market risk and (4) trading frequency.

On the X-axis, I coded each manager with a number most closely matching his or her management style and markets traded. On the Y-axis, I qualitatively gauged each manager's exposure to a bear market. High positive numbers on the Y-axis would be considered more risky, while negative numbers were considered less risky in a bear market. For example, if the manager was a trendfollowing market timer and used funds that could essentially go short the market, then they would be very risk averse to own in a bear market, because they typically could produce a profit during that condition. Whether they would or not was not important in my rating. The only condition was that their strategy seemed structured to deal either better or worse in a bear market scenario. Some managers indicated that they had no strategy at all for a bear market and were rated as more risky.

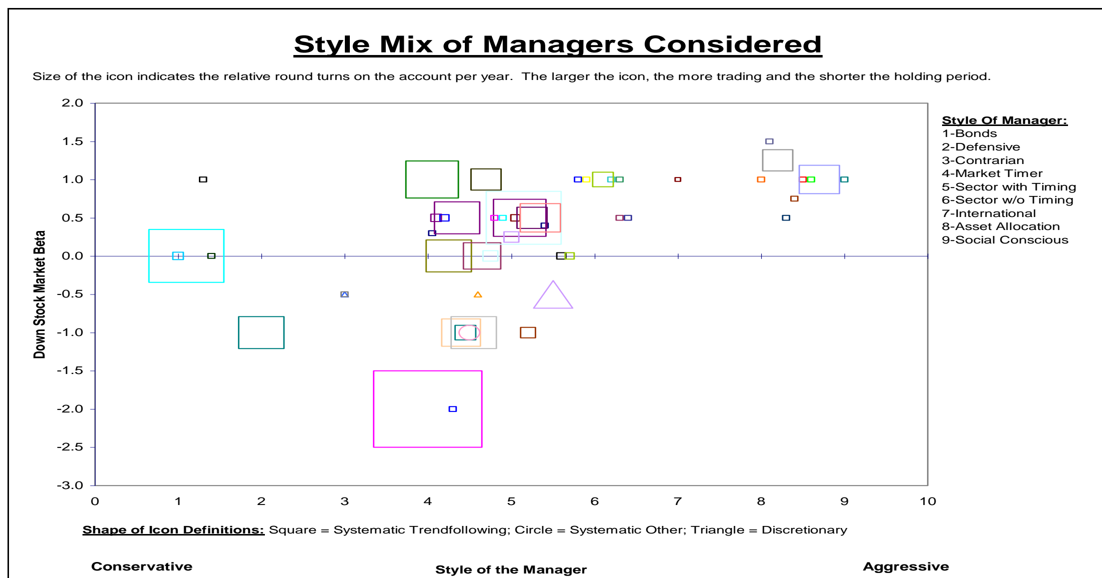
Different icons are used to indicate how the managers implemented their strategies. Managers were classified either discretionary, systematic trendfollowers or systematic other strategies. The size of the icons shows the frequency of trading. Shorter-term traders have a high frequency of trading, and, therefore, have larger icons. Smaller icons indicate that trader holds the positions for a longer period.

We now can look at the qualitative mix of the first three quantitative screens and then at what we get when we qualitatively select the portfolio.

## The Universe – Qualitative Profile:

The universe is combined into one graphic presentation in Figure B. One can readily see the clutter of so many styles and exposures. There clearly is considerable duplication on the profile.

**Figure B**

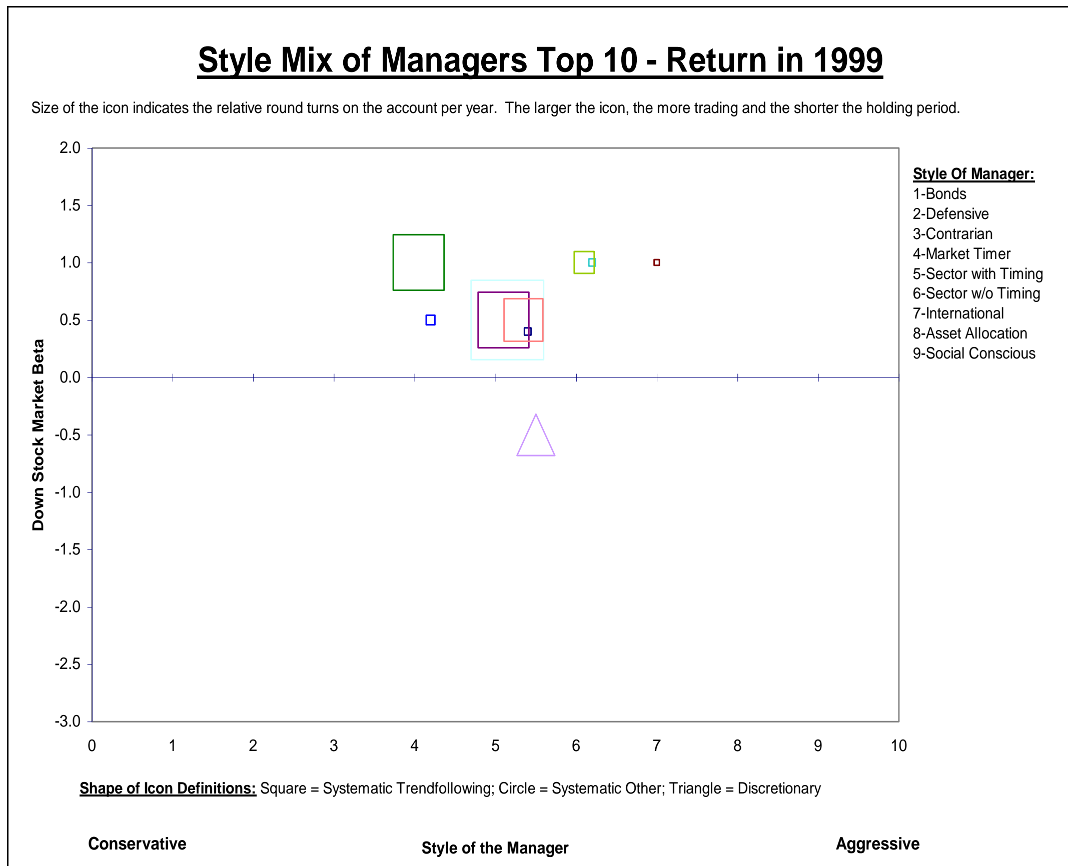



## High Performance Profile:

The top 10 total return group shown in Figure C is clearly not diversified, when looking at the graphical presentation. If an investor simply selected managers on the basis of performance, the resulting portfolio would not be diversified across markets, styles, trading frequency or exposure to bear markets. As this shows, upside oriented market timers and sector allocators had the best

performance over the past 10 years. At the same time, we have seen a great period for the stock market, so it isn't surprising that these styles would produce good results. It certainly doesn't mean they will do the same in the future

## Figure C

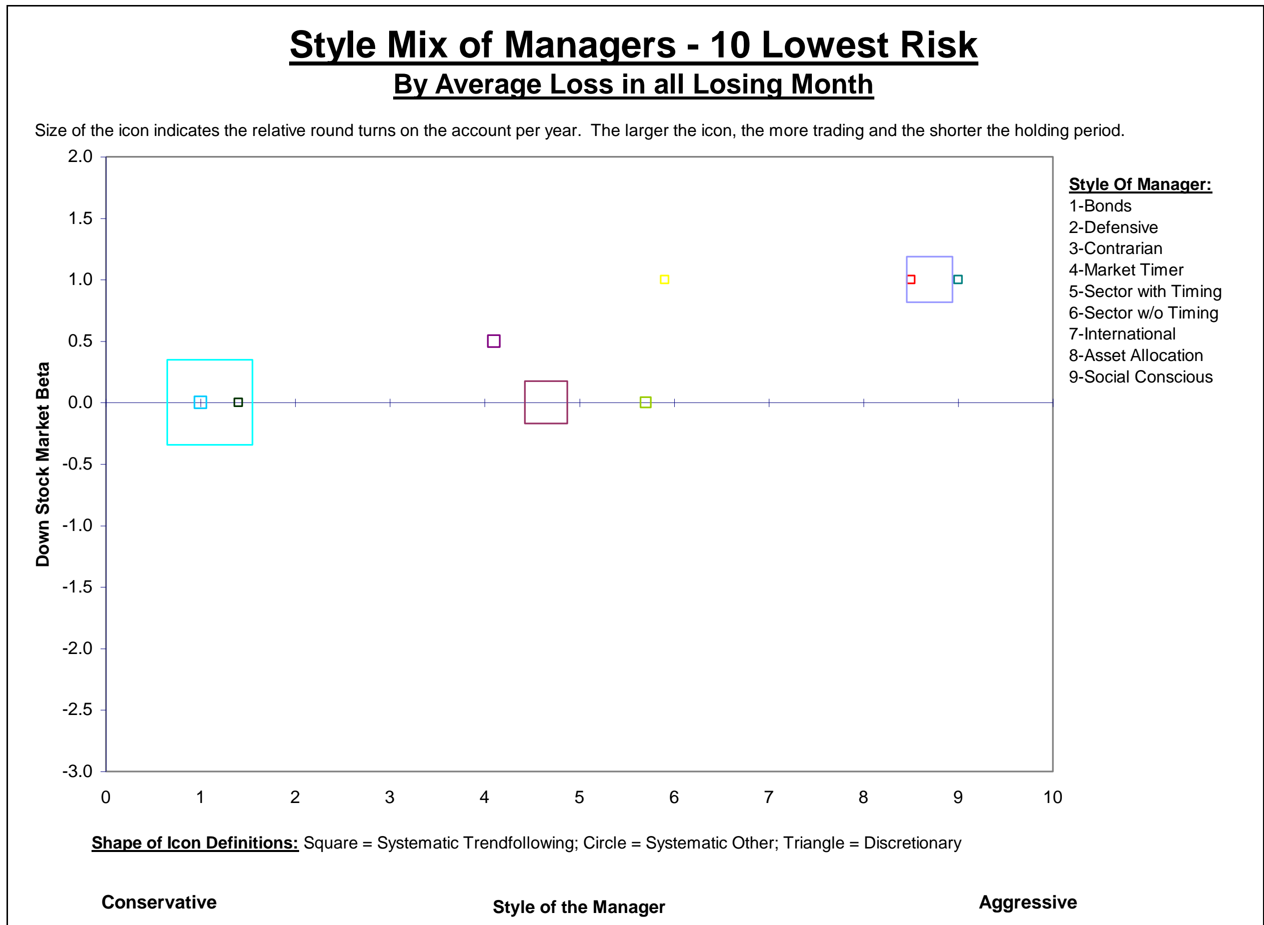



## Lowest Risk Profile:

This group includes the managers with the lowest average monthly loss during those months that they had negative performance. This approach did a much better job of diversifying the portfolio, with the exception that all of the icons are at or above the neutral position on the Y axis. This means that exposure to strategies that might be helpful in a bear market is non-existent. Since the stock market has been so strong in the last 10 years, investors looking at this potential strategy to select managers might find themselves with a lower risk group for a bull

market, but have no way to protect the portfolio in a bear market. The graphical profile is shown below in Figure D.

**Figure D**

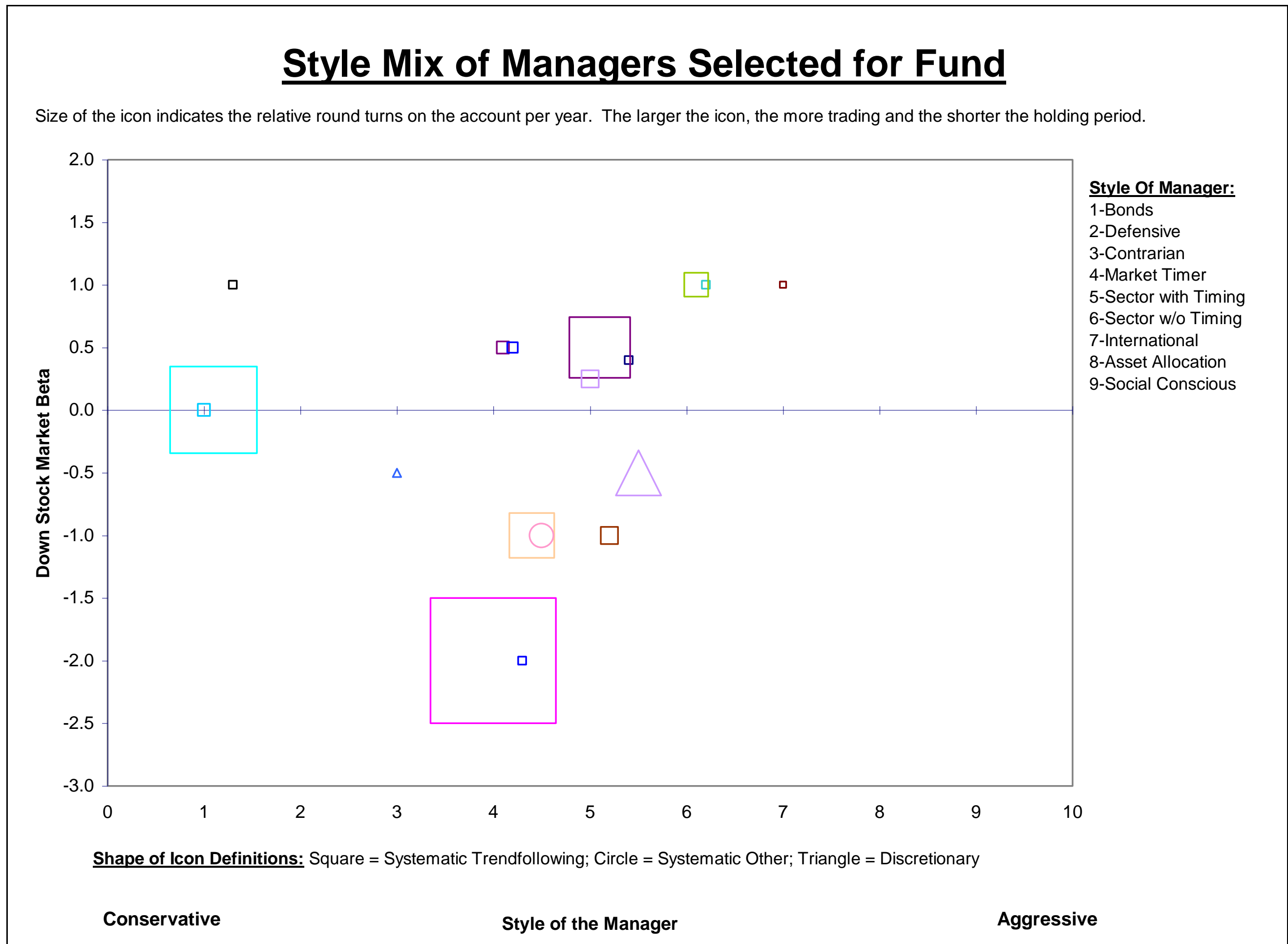



## The Qualitative Approach – Graphical Profile:

The first thing you notice about the selected group in Figure E is a conscious effort to have up and down market exposure with the icons spread from high to low. The second thing you can see is the diversification by market and style with the icons spread from right to left. The shapes of the icons cover all three styles of implementation and the sizes of the icons indicate a variety of trading frequencies. Three styles are not represented in the profile. Socially Conscious was determined not a style that was truly different from the others and was eliminated. Asset Allocation is what we're doing in the fund, so it seemed like duplication of effort. Defensive

was sought out in the managers, but we couldn't find a single strategy that fit that profile and met our standards.

**Figure E**




## Conclusions of the study:

From my observations, it seems a qualitative approach to manager selection, while clearly not as easy to do as quantitative, is certainly something to consider when attempting to diversify a portfolio. The reason is that qualitative screening gets closer to the independent variables that drive profits and losses. Quantitative approaches simply deal with the dependent variables, like historical performance, that flow from the managers' trading styles, exposures and trading frequencies.

Over the years, I have seen many investors attempt to perform very sophisticated quantitative screenings of managers, only to end up with portfolios that are concentrated in what worked well lately in the market. Qualitative screening avoids the problem of curve fitting in manager selection.

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