

# Revolving doors, musical chairs and portfolio performance

Is staff turnover bad for investment returns?

*It may seem inevitable that, in an industry as volatile as investment management, high-level staff will move into and out of jobs at a dizzying rate. Should investors worry that this “instability” is bad for portfolio performance? SCOTT DONALD’s research produces surprising answers.*



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It is almost an article of faith that staff turnover is bad in our industry. Consultants decry it, CEOs underplay it, marketers “spin” it. The media feast on the spoils. And yet a moment’s reflection inevitably calls forth a richer, more ambiguous reality.

Recent research into the performance implications of staff turnover confirms this reality. This study compares the performance of Australian equity and fixed-interest portfolios before and after the departure of the head of the portfolio management team allocated to the account. It finds that, on average, the performance of fixed interest accounts increased slightly after the departure of a portfolio manager, while in equity accounts the result was more equivocal. Within this general finding, however, there were a number of occasions where the change in performance, positive or negative, was quite dramatic.

These results pose some interesting issues for the industry. Consultants should perhaps be wary of presuming a negative outcome from staff turnover at an investment manager

they are reviewing, but they cannot afford to assume no impact. Understanding the whys and wherefors will be key. Chief executives of fund management firms, recognising that staff turnover, even at the highest level of portfolio management staff, is high by economy-wide standards, may want to reconsider the way in which they manage such fickle resources.

In particular, the study questions the value of “golden handcuffs” for senior portfolio managers, particularly in light of the fact that in many cases the inertia caused by ingrained investment processes, or else the team ethic espoused in some firms, renders the performance of the account less exposed to the individual than is popularly thought.

Although this study did not directly test for a relation between business success and staff turnover (say, by correlating cashflow with staff turnover), the implications of the research appear to be relevant. Other studies have suggested that recent investment performance has a non-trivial influence on new cashflow to fund managers. The study

described here suggests at best a minor relation on average between staff turnover and subsequent investment performance. Combining these results provides circumstantial evidence that points to no relation being present.

**METHODOLOGY AND DATA**

Information was drawn from Russell's database of fund management firms offering management of Australian equity and fixed-interest portfolios. In the six years between January 1994 and December 1999, there were 66 separate departures (43 in equities and 23 in fixed interest) of personnel playing the role of senior portfolio manager for the product.<sup>1</sup> We believe this to be a comprehensive list of those departures, drawn as it is from a combination of Russell's contemporary research and the ISFA submissions made by each fund management firm.

Each departure was treated as a separate "event". The prior 24 months' performance was used to build a model of returns for the firm against which the subsequent 24 months' performance was gauged. Where two departures occurred within 24 months of each other for a particular product, the prior or post history was severed at that point. Where that severance was within 12 months of the event, the event was discarded from the sample.

**RESULTS**

The 66 departures were spread across the six-year period, with a noticeable peak in 1998-99 in the case of equities portfolios. Moreover, as Figure 1 indicates, turnover in the region of 25%-50% of the industry in

any given year has been common in both asset classes, a level that appears far higher than would be expected across the economy. But does turnover in portfolio managers affect subsequent investment performance? The summary results are reported in Table 1.

The table shows there was a small increase in post-event performance within both segments of the sample. In the case of equities, however, this was accompanied by a higher level of risk (tracking error). Interestingly, proportionally more of the

fixed-interest events showed an improvement in performance than was the case for equities. Looking into this more closely, we can see, in Figure 2, how the instances of improvement in the performance of the equity portfolios are greater in magnitude than the instances of deterioration; it is this skew that generates the increase in the average overall.

An important question, though, given the volatility in returns inherent in any investment portfolio, is whether any of

FIGURE 2 Changes in performance, fixed interest and equities

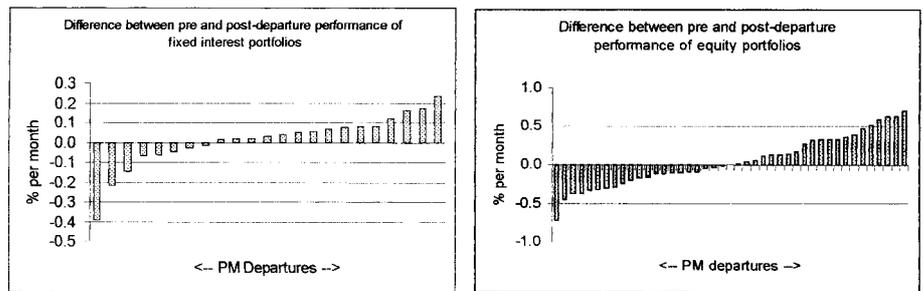
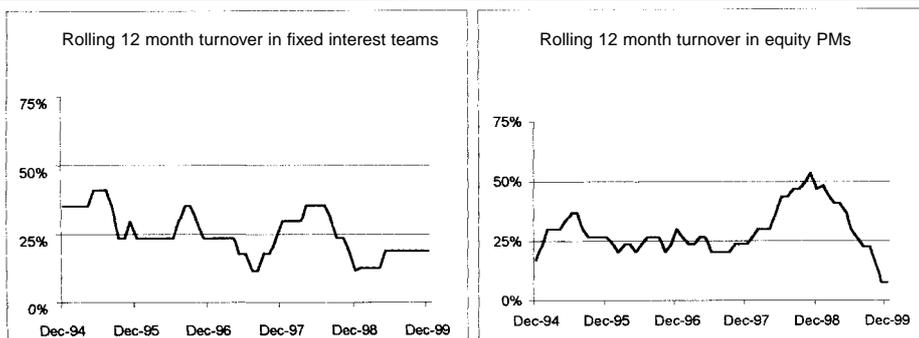


TABLE 1 Change in portfolio performance related to staff turnover

	Change in return (%pa)	Change in risk (%pa)	Increase in post-event return
Fixed interest	+0.30	-0.69	15/23
Equities	+1.32	+0.46	22/43

FIGURE 1 Staff turnover in fixed-interest and equity managers



these results is statistically reliable. That is, is this distribution of outcomes a likely outcome of a random process, or is there a signal present? Table 2 summarises the findings on this issue.

To interpret Table 2 it is important to remember that if more than 10% of a sample is significant "at the 10% level", for instance, this suggests that the result is not mere chance. Thus, the 5/15 observations of significant performance improvement in the case of fixed interest is roughly three times what might be expected randomly. Similarly, the 5/22 significant increase in return in equity portfolios is more than twice what

TABLE 2 Improvement/decline in performance

	Performance improves		Performance declines	
	Significant at 5% level	Significant at 10% level	Significant at 5% level	Significant at 10% level
Fixed Interest	0/15	5/15	1/8	2/8
Equities	3/22	5/22	2/21	5/21

might be expected randomly. Overall, then, it seems safe to say that there is a non-trivial number of cases where the subsequent return either improves or declines materially. On average, staff turnover may have no, or perhaps a slight positive, impact on subsequent performance, but it would be a brave (read “foolhardy”) analyst who relied on that result in any particular instance.

The second important question is whether these results, while they are statistically significant, are economically significant. That is, are the signals sufficiently large to be worth worrying about in reality?

The answer again would seem to be “yes”. The diagrams above depicted monthly performance differences ranging from insignificant to more than 0.5% per month in the case in equities and 0.10% per month in the case of fixed interest. Translated into annual numbers, these become over 6% and 1.2% respectively. To give some perspective on those numbers, over the same period the difference between the median manager and the top quartile in each case was approximately 3% per annum and 0.5% per annum. The data also appear to signal a change in risk

preference post-departure in the fixed-interest segment of the sample. As Figure 3 shows, there is a strong tendency towards a lower tracking error in the post-departure period, particularly where the firm’s tracking error prior to the departure was higher than average (say, above 1%). However, before reading too much into this result, it is important to recognise that there was a general decline in tracking errors over the period in which most

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of these events occurred, which would introduce a downward bias in the later months irrespective of whether a departure occurred. The direction of causality, if any, is of course moot.

**TOWARD A MORE ENLIGHTENED VIEW**

Attention to anecdotal evidence would clearly establish a plethora of reasons why

investment personnel leave a firm. Some of these have an obvious relation to the recent investment performance generated by the individual. Some have not. However, one of the strengths of empirical analysis is that it abstracts from the seductive allure of the anecdotal explanations and provides concrete, quantified measurements of the observed phenomenon. Received truths can be reviewed and, occasionally, unexpected patterns emerge.

In this case, the empirical analysis indicates that staff turnover is indeed a recurrent phenomenon, affecting between 25% and 50% of the fund management industry in Australia at any time. The performance consequences of the change in senior portfolio manager can sometimes be material, even though on average the signal is less distinct.

CEOs of fund management firms should not ignore this phenomenon, nor treat it as an exceptional occurrence. Their strategies must be resilient to the threat posed by staff turnover at a senior level, but not driven by it. The way they communicate the reasons for and consequences of turnover should also be reviewed in the light of the study.

Investors, too, should learn from these results. Taking a multi-manager approach will reduce exposure to any one portfolio manager leaving (so-called “specific risk”). Similarly, selecting managers with a robust, entrenched process will reduce a portfolio’s vulnerability to a departure. However, it seems likely that some turnover will occur, even in a carefully chosen portfolio of investment managers, and the key at that time seems to be not to over-react to the news; don’t assume the worst – the change may have little impact, or may indeed be positive.

**NOTE**

1 These were typically the chief investment officer, head of equities or fixed interest, or an investment-oriented chief executive of the firm. Note also that because the data are organised by event and the window of interest is determined by the date of the event, it is incorrect to say that any particular historical time period applies to the return series. However, the latest performance data used were for the month of March 2000.

FIGURE 3 Effect of departures on risk preference

