Leading Indicators of Future Performance: When is Change Bad for the Investor?

December 2024

DeMarche

Leading Indicators of Performance: When is Change Bad for the Investor?

December 2024

Point of Discussion

01 Introduction

02 Which Leading Indicators impact investors the most?

03 Example Case

04 Conclusion

Abstract

Institutional investors often emphasize past performance when selecting and monitoring investment strategies, but this can be misleading, as returns are often lagging indicators. At DeMarche, we prioritize leading indicators that can help guide our expectations for future performance. This paper explores the importance of monitoring key changes in these leading indicators—such as asset under management (AUM) gains and losses, team departures, and deviations in investment process or product focus—which can lead to future value destruction. By using real-world case studies, we demonstrate how these early warning signs often lead to underperformance. These examples highlight how proactive, forward-looking qualitative analysis can be used to ensure successful outcomes in institutional investment portfolios.

Institutional investors often place emphasis on performance during the research process, but while a strong track record is important, investment returns are often lagging indicators. At DeMarche, we prioritize leading indicators of future performance when researching investment strategies. Failing to recognize shifts in these leading indicators can have a damaging impact on an investor's returns. This paper will explore a number of leading indicators that we find to be key in determining an investment manager’s ability to outperform benchmarks and peers over an institutional investment horizon.

Which Leading Indicators Impact Investors the Most?

AUM

AUM (Assets Under Management) is the lifeblood of the asset management industry and is directly linked to an asset manager’s revenue. Most business models in asset management charge a pre-specified rate assessed on the total amount of assets managed. For example, a large cap growth manager may charge a 1% management fee on AUM. If the manager has $10 billion in AUM, they generate $100 million in gross revenue.

Investment managers typically generate more income for themselves and their firms as their assets under management (AUM) increases. This potential for increased revenue can sometimes lead to a prioritization of AUM growth over adherence to the investment process. When AUM becomes too large, it can hinder a manager's ability to generate alpha. Larger AUM restricts the flexibility to trade in or out of positions efficiently, impairing the manager's ability to execute decisions. This issue is particularly evident within higher risk/return asset classes, such as small-cap equity. For this reason, excessive AUM growth can serve as a leading indicator several quarters in advance of underperformance.

On the flip side, the gross revenue available to the firm or strategy covers the expenses necessary to operate. Examples of these expenses include employee salaries and bonuses, technology, office space, employee training, advertising, and legal fees. If a strategy charges a 1% asset based fee and AUM decreases from $10 billion to $5 billion, fee revenue drops from $100 million to $50 million. This means $50 million a year is lost that would have been used to support the investment strategy and firm.

When AUM declines, employee compensation often takes a direct hit, and fewer dollars are available to spend on marketing. This often creates a negative feedback loop that limits the strategy’s ability to raise new capital, potentially driving portfolio managers, sales professionals and

analysts to look for other employment opportunities. As talent leaves, so does the investment strategy's ability to execute their process.

Changes in the Investment Team

When we recommend an investment manager to a client, we believe in the people, process, philosophy and firm. Talented portfolio managers are not easy to come by, and we take pride in our ability to identify those that have exceptional skill. The DeMarche manager review process consistently monitors team changes because we believe that portfolio managers are the driving force behind performance. Identifying how each key decision-maker influences the strategy is critical in understanding how departures within team will impact portfolio results in the years ahead. As with most things, change is inevitable, and how we plan for it and deal with it makes all the difference in life.

While all changes impart some level of uncertainty, a well-planned succession, where an upcoming leader has been announced and has trained alongside the retiree over a reasonable period, can enable investors to gain confidence in the continuity of the investment process as the retirement date approaches. In such cases, we meet with the successor to understand how they plan to manage the portfolio, how they interact with the rest of the team, what they've learned from their predecessors and how their own biases may differ. Understanding these aspects of the new manager can help us assess the likelihood of a process change.

Conversely, the worst type of departure is material, unexpected and uncommunicated. For instance, if a portfolio manager leaves to join another firm, it raises significant concern. This could indicate underlying issues within the firm, potentially leading to additional departures and opens the door to more meaningful changes in the investment process and increased likelihood of poor performance.

We focus our research efforts on actively engaging both firm and investment team leadership on an ongoing basis to build confidence in the investment team's adherence to their process as leadership changes inevitably take place. The only way to have an informed basis for conviction in an investment strategy's future under new leaders is to have engaged with those leaders in the years prior to a transition.

Changes to the Process & Product

Changes in a product occur when a manager deviates from their established investment strategy. Examples include shifts in investment style, changes in geographic focus, and alterations to the investment universe. A common instance of a change in product happens in the small-cap space. When a small-cap strategy's AUM exceeds a certain level, usually around $10 billion, additional challenges arise. Because many of the companies they invest in have market caps below three billion dollars, the opportunity set is limited in terms of liquidity, especially since there are more hoops to jump through when a manager owns a significant amount (5-10%) of a company's outstanding shares. One example of an added challenge from owning more than 5% of a company is the requirement to file a Schedule 13D with the SEC, which mandates that the manager disclose the investment publicly within 5 days of reaching this threshold. Aside from increased compliance and regulatory costs, the public knowledge of a manager's investment decisions can make it more difficult to build up a position at their desired price. Consequently, small-cap funds with substantial assets often start to expand their investable market cap ranges into the mid-cap range and/or increase the number of portfolio holdings to continue growing AUM. This shift is unfavorable for investors, as the strategy then provides less exposure to small-cap stocks or reduces its potential to outperform by diluting exposure to their best ideas.

Changes in process occur when a manager modifies the system that drives decision-making for the portfolio. Examples include changes in the decision-making framework, alterations in risk management, and updates to research methodology. For instance, if a manager operates a quantitative shop, a change in the inputs of the model that drives decision-making constitutes a change

in process. Since the model drives decision-making, any change in its inputs must be understood. This can lead to uncertainty about future performance based on the changes in the underlying model.

Example Case – Change in Team

In March 2023, the DeMarche Manager Review Committee was notified of a structural change within the portfolio management team of an international equity strategy in which our clients were invested in. Previously, the strategy was led by two co-lead portfolio managers (PM 1 and PM 2), who jointly made final decisions, supported by a team of four other portfolio managers (PM 3, PM 4, PM 5, and PM 6). The Committee was informed that one of the co-leads (PM 1) was transitioning into a different role within the firm, leaving PM 2 as the sole lead portfolio manager for the strategy. As a result, PM 2 would now hold sole final decision-making authority. This significant shift in decision making authority prompted the Manager Review Committee to place the strategy under watch.

Later in 2023, the Committee revisited the international equity strategy and observed new team changes. PM 2 remained the sole lead portfolio manager, but PM 3 was transitioning away from the strategy, and PM 4 was leaving both the firm and the strategy entirely. To address these departures, the team added two new portfolio managers to replace PM 3 and PM 4. The Committee called for heightened review of the strategy. The committee asked the research team to conduct a heightened review within the month to reassess the manager's status and determine the strategy's path forward.

Later that month, the committee reviewed the product again. The research team highlighted a trend of underperformance over the past year, which had continued into the most recent quarter. With significant team changes and a concerning trend of underperformance, the committee voted to red-flag the strategy and advised clients to terminate the manager.

Since being red-flagged, the strategy has continued to underperform its benchmark. After a previously strong track record of consistent outperformance, it has now fallen short of its benchmark by more than 3% annualized over the past three years. This example underscores the importance of investment team stability as a leading indicator of performance.

Conclusion

At DeMarche, we prioritize leading indicators of performance when researching and monitoring investment strategies. Past performance is considered a lagging indicator. Leading indicators include many qualitative factors, such as changes in people, processes, and philosophy at an investment management firm and specifically at the investment strategy level. Changes in these leading indicators can create uncertainty about expectations for future performance. When our review of leading indicators identifies a problem, we employ an escalating series of actions, which may ultimately result in the termination of the investment manager. The most common issues impacting leading indicators include changes in key investment personnel, changes in the investment process, significant AUM gains and losses, and changes to the overall organization or ownership structure. Based on our experience, these types of developments in leading indicators often negatively impact future performance. At DeMarche, we pride ourselves on our ability to effectively monitor these leading indicators. By staying ahead of potential risks through consistent monitoring of leading indicators, DeMarche is able to safeguard client investments and drive long-term success.

Put Research to Work
with the DeMarche Team

Adam Strumpf, CAIA
Senior Consultant
(913) 384-4994

Luke Crawford
Project Analyst
(913) 384-4994