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INVESTMENT STRATEGIES

How to Choose a Money Manager

By the Investment Strategies Committee

If you don't have the ability or time to manage your own investments, finding a good investment manager is crucial. The Madoff scandal evidences how innocent investors can be hurt by relying on friends' recommendations in deciding who should manage their money. How to choose a high-quality investment manager was the question posed by Bruce Alan Mann, chair of the Investment Strategies Committee, to Marc Rosenberg, founder and president of Quality Manager Consultants ("QMC"). Mr. Rosenberg and his partner, Chartered Financial Analyst Gary Reneau, have advised high-net-worth individuals, family offices, and institutions for over 25 years on how to build a portfolio of fund managers that will perform in both calm and tumultuous times and on how to know when to hire and fire a manager.

Bruce Alan Mann: Marc, what do you see as some of the issues investors have when selecting a money manager?

Marc Rosenberg: The number one concern investors have is being able to ascertain whether a manager's track record is a result of skill or luck. On a purely statistical basis, it's nearly impossible to answer this question, as there are not a sufficient number of return data available that would allow a definitive answer. So we are left with "softer" data, such as the manager's educational background, his or her work history, the track record, and, of course, personal interviews. The reality is that selecting money managers is a little bit art and a little bit science.

Mann: What do you look for in a money manager?

Rosenberg: There are several characteristics we look for in managers. Number one is a coherent and proven investment strategy. For example, a strategy of investing in financially sound companies at a substantial discount to intrinsic value has historically proven quite rewarding, as evidenced by the success of people like Warren Buffett and other practitioners of the value school of investing. There are other equally profitable approaches that are proven money makers, the point being that the manager must be able to demonstrate why the strategy works, present evidence that it has in the past, and offer compelling reasons why it is likely to do so in the future.

The second characteristic we look for is a repeatable investment process by which the strategy is implemented, along with the infrastructure (people, systems, and resources) needed to execute. The manager may be quite capable and have a terrific investment strategy but, unless we see a clear pathway from idea generation to trade execution embedded in a process that can be repeated over and over, we won't have confidence the manager's performance can be replicated in the future. We are strong believers in Michael Mauboussin's work. Michael is the chief investment strategist at Legg Mason Capital Management and is a superb thinker on manager analysis and selection. Michael says that, in too many cases, investors dwell solely on outcomes without appropriate consideration of process. The focus on results is to some degree understandable. Results—the bottom line—are what ultimately matter. And results are typically easier to assess and more objective than evaluating processes. But investors often make the critical mistake of assuming that good outcomes are the result of a good process and that bad outcomes imply a bad process. The reality is that the best long-term performers in any probabilistic field—such as

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investing, sports-team management, and pari-mutuel betting—all emphasize process over outcome.

Mann: So you're telling me that process is more important than how a manager has performed?

Rosenberg: It's interesting: when we first sit down and meet with a manager, the first page he or she generally turns to in their presentation booklet is the performance page. We stop them right there and let them know this is the last page we wish to review because what we learn from all the other pages will inform the track record, not the other way around. In fact, the track record tells us very little about the manager. A manager may have delivered a wonderful return, but until we understand the strategy that generated those returns and, equally important, the risk taken in producing it, we really don't know much. Too often, investors pay too little attention to the castle and not enough to its foundation.

Mann: What other mistakes do investors make when selecting money managers?

Rosenberg: Given the foregoing, it won't come as a surprise that most investors are performance chasers. It has been demonstrated time and time again that a manager's assets under management increase *after* a period of investment outperformance. While this tendency is understandable, it is not the route to wealth creation. For one, as the manager becomes increasingly successful, it may become increasingly difficult for him or her to source attractive investment ideas of the sort that produced the outperformance in the first place.

Mann: Why can't we assume that a manager who has done well in the past will continue to do well?

Rosenberg: This can be a function of the manager operating in a market segment where the number of compelling ideas is limited. Take a micro-cap equity manager who invests in companies with market capitalizations of $250 million or less. There is just so much money that can be invested in this space due to the small size of the companies, so a substantial inflow of assets can be problematic. At some point the manager's buying and selling activities will begin impacting share price in an adverse way, the manager may eventually own such a significant percentage of a company that he becomes the market—rarely a good thing—or the portfolio becomes overly concentrated and prone to heightened price volatility. To avoid these problems, the manager may begin investing in larger companies to accommodate the manager's increased asset base. This is what is referred to as style drift, i.e., the manager is no longer sticking to the original strategy on which the track record is based.

Style drift represents a huge red flag for us.

Mann: I understand how this can happen to a traditional manager who can run out of good ideas and decides to broaden the category of companies he'll invest in, but what about managers focused on a specific area, such as hedge funds that arbitrage mergers and acquisitions?

Rosenberg: The same phenomenon can occur, but you also may see managers gravitating toward entirely different strategies. For instance, a manager whose original investment focus was merger and arbitrage may, with the pressure of putting to work an ever-increasing flow of funds, begin to delve into special-situations investing, which can include investing in companies coming out of bankruptcy, company spinoffs and recapitalizations, and other strategies that require deep specialization. Without the requisite expertise, the manager runs the risk of a poor outcome.

Style drift represents a huge red flag for us, as it's the rare manager who can "flex" from his or her original mandate and successfully integrate other strategies into the investment process. We try to be proactive and anticipate this problem by frequently reviewing flows into our managers, having already made a determination of the amount of money that can be intelligently and profitably put to work in the strategy. What we want to see is the manager acting to control these flows by closing the fund to new investment. Of course, that's a difficult decision for managers to make since it means, at a minimum, capping their fee income. Regardless, if a manager's assets under management exceed the market opportunity, we then suggest to our investors they consider withdrawing or paring down their exposure.

Mann: Are there any strategies you particularly like in today's environment?

Rosenberg: Let's step back for a moment. It is clear this country and other developed nations have entered a prolonged period of deleveraging. This essentially means individuals, corporations, and sovereigns are less interested in growth and expansion and more concerned about paying down their obligations to a sustainable level of income or revenue. In such an environment, economic growth is muted, downturns in the business cycle occur with more frequency, and there is a greater risk of "accidents" due to inappropriate policy decisions at the national and supranational level. What this tells us as investors is that we need to be more conservative in our choices, since the odds of something going wrong are higher than normal.

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Mann: This sounds like you favor investing in mutual funds that invest in debt securities. But aren't debt yields awfully low at this point?

Rosenberg: Of course, and the yields investors are receiving in ultra-safe investments such as Treasuries are almost nonexistent and, after taxes and inflation, translate into a negative return. But such is the anxiety of people when they fear more the return *of* their capital rather than a return *on* their capital.

In this environment, we recommend a mix of strategies, each with varying levels of risk but suitable in a well-diversified portfolio. We do think having both traditional and absolute return investments in a portfolio makes sense. On the traditional side, we think equity index funds continue to make sense, even though we are no longer in a buy-and-hold world. It is now commonly known that most active traditional managers don't beat their benchmarks, and we see no reason for this to change.

On the fixed income side, today's overarching theme is the pursuit of yield. What we will say here is that investors have a stark choice: safe investments in government and AAA corporate bonds that are literally a money-losing proposition or move out on the risk spectrum to earn more while running the risk of capital loss. We think the decision calculus comes down to this: if you believe that the authorities in the United States and Europe will ultimately resolve the problems that face them, i.e., the U.S. budget sequestration (otherwise known as the "fiscal cliff") and the European Union/Euro currency situation, then we may well be at the end of the secular bull market in bonds, and it's time to prepare for a new era of rising rates, with all that entails. However, if you have a more pessimistic view, then remaining in ultra-safe bond investments continues to make sense, and they will continue to outperform.

In this environment, we recommend a mix of strategies.

Mann: I've heard a lot about how well hedge funds perform. Should I consider them as part of my investment strategy?

Rosenberg: Hedge funds aren't for everyone. However, if you or your client are high-net-worth individuals or you represent a family office or institutional investor, you should definitely consider them. Unlike traditional managers, hedge fund managers can deal in both long and short securities, which afford them more opportunity to make money irrespective of market conditions. This has always been the allure of these managers, but with greater opportunity often comes greater risk. It is essential, then, these managers have a well-designed and thoughtful risk management process in place. This can translate into limits on individual and sector concentrations (in the case of stocks and bonds); tight stop losses at both the position and portfolio levels; investment triggers, such as a rapid increase in price volatility, that tell the manager risk is increasing and position sizes should be reduced accordingly; and other attributes of a robust risk management system.

Mann: If I decide to include a hedge fund as part of my investment strategy, how do I choose one?

Rosenberg: My comments regarding investment strategy and process apply equally well to hedge fund managers as they do to traditional managers—perhaps even more so. Hedge fund strategies can be complex, opaque, and difficult to analyze. We are predisposed to invest in hedge fund managers that have easy-to-understand strategies where the investment edge can be identified and is durable and repeatable. This, combined with a well-defined risk management process, suitable operations support, and fund governance, gives us the comfort that the manager's interests are aligned with investors' interests.

Mann: Are there any risks of investing in a hedge fund that I don't face when I invest in an index fund or publicly traded mutual fund?

Rosenberg: There are. Hedge funds are, in most cases, housed within small businesses, and they carry all the attendant risks of investing in a small business. Is the manager an ethical person capable of running a money management business? Are there suitable financial and operational controls in place? Has a business continuity plan been established in case of an accident to the manager? Are there independent third parties reviewing the manager's books and records? While the incidence of fraud in the alternative investment industry is not high, it does happen, so proper due diligence needs to be done with respect to the manager and the business. QMC pioneered the concept of applying forensic due diligence techniques to hedge funds. Forensic due diligence involves a much greater level of personal and professional inspection, going as far as inspecting manager tax returns and bank statements to ensure proper fund operation and governance. We think it will become the gold standard within the industry. VOE

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