Successful Investors Go Beyond Comparing Manager Composites

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Manager and product due diligence must go beyond examining a manager's track record. This approach is not news to most good firms in the investment consulting industry. Qualitative issues must always be considered, including manager tenure, philosophy and process, and firm health, to name a few. However, an often overlooked, yet critical, element of due diligence is evaluating the quality of a manager's advertised track record or "composite." A composite is the aggregation of all accounts that are managed in a particular strategy by a money manager. Because attractive track records can lead to inflows of more assets, and consequently income to investment firms, at Innovest we believe that it is not uncommon for investment firms to embellish their performance.

The Securities & Exchange Commission (SEC) provides advisors with procedures for disclosing investment performance. The SEC's rules are relatively strict and require disclosures in footnotes that often tell an interesting story about a firm and their composite construction. While the SEC frowns on back-testing and model portfolios that have been constructed with the benefit of hindsight, advertising such track records is not illegal when properly disclosed. Nonetheless, performance of such model portfolios can be highly misleading to investors unless all of the disclosures are carefully evaluated.

In addition, Global Investment Performance Standards (GIPS), issued by the CFA Institute, establishes detailed and stringent guidelines for investment firms' calculation and reporting of investment results to prospective clients. At Innovest, we believe that our recommended managers ordinarily should have track records that meet the stringent GIPS guidelines. If GIPS guidelines are not met, we carefully evaluate the reasons why. We must feel very comfortable with the construction of a track record before recommending a manager.

Innovest's research and due diligence process entails evaluating on an ongoing basis hundreds of managers, not only those who currently manage assets for clients, but those managers who might be recommended in the future. We have come across some manager track records that would seem impressive to most investors. However, upon our careful examination, we determined that a number of these track records misconstrued performance history and would mislead most investors.

Personal accounts posing as firm history. A misleading tactic is linking the firm's experience to a portfolio manager's personal account. We recently examined a firm that had a relatively impressive story and track record, but learned through our process that the "historical" track record was actually that of the manager's personal investment account. The experience of managing a small personal account is very different than managing a large number of accounts as a fiduciary. The responsibilities are different, including trading, client communication, and research. In addition, the pressure of managing assets for others makes personal performance history irrelevant when evaluating a product.

Today's strategies versus yesterday's track record. We analyzed a strategy's track record that was comprised almost entirely of exchange-traded funds (ETFs), including many sector funds and industry-specific allocations. The firm's marketing emphasized their ability to be tactical and nimble. The problem was that many of the ETF strategies had only been around a short time – but the track record had over 10 years of history!

Obviously, the strategy had changed over time, and the track record was questionable. While the advertised performance history was perhaps legal, it was highly misleading and not GIPS compliant.

Market timing and tactical strategies need a very long series of data points. The performance of managers that claim the ability to time the market should have long-term track records. The wide market swings of the last 10 years have made the theory of market timing look quite alluring. We have found that most firms eventually have a significant misstep with their calls, significantly damaging their long-term track records. For instance, many of the timers that "called" the 2000-2002 bear market got it wrong in 2008. We have found that it is very difficult to identify managers that have quality long-term records based on market timing calls.

Watch out for borrowed or purchased track records. We examined a manager's track record that smelled fishy. While the manager's current style focused on large cap stocks, our returns-based analysis indicated that the track record's historical returns looked much more like small cap performance. Upon further digging, we discovered that two different funds had been merged and the current track record was from the better performing of the two products. Even though the firm legally disclosed this history in the prospectus' fine print, the historical track record was very misleading. At times, firms may also hire a manager with a legitimate track record, add others to co-manage the portfolio, and then eventually retire the original manager. The firm then uses the long-term track record in their advertising and marketing. While this marketing strategy is legal, it can be misleading. Products are managed by people, not machines.

These are just a few examples of why investors and their advisors should dig deep under composites' performance numbers. Be skeptical of firms that have long, impressive track records with very little, or just recent, asset growth. Legitimate, impressive track records ordinarily gather significant assets over time. Examine historical asset flows, the number of accounts in composites and the investment strategies employed. Read all the disclosures and fine print, and be critical of models and back-tested track records that use hindsight as their guide.