Selecting Investment Managers for Individual Investors

by Harold Evensky, Stephen M. Horan, CFA, CIPM, and Thomas R. Robinson, CFA

LEARNING OUTCOME STATEMENTS

Mastery | The candidate should be able to:
---|---
| a. compare individual and pooled (commingled) investment vehicles; |
| b. distinguish between individually (IMAs), separately (SMAs), and unified managed accounts (UMAs); |
| c. describe the attributes of IMAs, SMAs, and UMAs from the client’s and manager’s perspectives; |
| d. distinguish among the following types of pooled investment vehicles: open-end mutual funds, closed end mutual funds, exchange-traded funds and notes, and private vehicles such as hedge funds; |
| e. explain the following mutual fund investment styles: equity, fixed income, market capitalization, geography, and sector classifications; |
| f. identify criteria for selecting independent information data providers; |
| g. describe the steps of the manager screening and selection process; |
| h. formulate and critique manager screening and selection process; |
| i. evaluate a manager’s adherence to a stated philosophy and process. |

You can have many different selection systems, but the bottom line has to be a system that, once the judge takes office that judge will feel that he or she is to decide the case without reference to the popular thing or the popular will of the moment.

—Stephen Breyer

This chapter defines a process and structure around which a wealth manager can select investment managers from the vast universe of mutual funds and independent asset managers to manage investments within each asset class.

One of the reasons for separating this chapter from the one on performance evaluation is to emphasize the point that the manager search and selection process is much more involved and nuanced than simply finding managers with the best historical performance. The practice of performance chasing has led many a wealth manager down the same path as the frenzied individual investor whose investment behavior tends to be one of the strongest contra-indicators in investment management. According to the Investment Company Institute, fund flows into equity mutual funds and technology funds reached their peak in early 2000, just before the collapse of the tech bubble, while they reach their bottom in the first quarter of 2003, just as the equities market embarked on a four-year bull market.

The wealth manager has two broad options for implementing the investments in each asset class—individual management and pooled (or commingled) management. The second option, pooled management, is the universe of mutual funds, hedge funds, and similar vehicles. Individual management may be further divided into three forms: individually, separately, and unified managed accounts.

INDIVIDUAL ASSET MANAGERS

Before turning attention to the external money managers, let’s consider the special case of the wealth manager implementing investment strategy by personally making security-specific buy and sell decisions. In this form of individual asset management, the wealth manager changes hats and becomes a money manager. Wealth managers considering this alternative should apply the same standards of evaluation to their role as money manager as they would apply to an independent money manager. This would include an unbiased evaluation of their investment management experience and credentials (e.g., CFA charter); their performance record (Global Investment Performance Standards [GIPS]); and their benchmark performance, trading costs, technology, research facilities, time devoted to money management, and so on. Setting aside the inherent conflict of interest in judging oneself, a competent wealth manager is unlikely to pass the screen as a money manager, if for no other reason than both wealth management and money management are full-time professions. It is difficult (if not impossible) for a single individual to maintain competence in both. The wealth manager’s firm will need to have adequate and well-educated staff in order to perform both functions. It is not uncommon for a wealth management firm to have a team of wealth managers and a team of money managers to manage individual asset classes. Even in such cases, the firm may not have expertise in all asset classes and will likely select external managers for some asset classes.

Individually Managed Accounts (IMAs)

This form of management is uniquely customized and professionally managed for the client. From the client’s perspective, primary attributes of this form of management are:

- The account(s) is/are in the client’s name.
- The securities are in the client’s name.
- The process is based on a relationship between the client and the manager.
- The portfolio is specifically tailored and managed for the unique requirements of the client.
- The portfolio goals can be changed significantly without changing managers.

From the manager’s perspective, individually managed accounts:

- Require substantial minimum investments, typically ranging from $10 million to $50 million or more.¹
- Require the attention of the most experienced, successful, and most highly compensated of the management team.

¹ In their October 1995 study, “The Coming Evolution of the Investment Management Industry,” Goldman Sachs developed a profile for a small investment management company. For even this small firm, over 15 years ago, the average account size was over $12 million.
- Limit the number of clients the firm can accept.
- Require individual attention to each security in each portfolio.
- Require a direct relationship between the client and the manager.

Separately Managed Accounts (SMAs)

This is a packaged form of private money management. Its name, separately managed, is derived from its similarity with an individually managed account. The characteristics from the client’s perspective are:

- The account is in the client’s name.
- The securities are in the client’s name (i.e., separate from others).

Unlike IMAs, customization of a separate account might be based on computer screening and arbitrary reallocation. A separate account is often based on a model portfolio. Each separate account will own a pro rata share of the model portfolio’s securities. As a result, separate accounts often have odd lot positions. For example, consider Ms. Boone with $100,000 placed with Manager Hot in Exhibit 1.

<table>
<thead>
<tr>
<th>Stock</th>
<th>Share Price</th>
<th>Allocation</th>
<th>Allocation</th>
<th>Value</th>
<th>Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$20</td>
<td>25%</td>
<td>25%</td>
<td>$25,000</td>
<td>1,250</td>
</tr>
<tr>
<td>B</td>
<td>30</td>
<td>25</td>
<td>25</td>
<td>25,000</td>
<td>833</td>
</tr>
<tr>
<td>C</td>
<td>40</td>
<td>25</td>
<td>25</td>
<td>25,000</td>
<td>625</td>
</tr>
<tr>
<td>D</td>
<td>50</td>
<td>25</td>
<td>25</td>
<td>25,000</td>
<td>500</td>
</tr>
</tbody>
</table>

Ms. Boone discovers that stock A is in a company that she believes is harming the environment. Unlike a mutual fund, the account allows her to request that stock A be eliminated from the portfolio. In an IMA, the manager might search for a replacement for stock A. In an SMA, the customization simply requires a programmer to instruct the computer to reallocate the client’s funds against the model while setting the allocation to stock A equal to zero (see Exhibit 2).

<table>
<thead>
<tr>
<th>Stock</th>
<th>Share Price</th>
<th>Allocation</th>
<th>Allocation</th>
<th>Value</th>
<th>Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$20</td>
<td>25%</td>
<td>0%</td>
<td>$0</td>
<td>0</td>
</tr>
<tr>
<td>B</td>
<td>30</td>
<td>25</td>
<td>33</td>
<td>33,333</td>
<td>1,111</td>
</tr>
<tr>
<td>C</td>
<td>40</td>
<td>25</td>
<td>33</td>
<td>33,333</td>
<td>833</td>
</tr>
<tr>
<td>D</td>
<td>50</td>
<td>25</td>
<td>33</td>
<td>33,333</td>
<td>667</td>
</tr>
</tbody>
</table>
From the manager’s perspective, separate accounts:

- Provide for significant leveraging of management talent. Senior management can design model portfolios, and junior managers, following the model and using computer allocations, can manage hundreds of accounts.
- Allow client contact to be managed by sales staff and third party representatives (e.g., brokers or Registered Investment Advisors).

Unified Managed Accounts (UMAs)

Unified managed accounts (UMAs) are a kind of hybrid between individually managed accounts and separately managed accounts. If a wealth manager determines that the best managers for various asset classes and investment styles are in the form of SMAs rather than mutual funds or other pooled vehicles, the manager can combine their collective buy and sell decisions into a single centrally managed account. It combines all of the assets into one account with a single registration.

The advantage of this approach is that the UMA allows the wealth manager to control and manage interactions among the investment decisions of the various sub-managers. For example, consider a UMA with separate value and growth managers. The value manager may purchase a particular stock because it has a low price-earnings (P/E) ratio. As the wisdom of this investment decision is borne out in the financial markets, the low-P/E stock may become a high-P/E stock. As a result, the value manager may sell the investment to realize the strategy’s success at the same time that the growth manager purchases the same stock.

The simultaneous purchase and sale of the same security by different managers has several negative implications. First, it unnecessarily increases trading costs. Second, it can impose unnecessary tax obligations on the client. In the example, the client unnecessarily or at least prematurely pays a capital gains tax despite continuing to hold the security. In other situations, one manager may sell a security to cut losses or because the security no longer fits the mandated investment style while another manager purchases the same security, creating a wash sale that excludes the client from realizing the tax loss.

These are just a few of the many interactions that a UMA can manage. Like the IMA, however, it requires substantial assets for proper diversification and economic feasibility, so it is not a viable option for many clients. A variation of the UMA can be implemented with mutual funds and other pooled vehicles, in which case the wealth manager functions effectively as the UMA manager.

Putting the Pieces Together

For the wealth manager, the only form of private money management realistically available is the SMA. Even if the minimum for truly customized private management were as low as $500,000 or $1 million, it would be impossible to adequately diversify most portfolios. A wealth manager using minimal asset class allocations would still need five or more managers (e.g., large-cap growth and value, small-cap growth and value, international, short- and intermediate-term bonds, taxable and municipal bonds).2

In considering separate account management, the wealth manager must determine the pros and cons vis-à-vis a pooled management alternative. The issues most frequently considered are listed next.

Customization

Separate accounts offer limited and mechanical customization. However, on the rare occasion that a client has a very specific need (e.g., “I refuse to own any company whose name begins with the letter C”), a separate account may be the only choice. Such unique needs are rare.

---

2 The nation’s largest pension plans use an average of 33 managers per plan.
Of course, the ability to restrict certain positions from a portfolio is only one form of customization. For the wealth manager, the ability to customize by diversification is far more important. With thousands of managers from which to choose in every conceivable asset class and style, the ability to customize with funds dwarfs the limited choices available in separate accounts.

**Tax Advantages**

One argument in favor of separate account management is that the account can be managed tax efficiently. We have noted in a prior chapter that the seminal study by Jeffery and Arnott demonstrates a modest value of separate account tax management of 10 basis points. However, subsequent research by Berkin and Ye (2003) under a different tax regime suggests that benefits of tax loss harvesting are initially quite high and level out to about 50 basis points annually after about three years. In fact, related research suggests that these techniques can be particularly well suited to advanced portfolio management strategies, such as active extended 130/30 strategies.

Another tax-related argument is that long-term investors in funds will suffer when less patient fund investors sell in a panic during a bear market. This argument assumes that well-managed mutual funds have a significant percentage of naïve investors; that the funds selected by wealth managers will not have adequate liquidity to meet redemptions; and that in a bear market, the forced sales, if any, will generate gains, not losses. None of these assumptions have been substantiated.

Mutual fund investors are often cautioned against buying shares of a fund with large unrealized capital gains because the new mutual fund shareholder will be responsible for paying capital gains tax on those gains if and when they are realized even if it is shortly after the investor purchases the shares and did not receive the benefit of the gains. This can happen if the manager decides the shares are overvalued or if a sale is triggered by liquidity needs of other shareholders redeeming shares.

Although paying a capital gains tax on returns one has not enjoyed is undoubtedly a bad thing, what is rarely mentioned is that investors can increase the cost basis on their mutual fund shares by the amount of the distributed capital gains. In other words, the gain they must realize on the sale of their mutual fund shares is reduced by the amount of the gains that were distributed by the mutual fund on the underlying investments. As a result, the tax disadvantage is really a timing mismatch (paying taxes sooner rather than later) rather than paying taxes on investment returns that are never realized.

The wealth manager needs to weigh the possible tax advantages of an SMA against the efficiencies of mutual funds and exchange-traded funds (ETFs). We note that it depends, at least in part, on the investment strategies. For example, passive investment strategies are often better suited for mutual funds because the potential SMA tax advantages are significantly reduced.

**Access to Exceptional Managers**

Managers of SMAs are rarely the most experienced or talented of a firm’s management team. Extraordinary talent is drawn to larger portfolios that provide more challenge and more compensation. Mutual fund portfolios are commonly multibillion-dollar portfolios. In addition, their performance commands significant, immediate, and continual public scrutiny. Basic economic logic suggests that large and visible portfolios are where firms are going to devote their top resources. In addition, it is the rare separate account manager that a wealth manager cannot access either through a public or an institutional mutual fund.

**Costs**

Occasionally the argument is made that separate account management is more cost effective. Traditionally, pooled accounts have had the advantage of institutional commissions, but separate accounts have tended to have less market impact. Because commission rates have dropped so dramatically since the 1990s, the difference in commissions is not as great.

---


So where is the cost-benefit of the separate account? Usually, the argument for cost efficiency relates to a strategy of implementing separate account management known as the wrap account, which derives its name from the packaging of the fees, commissions, and other expenses. In effect, they are wrapped into a single one-charge-covers-all account. Wrap accounts offer the advantage of eliminating any concerns regarding excess trading and other potentially excessive fees. Typically, a wrap account also includes the advice of an independent advisor who assists the client in selecting and maintaining the specific money manager.

The cost advantage projected when marketing wrap accounts is usually based on adding average independent advisor fees to average mutual fund fees. Unfortunately, the fee comparisons are grossly misleading. As an example, the average mutual fund fee is typically based only on equity funds and includes funds with 12b-1 fees (as shown in Exhibit 3). The average of the expense ratio for funds used by a wealth manager is likely to be half (or less) of the fees shown in wrap account marketing material.

However, the independent fee advisor, marketing against wrap accounts, tends to present equally misleading information. The standard wrap account fee is sometimes represented as 3 percent, although the average actually is much lower. The independent advisor also sometimes ignores the expense ratio of the funds used to implement the policy and almost always ignores the fund manager’s commission costs. A fair comparison is likely to find that the total costs for separate account, wrap account, and wealth manager “mutual fund management” are fairly close.

Exhibit 3 breaks costs down into explicit and implicit costs. Direct costs are wrap fees, management fees, and commissions—all of which vary by the type of financial intermediation. Implicit costs are composed of the bid-ask spread, market impact, and the opportunity cost of cash for liquidity purposes. Cost of cash refers to forgone returns and missed investment opportunities because a mutual fund or portfolio must hold a certain amount of cash to meet liquidity needs. One of the things to consider is that the implicit costs of equity portfolio management can easily be half of the total cost.

### Exhibit 3
Costs of Financial Intermediation for Equity Portfolio Management

<table>
<thead>
<tr>
<th></th>
<th>Hypothetical Index</th>
<th>Index Mutual Fund or ETF</th>
<th>Actively Managed Mutual Fund</th>
<th>Full-Service Retail Brokerage (Commission)</th>
<th>Full-Service Retail Brokerage (Wrap Fee)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Explicit Costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wrap fee</td>
<td>0.0%</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>1.00% to 2.00%*</td>
</tr>
<tr>
<td>Expense ratio^</td>
<td>0.0%</td>
<td>0.20% to 0.50%*</td>
<td>1.42%^</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Commissions^</td>
<td>0.0%</td>
<td>0.07%</td>
<td>0.39%</td>
<td>2.5%^</td>
<td>—</td>
</tr>
<tr>
<td>Implicit Costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bid-ask spread^</td>
<td>0.0%</td>
<td>0.17%</td>
<td>0.60%</td>
<td>0.60%</td>
<td>0.60%</td>
</tr>
<tr>
<td>Market impact^</td>
<td>0.0%</td>
<td>0.25%</td>
<td>1.00%</td>
<td>0.25%</td>
<td>0.25%</td>
</tr>
<tr>
<td>Cost of cash^</td>
<td>0.0%</td>
<td>—</td>
<td>0.74%</td>
<td>0.74%</td>
<td>0.74%</td>
</tr>
</tbody>
</table>
Exhibit 3  
(Continued)

<table>
<thead>
<tr>
<th>Hypothetical Index</th>
<th>Index Mutual Fund or ETF</th>
<th>Actively Managed Mutual Fund</th>
<th>Full-Service Retail Brokerage (Commission)</th>
<th>Full-Service Retail Brokerage (Wrap Fee)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>0.00%</td>
<td>0.44% to 0.74%</td>
<td>4.15%</td>
<td>4.09%</td>
</tr>
</tbody>
</table>

*a* Based on industry experience and informal survey.  
*b* Includes 12b-1 fees for mutual funds, but excludes sales charges such as front-end and back-end loads. Bergstresser, Chalmers, and Tufano (2006) report that, on average, total sales charges annuitized over a five-year holding period is 1.07%.  
*d* The average expense ratio for actively managed funds in the meta-analysis in Exhibit 4 is 1.41%. These expense ratios exclude loads, however, and therefore underestimate the true annual expense ratio. The average expense ratio for large-capitalization growth funds is 1.47%, according to Yahoo! Finance. As of this writing, the average expense ratio for all domestic equity funds according to Morningstar is 1.37%. The average expense ratio for all taxable bond funds according to Morningstar is 1.03%.  
*e* Commission estimates for mutual funds come from Karceski, Livingston, and O’Neal (2004), whose figures are conservative in relation to estimates from Swedroe (2000).  
*f* No known studies exist, but the anecdotal experience of the authors suggests annual commissions for commission-based full-service brokerages are about 2.5%.  
*g* Estimates are based on Karceski, Livingston, and O’Neal (2004).  
*h* Conservatively estimated using figures from Barra Inc. as reported in Swedroe (2000). The Barra study indicates that the typical small-cap or mid-cap stock fund could incur market impact costs of 3% to 5%. Using the most conservative estimates, market impact costs are at least 1%. Market impact costs for index funds are likely much lower than for actively managed funds because of their low turnover. Barra has since combined with Morgan Stanley Capital International to form MSCI Barra. Full-service brokerages would normally include some amount of market impact, but its magnitude in relation to mutual funds is uncertain. This figure is therefore conservatively extrapolated from index mutual fund data.  
*i* Actively managed funds are assumed to hold a 9.3% cash balance as reported by Mohatra and McLeod (1997) and Lipper Analytical Services. The cost of cash assumes an 8% return differential between stock and cash. Swedroe (2000) estimates the differential at 12%. The cost of cash can be estimated as the product of 8% and 9.3%. Index funds typically carry de minimis cash balances.

Exhibit 3  
Summary of Mutual Fund Studies

<table>
<thead>
<tr>
<th>Expense Ratio</th>
<th>Turnover</th>
<th>Commission</th>
<th>Implicit</th>
<th>Market Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bergstresser, Chalmers, and Tufano (2007)</td>
<td>1.60%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yan (2006)</td>
<td>1.45%</td>
<td>88.9%</td>
<td>0.393% active</td>
<td>0.601% active</td>
</tr>
<tr>
<td>Karceski, Livingston, and O’Neal (2004)</td>
<td>1.12% active</td>
<td>0.25% passive</td>
<td>0.071% passive</td>
<td>0.172% passive</td>
</tr>
<tr>
<td>Swedroe (2000)</td>
<td>1.53% active</td>
<td>0.20–0.50% passive</td>
<td>15% passive</td>
<td>0.30% passive</td>
</tr>
<tr>
<td>Fortin and Michelson (1999)</td>
<td>1.45%</td>
<td>80%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jayaraman, Khorana, and Nelling (2002)</td>
<td>1.45%</td>
<td>65%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dowen and Mann (2004)</td>
<td>1.06%</td>
<td>107.4%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Della and Olson (1998)</td>
<td>1.46%</td>
<td>73%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bers and Madura (2000)</td>
<td>1.49%</td>
<td>73%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mohatra and McLeod (1997)</td>
<td>1.57%</td>
<td>112%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bogle (2005)</td>
<td>1.56%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(continued)
Exhibit 4 (Continued)

<table>
<thead>
<tr>
<th></th>
<th>Expense Ratio</th>
<th>Turnover</th>
<th>Commission</th>
<th>Implicit</th>
<th>Market Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chalmers, Edelen, and Kadlec (2001)</td>
<td>1.09%</td>
<td>79%</td>
<td>0.28%</td>
<td>0.46%</td>
<td></td>
</tr>
<tr>
<td>Ennis (2005)</td>
<td>1.56% Yahoo!</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finance</td>
<td>1.47%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Morningstar</td>
<td>1.37%</td>
<td>95%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Excluding loads.

*bergstresser, Chalmers, and Tufano (2007) report that, on average, total annuitized fees over a five-year holding period including sales charges is 2.16%.

*yan (2006) also reports average front-end loads of 1.34%, average back-end loads of 0.51%, and average cash holdings of 5.33%.

*Quoting Lipper Analytical Services. They also report a cash ratio of 9.3%.

Exhibit 4 takes a closer look at the source data by summarizing the results of the studies used to construct Exhibit 3. Unlike commissions, mutual fund management fees have been remarkably stable over the years.

**Reporting**

Separate account proponents argue that ownership of individual securities results in greater accountability by the manager. To some extent, that is true. Fund managers frequently drift in their management style and, as they only have to report positions semiannually, there are potential gaps in accountability. The danger, however, is small and mutual fund accountability is increasing.

Wealth managers’ primary insurance against this risk is their original due diligence—hire managers who are prepared to be accountable. In addition, new technology, including factor analysis, provides additional tools to warn of drift. Finally, as the presence, prestige, and economic clout of wealth managers grow, fund companies will find it to their advantage to become more accountable. Many already voluntarily provide positions on a quarterly basis, and a few are beginning to provide information monthly, on a 30-day delayed basis.

With little lost regarding accountability, a great deal is gained regarding independent performance and portfolio data. With resources such as Morningstar, Value Line, and others, there is an almost endless stream of independent, substantive data available to the wealth manager to use in monitoring selected fund managers. By comparison, the independent reporting on separate accounts is virtually nonexistent.

**POOLED INVESTMENT VEHICLES**

Today there are more mutual funds than there are stocks on the New York Stock Exchange. According to the Investment Company Institute, there is over $11 trillion invested in 7,554 mutual funds, almost twice the amount invested at the turn of the millennium (which was more than twice the amount invested five years before that). There is another $800 billion invested in 900 different exchange-traded funds (ETFs). As a result, a fund exists to meet almost every investment objective. However, with thousands of funds it is difficult to select the appropriate funds to meet individual needs. An initial step in the selection process is to classify funds by objective, style, strategy, and asset class.
Types of Pooled Investment Vehicles

Many wealth managers use these pooled investment vehicles rather than direct investments to manage client portfolios. These vehicles include open-end mutual funds, closed-end funds, exchange-traded funds and notes, and private vehicles such as hedge funds.

Open-End Funds

Once upon a time there were only two primary types of widely available pooled investment vehicles in the form of mutual funds—open-end funds and closed-end funds. Open-end mutual funds are pooled investment vehicles in which investors make purchases and sales directly from the mutual fund company. When an investor purchases shares, the mutual fund company creates more shares and expands the size of the fund (thus the name “open”). Likewise, the fund company must draw on its cash reserves or liquidate securities to meet redemptions. Share purchases and redemptions are transacted at the fund’s net asset value (NAV), or the per-share value based on the market value of the underlying securities.

Closed-End Funds

By contrast, closed-end funds represent shares of a pooled investment fund that trades on an exchange. Investors purchase shares from existing shareholders rather than the fund company. Similarly, investors selling shares must find a willing buyer in the open market rather than from the fund company. In this way shares of closed-end mutual funds trade at prevailing market price based on supply and demand rather than at NAV. In general, closed-end mutual funds trade a discount to NAV, although that is not always the case, and there is a robust body of research investigating why that is so. Interestingly, there is some evidence to suggest that the premium or discount is positively related to realized future performance.

Exchange-Traded Funds

A more recent financial innovation that has done much to change the mutual fund landscape is the exchange-traded fund (ETF). Like a closed-end mutual fund, ETFs trade on an exchange, as their name implies. Like an open-end mutual fund, the sponsoring fund company can create or redeem shares based on market demand. Unlike either a closed-end mutual fund or an open-end mutual fund, the share creation and redemption process can be done in kind. For example, a fund company for an S&P 500 index ETF can infuse the ETF with shares of the constituent stocks underlying the S&P 500 index to create more shares rather than using cash. Similarly, to redeem shares the fund company can receive the underlying S&P 500 stocks without triggering a taxable event. This in-kind creation and redemption process adds another layer of tax efficiency on an already tax-efficient passive investment strategy.6

The market for ETFs has grown rapidly since their introduction in 1997 in terms of assets under management, the number of funds, and the variety of underlying assets. ETFs can be found for nearly all equity and fixed income management styles, as well as many alternative assets, including commodities, real estate, and even hedge funds.

Most ETFs track a particular broad market or style-based index, or are at least managed passively. In recent years, however, a growing number of newly introduced ETFs are actively managed, so it is no longer accurate to equate ETFs with passive asset management.

Exchange-Traded Notes

Exchange-traded notes (ETNs) are similar to ETFs in that they trade on an exchange. Unlike an ETF in which the investor owns a pro rata share of the underlying securities, an ETN is simply a senior unsecured debt security issued by an underwriting bank. The security may promise to

---

6 The tax efficiency of in-kind distribution is related to the ability of the ETF fund manager to redeem with low-basis positions.
pay an amount equal to the return on a particular index. Alternatively, it may promise payment that limits the upside potential in exchange for providing some downside protection, similar to a payoff of a structured product.

As senior unsecured debt, ETNs have counterparty risk not present in ETFs. As we saw in the recent financial crisis, counterparty risk is a very real and significant issue. So what are the possible advantages?

Because ETNs do not have any underlying securities, there are no interest payments, dividend payments, or capital gains on underlying securities. Rather, ETNs are often treated like forward contracts for tax purposes. Unlike mutual funds, the entire gain is determined by when and if the investor sells the security and not by either the investment behavior of other fund shareholders or the tax characteristics of the underlying investments. This tax treatment, however, has not escaped the attention of tax authorities and may be revisited.

ETNs also have the advantage of having no tracking error with the indexes they are intended to mimic because each has a contractual obligation based on that index. Aside from their additional credit risk, ETNs also enjoy less liquidity than do many ETFs. Wealth managers need to weigh carefully the advantages and disadvantages and compare them to the situation at hand to determine which vehicle is best suited for portfolio construction.

Hedge Funds

Much can and has been said about hedge funds. Unlike their name implies, they may or may not implement an investment strategy related to hedging. Their primary distinguishing feature is the fact that they are not subject to the same regulatory and reporting requirements as traditional mutual funds under the theory that they are reserved for sophisticated high-net-worth investors. As a result, they are not an asset class as some would have us believe. This more lax regulatory oversight allows hedge fund managers to implement investment strategies that mutual funds cannot. For example, hedge funds often use leverage and short sales in their investment strategies.

An exhaustive discussion of hedge funds is beyond the scope of this chapter. We would like to focus, however, on two fundamental characteristics of many (if not most) hedge funds that in our opinion significantly limit their value. First, a typical fee structure is the 2/20 arrangement in which a hedge fund manager receives as compensation 2 percent of assets under management on an annual basis plus 20 percent of any investment gains. By itself, 2 percent is a very hefty management fee that is extremely difficult for most investment managers to consistently overcome. Adding the 20 percent incentive fee raises their hurdle even further. As a result, hedge fund managers must add substantial value to overcome the fees they charge.

Consider the unusual hedge fund manager that can consistently produce 14 percent returns annually. (Keep in mind that Bernie Madoff lured the investors that he swindled by fallaciously reporting a consistent annual return of 12 percent annually.) The 2 percent management fee reduces this investment return to 12 percent. The 20 percent incentive fee reduces it by another 2.8 percent (that is, 0.20 × 14%), leaving only a 9.2 percent for the investor. That doesn’t sound too bad, but consider that the average geometric return for the stock market from 1926 to 2009 was 9.8 percent. But wait! There’s more.

That 9.8 percent return could have been earned using a tax-efficient passive investment strategy. Many, if not most, hedge fund strategies are highly tax-inefficient because they either are based on high-turnover investment strategies or use relatively heavily taxed investment vehicles, such as options. This tax inefficiency can easily consume another 20 percent of the fund’s pretax investment returns, reducing the investor’s after-tax return to 7.36 percent.

Hedge fund fees have come under pressure in the aftermath of the most recent financial crisis, but they remain high. We are not categorically opposed to hedge funds and believe that they can be a useful investment vehicle in certain situations, but these concerns as well as others (such as the strong survival bias associated with hedge fund returns, limited retail access to institutional quality funds, and sometimes limited liquidity and strict lockup periods) lead us to believe that hedge funds are useful in the special case rather than the usual case.

7 For additional detail see Mark Hurley, “Alternative Investments,” in The Investment Think Tank (New York: Bloomberg Press)
INFORMATION SOURCES

Information on mutual funds is widely available both directly from the funds and from independent sources.

The Fund

All too frequently, when evaluating managers, the wealth manager turns to independent data providers only. Although the independent provider is an indispensable source, the wealth manager must also carefully analyze the information available from the fund itself.

Fund Prospectus and Other Related Offering Documents

These documents should be scrutinized carefully so that the wealth manager fully understands the risks, opportunities, and fees of the offering.

Summary of Expenses

The summary includes the various types of expenses that the fund will incur, such as management fees, audit, legal, shareholders’ services, transfer agent, and custodian expenditures. It will also provide information regarding items such as sales charges and deferred sales charges.

One common technique used by fund companies is to absorb a portion of the expenses for a limited period of time. If so, the agreement will be described in this portion of the prospectus. The agreement to absorb expenses is at the option of the fund and may be terminated without shareholder action. The wealth manager needs to carefully monitor such funds. If he or she does not monitor, a wealth manager may naively maintain a fund that subsequently eliminates its subsidy, effectively raising the expenses to the investor beyond an acceptable level.

Financial Highlights

This section includes information regarding income and capital charges. In addition, the ratio/supplemental data table includes historical data on the fund’s net assets, expense ratio, and portfolio turnover.

Objective, Policy, and Risk Considerations

These sections detail how the fund will be invested and specify limitations regarding the types of securities it can invest in. They also detail such things as the ratings on bonds, the various countries the fund is allowed to invest in, as well as limitations regarding the investments in any one security or type of securities. Another section may stipulate its limitation on investing in restricted securities. Requested changes in a prospectus should be a caution flag for an advisor. For example, the request of a domestic equity manager to increase foreign holdings or a fixed income manager’s request to increase its holdings in illiquid private placement securities should be a trigger for further investigation.

These sections also discuss to what extent a fund may borrow or lend its portfolio securities; whether it can write options on securities, indexes, or currencies; to what degree the fund will use futures; and its hedging ability if it invests in foreign securities. Other areas that may be covered are the ability of the fund to invest in closed-end funds or utilize repurchase agreements. Unfortunately, the trend has been for funds to request, from their shareholders, the authority to do practically anything they wish; hence there is less value in relying on prospectus restrictions and a greater necessity for active monitoring.

Purchasing and Sale of Shares of the Fund

This section covers the sales charge break points and minimums. Also, there may be provisions in this section by which an advisor can acquire a load fund as a net asset value purchase.

Management of the Fund

This section discusses the management of the fund. Unfortunately there is likely to be limited information here. Rarely will the name of the individual(s) be disclosed. At most this section will alert the advisor to the existence of a sub-manager. The advisor must use other sources to adequately evaluate the management.

Investment Limitations

Included in this section are the restrictions imposed on the fund manager, and the types of securities, and investment techniques the manager is allowed to use.

---

8 See also Robinson, Schulte, Marmorstein, Trent, and Gervais (2010).
Trustees and/or Board Members and 5 Percent Shareholders   If a single shareholder owns too much of the fund and decides to liquidate his or her ownership, it may adversely affect the market value of the fund. This is a particular risk in funds that invest in limited-market securities such as small stocks, real estate investment trusts (REITs), municipal bonds, or any other low-trading-volume security.

Detailed Financials   In addition to a detailed listing of investment positions, the payables section under “Liabilities” provides information regarding the dollars being redeemed versus the amount being invested. This allows the advisor to review the degree of inflows and outflows of funds under management on a net basis that occur over a period of time. If too much cash in relation to the fund's asset base is flowing into or out of the fund, it may have too much cash, which may cause the fund manager to deviate from the specified management style. Too much cash outflow may force the manager to sell illiquid securities.

The next items to review are the fund's investment income and expenses. In the case of some high-expense funds, the investment income may actually be negative.

Footnotes   The next and last section to review is the statement footnotes. The footnotes many times provide substantial detail on what occurred in the fund, as well as the history behind its operations.

Annual and Semiannual Reports

Included in the semiannual or annual report, of course, are the financial statements. These statements provide the same type of financial data discussed earlier. Semiannually, the funds are required to provide their current holdings. As many of the independent data providers have agreements with many funds to receive more current updates, the independent data provider is a better source for position information.

A significant section is the letter written by the fund management. The letter may provide valuable insight as to the ongoing business and investment philosophy that the fund will utilize over time. A management that writes a letter providing little insight may in fact be providing important information regarding management's concern for the fund's investors.

Independent Publishers, Analysts, and Databases

There are a number of independent firms that provide data services to the practitioner regarding fund managers. As the major players are so well known and heavily marketed, here we simply share with the reader Harold's biases and recommendations.

Primary Independent Sources

We use the expression “primary independent” to describe those firms that are in the business of obtaining and distributing information regarding funds. These firms often provide their own proprietary rating systems; however, the rating systems are relatively simplistic and irrelevant for the wealth manager.

It is the responsibility of the wealth manager to evaluate a fund’s style, performance, and risk in a far more detailed, sophisticated, and professional manner. A useful list of criteria for selecting data providers includes the following:

- Extent of coverage. How many funds are covered by the service?
- Frequency of updates. How frequently is the data updated, and how current is the data in the updates?
- Search capabilities. What fields are available for screening? Can specific search criteria be saved for future reference? Can the results be ranked?
- Customization. Does the database allow customized comparisons (e.g., one fund vs. another) or tracking of customized portfolios? Does it allow you to display only those data fields of interest?
- Hypotheticals. Does the program allow you to design hypothetical portfolios? Does it provide for comparisons between benchmarks and funds? Will it handle variable cash flows? Taxes?
- Graphics. Can the data be graphically displayed? In color? Printed? Printed in color?
- Technical support. What kind of technical support is available?
SCREENS AND THE SELECTION PROCESS

Fund descriptions such as “aggressive growth” and “growth and income” may have little meaning when selecting managers to implement an optimized portfolio. Once the wealth manager has determined which asset class and strategies will be used in the practice, he can begin the manager selection process. The following discusses the “typical” process used in determining those managers to include in his approved list.

Manager Sieve Overview

The process or sieve is designed to screen out inappropriate and unsuitable managers. Because there are thousands of managers to select from, the Manager Sieve requires multiple screens. We offer brief descriptions of these four screens followed by recommendations for specific criteria to be used in each screen.9

Screen #1—Asset Classes

This first pass eliminates thousands of inappropriate managers. The process requires that the wealth manager screen the available list of managers against the selected asset classes. For example, if he restricts the choice of managers to those participating in the Charles Schwab One Source Select list, he would overlay the One Source list with the selected asset classes. The funds passing that screen would include only One Source funds that matched the asset classes used in the firm’s allocations. If, for example, he did not use load funds, their past performances, risk profiles, and expense structures would be irrelevant and they would not pass a no-load screen.

Screen #2—Fatal Flaws

Like screen #1, this is a global screen (i.e., it is applied across the board to all of the managers remaining in the selection pool after having passed screen #1). The criteria in screen #2 are what can be referred to as fatal flaws. While screen #1 eliminated inappropriate but possibly good funds, screen #2 is intended to eliminate generically bad funds. Naturally, the criteria for generically bad are the responsibility of the wealth manager. An example of such a criterion is a maximum expense ratio or the existence of sales charges.

Screen #3—Philosophy, Process, and People

This screen is applied to each group of funds, asset class by asset class. It is based on a manager selection model suggested by Robert Ludwig of SEI that we call “Ludwig’s Three Ps.”10 The premise of the model is that manager performance is an output. Initial manager evaluation should not focus on performance but on the three critical input factors that result in the performance output:

1 Philosophy
2 Process
3 People

Screen #3 filters out managers based on these three Ps.

Screen #4—Performance

Now, after the universe of available managers has been whittled down to the relatively few remaining after passing through screens #1 through #3, we apply the test of performance. It is applied asset class by asset class.

---

9 The following screens are general guidelines. If exceptional managers come to our attention and they do not pass screens #1 and #2, we will still pass them on to be tested by screen #3.

Manager Sieve—The Specifics

Now let’s take a look at the specifics of each screen within the manager sieve.

**Screen #1—Asset Classes**

As noted earlier, the screening process begins with the universe of available funds. In our case we generally begin with the no-load funds available through Charles Schwab, Fidelity, or Ameritrade. This includes ETFs, retail and institutional no-load funds, as well as those load funds offered to the clients of advisors at net asset value.

**Selecting Funds by Asset Class**  This is the first filter. Using our asset class taxonomy, we eliminate thousands of managers from consideration. For example, our criteria for core allocations eliminate all long-term and low-quality fixed income funds, global fixed income funds, specialty funds, convertible funds, and aggressive growth funds.

**Selecting Funds by Capitalization Class**  This criterion narrows down the pool of appropriate managers by eliminating those funds that do not meet our required capitalization criterion. A significant decision required of the wealth manager is to determine whether the criterion chosen to select a manager’s capitalization class will be average capitalization or median capitalization. For example, Morningstar uses the median and Value Line uses the average. At this stage, we eliminate from consideration any manager who purported to be a small-cap manager but had a portfolio median capitalization in excess of $2 billion.

**Selecting Funds by Style**  At this stage of the process, we use a style screen based on the portfolio style analysis used by Morningstar. Even though this standard will pass a number of managers who have a weak style orientation and managers who do not remain consistent to their style, we are not concerned, as screen #3 will later eliminate any managers considered wishy-washy. In the early stage of the analysis, the preference is to err on the side of passing an unacceptable manager through the screen rather than inadvertently rejecting a good manager.

**Screen #2—Fatal Flaws**

These are the criteria that a wealth manager considers mandatory. For example, we apply the following criteria.

**Concentration**  We do not believe in the use of sector funds in our core allocations. We are also concerned with excessive sector concentration. In order to avoid such managers, we screen out funds with sector weightings in excess of three times that of the S&P 500. For international equity funds we screen for weightings in excess of 35 percent for any country ex-Japan. The fund is eliminated in screen #2 if the allocation to Japan exceeds 150 percent of Japan’s weighting in the EAFE index.

**Quality**  In keeping with our focus on high-quality fixed income investments, screen #2 eliminates those funds with less than an average bond quality rating of A.

**Foreign Equities**  As we believe that the asset class allocation is a critical factor in the long-term performance of the portfolio, we are hypersensitive regarding managers who drift from their style. At the stage of screen #2 we eliminate domestic equity managers who have allocations in excess of 20 percent in foreign equities.

**Expenses**  If future returns revert to (or go even lower than) the mean of long-term historical returns, as we believe likely, then a fund’s expenses will be one of the primary determinants of its performance for the next decade. Funds that are able to control costs and manage expenses will, all else being equal, outperform their peers that are burdened by higher expenses. A 1.5 percent expense ratio on an equity fund that earns 10 percent means that 15 percent of the return is lost.

---

11 The median for the companies in the NYSE Composite is about $1.5 billion; the average is closer to $8 billion.
Based on our belief that even the best of managers cannot overcome the hurdle of excessive expenses, we generally eliminate all fixed income funds with expense ratios in excess of 0.8 percent, domestic equity funds with expense ratios in excess of 1.2 percent, international equity (developed countries) funds with expense ratios in excess of 1.5 percent, and emerging market funds in excess of 2 percent.12

**Performance Record**  In spite of all of the research and the traditional warning that “past performance is no guarantee of future performance,” most investors begin the manager selection process by starting with the manager’s past performance. Evensky’s Manager Sieve, with one exception, does not seriously consider performance until after screen #3. The exception is the elimination of poor performers at this stage. The traditional warning actually misstates the results of many studies.

A more accurate statement describing the results of the research would be that past superior performance does not guarantee future superior performance; however, past poor performance may predict future poor performance.13 As a result, we screen out those funds that have performed in the bottom half of their asset class for the prior five years or the bottom one-third for the prior three years.

**Soft Sieves**  The following criteria do not automatically eliminate funds in screen #2. They are applied to each of the funds passing the screen. The decision to eliminate a fund based on these soft criteria is made by the investment committee case by case.

**Fund Capitalization.**  There are different schools of thought about the ideal size of a mutual fund. On the one hand, one says that bigger is better—the more assets, the more a fund can benefit from economies of scale in administration and other expenses, brokerage costs, and so on. Also, a small fund may lack the buying power necessary to command a large enough share of the choicest stock issues, especially initial public offerings (IPOs). (This has occurred among real estate mutual funds, where the smaller funds may not be able to obtain positions in new REITs.) On the other hand, some studies have indicated that the promised economies of scale often never materialize. As funds increase assets, the manager may find it difficult to find stocks meeting his investment criteria. This may cause the manager to purchase equities outside his guidelines, or to hold large sums of cash. Both problems can negatively impact performance. In addition to the absolute size of the fund capitalization, it is important to study the history of a fund’s growth in assets. Has the fund lost assets over the past few years? If so, why?

Has the fund grown too rapidly over the past few years? Many funds solve the problem of rapid growth and large influxes of cash by closing to new investors. Part of the art of fund selection is to evaluate the credibility (or lack thereof)14 of fund closings. We rarely eliminate funds from consideration solely due to the size of assets; however, we frequently eliminate funds at this stage due to rapid growth.

**Manager Tenure.**  When analyzing a fund’s historical performance, it is obviously important to determine whether the person(s) (or at least the philosophy and process) responsible for the past performance is still there. At screen #2, we typically eliminate funds with new managers if their management style seems to be significantly different from the prior managers. In effect, hiring such a manager would be to accept the famous pig in a poke. As funds rarely report this information, we rely on our manager interviews and the observations of Morningstar and Value Line analysts to alert us to these changes.

**Turnover.**  A fund’s total expenses are not completely revealed by an examination of its expense ratio. Brokerage commissions and trading costs, including bid-ask spreads, are on top of the disclosed expense ratio (see Exhibit 3). A fund’s turnover rate is often the best indicator of trading costs. Hence, we will occasionally eliminate a fund due to what we consider excessive turnover.

---

12 We consider these generous standards; however, at this stage we would still rather err on the side of passing through a manager we might later reject than reject a manager we should have considered.
13 The consistency of poor performance seems to primarily be related to excessive fund expenses, not incompetent management skills, and research bears this out.
14 For example, was the closing enacted well in advance of the effective date as a marketing strategy to generate new investments?
**Screen #3—Philosophy, Process, and People**

We consider screen #3 the heart of our selection process. By the time we have completed screens #1 and #2, there are relatively few funds in each asset class remaining. With a reasonable number of candidates to consider, we can devote significant resources to evaluating each manager.

**Philosophy**  We ask managers why we should give them some of our clients’ funds to manage. We expect a clearly defined, credible, and consistent statement of their strategic view of their investment markets. We agree with Charles Ellis that this is a competition of professionals. We want to know how managers will provide our clients excess risk-adjusted returns on the funds under their care, given that the market for alpha is a zero-sum game.

In order to evaluate a fund’s philosophy (and process and people), we employ the following steps:

- We review the fund’s prospectus, most recent semiannual and annual reports, and marketing materials.
- With that as background, we then review the comments of the Value Line and Morningstar analysts.
- We then query our Alpha Group friends for any information or thoughts they may have regarding the manager.
- Finally, with all of this information at our disposal, we interview the manager. On occasion the meeting is in person, but it is usually by phone. The interview allows the manager to elaborate on his or her philosophy. It is also an opportunity for us to obtain a gut feeling as to the manager’s competency and a comfort level with his or her style and personality. Although it may not be scientificaly sound, we have rejected managers based on our interview. We hire commitment, brains, and passion, and we reject pomposity, simplicity, and marketing hype.

**Process**  Process is the manager’s daily implementation of his or her philosophy. As with the philosophy, we are looking for a clearly defined, consistent, and verifiable process. Examples of process would include:

- Who makes the decisions (e.g., research, allocations, purchases, and sales)?
- How are new investment ideas generated?
- What resources are devoted to research?
- What is the manager’s trading discipline?
- What is the manager’s buy and sell discipline?
- What is the firm’s compensation policy?

We are not concerned with the amount anyone is paid. We want to know if the manager is paid based on long-term or short-term performance. We want to know if the compensation structure encourages teamwork or star performance.

**People**  Generally, we are concerned with the background and experience of all of the members of the fund’s management team. Also important are the capabilities of the staff support and the process for managing professional growth. Naturally, we are particularly concerned with the lead decision maker(s). It may be of little value to know that the fund passed the philosophy and process test if the manager is new and plans on implementing a new philosophy and a new process. A new manager may have a fabulous track record, but if the new investment style is different from that of the predecessor, the portfolio repositioning may generate portfolio turnover. This could mean increased trading costs and increased capital gains distributions, as well as style drift. However, just because a fund has a new manager does not automatically eliminate a fund from consideration. If the new manager’s investment philosophy/discipline can be determined from an examination of his or her prior record, either at the fund (if the new manager was a member of the investment team) or the record of a fund previously managed and it is consistent with the past manager, the fund may still be an acceptable choice. As Don Phillips of Morningstar recommends, we are looking for managers who have a passion for their work.

---

15 The Alpha Group is an informal study group of 17 financial professionals founded over a decade ago.
Philosophy, Process, and People—An Example  The following excerpts from a few sections provide an excellent example of a marketing piece that reflects the substance of the Three Ps instead of marketing hype.

Our Investment Philosophy

Over the years we have been guided by the philosophy that the most profitable investment opportunities are found in companies experiencing periods of rapid change. We believe these dynamic companies fall into one of two categories:

1. High Unit Volume Growth: This includes both established and emerging firms, offering new or improved products.
2. Positive Life Cycles: These companies experiencing major change . . . change as varied as new management, products, or technologies.

The Research Staff

Most analysts have gone through our in-house training process. As a further aid to staffing, we established a program to track the careers of thousands of practicing securities analysts.

Streamlined Decision Making

Purchase Decisions—Our “bottom up” approach to stock selection places primary emphasis on individual security selection . . . analysts present investment ideas directly to senior management . . . if senior management agrees with the case made for a stock, a buy program is implemented immediately. For optimum liquidity, we never own more than eight days’ average trading volume of any stock across all accounts (four days for NASDAQ stocks).

Portfolio Management

A performance run is performed twice daily to give us a sense of overall performance. Additional computer tabulations show how each stock is performing in absolute terms and relative to the market for 5, 10, 15, and 20 days, and for the year-to-date.

The top-down component links the firm’s database to each portfolio. Portfolio managers can evaluate overall portfolio characteristics such as weighted growth of earnings per share . . . as well as each portfolio’s reaction to different stimuli from the economy.

Only after a fund has passed through screen #3 do we begin to seriously consider its performance record.

Screen #4—Performance

If the only reason you give someone to buy your fund is because you are No. 1, then you should expect people to sell when you are No. 2.

—William Guilfoyle, President of G.T. Global

As this screen is performance based, it is worthwhile to once again place the importance of performance in perspective having already discussed the technical details of measuring and evaluating performance in the previous chapter. As we have already mentioned numerous studies that suggest how worthless past performance is as a predictor of future performance. what follows are the comments of three successful wealth managers:16

- Ross Levin—“Past performance has been a very poor indicator of future performance.”

Roger Gibson—“Trying to identify funds that will beat the market represents a triumph of hope over experience.”

Lynn Hopewell—“Picking individual mutual funds is the last thing a financial advisor should get paid to do.”

Bob Veres, wrote, “Put another way, all of the time and research spent evaluating track records may be just as ineffective as consulting an astrologer, relying on a Ouija board, or using Tarot cards to select mutual funds.”

With those sobering reminders regarding the importance of performance, let’s continue the description of the Evensky & Katz performance screen.

**Total Return—Relative**  Historical returns should not be viewed in a vacuum but must be viewed relative to appropriate benchmarks. The selection of appropriate benchmarks is another piece of the wealth manager’s art. Until the advent of ETFs, we used the manager’s peer universe as our benchmarks. However, now that ETFs exist in almost every conceivable market flavor, we consider an investable index a far superior benchmark alternative. Once the benchmarks have been selected, it is necessary to compare the fund’s performance over a wide variety of periods.

**By Market Cycles.**  According to Standard & Poor’s (S&P) there have been about 10 completed bear markets and bull markets since 1950. S&P defined bear markets as a drop of 20 percent or more from the market’s previous high. Returns on the subject fund can be compared to returns on appropriate benchmarks for the same periods. In comparing relative returns during bear markets, you can assess how well the fund manages downside risk. S&P reports the following dates for bear market periods:

- August 3, 1956, to October 22, 1957
- December 12, 1961, to June 26, 1962
- February 9, 1966, to October 7, 1966
- November 29, 1968, to May 26, 1970
- January 11, 1973, to October 3, 1974
- November 28, 1980, to August 12, 1982
- July 16, 1990, to October 11, 1990
- March 24, 2000, to October 9, 2002
- October 9, 2007, to March 9, 2009

**By Year, Quarter, and Month.**  An examination of a fund’s total return on a rolling year-by-year and even on a quarter-to-quarter and monthly basis is advisable. Did a fund get lucky in only one year, which has boosted its historical three-year or five-year returns, but has never duplicated that superior performance before or since?

**Exceptional Returns.**  Did the fund achieve returns that were too good? That is, did the fund’s performance far exceed the returns of other funds in its asset class? Such exceptional returns can be a warning that the manager is either investing outside of the asset class and/or implementing aggressive strategies. How about the bad returns? If a fund had a quarter or an entire year where it showed a substantial loss relative to its benchmark, can your clients stand a similar loss in the future? Morningstar provides monthly return tables that can be quickly scanned for exceptional returns.

**Risk Matters.**  It is, of course, unwise to examine performance without also considering risk. Therefore, it is helpful to examine risk-adjusted performance using the performance appraisal measures such as the Sharpe and Treynor ratios.

---

MONITORING THE MANAGER

What gets measured gets managed.

—Anonymous

Once the wealth manager has selected a universe of approved managers, he or she must constantly monitor their performance. The primary focus of the process should be to monitor the approved managers’ adherence to their stated philosophy and process; presumably that’s why they were hired. We are very patient with poor performance and very impatient with changes in philosophy or process.

Performance

In evaluating performance, it is important to examine the returns generated by the manager relative to the risk undertaken as well as relative to other investment alternatives.

Relative to the S&P 500

Unless the manager is a core domestic manager, we consider performance relative to the broad domestic market irrelevant. This seems like an obvious policy. Unfortunately, the media loudly and consistently trumpets “market” returns (i.e., the Dow or S&P 500) as if they represent the only real measure of performance. The framing of this policy is part of our continuing effort to manage our clients’ expectations. By discussing our policy early on with new clients, we reduce their discomfort during those periods when our asset class managers underperform the broad market.

Relative to Other Peer Group Managers

Although we track our managers’ performance compared to other managers with similar asset class/style orientations, we do not use a divergence in performance as a specific criterion for manager evaluation. It is well understood that peer groups make poor benchmarks because they lack several qualities of a valid benchmark.

We use the comparison of a manager’s performance to a peer group as an early warning signal for style drift. For example, extraordinary short-term performance vis-à-vis a peer group raises a red flag. We then investigate the cause of the superior performance. If it is attributable to the successful implementation of the stated philosophy, we smile and call the manager to say, “Great job!” If it is attributable to a successful but out-of-style bet, we frown and call and ask, “What’s up?” Our primary standard for relative performance is comparison to an appropriate benchmark (i.e., an investable index).

Relative to Their Benchmark

If managers have remained consistent to their philosophy and process, we are patient with underperformance. For approximately two to three quarters, we take no action. If the underperformance continues through the fourth quarter, we place the manager under review.

Under Review

At this stage, we neither fire the manager nor do we remove him or her from the approved list. We do, however, significantly increase our monitoring efforts. This includes a personal interview with the manager to discuss the underperformance, contact with the Morningstar analyst who monitors the manager, and queries of Alpha Group friends for any observations they may have. We also carefully review the changes in the fund’s portfolio positions as well as a detailed historical review of its modern portfolio theory (MPT) statistics.

The goal of this process is to confirm our preliminary conclusion that the manager has remained consistent to the philosophy and process and is just suffering from the endemic market malady of being in the wrong place at the wrong time. If we are comfortable with the manager’s response to our concerns and we believe that he is remaining consistent in his philosophy, we make no changes. However, we notify our clients that the fund is under review and, as a precaution, we also begin the process of searching for a possible replacement manager.
If the manager’s performance continues to be subpar for an additional three to four quarters, we either place him on the watch list or replace him with a new manager.

**Watch List**

This describes a list of funds that are no longer on our approved list but in which we maintain positions. Although we are patient, there comes a time that the pain of underperformance becomes so intense as to require action. For our practice, that is about two years. By then, even if we cannot account for the underperformance, we consider firing the manager.

The problem we frequently face is that firing a manager may generate a significant taxable event for our taxable clients. We do not let taxes dominate our investment management, but we do not ignore their potential impact. Once again, relying on our intelligent application of the art of wealth management, we attempt to balance the tax consequences of firing the manager with the market risk of keeping the manager. If the manager has remained consistent to his style, if his underperformance is relatively modest, if we believe that his performance is likely to improve, and if our clients have significant capital gains exposure, we will keep our positions in the fund for our taxable clients. For sheltered accounts and new clients, we will use a new manager in that asset class. The old manager is placed on our watch list.

**Consistency**

Someone might ask, “Did they turn stupid overnight?” The answer is no. We underperformed, but we stuck to our philosophy.

— David Minella, President, LST Asset Management

For managers on our approved list, our monitoring of consistency is based on fundamental qualitative portfolio analysis and mathematical fundamental factor analysis, not statistical factor analysis. That’s a fancy way of saying we look at the portfolio and talk to the manager. We look at, but do not rely on, the style analysis charts.

**Portfolio**

In spite of his belief in the value of return analysis, fundamentally, it’s what’s in the portfolio that counts. What is the manager doing with the client’s money? We review the positions, name by name, to see if they seem consistent with the manager’s philosophy. We do not expect to see go-go firms in our value manager’s portfolio or dogs in our growth manager’s portfolio. The process is unquestionably subjective, but we consider it our first line of defense.

**Fundamental Factors—Primary**

The four primary factors we track are management, book-to-market ratio, capitalization, and standard deviation. If there are any significant changes in any of these factors, the result is in an immediate and detailed review of the portfolio.

**Fundamental Factors—Secondary**

These factors are secondary in that variations do not necessarily trigger an immediate full-scale review but often trigger a call to the manager for an explanation. The secondary factors include:

- Cash positions. We look for variations from the manager’s normal cash allocation range.
- Turnover. A 50 percent increase in turnover. For example, if the normal turnover is 40 percent, we become concerned if it exceeds 60 percent; if the normal turnover is 90 percent, we are unlikely to become concerned unless it exceeds 135 percent.
- Maturity/duration. We look for movements toward either end of the fund’s policy range.
- Quality. We watch for any change in the average quality rating.
- Expenses. Any change in excess of 5 basis points gets our attention.
- Sector allocations. Any changes that result in the portfolio’s allocations exceeding the standards described in the Investment Policy Statement prompt a call to the manager.
**Statistical Factors**

Although our primary criteria for monitoring our approved managers are fundamental factors, we see little reason to ignore the possible benefits of statistical factors, so we review the funds’ style analysis charts.

**External Factors**

External factors include any source of independent information. Examples include:

- Morningstar and Value Line Analysis.
- No-Load Fund newsletter—Ken Gregory and Craig Litman’s manager interview and comments are always worth reading.
- Information provided directly from the fund, including the fund’s marketing material.

  We cannot count on information being available on every manager. We use what we can find, including:

  - Interviews.
  - Commentary and analysis in the media (e.g., Forbes, Barron’s, AII Journal).
  - Manager interviews.
  - Conference calls (e.g., Schwab, fund sponsor, Alpha Group).
  - Networking (e.g., Alpha Group).
  - Professional conferences.

---

**PARTING COMMENTS**

Once managers have been approved, it is critical to continually evaluate whether they adhere to their investment philosophy and how consistently they follow their investment process. Fund managers should not change their stripes as market cycles come and go. Otherwise, all of the effort expended in the selection process will be worthless. Although we may not be able to guarantee the managers’ performance, we should be able to guarantee our diligence.
APPENDIX

Mutual Fund Classifications

The most common classification system, and the one most familiar to the public, is the mutual fund's objective as reflected in its prospectus. Ostensibly, this is a statement of the objective the fund is trying to achieve. For many funds today, that objective may be to mimic a particular index, so one common classification that applies to both equity and fixed income mutual funds are index funds.

Equity Mutual Funds Classifications

In addition to equity index funds, a variety of other fund styles are available.

Balanced Funds

A balanced fund invests in a combination of stocks and bonds. In general, many balanced funds will keep at least 25 percent of the portfolio's assets in stocks and bonds at all times. Balanced funds can be flexible in response to economic change by shifting their mix of stocks and fixed income securities.

Growth and Income Funds

Growth and income funds seek both long-term capital growth and current income by investing primarily in equity securities. Growth and income are usually considered near equal objectives, although many funds classified as growth and income specifically state that income is secondary. These funds tend to invest in well-established companies that have a stable and reliable dividend history. When compared to growth and aggressive growth funds, these funds tend to have less volatility, lower expenses, lower turnover, and lower market value (price–earnings and price–book) ratios.

Equity Income Funds

Equity income funds have as their prime objective current income, with capital appreciation being secondary. As a result, these funds emphasize companies that pay above-average dividends. Since dividend yield is the less volatile component of total return (compared to price appreciation), these funds are generally less volatile than growth funds and growth and income funds.

Growth Funds

Growth funds invest for capital appreciation rather than current income. Their focus is on companies whose long-term earnings growth may exceed that of the market. Current income is either a secondary objective or not an objective at all.

Aggressive Growth Funds

Aggressive growth funds seek maximum capital gains. Toward this objective they may take high risks, buy volatile stocks, and trade them actively. They may employ techniques such as options, short selling, and leverage.

Fixed Income Mutual Funds Classifications

Unfortunately, the fund's stated objective is often misleading, particularly for fixed income funds. For example, some funds may say they are invested in government securities but allow a certain percentage of the fund to be invested in lower-rated securities or futures contracts. Many money market funds were found to have pieces of toxic asset-backed securities in them, causing their sponsors to "break the buck" during the financial crisis.

The wealth manager must be familiar with the various fund objectives, as they are the classifications clients will normally use (at least until they have been reeducated by the wealth manager). However, the wealth manager must also examine the underlying holdings of each fund to determine whether some other classification should be considered.
Corporate Bond (General)
Corporate bond funds seek income by investing in fixed income securities, particularly investment-grade bonds. They may be further defined by the quality of bonds in the portfolio. Subclasses include:
- Corporate bond (high-quality)—Primarily invested in bonds with ratings of A or better. Generally maintain an average rating of AA.
- Corporate bond (high-yield)—Primarily invested in bonds with ratings below BBB.
- Convertible bond—Invested in convertible bonds and preferred stock.

Government Bond (General)
Funds that seek income by investing in Treasuries, agencies, and government-guaranteed mortgage-backed securities. Subclasses include:
- Government (Treasury)—Largely restricted to Treasury issues.
- Government (mortgage)—Primarily invested in GNMAs, FNMAs, and FHLMCs.

Municipal Bond
Funds that seek income in fixed income securities exempt from federal income taxes.

Money Market
Money market funds are designed to be short-term in nature and cash equivalents. As a result, they offer a low rate of return at low risk.

Market Capitalization
Returns and risk vary by company size. Equity mutual funds are further classified based on the market capitalization of the underlying holdings.

Small-Cap
Mutual funds that invest in companies with low market capitalizations are considered small-cap mutual funds. While there is no precise definition of small-cap, evaluation services such as Morningstar often define a small company as one with a market capitalization of below $1 billion.

Mid-Cap
Mutual funds that emphasize medium-size companies are considered midcap. A midcap company usually has a market capitalization ranging from $1 billion to $8 billion.

Large-Cap
Mutual funds that emphasize companies with market capitalizations above $8 billion are considered large-cap funds.

Geography
Mutual funds are also classified based on the geographic location of their underlying holdings.

International or Global
International mutual funds are typically defined as those that invest in markets outside of the United States. Global funds mix asset classes and generally invest in any country in the world, including the United States. Most international managers focus on the 20 major markets that represent the majority of the developed world.

Emerging Markets
Emerging market funds focus on smaller, less efficient markets (not necessarily smaller companies), which, despite the diminutive size of the individual markets, in aggregate are estimated to account for between one-quarter and one-half of the world's total economic output. While investments in these funds tend to be very volatile, they offer the potential for high returns.
Frontier Markets

Frontier markets are actually a segment of the emerging markets category representing the less economically developed markets within the emerging market classification.

Styles

Equity mutual funds are also typically classified by investment style: value, growth, and core (or blend). Morningstar/Ibbotson uses the following criteria to create the Morningstar Style Indices and Style Boxes based on underlying equity holdings:

- Value stocks are classified based on five value factors—forward price-to-earnings ratio, price to book, price to sales, price to cash flow, and dividend yield. The greatest weight is allocated to the forward price-to-earnings ratio.
- Growth stocks are classified based on five growth factors—forward long-term earnings growth rate, book value growth, sales growth, cash flow growth, and trailing earnings growth. The greatest weight is allocated to the forward long-term earnings growth rate.
- Core stocks are those not classified as value or growth.

Other Classifications

A variety of other classifications are available, particularly since the advent of ETFs and ETNs.

Sector

Not true asset classes, specialty or sector funds represent various undiversified funds that emphasize a specific market sector. This could include financial services, health care, technology, and utilities. Many specialty funds have high expenses, high portfolio turnover, and high manager turnover.

Commodities

This category can include aggregate commodity index funds or subsets invested in individual commodities, including precious metals. These funds add diversification to a portfolio due to their low correlation with other asset classes, other than during times of crisis.

Real Estate

Real estate funds direct their investment dollars to companies that derive the majority of their profits from real estate (primarily REITs). As with commodities funds, it is important to verify the correlation of the selected fund(s) with the asset class assumptions.

RESOURCES


