Financial DNA®

A Behavioral Approach to Selecting a Fund Manager - by Hugh Massie

The determining factors for selecting a fund manager are always very topical at many industry conferences and other forums of discussion. Recently, I gave a presentation as part of a panel in New York on manager selection. Generally, the quantitative and structural issues of the fund were heavily focused on by most of the presenters. We all undeniably agreed that the quality of the management team is very important.

However, the different perspective I gave was that in practical reality far more attention should be given to understanding the real behaviors of the management team. When the matter of the due diligence is discussed, it is alarming that the behavioral issues are rarely examined to a sufficient level with a reliable process.

The Rationale for Behavioral Discovery

There is no doubt that a dominant factor in the selection of fund managers is the behavioral dynamics of firstly the investors and secondly the fund management team. It is not difficult to identify that the success or failure of any investment decision can often be traced to the human behavioral issues. It can be argued that 80% of financial success comes down to emotional intelligence ("EQ") and 20% to intelligence ("IQ"). Therefore, in our approach we are strong advocates of "understanding people before numbers" by focusing on the qualitative factors as the driver of manager selection.

A reminder of this point is the statement that Warren Buffet made in attributing his success to his own behavioral style. In other words, he has a deep understanding of himself, relates to others as is necessary for his business activities and has with great discipline pursued a strategy that is consistent with his behavioral style.

> **"How I got here is pretty simple in my case. Its not IQ, I'm sure you'll be glad to hear. The big thing is rationality... it gets into the habits and character and temperament, and behaving in a rational manner."**
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> – Warren Buffet
> (in Fortune Magazine, July 20, 1998).

The key point to the success formula in fund manager selection is being able to objectively predict the behavior of an investor and the fund management team. In particular, the behaviors when the person is under pressure and consequently when more prone to making decisions at the wrong time that are not aligned to the best interests of the parties who may be affected. This is particularly important in times of turbulent financial markets. By being able to predict a person's behavior, optimal financial decisions can be made with far more reliable knowledge. What should be discovered are both a person's natural hard-wired behavior as well as their learned behavior from the environment they have existed in during their life, represented by experience, family, education and values.

Step 1 – Understanding the Investor's Behavioral Style

The first stage in manager selection by an advisor or investor is to discover the behavioral style and innate preferences of the investor. This must be matched to the profile of the fund. In this regard, the complete human behavior of the investor needs to be uncovered, not just investment risk tolerance, which is often situational and not objective (a topic warranting its own discussion). There are many additional behavioral issues to be addressed, some of which include:

1. Desire for control;
2. Ability and willingness to accept complex structures and investment programs;
3. Emotional drivers;
4. Investment style;
5. Requirement for results;
6. Risk tolerance for the asset class (which may differ to other asset classes);
7. Investment education;
8. Inherent investment motivation.

Step 2 – Examining the Behavioral Style of the Fund Manager

Businesses often spend time and resources on the screening process for hiring people to employ, although often the process performed is not enough. The time spent by investors and advisors on screening the individuals in a fund management team is usually less than recruiting, notwithstanding the cost of a mistake is high.

The reliability of the fund manager performance will be driven by the behavioral style of the management team, like in any business. Again, the golden key is the ability to predict the behavior of each team member. Some important behavioral factors to uncover for each person in the team are:

1. Visionary or reactive thinking style;
2. Ability to commit to strategies or spontaneous;
3. Emotional or rational decision-making style;
4. Levels of inherent ambition;
5. Preparedness to take chances or cautious;
6. Money management style and aptitudes;
7. Organizational abilities and precision;
8. Resourcefulness and problem solving abilities.

In selecting the manager, close attention also needs to be paid to the following organizational factors that are qualitative:

1. Balanced team dynamics so that all blind-spots are covered;
2. Sound leadership not only in daily decision-making but in managing a stable high quality team;
3. A succession plan that provides confidence and stability;
4. Sound corporate culture with adequate accountability;
5. Strong execution and operational capabilities;
6. Relevant experience and demonstrated track record.

A critical factor will be the ability of the manager to manage the relationship with the investors based on open communication, transparency of information flows and mutuality. Again, the handling of investor relations will be behaviorally driven.

Whilst we have concentrated on the behavioral aspects, this does not mean the more quantitative aspects are not important. Many of these factors will drive or be driven by the behaviors of the team:

1. Deal structure assessment;
2. Strategic direction;

3. Negotiation points and key terms;
4. Access to advisory board and corporate governance structures;
5. Alignment of interests and fees;
6. Internal remuneration structures for the team;
7. Exit strategy;
8. Taxation.

About the Author:

Hugh Massie is the President of Financial DNA Resources. In his work as a Wealth Mentor, Hugh specializes in human behavioral discovery using the proprietary Financial DNA® Discovery Process to liberate and empower people, families and organizations internationally to implement committed wealth creation decisions aligned to the core of who they are. Hugh is the author of a book "Financial DNA® – Discover Your Unique Financial Personality for a Quality Life".