Ten Ways to Improve Manager Selection

By Nancy Opiela
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Today's emphases on fiduciary responsibility, risk management and increased transparency require better due diligence when selecting managers. Especially in today's turbulent markets, advisors who spend more time and resources to do due diligence well can find themselves at a distinct competitive advantage.

While these tips won't necessarily help you identify the next active management superstar, they can bolster your manager selection and due diligence program:

1. **Solidify your core**. Scott Welch, Senior Managing Director of Investment Research and Strategy at Fortigent, LLC, a Rockville, Maryland provider of outsourced wealth management solutions, advocates the rigorous due diligence that moves beyond past performance to look forward. His process is named "SMART^2," and it addresses the following topics:

   - **Strategy:** What is the fund's philosophy? How do the fund's objectives and strategic strengths rate both in isolation and relative to peers? Is the fund's strategy intuitive, implementable, and repeatable? How viable is the strategy given existing market conditions and economic factors?
   - **Structure:** What is the fund's legal structure? How liquid is the fund? Will the fund be forced to sell key holdings if it faces unforeseen redemptions?
   - **Management**: What is the management team's previous experience and tenure together? What is the depth of the fund's organizational infrastructure?
   - **Methodology:** What is the fund's decision-making process? Consider all elements of it, including idea generation, hypothesis testing, modeling, execution, and monitoring.
   - **Asset Allocation:** How robust is its asset allocation process, and does it create true added value? Is there a meaningful quantitative aspect to it? How are reallocation and rebalancing decisions made?
   - **Assets under Management:** Does the fund have sufficient assets under management to execute its strategy successfully? Has it reached critical mass to secure business viability? Have assets grown too much or too quickly?
   - **Risk Management:** How does the fund analyze and manage risk? What are the quantitative and qualitative metrics it employs? Is the process disciplined? Is there adequate transparency? Is there separation between the portfolio and risk management functions within the fund?

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- **Research:** Is the fund's research superior to peers'? Does it give the fund an informational edge? Is the depth of the research team adequate, and is there meaningful use of qualitative and quantitative analysis?
- **Track Record:** What are the risk-adjusted returns, alpha generation, and the volatility of returns? How do positive and negative months compare? What was the worst drawdown and time of recovery? How has the fund performed both absolutely and relative to peers? Under what market conditions should the fund perform best / worst?
- **Tax Efficiency**: Is the fund's strategy tax efficient? Are historical after-fee, after-tax returns compelling?

"In today's transitioning market, advisors need transparency into the manager's positions, trading strategy, books and records," Welch says. "Specifically, advisors should seek a greater understanding of return drivers by asking: Are the returns of a fund consistent with what the stated strategy should generate? What is the degree to which leverage (or lack thereof) drives returns? How, and how often, is the portfolio priced?"

A volatile market also makes it essential for advisors to explore the liquidity profile of funds. Welch explains: "Managers should provide regular liquidity reports – how much is available at any given point in time as well as information on the concentration of investors within the fund – to help advisors determine how one large redemption request might affect remaining investors."

2. **Examine the intangible values.** Even if you are doing your due diligence well, there always will be surprises in areas you haven't considered, says Mari Adam, CFP®, President of Adam Financial Associates, in Boca Raton, Florida. The illegal market timing from 1999 to 2000 and derivatives in mutual funds are both good examples. "Making an effort to understand the values and the intangibles that permeate the fund company's corporate culture can help minimize surprises," she says. "There's no substitute for a visit to the home office and a face-to-face meeting with the fund manager."

   "I like to learn more about the environment the managers work in," she adds. "I was visiting a manager on the recent 'flash crash' day and the fact that nobody lost their cool made me confident in the firm."

   Adam also favors privately owned companies. "Public companies operate to please stockholders," she says. "It's also interesting to explore how companies incent their fund managers. I prefer the approach of evaluating performance over a rolling three- or five-year period as that doesn't result in an emphasis on short-term returns at the expense of long-term performance."

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3. **Keep risk at the forefront.** Peter Mustian, Director of Due Diligence at Innovest Portfolio Solutions LLC , Denver, Colorado, aims to find managers who consistently hit singles and doubles, not occasional home runs. "We require all our managers to fill out a 30-page questionnaire to give us detailed information on their strategy and personal background so we can dive in deep, qualitatively, to understand how they invest," he says. "We summarize the document and share our analysis with clients every quarter. We also note our major, minor, minimal concerns for each manager. No product is perfect, so we always present the pros and cons, noting, for example, products likely to lag in a particular environments. Being honest about risk helps set client expectations."

4. **Seek current information.** Richard Sincere is Chairman and CEO of Sincere & Co. Ltd, an Evanston, Illinois firm that introduces independent advisors to quality mutual funds before they have a three-year track record. He insists that advisors require more current information than the industry now provides. "Traditionally, managers have kept advisors informed with quarterly performance reports, but that leaves them guessing what's going on the rest of the time," he explains. He represents Marketfield**,** a long-short fund, which he says has staked out a position at the cutting edge of where this industry is headed by providing real time information. "Every day advisors get insight into what the manager is thinking. Marketfield's largest investors get it in real time. Others receive the analysis at the end of the day. Either way, advisors are crystal clear on what the manager is thinking both fundamentally and qualitatively," Sincere said.

   Additionally, Marketfield writes quarterly market commentaries, issues longer whitepapers once or twice a year, routinely posts to their blog, and hosts a variety of conference calls. "Our integrated marketing is designed to illuminate what the manager is thinking and prepare advisors to share those insights with clients," Sincere explains. "Even Marketfield's ads, two-page spreads devoid of marketing hype, focus on intellectual content and offer real information the advisor can digest and share with clients."

   "There's no guessing what managers are thinking and that's something that all advisors must demand from portfolio managers," Sincere continues. "When advisors visit a fund company, they get the portfolio manager's hour-and-a -half PowerPoint presentation and see everyone in their best suit behaving properly. I believe advisors deserve greater insight into what the managers they hire are all about."

5. **Make a review part of the process**. Every quarter, Andrew Sohn, ChFC**,** of Sohn & Associates, Inc., in Boxboro, Massachusetts, gathers his research staff and fellow advisors in a conference room to discuss the performance of their funds as well as any changes that may have occurred over the quarter. "Semi-annually we invite the top six or eight companies we use to send a VP to our office to provide additional

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information that can supplement what's found in the prospectus," Sohn says. "For years, I was laughed at for routinely asking whether the SEC, state, or federal government was investigating the firm for anything, but nobody laughs at that question anymore."

Annually, Sohn's director of research conducts due diligence meetings for the top funds he uses. "If we learn something new from the managers, we'll share that with clients, just as we keep them informed about funds we are watching, whether it's for style drift or another issue," he says.

6. **Avoid conflicts of interest.** Receiving a dozen calls from wholesalers each week, Sohn instructs his director of research to respond by sharing the firm's six to eight major investment criteria. "We tell the companies: when you pop up on our screen, we are happy to talk to you," Sohn explains. "Often, they will offer to take us to lunch or dinner, but I am very sensitive about not feeling like I owe anyone anything. Accordingly, rather than meeting at a fancy restaurant to talk, we invite the fund company representatives to come to our office. And they are more than happy to come in, especially as their budget doesn't take a hit. In this way, hope we might get a little more respect from them."

7. **Focus on operational due diligence.** With the Madoff scandal putting custody and brokerage relationships center stage and debate continuing over industry best practices and additional regulation, John Egan, CFP®, president of J.M. Egan Wealth Advisors, in Madison, New Jersey, takes advantage of a unique field trip opportunity offered by SEI, one of the fund companies he uses, to visit their office. Notes Egan, "SEI's program offers our clients and potential clients the opportunity to visit their operation in Pennsylvania to tour the trading floor and see where money comes in, how it's invested, and how investments are monitored and reported on. Everyone who takes advantage of the program finds it beneficial."

8. **Hire specific expertise.** Seeing opportunity in the emerging markets, Michael Finer CPA, PFS, CPF®, CLU, president and chief financial planner at Major League Investments, in Salem, Massachusetts, hired David Henry, CFA to serve as director of emerging markets. "David's extensive experience includes several years as the chief investment officer of Carruth Management, a premier family office in the Boston area," says Finer. "David also has extensive experience researching and investing in emerging markets including China, India and Brazil and has worked as a global fixed income analyst."

   Finer and Henry recently collaborated on a white paper that provides an overview of emerging markets and explores the factors that they feel now make Brazil so compelling. "We'll post the paper on our site and mail it to clients," says Finer. "Especially now that we have the expertise in house, we want to share our thinking with clients so they feel comfortable with our new emerging markets portfolio."

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9. **Consider outsourcing.** Fortigent was recently retained by Moss Adams Wealth Advisors LLC, the wealth management division of Moss Adams LLP to complement its in-house investment research capabilities "All advisors have some level of research capabilities or expertise in one area, but often, rather than staff up or push current staff to get up to speed on a new market segment, they choose to supplement their capabilities with our firm's research," says Welch. "Typically advisors want access to all 175 managers on our platform and ask us to conduct a number of proprietary searches. For instance, they could be looking for an emerging markets fund with an emphasis on technology or small-cap exposure."

10. **Communicate more with clients.** In today's shattered trust environment, clients don't know what to believe, who to trust, and are skeptical about advice, says Chip Roame, Managing Principal, Tiburon Strategic Advisors, Tiburon, California. "Clients historically have generally not cared to engage in the due diligence process, but today advisors can benefit from communicating more of their selection process to clients, even if they do not understand it," he says.

    Sue Stevens, CFP®, CPA, CFA, president of Stevens Welath Management Deerfield, Illinois, agrees. "In this period of heightened anxiety, more than ever our role as an advisor is to calm clients by providing information that puts market events in context." To that end, Stevens has begun sharing more of her strategic thinking with clients. "I might discuss how much we've moved to cash and why or the role of international bonds," she notes. "Where clients once might have only glanced at my newsletters, now they are reading them."

    In an effort to keep his clients up-to-date, Rick Kahler, CFP®, President of Kahler Finanical Group in Rapid City, South Dakota, posts details of visits to the fund companies he uses on his website. For example, he recently wrote, "Last week and this week I spent a day at the offices of American Century, Kansas City, and AQR, Chicago, meeting with their portfolio managers. I gained a number of insights into their projections for the economy, strategies they are implementing, and the philosophy behind some of their funds. I have planned several other trips in the near future to visit with other fund managers that we also use in implementing our investment strategy."

    "I want clients to understand and appreciate our due diligence commitment and the time we take to ensure we are using the most effective managers possible in implementing our portfolio asset allocations," Kahler says.

Although historically viewed as an expense secondary in importance to revenue-producing activities, clients' current insistence on transparency increasingly is transforming due diligence into a way to build and enhance trust and differentiate a firm. "Advisors who are unwilling or unable to conduct appropriate levels of due diligence will, at best, find

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themselves at an extreme competitive disadvantage," Welch concludes. "At worst, they will find themselves out of business."

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