# Evaluating Investment Firms For the Private Investor

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The importance of making a good decision on a steward for your investment assets cannot be overstated, but unfortunately most people have a less-than-adequate familiarity with either investing or the business of investing to make a proper choice of investment manager. And in a marketplace that is significantly broad and deep, investors find themselves at an extreme disadvantage to the slick salespeople who stand ready to "help" investors find a place to put their hard earned wealth. All too often people choose the manager or firm that is in the right place at the right time, a choice of convenience that they hope will work out over time. Frequently that choice of convenience is later regretted, either due to some service or advice shortcoming, a loss of assets, or both, and the investor is back at square one again. Investment manager selection does not have to be trial and error.

In this shortpaper I offer a framework for evaluating investment managers to help private investors consider the most important questions up front and prevent regrettable choices. Armed with a checklist of things to consider, investors can take the offensive when in a discussion with someone offering investment services. Good firms with worthwhile approaches to investing will actually appreciate an educated investor since they can then forego the pitch and get into the information sharing that is so important. But, before considering an evaluation framework, a little introspection is required.

## Decide What You Want and Need

Not all investment management firms do the same thing, and it is important as a consumer of their services that you know what you need before shopping for someone to work with. Is advice and investment execution your only goal? Do you need additional services such as banking, tax guidance, trust and estates work, or complex financial planning? What kind of service is important to you – do you want to be pampered when visiting with your investment manager and do you feel better with an entire team of people looking after your needs, or are less frills and a streamlined effort more to your liking? Do you want someone local or is having your money managed out of New York, Chicago, and London more important? Every investor is different, and having a sense of what is important to you is critical so that you can evaluate those things most important to you and those firms that offer all you seek.

For a private investor looking to hire someone to manage their investment portfolio, their choices fit into three categories: 1) brokers/financial advisors at the various brokerage firms such as Merrill Lynch, Morgan Stanley Smith Barney, and Wachovia; 2) boutique independent asset managers known as Registered Investment Advisors; and 3) private banks, trust companies, and private wealth firms such as JP Morgan Private Bank, Northern Trust, and Bernstein Global Wealth Management. Each might cater to a decidedly different private client, and the services they offer can be quite varied, but knowing a little about each one can be a useful starting point as you evaluate what you need relative to what is out there.

The brokerage industry is well-established and ubiquitous. They tend to be what most think of first when it comes to money management, but one should consider the other two categories before simply defaulting to your local Merrill Lynch branch. The conflicts of interest between brokerage firms and their clients are notorious and significant, and one must remember that these firms exist first and foremost to be distributors of financial products. There is a very blurry line between whether a broker has any fiduciary duty to his clients and the legal determination about this is far too complex for most to ascertain. For those who are adamant about ensuring their advisor has no conflicts of interests and sits on the same side of the table as them when handling their portfolio, it is best to avoid this part of the industry. That is not to say there are no good advisors at these firms, there most definitely are, and one can find their money very well managed at these firms. However, given there are other excellent options that avoid systemic conflicts of interest, it simply makes sense to pursue those options first unless there is some compelling reason to seek a brokerage relationship.

Registered Investment Advisory (RIA) and private wealth management firms are held to a much clearer fiduciary standard and tend to conduct business differently than your average broker. These firms are fee-based and begin by asking what a client needs rather than what needs selling. Nevertheless, service offerings and levels of expertise can vary greatly at these firms, so one needs to pay close attention to what services come with a relationship and how much you are paying for them – no reason to pay for something you do not need and do not want. Additionally, size does not matter as one might expect. Common thinking is that larger firms offer scale, research capabilities, and expertise that cannot be matched by smaller firms. While this may be true in some narrow areas of the capital markets and client situations, most of the services an average high net worth investor needs are fairly commoditized so that a firm's scale is not significant, and the research offerings and expertise of larger firms is vastly overvalued except in very few circumstances. What gets overlooked in smaller firms is the personalized attention and flexibility they often offer their clients. Big firms tend to operate with several layers of bureaucracy and clients end up dealing almost exclusively with a client service team instead of working with the actual investment decision makers. For those who do not mind middlemen and instead want a global brand, larger firms are probably a fine choice, but investors should understand the tradeoffs.

So, there truly is a rich and varied spectrum of investment managers out there. Figure out what it is you want to pay for, find the firms that do that well, and then compare the few you consider top notch in great detail. Ask good questions and demand good and complete answers, and stay focused on the things that truly matter (advice, portfolio management, and costs) instead of being swayed by fancy office space, expensive meals, and "empathy". If they are leaning too heavily on the latter, consider it a significant sign that their marketing machine has taken over the executive suite. Now, on to what those good questions should entail…

## A Framework for Differentiation

Let me begin by discussing a particular item that should be thought about throughout the evaluation process: alignment of interests. The largest investors (called institutional investors, charged with investing pension fund, union, endowment, and large foundation assets) usually employ investment consultants to guide them through the process of manager selection and portfolio construction. These consultants act as their fiduciaries and their most important role is to look after their clients' interests. Unfortunately, private investors have no such luxury and ensuring alignment of interests between themselves and their chosen investment firm(s) falls squarely on their own shoulders. There is no "alignment of interests" line item in the evaluation framework below because that implies it is something to think about once and check it off the list. Instead, it is an item that needs to be considered during each step of the evaluation – within advice, portfolio management, and costs. Any time you feel a manager's interests are not completely aligned with your own, move on to the next manager regardless of how good that manager looks on all other criteria.

So, just how does one differentiate between the good, the bad, and the downright horrible asset managers in this very complex marketplace for investment advice? The investment consultants mentioned earlier evaluate four areas when doing due diligence on asset managers for their institutional clients: people, philosophy, process, and performance. But evaluating managers for private investors requires a different framework since private clients require more in the way of advice from their investment managers than do institutional clients and their consultants. Therefore, my proposed framework organizes the evaluation in three broad categories: Advice and Service, Portfolio Construction/Management, and Costs. Each of these three areas is incredibly important either to the overall investor experience, long-term investment results, or both. Additionally, private investors often treat each of these areas with varying degrees of importance, so using this framework will help to differentiate firms in a way that is helpful no matter which area is at the top of one's hierarchy of needs.

Below is a framework for comparison, and remember to consider alignment of interests between investor and firm throughout the evaluation process (a more complete version is available at the end of this shortpaper):

1. Advice/Service
    - Knowledge, experience, and ethics of those giving advice
    - Availability and accessibility of managers and services
    - Responsiveness: timeliness and thoroughness
2. Portfolio Construction/Management
    - Investment philosophy of the firm/team
    - Portfolio construction process
    - Research platform
    - Execution of investment ideas
    - Reporting and performance measurement
3. Costs
    - Advisory fees as a percentage of assets under management (ensure relationship is fee-based, not commission-based – anyone making money off of product sales must be avoided at all costs)
    - Underlying expense ratios of any investment structures used (mutual funds, separately managed accounts, wrap accounts)
    - Trading costs
    - Taxes

Now let's expand on each of these areas in slightly more detail in order to get a better understanding of what one should be looking for.

## Advice/Service

While each of the three categories is significant, the Advice and Service category is unique in that it has perhaps the greatest effect on the investor's day-to-day experience yet might be the hardest to evaluate ahead of time. A firm's ability to advise comes from the background and expertise of those on the investment team. Investment education, knowledge, and perspective are extremely important, as is the ability to communicate both simple and complex issues effectively. The service component is a function of the investment team's availability and responsiveness, basically how they handle all interactions with the client or prospective client. Additionally, investors may want to have access to other services that fall outside, but are related to, investment management.

Knowledge, experience, and ethics of those giving advice:

- Education
    - College education from a credible institution (required)
    - Master's or doctorate *in an investment related field* such as economics, business, or finance (desired), again from a respected institution
- Professional credentials
    - Chartered Financial Analyst for those managing portfolios (highly desired)
    - Certified Financial Planner for those giving planning advice (desired)
    - Series 65 or 66 licensed (required by regulatory authorities, but can be waived for certain professionals with qualifying designations such as CFA and CFP)
    - Decode the alphabet soup found in the broker community at http://apps.finra.org/DataDirectory/1/prodesignations.aspx, and think critically about whether the designation is substantial or just a marketing gimmick (most are the latter)
- Years of experience
    - Make sure they have worked in the industry through at least one full market cycle (since 2003 is fine, anything more is better)
    - Too much, oddly enough, can also be limiting in that much has happened over the last decade and if one has not kept up with the advances in the industry, that is also a problem (rare, but worth considering)
- Breadth of experience (investment and industry)
    - In core asset classes: global equities (domestic, foreign developed, and emerging markets), U.S. Treasury bonds, and real estate (required)
    - In non-core asset classes: corporate bonds, high yield bonds, municipal bonds, asset-backed securities, foreign bonds, commodities, currencies (highly desired)
    - With alternative strategies: hedge funds, private equity/venture capital (desired)
    - Using quantitative and fundamental research methodologies (desired)
    - In operations, trading, sales, client service (a working knowledge of each of these areas is strongly desired)

 

- Ethics
    - What is the moral foundation of the firm and its senior leadership?
    - Review their Code of Ethics; how is it applied and monitored?
    - Look for signs of community involvement and sense of service
    - Review the firm's Form ADV (Parts I and II), a regulatory filing detailing how the firm conducts business, including any ethical violations and potential conflicts of interest

Availability and accessibility:
- Number of clients
    - The fewer the better – more time to devote to each client and account
    - More than 50 relationships should be closely scrutinized for manageability
- Ability to access investment decision-makers
    - Request to speak with those who actually determine the investment strategy and portfolio construction
    - Can you reach them directly or do you need to go through intermediaries?
    - Any relationship that excludes direct access should be avoided
- Turnover of those on investment and service teams
    - Consistency of decision makers is crucial
    - Turnover in service personnel can be accepted to some degree, but for anyone fairly new, treat their firm and strategy knowledge with skepticism
- In addition to investment management, what other services might you have access to through your relationship with this firm? (require only what you need)
    - Financial planning/retirement planning
    - Trust services
    - Banking/check writing/credit cards
    - Mortgage or business lending
    - Other

Responsiveness
- Does the firm respond in a timely manner to requests and inquiries?
- Are the responses thoughtful and thorough?
- Are all interactions informative and useful?
- Does the manager exhibit patience and understanding?

## Portfolio Construction/Management

While advice and service define the day-to-day experience for an investor, it is the portfolio construction and ongoing management of your assets that ultimately determine whether investment goals are achieved. So, arguably, it is this piece of the puzzle that is most significant yet also the piece that many investors and investment managers spend the least amount of time examining. Perhaps it is lack of investment sophistication on the investor's part that keeps them from thoroughly evaluating a firm's portfolio management capabilities. That makes sense after all – how does one know what to ask if they themselves aren't experts in the field? Can you adequately evaluate a doctor's ability to remove your appendix or a mechanic's ability to replace a transmission? Probably not, and it's the same with investing to some degree. But there are some questions that one can ask to at least get a sense of the manager's thoughtfulness in this area, and his/her responses should also give you an idea of their willingness to inform, educate, and communicate. And, if you truly are interested in understanding the portfolio management process, your manager should be willing to spend time explaining things in adequate detail. A true professional who is confident in his/her approach should appreciate a curious client.

One might think that performance numbers can tell how capable someone or some team is in terms of portfolio management, but unfortunately it often does not work that way. Since private client situations differ considerably from one to the next, their portfolios also reflect very different things. So, to take the performance of one client and use that to reflect how you might have done over that same period is likely misleading. Often, investment firms cannot legally give you performance data in the private client realm and if they can, it is a composite of all "similar" private clients that comes with many disclosures that tend to negate the applicability to your own situation. But those things should not keep you from asking for it and examining it closely, because it *does* represent *something,* of course. And always remember the old, but true, adage – "past performance is no indicator of future performance."

So, when evaluating the portfolio construction and management capabilities of an investment firm, start with some of these questions and look for thoughtful and well-articulated responses that seem intuitive:

*What is the overall investment philosophy of your firm/team?*

- Passive vs. active management
- Top-down vs. bottom-up investment selection
- Investing vs. speculating (long-term vs. short-term focus)
- How do you think about risk?
- How much does a global perspective matter?

*Tell me about how you construct portfolios. Specifically,*

- How asset classes are defined and evaluated
- How specific assets are selected and their portfolio weights determined
- If any of the investment management is outsourced to third parties and why
- How adequate diversification is achieved and overlap controlled
- How risk is factored into the construction
- How investment themes are manifested within the portfolio?
- If the investment platform has any limitations as to what you can invest in

*Discuss the kind of investment research in which you engage. What is its*

- Focus (top-down, bottom-up, technical, fundamental, momentum, strategic, long vs. short term, etc.)
- Impact on the investment strategy

 

*Execution of investment ideas*

- Are taxes considered?
- How much turnover should I expect?
- How do you think about rebalancing?

*Reporting and performance measurement*

- Type and frequency
- How is performance measured/what do you use as a benchmark?
- How often are portfolios reviewed with clients?

These questions are all starting points for discussion, so use them to take you wherever you need to go. They are not comprehensive, but the issues raised above should be considered as a minimum threshold of what you need to know about your manager if you are doing a complete job of due diligence regarding portfolio management.

## Costs

The costs of an investment strategy directly reduce investment returns and so it is incredibly important to give this area considerable scrutiny. Unfortunately, in many cases the cost of an overall investment strategy can be difficult to determine, and many firms work hard to keep it that way. Most investment platforms have several layers of fees and very few investors understand all aspects of how they are paying for the services they are getting. When undertaking due diligence on costs, specifically ask your manager to account for his advisory fee, management fees paid to third party managers, and/or fees on any separately managed accounts or wrap accounts (wrap accounts bundle multiple strategies and "wrap" all the fees into one) you are or would be in. Also find out if there are any fees not included in those just mentioned such as custody fees, 12b-1 fees (a mutual fund marketing fee) and redemption fees. And as you are asking these questions, focus on the advisor's ability and desire to offer full disclosure – most cannot answer these questions and will need to research them before giving you an answer, and very few are comfortable with this topic. The reason is that costs to the investor are not a focus in most places and they tend to be rather high. Brokers don't particularly care, assuming that everyone charges pretty much the same thing on all platforms, so to quibble about costs to them seems pointless. The problem is, some firms pay very close attention and when you take out the fat of most investment platforms you find it's quite easy to give investors access to the capital markets for a very fair cost, leaving more in a client's account to invest as intended.

There are two other kinds of costs you should understand: trading costs and taxes. Both of these are strongly affected by the amount of turnover in a strategy, or put a different way, how much trading activity occurs in the account. The less trading, the lower the trading costs (obvious) and the fewer opportunities for realized capital gains. So ask the investment manager what kind of turnover is likely for the proposed strategy and how they evaluate trading costs and tax efficiency. Again, if they stumble through an answer or do not seem to have considered one or the other, be very suspicious of their capabilities. Trading costs have come down considerably over the last decade, and there are numerous ways to invest in very tax-efficient ways, so for a client to pay a lot in trading costs or taxes is simply hard to explain. And you will want to know about these things before hiring a manager, not after – these costs are the most controllable part of an investment strategy and investors should demand that they are handled properly.

There is one final point about fees. Be careful not to turn your due diligence into an effort to simply locate the low-cost provider. The key is to find a manager who charges a *fair* fee relative to what they offer you in terms of investment advice, service, and portfolio management. The cheapest option may not necessarily be the best if they cannot properly advise you or if the portfolio they might construct for you, while low-cost, simply cannot offer solid risk-adjusted returns relative to other options. Costs are just one piece of the more complex puzzle that is investment manager evaluation.

## Summary

Investment manager evaluation is no simple task, especially for those who do not do it for a living, but it is extremely important given what is on the line. Take the time to first consider what is most important to you as an investor, allowing the most important items to narrow your search to a manageable list. Then, use the framework offered in this shortpaper to keep your evaluation disciplined and rigorous.

Measure what is measurable, but keep a close eye on those things that are less measurable because those things are likely to make the difference between a good relationship and great one, or a bad relationship and a horrible one. These are the things such as a manager's ability to communicate complex issues in a way that is informative and interesting, yet not condescending. These are things like a manager's willingness to answer all the questions above because they are important to you, regardless of how much of an inconvenience it is for him to research when he did not know the answer to begin with. These are things such as the overall transparency of an investment process without your need to ask probing questions (some firms simply have a very easy to understand and transparent approach).

Just like investing itself, manager evaluation is an art as much as it is a science, and it takes time and effort. But, your time and effort should be rewarded through a better overall investment experience, however one might define it.

# Evaluation Framework

1. Advice and Service
    - Knowledge, experience, and ethics of those giving advice
        - Education and professional credentials
        - Years AND breadth of experience
        - Evidence of strong ethical foundation
    - Availability and accessibility of managers and services
        - Number of clients
        - Ability to access investment decision-makers
        - Turnover of those on investment and service teams
        - Availability of other services
    - Responsiveness: timeliness and thoroughness

2. Portfolio Construction/Management
    - Investment philosophy of the firm/team
    - Portfolio construction process
        - Definition and evaluation of asset classes
        - Security selection and portfolio weighting
        - Use of third-party managers
        - Overlap and diversification
        - Risk control
        - Incorporation of investment themes
        - Investment platform limitations
    - Research platform
        - Focus (top-down, bottom-up, technical, fundamental, momentum, strategic, long vs. short term, etc.)
        - Impact of research on investment strategy
    - Execution of investment ideas
        - Tax management
        - Turnover
        - Rebalancing methodology
    - Reporting and performance measurement
        - Type and frequency
        - Performance measurement
        - Client reviews

3. Costs
    - Advisory fees
    - Expense ratios and fees within any investment structures used (mutual funds, ETFs, separately managed accounts, wrap accounts, Fund of Funds, etc.)
    - Trading costs (commissions, spreads, redemption fees)
    - Taxes