How to Properly Select and Evaluate an Investment Manager

Like clients, every advisor has a different level of knowledge of the due diligence process.

Oftentimes advisors rely heavily on the due diligence efforts of a third-party such as their broker-dealer or Turnkey Asset Management Platform (TAMP). Regardless of your situation, we hope that the process outlined below gives a solid baseline process for manager evaluation. Hopefully it will help you gain comfort with your investment selections, help demonstrate the value you're providing your clients, and fulfill many of your fiduciary duties as an advisor.

After 25 years or so of being an investment advisor, my career has morphed, at least to a certain degree, into that of a portfolio manager. Perhaps having both advisory and management experience gives me a unique perspective on how to evaluate an investment manager. To us, it is a relatively straightforward process that has three distinct phases:

1. Determining the Needs of the Investor

This first part may seem a bit counterintuitive, but before you can evaluate a manager, you need to know exactly what the investor's needs are. How else can you determine whether or not the manager has a solid chance of meeting these needs? Of course, advisors won't seek a new manager for each and every client, and we recognize advisors often have a few "go to" managers that are appropriate for common situations. But, when selecting a manager to put into a new or old portfolio, we need to start with some of the basics:

- ❑ **What are the investor's goals?**
  - › *How much time does the client have to meet these goals? What asset class or classes are being considered to meet these goals?*
- ❑ Are there **constraints or preferences to the geography of the investment**?
  - › *Are there constraints or preferences to the size of companies being considered?*
- ❑ Does the **investor have maximum volatility or drawdown expectations**?
- ❑ Are their **income needs required from the investments**?
- ❑ Are any of the answers to the above **restrictive or can the investment be unconstrained or tactical**?
- ❑ What **returns are needed over time** to meet the investor's goals?

In our opinion, the answer to this last question should become the benchmark for the investment. If an investor understands that their portfolio only needs to take on the risk and reward characteristics needed for them to achieve their goals, then we can dispense with the tomfoolery of using an arbitrary index which has no tieback to the investor, their goals, or their true investing success.

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2. Initial Due Diligence

After decades of advising clients, experience now drives much of our thought process. We also have the experience of being put through dozens of due diligence processes ourselves. The following are what we consider to be the most crucial criteria needing answers from a manager:

- ❑ **What is the manager's philosophy?**
  - › *Does this philosophy fit with the overall profile and needs of the investor?*
- ❑ Is the manager's **process consistent and repeatable?**
- ❑ What is the **longevity of the management team** and/or the investment process being used?
- ❑ Does the manager **conform to Global Investment Performance Standards (GIPS®)?**
  - › *Are you looking at real or hypothetical, back tested performance? Is the performance verified by an independent third party? Ask to see the verification!*
- ❑ **What types of investments are used?**
  - › *Is there a defined investment pool or universe? Does the manager use margin, leverage, options, derivatives or other high-risk attributes within their process? Does this sync with the investor's needs and risk tolerance?*
- ❑ **What is the manager's fee relative to their peers?**
  - › *Unfair comparisons often lead investors down an inappropriate path.*
  - › *As an example, comparing an active, emerging market manager to a large-cap, U.S. index-following manager is like comparing apples and bricks. It is both unfair and unproductive.*
  - › *Another example is that mutual funds do not include trading costs in their fees. Comparing the advertised fee of a mutual fund versus that of an SMA Manager would not be fair comparison as mutual fund trading often doubles the advertised expense. Fees are important, but process is more important.*
- ❑ Does the **long-term performance** record of the asset class and the manager match the returns needed to **meet the investor's goals**?
  - › *Be careful with this one! Due to the cyclical nature of all investable markets, investing through the rearview mirror in asset classes that have done well is often the worst place to invest going forward. Thus, the classic disclaimer used by all managers: Past performance is not indicative of future results.*
- ❑ What is the frequency, the types of, and quality of the **manager's communication** to their investors? Communication is paramount.
- ❑ Finally, **is the manager, the philosophy and strategy set up to meet the investor's needs** over time?

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3. Ongoing Due Diligence

Ongoing due diligence needs to be an open discussion and fluent process. The review process can be boiled down into just a few questions:

- ❑ Have the **investor's needs**, timelines or other relevant **financial circumstances changed**?
- ❑ **Have any of the initial due diligence answers outlined above been violated or changed significantly**?
  - › *Specifically, was there a change in ownership of the firm or a major change to the management team? Was there a change in process? Did they deviate from their core competency? Any "yes" to these questions should prompt a full due diligence review.*
- ❑ Has there been a **change to the macroeconomic backdrop that now alters or eliminates the original investment thesis** of selecting that manager?
- ❑ And now the doozy: **What is your timeline and evaluation process for poor performance?**
  - › *Prudence dictates that you have a predetermined time period and evaluation metric for dealing with poor performance. To us, the evaluation metric is simply the returns needed over time to meet the investor's goals.*
- ❑ **Is the investment's under-performance acute** (short, one-time period) or **chronic** (lasting over long periods of time such as three years)? Chronic underperformance without good reason should prompt a full review.
  - › *For the bad month, quarter or year, not so fast. Realistically, almost every manager goes through a period of underperformance. It is almost inevitable. But one bad month, quarter or even a year should not result in a termination unless it comes with another significant issue from the considerations outlined above. Depending on the circumstances, there is often an urge to fire the manager without giving the process, and all of the other reasons you hired the manager, a chance to work. Firing after a large drawdown is often the worst time to let a manager go… at the bottom.*

Tying it All Together

As we have mentioned, we have been through this process dozens of times as both the advisor and the asset manager. In our opinion, it is crucial to stay current with your ongoing due diligence with the manager, their team and their process. Most importantly, stick to your process of ongoing evaluation and share this process with your clients. If clients understand that all managers will have periods of underperformance and that you, as the manager of managers, have a well thought out process to deal with performance, then everyone's comfort level rises.

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Whether it is a mutual fund, a separate account manager or an ETF, knee-jerk reactions and/or panic selling are often the worst thing to do, and often happen at the worst time. Investing is meant to be over years and decades, not short periods. If the process is not broken and all the due diligence answers remain the same, then patience is often the best course of action. If both you and your clients understand this up front, and you give a fair time period to let the manager's process work, then the possibility of making an over-reactive mistake is significantly reduced.

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