Reprinted from:
THE NATION'S OLDEST WEEKLY BUSINESS JOURNAL
DENVER BUSINESS JOURNAL
VOL. 60 NO. 6 July 25, 2008-July 31, 2008 64 PAGES $2.00

Before firing money manager, consider these factors

RICHARD TODD
PERSONAL FINANCE

I had a recent conversation with an investor who explained that he was firing a manager for having underperformed his benchmark for two years.

The conversation reminded me of a famous 1984 speech and subsequent article by Warren Buffet for the Columbia Business School. Buffet's "Super Investors of Graham-and-Doddsville" presented the cumulative track records of nine great investors. His study illustrated the swings in performance of these top managers and how underperformance, at times, can be prolonged and painful.

Similarly, the investment advisory firm Litman/Gregory conducted a thoughtful study of mutual funds' performance. L/G evaluated the funds that had outperformed their benchmarks for 10 years. Its study concluded that more than 90 percent of these top-performing managers had at least a single three-year period during which they underperformed their respective benchmarks by two percentage points or more. L/G's evaluation of small-cap mutual fund managers reached a similar conclusion.

In its study of retirement plan sponsors, the institutional consulting firm Watson Wyatt concluded that investment committee members are far too impatient with underperforming managers.

In an ideal world, the decision to terminate managers would precede poor performance, and the hiring of new managers would begin with the uptick in their performance. Significant value would be added. But that's unrealistic.

According to the investment firm Davis Advisors, the most common thought process with investors — high-net-worth and institutional alike — is, "When a manager does badly for one year, it is acceptable; for two years, it is troubling; for three years, it is time to make a change." While investors certainly deserve advice beyond "be patient," in the end, evidence indicates that patience is an investment virtue.

Instead of reacting to recent performance, the due-diligence process should focus on understanding the drivers of investment performance, regardless of whether managers are beating or lagging their benchmarks. Understanding a manager's strategy and investment approach is paramount to understanding their forward-looking edge over passive management and other active managers. Investors must be clear on their reasons for dumping a poor performer. Nearly always, those reasons should go beyond performance.

Some of the most common reasons to terminate equity managers in today's market include:

• **Concentration** — Large positions in sectors can be a big red flag when evaluating most managers, regardless of performance. Managers who had large concentrations in financial stocks were punished for that concentration in the last year. While thematic, top-down managers may deserve special consideration, intensive due diligence and possible termination should be strongly considered when managers have a large overweight in an economic sector or industry.

• **Approach deviation** — Some domestic equity managers have significant allocations of foreign companies in their domestic portfolios. In the past several years, the weakness of the U.S. dollar has provided a significant boost to those funds holding international stocks. The resulting problem is that an investor's total portfolio may be pushed to an international stock overweight. Should the dollar strengthen, the portfolio likely would be hurt.

Morningstar classifies equity funds as "domestic," though as much as 30 percent of the portfolio is comprised of foreign companies. Even lower allocations to non-U.S. companies can cause problems in a diversified portfolio.

• **Manager size** — Large pools of assets can be a significant detriment to performance, especially with small- and mid-cap managers. Since these managers often invest in stocks that are thinly traded, it's much more difficult for them to buy or sell large positions without significantly affecting their prices. Managers often take an alternative approach, adding more stocks to the portfolio, which could be a change in the managers' stripes. It's better for these managers to close their doors to new business in order to protect the integrity of the product and their investment process.

• **Manager change** — A key manager leaving can be a gigantic problem. At times, the product's historical track record should be thrown out the door when a manager departs. If a manager is retiring, there should have been a well-thought-out transition plan that included gradual changes and co-management responsibilities. With the plethora of money-management products in the marketplace, there's no reason to be a guinea pig with a new manager.

• **Ownership change** — A merger or outright sale of an investment firm can turn it and its culture upside down. When ownership changes, make certain that the firm's key managers and analysts have incentives to stay. Understand the potential impact of a manager's liquidity event, including any lack of motivation to succeed, and to put time and effort into the firm and its investment products. Sudden wealth from an ownership change can alter everyone's work habits.

Too many investors have an itchy trigger finger, and, as a result, sell low and buy high. All managers have periods of underperformance; the key issue is understanding why poor performance occurred. Carefully monitoring managers in areas beyond performance can lead to more rational replacement decisions.

Innovest Portfolio Solutions LLC provides investment consulting services to retirement plans, foundations, endowments and wealthy individuals. We can be reached at (303) 694-1900.
Rich Todd can be emailed at richt@innovestinc.com