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When to Sell ... and When Not To

JEFF MCCONNELL, CFA
Executive Director
Morgan Stanley Wealth Management
Jeffrey.McConnell@msgraystone.com
+1 914 225-7228

LISA SHALETT
Managing Director
Morgan Stanley Wealth Management
Lisa.Shalett@morganstanley.com
+1 212 296-0335

Most investors focus their efforts on the buy side, and indeed, much has been written about how to categorize managers, how best to evaluate them for potential purchase and how to group them together within a portfolio. There is much less documentation about the decision of when to redeem, or sell, a position with an investment manager. Yet a satisfactory long-term return can be earned only by following a disciplined process for both buying and selling: The portfolio of an investor who consistently sells at the wrong time is just as likely to trail its benchmark as if their process is hindered on the buy side.

What are the factors an investor should consider in deciding to redeem a position with a mutual fund, SMA or co-mingled fund or any actively managed vehicle? Below we describe a framework for developing a thesis—a rationale for recommendation—for each strategy within the portfolio at the time of purchase, evaluating each strategy against its thesis on an ongoing basis, and using that thesis to determine when a strategy should be replaced.

Introduction

Ample evidence shows that investors do a poor job buying and selling the active managers in their portfolios. A review of mutual funds' dollar-weighted returns as measured by Morningstar's Investor Return metric—the return the average investor in a fund has achieved in a given time period based on flows into and out of the fund—makes that clear. Across most categories and in most trailing time periods, these dollar-weighted returns have trailed the time-weighted, net asset value (NAV) returns that mutual funds publish (see Exhibit 1, left chart). In other words, no matter what the investment style, fund investors' buy and sell decisions have cost them: The average investor would have been better off staying put. Importantly, this effect is not limited to individual investors. It's also evident in the comparison of NAV return to institutional investors' returns using mutual funds' institutional share classes. Investors who make up the so-called "smart money" have also detracted from their overall return owing to poorly timed buy and sell decisions (Exhibit 1, right chart).

Most investors focus their efforts on the buy side, and indeed, much has been written about how to categorize managers, how best to evaluate them for potential purchase and how to group them together within a portfolio. There is much less documentation about the decision of when to redeem, or sell, a position with an investment manager. Yet a satisfactory long-term return can be earned only by following a disciplined process for both buying and selling: The portfolio of an investor who consistently sells at the wrong time is just as likely to trail its benchmark as if their process is hindered on the buy side.

This paper will primarily discuss the factors an investor should consider in deciding to redeem a position with a mutual fund, separately managed account (SMA) or co-mingled fund or any actively managed vehicle. We will describe a framework for developing a thesis—a rationale for recommendation—for each strategy within the portfolio at the time of purchase, evaluating each strategy against its thesis on an ongoing basis, and using that thesis to determine when a strategy should be replaced.

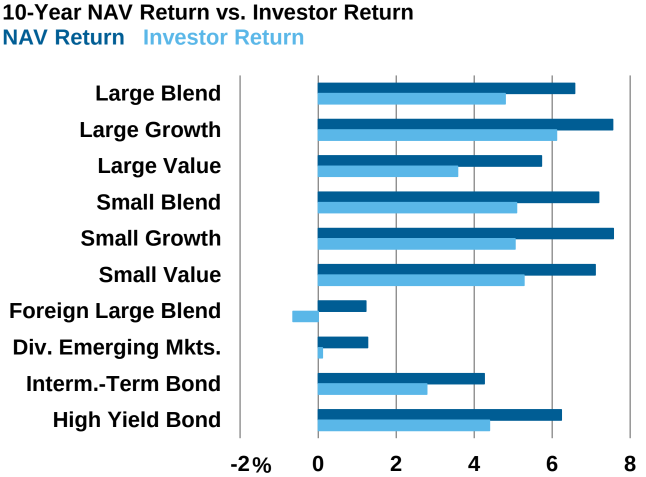
Building the Sell Decision Into the Initial Purchase

A disciplined buy process should incorporate the metrics that will be used to evaluate investment strategies on an ongoing basis, as well as the factors that might lead to a re-evaluation of the strategy. As one example, Morgan Stanley's Global Investment Manager Analysis team (GIMA) performs in-depth analysis on investment managers to develop a thesis for the selection of each strategy. GIMA's process includes:

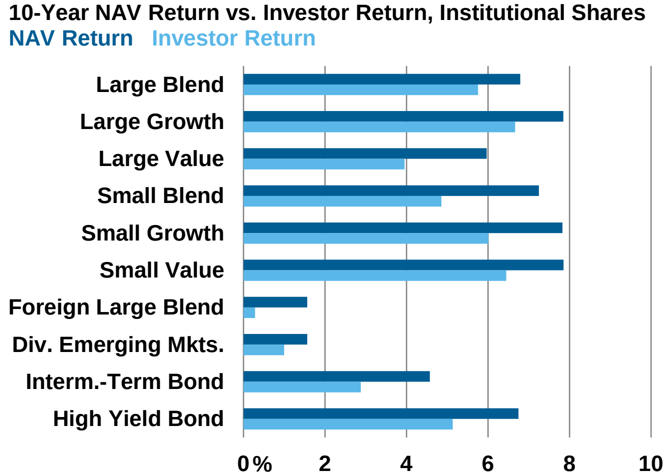
- Meeting with firms and portfolio management teams to determine the key decision makers and important support personnel;
- Thoroughly examining a portfolio's performance to evaluate the manager's overall capabilities, as well as to gauge the market environments in which the portfolio should be expected to perform well and those in which it is likely to trail its benchmark and its broad category peers.
- Determining the strategy's primary drivers of performance, and how consistent and repeatable they are likely to be.

Exhibit 1: Investor Results in Mutual Funds Have Lagged the Net Asset Value Return

10-Year NAV Return vs. Investor Return



10-Year NAV Return vs. Investor Return, Institutional Shares



Note: NAV return and Morningstar Investor Return© are both calculated after subtracting normal fund expenses, including management, administrative, and 12b-1 fees. For category definitions, see page 6.
Source: Morningstar as of Sept. 30, 2017

- A quantitative review of the strategy, including our proprietary Adverse Active Alpha℠ measure, which helps identify those managers with strong stock-picking skill and the potential to outperform their peers and benchmarks, particularly during difficult market environments.

Taken together, these factors help GIMA form a thesis for each strategy on the Focus and Approved lists. Our analysis isolates the key decision metrics unique to each strategy we evaluate, as well as those potential issues or changes most likely to make us reconsider our recommendation. For example, identifying the key decision-makers within a strategy's investment process requires us to re-evaluate the strategy should one or more of those individuals leave.

In addition to the general factors considered when assessing any investment strategy for inclusion on the Approved or Focus List, the selection of a strategy within an overall allocation entails additional criteria that should be considered. These criteria will differ by portfolio, but generally should include:

- An evaluation of the existing portfolio holdings, the role the strategy under review is expected to fill, and how all of the strategies fit together within the overall portfolio.
- Any other client-specific considerations. Those could include matching a corporate pension plan's liabilities or meeting an endowment fund's spending requirements, as well as a client's Investing with Impact objectives and how the strategy helps the client meet those goals.

It follows that GIMA's ongoing monitoring process will focus on the key factors behind each strategy's selection. A violation in any of the basic tenets of our selection thesis triggers a review of the strategy, and of our recommendation behind it.

When Not to Sell

It's important to note, however, that in almost no case will we automatically remove our recommendation on an investment. While a number of events might lead us to initiate a review, implementing an automatic sell decision based on quantitative screens or specific events can be counterproductive. It's true that in certain cases (for example, the departure of a key investment decision-maker without a strong backup) we are more likely than not to change our recommendation. However, each situation entails its own specific characteristics, and a sell (or buy) decision that does not take those into account is likely to lead to suboptimal results.

That is particularly true when considering questions of underperformance. An effective process for evaluating investment strategies needs to take into account the nuances of the manager's approach, and how those are likely to translate into relative performance. When we add a strategy to our platform, our due diligence stresses an understanding of the manager's investment process, and the types of market environment the strategy is likely to find favorable—and unfavorable—compared with its category peers and its benchmark index. When assessing a strategy's returns, we are much more forgiving during those laggard periods in which a strategy is a poor match for the market environment than we are if a strategy trails its benchmark in a market in which we expect it to have a tailwind. Note that the opposite also holds: While we might be pleasantly surprised when a strategy leads its index and its peers during a market environment in which we expect it to struggle, we are likely to review the strategy to make sure nothing has changed that would threaten our thesis.

Our manager selection process gives strong preference to those strategies positioned differently from their benchmarks. "Active share," a measure of how different a portfolio is from a given index, is an important component of both our overall review and our proprietary Adverse Active Alpha measure. Our belief is that in order to outperform an index, an actively managed strategy must be different than that index. However, there is a critical corollary: No portfolio built differently from the market will outperform it all the time.

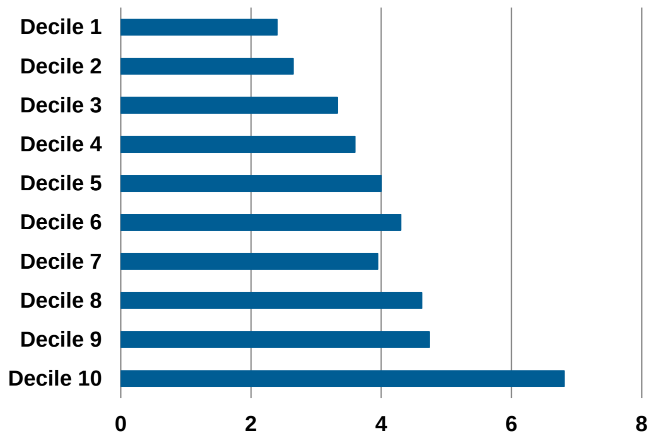
Active share has gained popularity because it is an intuitive measure of how different, or active, a strategy is relative to its benchmark. When deciding to pay active management fees for a strategy with the goal of outperforming a given benchmark index, the first requirement should be that its portfolio is truly managed differently from the benchmark's. However, no actively managed strategy is going to post better returns than its benchmark across all time periods, and the more active a portfolio, the steeper its underperformance relative to its index during an unfavorable environment is likely to be. And if a portfolio is concentrated, a few of its large holdings turning down at the same time can greatly damage its trailing returns at a given point in time.

Consider the data in Exhibit 2 (see page 4), which show a clear trend: Those mutual funds with the highest levels of active share demonstrate much higher volatility in their excess returns—and much steeper periodic downside relative performance—than their peers whose portfolios are positioned closer to their benchmarks. Thus, when evaluating a portfolio with a high degree of active share, our analysts expect some periods of relative underperformance owing simply to the portfolio's different positioning.

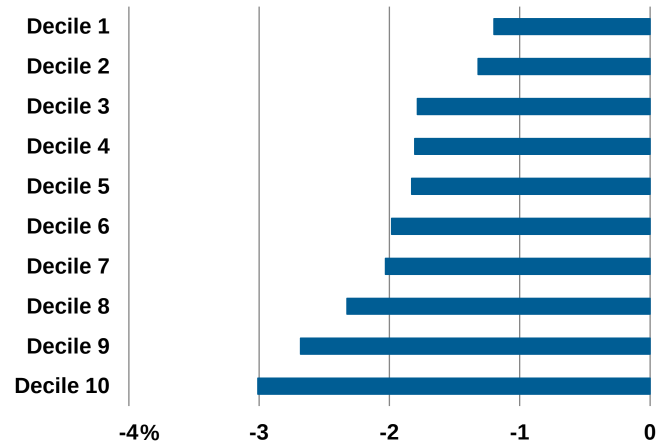
Whether because of different positioning relative to its benchmark, or because of a market environment unfavorable to its style, every strategy is going to face headwinds at times. One reason for the gap between funds' actual returns and those their

Exhibit 2: Funds With Higher Active Share Have Displayed Greater Volatility

Relative Volatility by Active Share Decile



Worst Three-Year Relative Return by Active Share Decile



*Note: Decile 10 has highest active share and Decile 1 has the lowest.
Source: Morningstar as of Sept. 30, 2017

investors have achieved is investors' tendency to sell their positions during those natural downturns. Before redeeming a strategy whose trailing returns have been dragged down by recent performance issues, it's critical to determine if those struggles are a natural result of the manager's approach, or are due to a drop-off in quality.

When to Sell

While most investors would be well served by being slower to redeem their manager positions, there are situations in which making a change is warranted. Those decisions can be grouped under a single philosophy: When an investment vehicle is no longer adequately filling the role for which it was selected—when it violates the thesis governing its selection—it should be replaced.

Of course, making that determination requires an in-depth review of the strategy. That can be triggered in a number of ways, most of which tie back to the criteria used at the time of selection:

Performance differing from expectations. As described above, it is crucial when selecting a strategy to understand the market environments in which it is likely to out- and underperform its peers and benchmark**.** Only with that knowledge can the analyst adequately evaluate whether a slump in returns is worrisome or is within the realm of expectation for the strategy. For that reason, monitoring processes based on quantitative performance screens are not effective for driving decisions: A portfolio can face a headwind from the market for a much longer time, and to a much steeper degree, than a quantitative screen is able to capture without immediately triggering an automatic sell, likely at exactly the wrong time. As shown earlier, that is particularly true for a portfolio with a high active share measure.

Of course, knowing that such downturns are possible and actually living through one are two different things. It is extremely difficult to keep investors and clients focused on the long term during periods in which a manager's trailing returns badly lag their peers and benchmark. That's true even of institutional investment committees, which are often focused on reviewing quarterly results. However, maintaining a longer-term perspective—counseling and exercising patience—is paramount at those times.

All this makes the performance question the most difficult to examine when evaluating a manager for potential redemption. There are certainly situations in which underperformance alone is sufficient reason to fire a manager. Typically those fall under the heading of the manager's returns not meeting the expectations of their selection thesis—volatility has been much higher than anticipated, for example, or the strategy has underperformed during a period in which it should have benefited from market tailwinds. However, to merit redemption in most cases, subpar returns should occur in conjunction with one or more of these factors:

Organizational changes. The key investment decision-makers should be identified at the time of selection. That includes, among others, the members of the portfolio management team responsible for buy and sell decisions, analysts covering sectors or industries prominent in the portfolio and the person or people overseeing the analyst team. It's also critical to understand succession plans—how the reins of a portfolio are to be passed and to whom.

It is in the investment management firm's interest to downplay the effect of personnel departures, particularly given that the firm, not the portfolio manager, "owns" the strategy's track record. Thus, it's important to maintain a clear sense of the investment team's structure and its members' roles. Any loss of key investment personnel should be closely reviewed and evaluated relative to the analyst's understanding of the investment team. And any assessment of a strategy's historical returns needs to take into account the length of time the current team has been in place—those periods in which the current decision-makers were not involved should be underweighted, if not disregarded.

Losses among senior management could also be a sign of firm difficulties. Those travails could potentially permeate the investment side, and should be monitored, although on their own they are not often cause for major concern.

Large fluctuations in assets under management (AUM). It's important to understand at the time of selection how much a team is comfortable managing in a given strategy. That requires not only a discussion with the manager, but an examination of the portfolio: How important are the smallest and the least-liquid positions in a portfolio to its success, and how would asset growth affect the managers' ability to continue to invest in them? If assets have grown, an increase in the portfolio's number of holdings or its average or median market capitalization can be an indication of stylistic changes. Knowledge of the firm gained during initial due diligence can help clarify the issue: Has the firm shown itself willing to close its strategies to new investments to avoid asset bloat? Also, how large a factor in compensation (for investment professionals and others) is firm or strategy asset growth?

On the other hand, large decreases in firm and strategy assets should also be monitored. That is particularly true when evaluating smaller asset managers, whose profitability breakeven points could be breached, leading to staff cuts. Familiarity with the company's financials from the outset will enable proper analysis of AUM shifts going forward.

Increased competition. Managers whose success relies on exploiting specific market opportunities will be negatively affected by the presence of similarly styled managers in their preferred hunting grounds. For example, quantitative managers as a group suffered in 2007 and 2008 as many of them pursued similar trades in the mortgage market. When those trades fell out of favor, the amount of managers unwinding similar trades steepened the losses for all of them. Idiosyncratic managers are less likely to be affected by this issue, but monitoring a manager's peers will help develop an understanding of their opportunities. Additionally, an increase in a manager's cash position could be an indication of difficulty in finding attractive investments, especially if the shift has taken its cash stake outside its historical range.

Changes in management approach. Undoubtedly, managers changing their stripes would be cause for close examination, if not outright redemption. However, aside from shifts driven by changes to the portfolio management team or rapid asset growth, true style changes are rare. Portfolio managers usually maintain over time their preferred investment approach.

Tax considerations. Taxable investors should consider their tax situations and how those might affect the timing of selling a position within their personal portfolios. A large potential capital gain could determine when a sale should be made. Similarly, mutual funds distribute their own capital gains annually; the timing of those issuances should also be weighed when making the sell decision.

These criteria, including any strategy-specific factors considered at the time of purchase, form the basis of the periodic test of the analyst's selection thesis. When that thesis has been violated, it's time to sell the position.

Conclusion

The decision of when to redeem a position with an investment manager is not an easy one. Many investors, retail and institutional alike, struggle with this aspect of investing. Our preferred approach is to build into the selection process a thesis for each strategy, and stick to it. A robust sell process requires periodically revisiting the thesis. Effective portfolio management entails discipline in building the thesis at the time of selection, ongoing monitoring based on the main components of the thesis, and redeeming when one or more of those components have been violated and the strategy is no longer adequately filling the portfolio role for which it was selected. ■

Definitions

MORNINGSTAR® INVESTOR RETURN™ Also known as dollar-weighted return, this measures how the average investor fared in a fund over a period of time. Investor return incorporates the impact of cash inflows and outflows from purchases and sales and the growth in fund assets. In contrast to total returns, investor returns account for all cash flows into and out of the fund to measure how the average investor performed over time. Investor return is calculated in a similar manner as internal rate of return. Investor return measures the compound growth rate in the value of all dollars invested in the fund over the evaluation period. Investor return is the growth rate that will link the beginning total net assets plus all intermediate cash flows to the ending total net assets.

LARGE BLEND These portfolios invest in a variety of large US stocks. Stocks in the top 70% of the capitalization of the US equity market are defined as large cap. The blend style is assigned to funds where neither growth nor value characteristics predominate.

LARGE GROWTH These portfolios invest primarily in large US stocks that are growth-oriented. Stocks in the top 70% of the capitalization of the US equity market are defined as large-cap. Growth is defined based on a strong growth style (high growth rates for earnings, sales, book value, and cash flow) and a weak value style (high price ratios and low dividend yields).

LARGE VALUE These portfolios invest primarily in large US stocks that are value-oriented. Stocks in the top 70% of the capitalization of the US equity market are defined as large-cap. Value is defined based on a strong value style (low price ratios and high dividend yields) and a slow growth style (low growth rates for earnings, sales, book value and cash flow).

SMALL BLEND These portfolios invest in a variety of small US stocks. Stocks in the bottom 10% of the capitalization of the US equity market are defined as small-cap. The blend style is assigned to funds where neither growth nor value characteristics predominate.

SMALL GROWTH These portfolios invest primarily in small US stocks that are growth-oriented. Stocks in the bottom 10% of the capitalization of the US equity market are defined as small-cap. Growth is defined based on a fast growth (high growth rates for earnings, sales, book value, and cash flow) and a high valuations (high price ratios and low dividend yields).

SMALL VALUE These portfolios invest primarily in small US stocks that are value-oriented. Stocks in the bottom 10% of the capitalization of the US equity market are defined as small-cap. Value is defined based on a strong value style (low price ratios and high dividend yields) and a slow growth style (low growth rates for earnings, sales, book value, and cash flow).

FOREIGN LARGE BLEND These portfolios invest in a variety of big international stocks. Most of these portfolios divide their assets among a dozen or more developed markets, including Japan, Britain, France, and Germany. These portfolios primarily invest in stocks that have market caps in the top 70% of each economically integrated market (such as Europe or Asia ex Japan). The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios typically will have less than 20% of assets invested in US stocks.

DIVERSIFIED EMERGING MARKETS These portfolios invest at least 70% of total assets in equities and invest at least 50% of stock assets in emerging markets.

INTERMEDIATE-TERM BOND These portfolios invest primarily in corporate and other investment-grade US fixed-income issues and have an average duration of 3.5 to six years or (if duration is unavailable) an average effective maturity of four to 10 years.

HIGH YIELD BOND These portfolios primarily invest in US high-income fixed-income securities where at least 65% or more of bond assets are not rated or are rated by a major agency such as Standard & Poor's or Moody's at the level of BB (considered speculative for taxable bonds) and below.

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Investing in the markets entails the risk of market volatility. The value of all types of investments may increase or decrease over varying time periods.

Neither **growth** nor **value investing** guarantees a profit or eliminate risk. The stocks of **growth** companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations. Not all companies whose stocks are considered to be **value** stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

To the extent the investments depicted herein represent **international securities**, you should be aware that there may be additional risks associated with international investing, including foreign economic, political, monetary and/or legal factors, changing currency exchange rates, foreign taxes, and differences in financial and accounting standards. These risks may be magnified in **emerging markets and frontier markets**.

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The value of **fixed income securities** will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Bonds are subject to interest rate risk, call risk, reinvestment risk, liquidity risk, and credit risk of the issuer. **High yield bonds** are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.
The returns on a portfolio consisting primarily of **environmental, social, and governance-aware investments ("ESG")** may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria.

Adverse Active Alpha (AAA) is a patented screening and scoring process designed to help identify strong stock picking equity managers with characteristics that may lead to future outperformance relative to index and peers. While highly ranked managers performed well as a group in our Adverse Active Alpha model back tests, not all of the managers will outperform. Please note that this data may be derived from back testing which has the benefit of hindsight. In addition, highly ranked managers can have differing risk profiles that might not be suitable for all investors. Our view is that Adverse Active Alpha is a good starting point and should be used in conjunction with other information. Morgan Stanley Wealth Management's qualitative and quantitative investment manager due diligence process are equally important factors for investors when considering managers for use through an investment advisory program. Factors including but not limited to, manager turnover and changes to investment process can partially or fully negate a positive Adverse Active Alpha ranking. Additionally, highly ranked managers can have differing risk profiles that might not be suitable for all investors. For more information on AAA, please see the Adverse Active Alpha Ranking Model and Selecting Managers with Adverse Active Alpha whitepapers. The whitepaper are available from your Financial Advisor or Private Wealth Advisor. ADVERSE ACTIVE ALPHA is a registered service mark of Morgan Stanley and / or its affiliates. U.S. Pat. No. 8,756,098 applies to the Adverse Active Alpha system and / or methodology.

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