Investors are increasing their allocation to passive index-tracking funds as the cost of investing comes under ever more scrutiny. This leaves the "active" fund management industry competing for the few star fund managers who can consistently outperform. But what happens when a star manager leaves? Should you stay, follow or move somewhere else? This month we consider the options and use PIMCO's star manager and "bond king" Bill Gross as a topical example.

Over the past 12 months several superstar fund managers have departed for pastures new. Bill Gross recently left PIMCO and was the highest profile global defection for years. This follows hot on the heels of another star manager, Julie Dean, leaving Schroders (her predecessor Richard Buxton, another major star, left for Old Mutual in March 2013) and perhaps the most high profile manager to leave in the UK was Neil Woodford, "Mr Invesco", who departed to set up his own firm last October.

Investors should expect that good managers may move around, sometimes for extra cash, more control or simply for a change of lifestyle. When they do leave**, investors are left wondering whether to move with the star, stay put and hope for more of the same good performance or move entirely to a new fund or manager.**

With the PR teams on both sides working overtime and no guarantee of success if you stay or go, **we consider whether investors should follow or not when their favourite manager jumps ship.** We also consider the wider implications when a giant like PIMCO starts to suffer large outflows as a result of their "flagship" manager leaving.

Bill Gross co-founded PIMCO in 1971 with $12m of assets under management. PIMCO thrived during the 1980s as the bond market expanded exponentially and Gross was widely seen as the bond guru of Wall Street. **At its peak, Gross's Total Return Bond Fund managed a whopping $293bn,** double the size of the nearest rival and by June 2014, PIMCO managed over $1.25tn. Whilst this is clearly not all down to the investment or marketing prowess of one man, **clearly his early success generating returns, along with an excellent personal "brand" fuelled ever increasing asset gathering**.

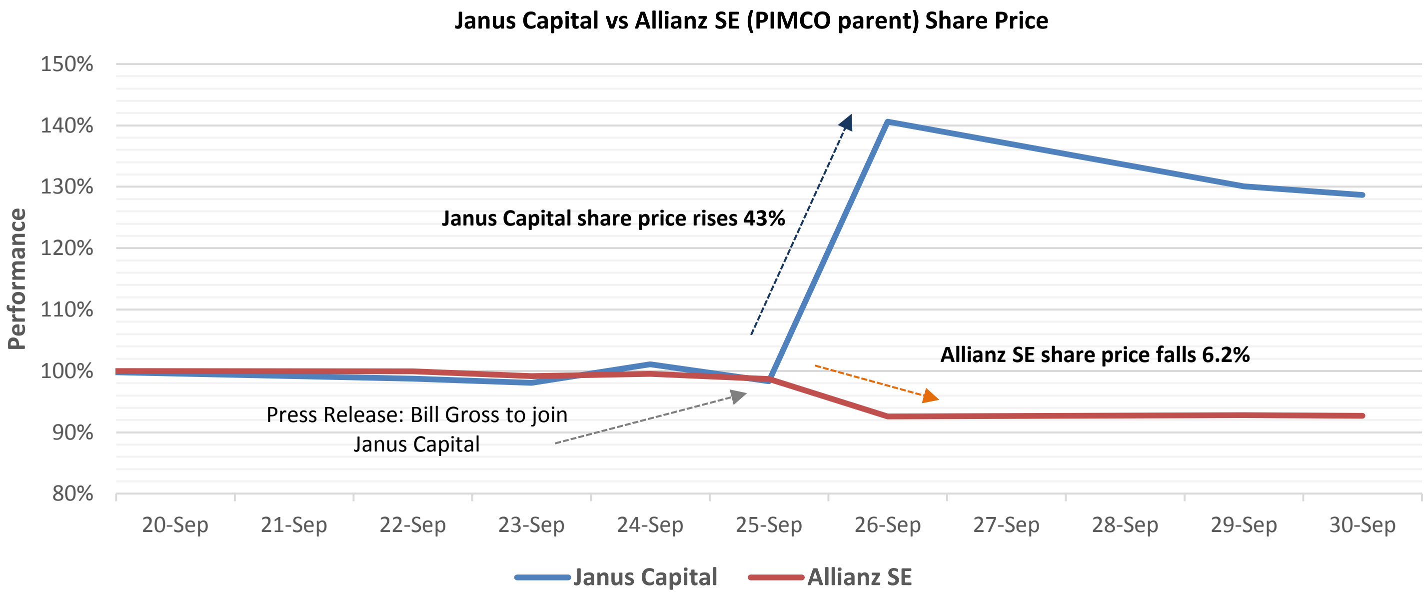
When Gross announced his departure shares in Allianz SE, PIMCO's parent company fell 6 percent which Morgan Stanley believe implied the loss of about $400 billion in assets under management in the wake of Gross' departure. **Conversely, the shares of his new home, Janus Capital, rose 43%** on the....

Smiles all round - Star fund Manager Bill Gross leaves PIMCO for Janus

....announcement, so **the market clearly thinks that money will pour out of PIMCO and into Janus** as a result of Gross leaving. Sure enough $10 billion left the mutual fund giant in one day after Bill Gross announced his departure and his fund lost 10% of its assets in September alone.

However this masks the fact that performance of Gross's fund had been suffering for some time. It was in the bottom 20% of the peer group over one year, and suffered 14 straight months of net redemptions leading up to the announcement of his departure, with a reported $4.5 billion of redemptions in June alone. **Also PIMCO's widely respected CEO Mohamed A. El-Erian left in January** amid rumours that he and Gross has fallen out about the longer term investment strategy for the firm. **There were suggestions in the market therefore that Gross was on the verge of being ousted at PIMCO** anyway and that his move to Janus may have been a jump before he was pushed.

This should mean that **it is not a cut and dried case for investors to simply redeem from PIMCO and move to Janus immediately**.



At the same time, **often when a manager is starting out, either for the first time or at a new firm, they feel invigorated and revitalised.** When that manager is very high profile they **also feel intense pressure to justify their move by generating good performance early on.** This should mean that they are highly incentivised to do a good job for loyal followers and new clients, as their reputation is at stake.

Also, at their old firm, **many superstar managers end up managing more money than they feel comfortable with** and starting again with a tiny fund (as Gross has done at Janus, with only $13m) allows them to return to being nimble and dynamic. **This is because size really does matter**. Huge funds tend to lead to large holding sizes and the bigger the holding the more difficult it is to sell it in times of stress. If you own $5,000 worth of a company, it is a great deal easier to sell it to someone at a reasonable price than if you own $50m of the same stock. Given this "super-tanker" effect, Bill Gross might argue that managing a fund with $200bn is bound to impact performance when compared to a far more nimble fund and that a fresh start allows him maximum flexibility to express his investment philosophy.

Another consideration has to be the strength of the team left behind. If a star manager goes off the boil after a few years of excellent performance they can still be made to look good by the quality of the growing investment team around them. This might then mask the dwindling contribution to performance of the star manager, yet they will still be the one paraded around at the annual conference, holding all the interviews and appearing on all the adverts. Therefore **most investors may feel that the star is the reason for the continuing success of the fund, when in fact it may be the structure of the investment process around them**. This means that when a star manager leaves, investors should consider the strength of the team left behind and determine whether the moving manager was the main reason for the success of the fund.

The other major factor to consider is inflows and outflows. If you stay in a fund that is suffering large redemptions, the chances are that the fund provider will be forced to sell assets that otherwise you would want to hold onto, just to satisfy the need to give investors their money back (consider it the same theory as a run on a bank). Therefore, **regardless of how good the crew left behind are when the captain jumps over the side, they can't be expected to sail a sinking ship.**

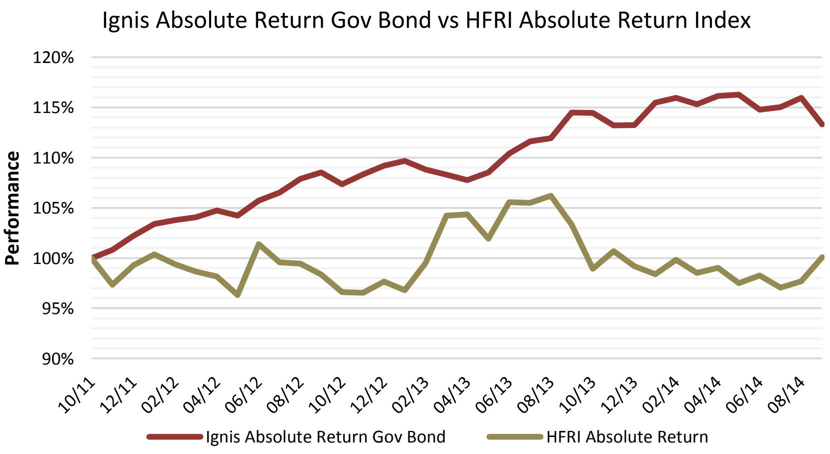
Likewise if a fund is bringing in a lot of new money, you may find that the manager is forced to buy things that they wouldn't otherwise want to buy just because they have to invest in something with all this new cash. That's why some managers actually close their funds to new investors (against the better judgement of their profit hungry CEOs) because they realise that they can't sensibly invest all of the new money that they are being asked to without damaging performance.

Therefore, since it is often difficult to really know what performance contribution the star made to the fund over the years, since you don't really know how many redemptions they will suffer when they leave and since the star's arrival at a new firm is no guarantee of immediate success, **often an investor's best option is to sell on the news of departure and reinvest in a rival's fund in the same sector.**

After a while, say 12-18 months, you then have the opportunity to consider how the star manager is getting on. Has he attracted new money? Is the inflow manageable? Has he performed well? Is his strategy the same? At this point you can then decide whether to invest with him again or not. This then takes away some of the risk associated with following immediately and whilst you may miss out on some performance in the short term, at least investing in a rival with a good track record allows you to participate in the same asset class in the meantime. **The only risk with this approach is that the manager attracts so much new money that the fund closes to new investors** and you may miss out but frankly we believe that that is a risk worth bearing.

We are very much of the view that investors should not be blinded by the status of the manager and **should take the lowest risk approach when a star manager leaves.** If this means selling a fund that has performed well, investing elsewhere until the star has a chance to build up a good track record at their new firm and then deciding whether or not to move then so be it. We adopt this approach for our clients as we feel that it is the lowest risk approach to following talented investors.

Looking on the bright side, **at least having invested in a star fund manager and having participated in their rise to the top it's no bad thing to be faced with such a dilemma**. Better to have loved and lost than never to have loved at all.



13/10/14 p.s - No sooner do we utter the above words than the senior fixed income team at Ignis Absolute Return Government Bond (headed by Russ Oxley) decide to leave! The team were star performers for many years, as the chart to the left shows. We held the fund in many client portfolios and with the announcement this morning we felt that we had no choice but to redeem, which, being active and nimble enough, we have now done.

We will watch with interest and decide whether to eventually follow Russ or to invest elsewhere, in the meantime finding a suitable investment to replace Russ and his team.