Soul-searching

COVID-19 helped create a wave of asset manager retirements, causing potential headaches for due-diligence teams

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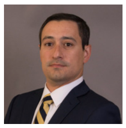

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- Asset management firms weren't immune to a spike in pandemic-related early retirements.
- Product rationalization, the relentless rise of passive investing and heightened asset manager M&A activity are also contributing to an increase in investment professional turnover.
- This creates a headache for advisors and plan fiduciaries as it forces them to reevaluate products they had previously recommended.
- Typical due-diligence analysis is less effective in these situations, and advisors must rely more heavily on qualitative factors that aren't as directly observable as traditional metrics.
- Great-West Investments™ (GWI) manager research teams offer some insights on how they evaluate sudden changes to investment teams and the firms that employ them.

There aren't many things that focus your attention in quite the same way as a global pandemic.

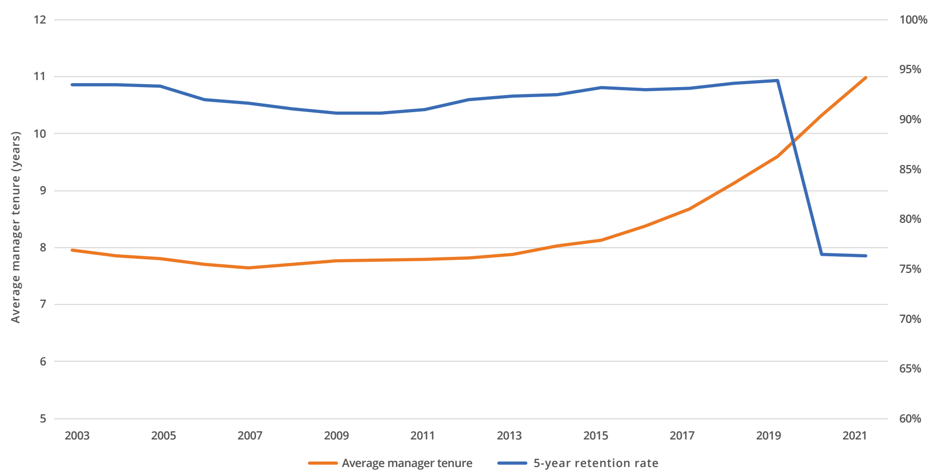
Whether you were personally affected by the COVID-19 lockdown or were fortunate enough to merely observe it from the sidelines, there's a good chance that at some point — maybe while churning your way through the dregs of the Netflix catalog wearing sweatpants and that old T-shirt you hadn't worn since college — the virus caused you to reevaluate your priorities.

You weren't alone. According to researchers at the St. Louis Federal Reserve, COVID-19 caused a wave of excess retirements that may have numbered as many as 3 million U.S. workers. One reason cited by the Fed was an uncharacteristically robust spike in stock market and property values during the COVID recession that made it easier than it had in earlier downturns for near-retirees to step away from their desks and permanently don those sunglasses and Bermuda shorts.

Of course, the asset management business wasn't immune from this trend. In fact, in some ways the industry might have been even more susceptible to post-pandemic soul-searching given that worries about funding post-retirement expenses probably matter less to the well-compensated captains of finance than they do to the average American. (Meanwhile, rising portfolio and home equity values sparked by the robust post-COVID rally arguably matter more to this well-heeled set.)

Buh-bye ...

Portfolio managers are staying longer than in the past, which may fuel a period of higher turnover



Source: Morningstar Direct. GWCM Calculations.

Add to that a few longer-standing trends in the asset management business, such as an ongoing wave of product consolidation and persistent M&A activity in the space, and it's perhaps less than surprising that the five-year retention rate among investment professionals underwent a steep-change during the pandemic, dropping from a decades-long level of 90-95% to roughly 76% in 2021. Anecdotally, too, the manager research team at GWI has noticed an increase in the number of long-tenured portfolio managers stepping away from products they had led for years. In some cases that personnel turnover had been planned well in advance; but in others, the staffing changes had a decidedly more ad-hoc feel.

Navel-gazing aside, some of the more obvious factors driving the recent increase in investment professional turnover remain very much in place today. For example, the ongoing wave of industry consolidation seems likely to continue as many of the pressures responsible for it — namely, compressed investment management fees and deteriorating margins, increasing returns to scale, and the relentless rise of passive management — have shown few signs of abating. Add to that a noticeable rise in the average tenure of portfolio management staff that has occurred since around 2015 as the industry's collective hair color inevitably becomes more gray, and it's fair to wonder whether even more investment personnel turnover is due in the near future.

That, of course, begs another question for advisors and plan fiduciaries: At what point does investment team turnover (and its close cousin, a change in control of the sponsoring asset management firm itself) morph from a due-diligence challenge to a fiduciary risk? This is a particularly vexing problem because many of the techniques commonly used to vet an investment strategy — such as its historical track record, investment philosophy and process, and team culture — are suddenly no longer as relevant as they were when the strategy was first considered.

Great-West Investments maintains a full-time staff of manager-research professionals who continually analyze underlying funds and regularly interact with the investment professionals who manage them — an outgrowth of our firm's role in managing a range of subadvised products across a range of asset classes as well as our responsibility for monitoring a long list of strategies relevant to Empower Retirement's even larger book of business.

It's therefore standard operating procedure for this team to deal with questions surrounding the viability of investment strategies amid investment staff turnover and change-of-control events. Given the recent rise in these types of events (and the potential likelihood that it will continue), we thought it might be useful to share a brief checklist of some of the items the team considers when attempting to assess whether a strategy undergoing such change remains viable:

1. **Continuity of process** – Is the investment process well defined, reasonable and repeatable?
2. **Continuity of personnel** – Was the strategy co-managed? Is the underlying investment team still in place? Does a legacy of success stand a chance of sustaining? In the case of the incoming manager, has there been evidence of success in the past?
3. **Continuity of culture** – Is there a threat to the firm's or team's philosophy? New management? New ownership?
4. **Alignment of incentives** – Does the firm and/or remaining personnel have strong incentives and alignment with shareholders?

Like virtually all aspects of due diligence, the evaluation of a new portfolio management team or the analysis of a change-of-control event is as much art as it is science, and the checklist above is designed to be more of a starting point than an exhaustive list of things to consider.

Advisors, consultants and plan sponsors must ultimately decide for themselves whether an investment product undergoing significant change remains appropriate for their clients. But if recent trends continue, the analysis required to make that determination could become even more a part of the due-diligence process than it has in the past.

When might it not be advisable to react to a change?

Case study: Small-cap growth

For years, Great-West Investments has utilized a well-known small-cap growth team at a large global asset manager located in our hometown as a subadvisor. In 2013, the strategy's two long-time co-managers suddenly announced they would be leaving for a crosstown rival.

That's a potential nightmare scenario for a due-diligence team, because much of the work involved with identifying, hiring and monitoring the investment team in the first place is suddenly rendered less relevant, perhaps even moot.

In this case, however, GWI chose not to make a change. After meeting with the team, we discovered that the departing managers would be replaced by the firm's equity CIO — a long-tenured investor who had previously managed the same small-cap growth strategy and was very familiar to the GWI team.

The company's official line was that the CIO was returning to the strategy out of a genuine love for managing client assets. Skeptical at first, GWI's analyst team met with the incoming manager and found this explanation to be entirely credible. Our analysts were further reassured that the returning manager would keep the strategy's process intact and would continue to rely on the same analyst pool and analytical resources as the outgoing manager. As a result, the returning manager "ticked all of the boxes," and GWI continues to invest alongside that manager today.

Methodology: 5-Year retention for firms over $1bn AUM. Manager Tenure at the firm level over the same time period in a sampling of asset classes: US Large Blend, US Small Value, US Intermediate Term Bond, Foreign Large Value.

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