Fund Manager Succession: Make or Break

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Succession management hinges on the psychology of change. The replacement of one person, or team, with another. In the arena of active investment management, the issue can be particularly acute. Managed well, it can lead to success for all stakeholders. Managed poorly, it can spell disaster: impaired stewardship, broken trust, and client exodus.

As investment consultants, we have seen many approaches to succession over the years. Some succeed. Yet many more fail, or muddle through for want of sufficient attention.

There are always two issues of importance. The first is *who makes*, or even has input to, the succession decision. Is it the fund manager, owner or both? Is it the relevant team, or hierarchy? Could it even be a significant client?

Clearly, they have different priorities, and might make very different choices. Successors chosen on factors other than meritocracy – such as nepotism, or perceived fairness - may be deeply damaging in any industry that relies on a performance culture to execute well.

The second issue is the extent to which the individual (or team) is integrated into the business, and decision-making dynamics, as a whole. This effects how much *destabilisation* occurs after the changes.

Inevitably, in some industries and jobs, the “change of personnel” is less dramatic than in others. This is not always because of the complexity of the job or the skills involved, but rather the latitudes of job holder to do things differently. For example, airline pilots are expected to have near identical skills and judgements and hence be relatively easily replaceable. They are closely monitored and regulated, to weed out those who do not meet the safety bar, guaranteeing minimum standards. This is for good reason, as failure can be both devastating and highly visible.

Within active investment management, the problem of succession is different, if not greater than for most industries. One reason is a deep-rooted inefficiency within the industry: simply being named a portfolio manager, or trained as one, offers no guarantee of success. Lack of transparency, information asymmetry, and limited scrutiny has contributed to the persistent presence of many insufficiently talented professionals. Shockingly, over 80% of US domestic funds - and their managers - have underperformed over the last 10 years.

Another reason is the inherently idiosyncratic nature of the portfolio manager’s task. Active managers are stock-pickers, who need to not only need to gather information, but also judge the weight of risk vs reward when allocating client capital. Many may state they use the same process, even at the same firm, but can easily form differing conclusions on the same stock despite identical evidence. They form different views, because they are different people. Each will have their own skill. And each will have their own “efficient frontier”- the risk they are prepared to take for a given perceived gain.

For this reason, succession planning can profoundly influence manager psychology *well before any changes in stewardship actually occur.* This is particularly the case if a manager’s investment horizon exceeds their own employment horizon. In this manner, managers “plant crops” they will not be around to “harvest”. Could they take more risk than usual, being less diligent, or concerned with the outcome? Possibly. Or could they reduce risks, improve liquidity, as part of an exit glide path? All depends on personal motivations and alignment structures.

Succession also poses the potential for significant conflicts of interest, which must be managed carefully. The commercial viability of a firm, or strategy, may naturally depend on continued client confidence.

We have seen firms spin succession in the most positive light possible, to allay concerns. It achieves the exact opposite. Some have sought to treat their investors as a problem to be managed - announcing with no notice that a succession change has already happened to an investor's mandate. Other firms may misrepresent incremental changes to stewardship as only hygienic in nature, despite a much more material reality.

Such approaches may be tempting, to control the message to clients, but ultimately treats them with a disdain not easily forgotten. It is unwise to suggest to customers that you have a casual relationship with the truth.

Success in succession can never be guaranteed – though fund managers can take steps to optimise their chance of success:

- Prioritise investment integrity. Transitions that succeed only in terms of retaining client AUM cannot be deemed a success. If this come at the cost of long-term investment integrity (an ability to add value), success will not be sustained. The truth will out over time.
- Plan your succession strategy as early as feasible. Ideally from day one. The more time, the more room to execute, test, and change if required. Leave it too late, and succession may become Hobson's choice – no choice.
- Embrace the aim of planning. Succession planning should be seen as a way of protecting a strategy, legacy, team and company. Not threatening a leader's involvement. Financial and behavioural alignment should extend well beyond any handover.
- Embed your process. Decision making is individual, but must still occur within the context of a process. Ensure yours is more than marketing. Document and engrain a clearly understood set of principles that underpin your investment edge. If an investment values system is not properly engrained, expect it to be ephemeral on succession.
- Be open and credible. It may be tempting to paint the most positive picture, but this is ultimately self-defeating. By presenting successors as exactly the same as predecessors, they risk being seen as inferior carbon-copies. Instead, share the issues faced and how they may be overcome. This builds trust, and when needed, forgiveness.
- Test the next generation by allowing them to fail. By giving them responsibility ahead of time, successors establish their own record, and prove their ability. Gather evidence, as informed clients will need more than warm sentiments. Risks should be managed, however. They should not be practicing with your clients had earned money.
- Implement robust investment oversight. Not a process simply focussed on volatility and compliance, but one that seeks to test the quality of your succession candidate's decision making. To what extent do they truly care about client capital in each decision they make; how informed, and how considered.
- Be open to the evidence as it presents. Should a longer learning curve be required than planned for, or another successor need to be selected, be willing to make the change.

It is both true and a truism that we are all different. Truly talented portfolio managers can be unique in many ways. They are never totally replaceable or substitutable, as they will all have idiosyncratic markers of their style. This does not mean the next generation may not be equally talented, but this cannot be assumed. It pays for both managers and clients to prepare, ask questions, and to tilt the odds of success in their favour.

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