Marketing To Sophisticated Investors column
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Could Your Fund Marketing Be Inciting Strategy Drift Fears?

Tip 16: Preparing For Post-Pandemic Asset Raising

Welcome to the sixteenth of a series of articles offering insights and tips to prepare money management firms for improving their abilities to out-market competitors and attract assets from sophisticated investors in the coming post-pandemic, recessionary world.

Sophisticated investors keep a sharp eye out for potential strategy drift. If the way you communicate and present the detail of your investment process to them gives an inkling that you might be susceptible to strategy drift your fund will be cut from consideration and you will not make it through the due diligence gauntlet.

Strategy drift is not to be confused with style drift. So, let's define terms. Style drift tends to refer to what used to be called by mutual fund managers the Morningstar tic-tac-toe board problem. If they listed your mutual fund as a small cap growth manager and it was part of your investment process to hold on to your winners when they grew to become mid-cap and continued to show promise, over time your portfolio would take on a mid-cap tilt. Morningstar would reclassify your fund from small cap growth to the mid-cap growth spot on its nine-box fund grouping classification, and accuse you of style drift. (Yes, this happened to a client of ours last century.) Note that there was no mention of any change to the portfolio manager's strategy here.

So, what's the strategy drift issue then that concerns sophisticated investors? The fear of making an allocation and then finding occasion, down the road, where risk/return characteristics of portfolio holdings significantly change from what the investor had expected from the portfolio manager due to the manager unexpectedly making substantial changes to strategy implementation.

It is perfectly acceptable among family offices, endowments, foundations and plan sponsor investors for a money management firm to have within its investment process predetermined tactical changes it may deploy when its strategy is faced with certain pre-identified market conditions. It is not acceptable, however, when an underperforming portfolio manager makes what investors know are significant changes to the strategy they had been sold on and bought into because the manager is chasing returns to recover from recent underperformance. When this occurs what also tends to happen is that the characteristics of the portfolio holdings significantly shift as well, with the risk level per holding having increased, sometimes substantially.

How bad is strategy drift in the eyes of sophisticated investors? It just about did in a style of stock investing.

Why there aren't a lot of GARP managers any more

Remember GARP investing? In the mid to late 1990s there were quite a number of investment boutiques running Growth At A Reasonable Price stock portfolios. You could say it almost became a fad. Many of these boutiques won allocations from institutional investors.

As the tech bubble grew in the late 1990s the performance of many GARP portfolio managers began to suffer. As each new quarter ticked by, underperformance for them seemed to go from being the exception to the rule to becoming the norm.

A problem many GARP managers suffered from at the time was that they were running client funds using only partially thought-out strategy implementation. Quite a few were doing the equivalent of piling into a momentum trade without thought as to what to do when conditions changed. As the tech bubble was temporarily inflating tech stock valuations and prices many GARP managers became more attracted to story stocks that lacked the stronger fundamentals they previously sought out in what used to be their investable universe.

Back then, portfolio positions and changes were not reported with the frequency and transparency they are today. Then, as now, many institutional investors were conducting their own risk analytics on their various asset allocations (or having their investment consultant firms do so for them). The data they got to work with was end-of-quarter information reported some weeks past the close of a quarter. In the late 1990s the risk analytics assessments run by many of the institutional investors on these allocations of theirs was finding significantly different holdings profiles than what these investors saw and were told about during their due diligence vetting before they made their allocations. Specifically, the risk levels of securities in the portfolios were found to be much higher than what the institutional investors were comfortable in, and had intended on, holding.

Investment committees began calling in their GARP managers, wanting an answer as to why, after some years of investing with them, the risk characteristics of their GARP portfolio allocation seemed to have dramatically shifted from how it was when they had first bought into their GARP manager's strategy. Further, why is this coming as an uncommunicated surprise? What was the reason (or excuse) most offered up by these GARP investing money managers? It was: *Our definition of 'reasonable' changed!* In many of the investor/manager conversations about this, there was little to no elaboration provided to support this as being an acceptable enough response. The problem from the investor side was that this move was often going against guidelines they had set in their investment policy mandates with these managers, which these managers broke in chasing performance by ramping up the risk exposure in buying stocks of companies with much lower quality fundamentals.

For money manager firm owners who were not around at the time, here is what happened next: The institutional investors knew the difference between when portfolio managers make tactical changes versus when there is strategy drift. The investors dropped the money managers who broke from investment policy statement guidelines. GARP management style fell out of favor. Many of the GARP managers lost their institutional clients and ended up shuttering their funds within a short period of time.

Remembering back about the fate of what seemed to once be a plethora of GARP managers always brings to mind, as a lyrical epitaph, the final line in the last verse of The Irish Rover's greatest hit from 1968. (You can look it up.)

5 tips to quell the potential strategy drift fear

Whatever the risk/return of your strategy, whatever the intended and accepted range of characteristics your basket of holdings may have, here is how to show prospects as they vet you that strategy drift should not be a concern with your fund.

1. **Characteristics** — Take into account a range of changing market conditions. Determine what fluctuation in characteristics your portfolio holdings are likely to display in these various times. Include in this thinking the degree of expected and acceptable changing risk levels. You need to craft detailed communications about this information and be able to tie it in to discussion of the investment methodology and risk management processes followed by your portfolio manager.

2. **Performance** — Be able to address the issue of expected performance in different market conditions in your communications with prospective investors. Sophisticated investors recognize that no strategy outperforms in all market conditions. Set proper expectations before they allocate. Don't let this wait until you underperform and get IR questions from investors. Then it will be too late for client retention.

3. **Process** — Set investment process strategy implementation rules that take into account different market conditions and that you can live with. What will you do when market conditions shift enough to initiate some tactical changes to your strategy implementation? How will you do so and how will your temporary tactical changes not shift the underlying strategy, thereby avoiding strategy drift?

4. **Print** — Be prepared to deliver all this information not only verbally but also, importantly, in detail in print, during your firm's due diligence vetting by sophisticated investors.

5. **Mind the gap** — If your firm is putting this information in print for the first time look to identify gaps in your investment and risk management processes that could potentially lead to the unintended consequence of strategy drift.

These actions will reduce the potential of your firm being perceived to be a strategy drift threat.

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About the author

Bruce Frumerman is CEO of Frumerman & Nemeth Inc., a 34-year-old financial communications and sales marketing consultancy that helps financial services firms create brand identities for their organizations and develop and implement effective new marketing strategies and programs. Frumerman & Nemeth's work has helped money management firm clients attract over $7 billion in new assets, yet they are *not* third-party marketers.

Frumerman & Nemeth is internationally recognized for its work in crafting for clients the beyond-the-numbers story of how they invest — content that investment committees actually discuss, debate and vote on behind closed doors when considering firms on a short list for potential investment. Importantly, this is required due diligence content that cannot be communicated in pitchbook format.

Frumerman & Nemeth's work also includes providing strategic consulting on product and strategy-specific branding, crafting the required strategy-specific content detail and designing and producing the marketing tools needed to make it through the two-month to two-year institutional selling cycle. Clients also employ Frumerman & Nemeth to help promote the intellectual acumen of management — helping them get speaking opportunities, write and give speeches as panelists or stand-alone speakers at industry conferences, and through media relations marketing services.

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