PERSONAL VIEW

They do it with mirrors – part 2

Steve Delo, independent trustee of the year

In the previous issue, I used Agatha Christie's premise from *They Do it With Mirrors*, to illustrate why active investment manager selection is so difficult. To recap, **A successful investment business = track record + skill +story**. But, you can just as easily build a profitable, powerful investment management business with just two components, namely track record and story. Skill is not a critical component!

Investment managers do not have the control over investment returns that trustees think they have, certainly not in the short term. All active investment managers operate to some extent by reacting to available information and making a judgment on what to buy, what not to buy, what to hold and what to sell. How they go about it is their "process."

From what I have seen of investment managers, they are capable of creating a process that can add value versus equivalent passive management. To add value through skill requires rigorous application of that process over time. In the short term, outcomes probably have more to do with random fluctuations in the market in which you are investing than with process decisions.

Remember that quote from Warren Buffett: "In the short run, the market is a voting machine. In the long run, it's a weighing machine." What that means is that the short-term price of a share – or a market – fluctuates, stirred up by scraps of market information, hype and rumour. In the longer term the share price will be more related to the actual value of the company. However, I contend that the short term is longer than you think and the long term is longer than any investor will reasonably wait!

This does not make an easy environment in which to try to find skill. Taking Buffett's quote, the task is about identifying an investment manager that is genuinely weighing and not simply counting votes. Granted, some skill in vote counting – and assessing the direction of travel – can, riskily, add value.

Trustees must seek out fund managers who have a process they believe weighs accurately, but their manager selection and monitoring processes should be locked onto things that show meaningfully that weighing skill is being applied. Let's call these things "weighing factors." There are other factors trustees could look at that fall into the alternative category of "voting factors". These won't tell you anything useful about the long term weighing skills of the manager. They will distract you.

Mixing metaphors, to get through the smoke and mirrors of manager selection and improve outcomes, trustees need to review the balance between voting factors and weighing factors in their investment governance. They should reduce the emphasis on voting factors and increase emphasis on weighing factors:

- Voting factors: Performance monitoring. Attribution analysis. What was bought and what was sold? General economic commentary. Economic forecasts. Fund manager marketing.
- Weighing factors: Investment philosophy and changes to it. Process and changes to it. Quality of intellectual capital and staff. Business culture. Reasons for buying/selling individual stocks. Consistency of all these components.

Many trustee boards may gulp at how unbalanced their governance processes are! ■