How To Choose A Money Manager

mmreview@slip.net www.ManagerReview.com (415) 386 7111

WHAT YOU NEED TO KNOW

Which money manager should you hire? To make this decision, you must consider several factors:

1) the qualifications of the prospective managers, including registrations and referrals;

2) the absolute, risk-adjusted and relative performances of the prospective managers;

3) your own investment objectives; and

4) the services of a data provider or a professional consultant to simplify your search.

IS YOUR MANAGER QUALIFIED?

Before hiring a money manager, you should first establish that the manager is responsible and reliable. This process is known in the industry as *due diligence*. It simply means that care has been taken to substantiate a manager's suitability.

The Form ADV

The Investment Advisors Act of 1940 mandates that all money managers register with government regulatory agencies (see table below). As part of the registration process, managers must file various disclosure statements, the most important one being the Form ADV. By law, the manager must provide Part II of this form (or equivalent disclosure) to all prospective clients.

The Form ADV provides basic background information on a manager's ownership, financial condition, state registrations, and potential conflicts of interest with fees or commissions, as well as the background of the firm's principals and any disciplinary or legal problems. Investors should keep in mind that the purpose of the Form ADV is to place basic information about the manager on the public record. The SEC never passes on the merits or accuracy of the information provided in the ADV.

With an ADV in hand, the investor has an opportunity to conduct a rudimentary background check. Prior employment of the firm's principals is an obvious area of interest. If legal actions against the firm are discovered, investors should try to obtain copies of the complaints. By checking with state and/or SEC enforcement divisions, the investor may uncover actions taken against a manager for regulatory violations.

Investment adviser registration requirements

Assets under management	Registration requirement
$25 million or more in assets	Manager must register with the Securities & Exchange Commission, or SEC.
Less than $25 million	Manager must register with the appropriate authorities in all states where company business is transacted.

Source: SEC

The Form 13F Filing

If an investment advisor manages $100 million or more in equities, SEC regulations require that a quarterly 13F statement be filed, listing the equity positions and number of shares held. Investors can compare the manager's publicly reported numbers with the 13F filing of record to get a rough verification of performance.

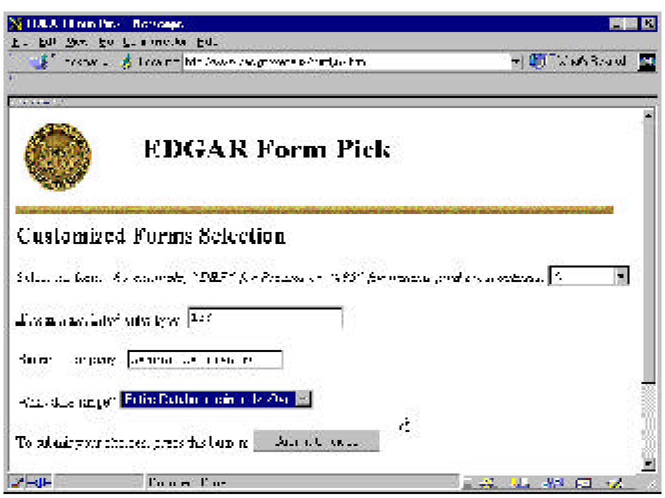
Some managers may argue that, because portfolio adjustments often occur between filings, the 13F is an inaccurate basis for measuring performance. However, most managers have relatively low portfolio turnover of about 25% a year, or roughly 6% per quarter. Even a 40% annual turnover rate translates to a mere 10% change in portfolio positions per quarter. Given these statistics, most 13F filings provide a good starting point for double-checking performance claims.

You can access 13F statements at the SEC's Web site (http://www.sec.gov/edaux/formlynx.htm), by searching the EDGAR (Electronic Data Gathering, Analysis, and Retrieval) database. (See diagram below.)

Referrals

To learn more about a manager's reputation, it's logical to look at the manager's existing clientele. You may wish to ask a prospective manager for referrals, or for a list of active clients. "Size up" the manager by finding out the number of clients and the total value of assets under management. It's also prudent to ask for the number of new accounts acquired and lost during the past five years. A good manager has little to fear from this question.

Get 13F statements on the Web



13F statements can be viewed at the SEC's Web site.

EVALUATING PERFORMANCE

Once a manager's credibility has been established, it is critical to evaluate the manager's historical investment performance. Returns are important, but only the tip of the iceberg. Other key factors to consider include:

· **Risk**
Ideally, investors want high returns with minimal risk.

· **Relative performance**
Compared to other managers and market indexes.

· **Reporting standards**
Different managers define "performance" differently.

Risk Analysis

When selecting a manager, it is not enough to assess returns alone. To make an informed choice, you must look at a manager's underlying risk. Risk is the statistical likelihood that your investment will perform unfavorably.

Risk can be mathematically defined and calculated. Usually, risk is measured with standard deviation, or the variability of a series of numbers about their average. For example, a $1 million portfolio with a quarterly standard deviation of 5% history has fluctuated $50,000 (5% of $1 million) or less per quarter two-thirds of the time. Low standard deviation means low risk. High standard deviation means high risk.

When this risk factor is considered, managers who might have seemed similar can suddenly look very different. For example, look at these two managers:

	--- Returns (%) ---				Full	Standard
	1Q	2Q	3Q	4Q	Year	Deviation
Manager A	+5	+5	+5	+5	**+21%**	**0%**
Manager B	+9	-13	+24	+3	**+21%**	**40%**

Managers A and B have both achieved a full-year return of 21%. But look at the quarterly returns. Manager A has delivered consistent, reliable results every quarter. Manager B is all over the map. Though the annual returns are the same for both managers, most investors would rather choose the lower-risk option – Manager A.

Of course, you may not want a low risk manager. After all, you have to take risk to get growth. You may want to hire the manager who takes the smartest risks, not the smallest risks. Consider two more managers:

	Manager Y	Manager Z
Returns achieved	25%	16%
Risk assumed	30%	8%

To compare these managers, simply divide risk into return. This ratio, called the Efficiency (or Return/Risk) Ratio, tells you how many units of return "bang" the manager gets back for every unit of risk "buck" taken.

	Manager Y	Manager Z
Return / Risk ratio	0.833	2
This ratio is...	Low = Inefficient	High = Efficient

MMR considers Efficiency Ratios to be a particularly important measure of manager performance. MMR's database relies heavily on risk analysis to evaluate managers.

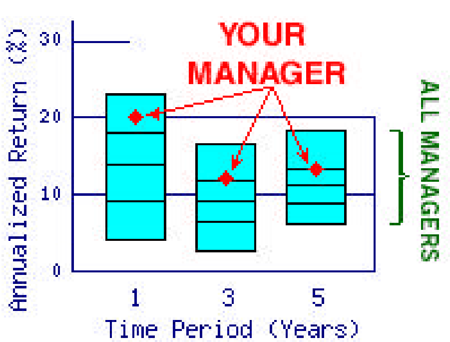
Relative Performance

To truly compare and understand manager performance, you must look beyond returns, and even beyond risk-adjusted returns. It's essential to evaluate a manager's numbers in the context of:

· Other managers' performances
· The behavior of market indexes

Collecting enough information for a meaningful comparison is generally beyond the scope of the individual. It requires a data provider, such as MMR. Comparison reporting is a principal feature of the MMR database, which incorporates rankings, custom comparison functions, and quartile charts for all managers.

Compare your manager to peers



Quartile charts highlight your manager's performance against the spectrum of all manager performances.

Reporting Standards

As you research manager performance, it's crucial to establish how "performance" is being defined. MMR strongly recommends that investors ask prospective managers four questions, listed below. MMR requires that all tracked managers answer these questions to be included in MMR's database.

1) Is the performance composite, representative, or proforma?

It's reasonable to assume that "performance" means "real money earned or lost for all clients." It's reasonable – but it's not always correct.

Many managers do report performance on a *composite* basis – that is, by tallying up profits or losses for each client and aggregating the results. However, some managers may show you *representative* performance numbers. This means that one, or a few, client portfolios have been singled out and are being presented as a fair representation of an average discretionary account. Other managers may use *model* or *pro forma* numbers, drawing on backtests or something else other than actual managed portfolio returns to provide a hypothetical historical performance.

As you search for a manager, you should always make sure you know what you're looking at. Have every prospective manager clarify to you whether performance numbers are composite, representative, or a proforma model.

2) Is the performance audited?

A manager may hire a third party, such as an accounting firm, to check and verify the firm's reported performance figures. This procedure, called an *audit*, can provide some independent confirmation of performance claims. Ask prospective managers whether or not their performance figures are audited, and if so, by whom. Also carefully examine what is being audited. If the audit is too restrictive in scope it may give a false impression as to the manager's composite performance. You may wish to obtain and review a copy of the audit.

3) Is the performance reported net or gross of fees?

Naturally, money managers are paid fees for their services. A manager's reported returns may or may not reflect these fees. If performance is reported on a *net* basis, you are looking at the profits or losses posted after all management fees have been subtracted out. If performance is reported *gross* of fees, the returns do not include any adjustment for fees paid.

4) Is the performance AIMR Compliant?

In 1991, the Association for Investment Management and Research (AIMR) endorsed a set of Performance Presentation Standards for the investment management industry. These standards provide managers with a standardized format for calculation and presentation of their performance for clients. Investors should check to see whether prospective managers report their performance in compliance with AIMR standards.

YOUR OBJECTIVES

Every investor has a unique set of investment objectives. It's important to define your own objectives, so that you can identify the managers who are best suited to your needs. Your choice of manager will depend on factors such as your:

· Risk tolerance
· Income needs
· Tax sensitivity
· Expectations of contact with the manager

Risk tolerance. Risk is not necessarily bad. All investments involve some degree of risk, and to grow your assets, you must take risks. In fact, the more growth you want, the more risk you must assume. The point at which your dislike of risk overrules your desire for asset growth is your risk tolerance. In other words, your risk tolerance is your answer to the question, "*What's the maximum drawdown in my portfolio that I am comfortable with?*"

Your risk tolerance will depend on many factors, including your time frame, your goals, and your natural tendency towards conservatism. A pension plan obligated to disburse monthly payments will probably be a very conservative, risk-averse investor. A young couple investing for a newborn baby's college tuition will probably feel comfortable with a more aggressive, somewhat riskier investment plan.

It's vital to define your risk tolerance. Once you identify your risk parameters, you can eliminate investment products and managers that are deemed too risky.

Income needs and tax sensitivity. Your investment plan should also take into account your desire for steady income – or, in certain cases, your desire to avoid earning income or incurring taxable capital gains. If you expect your portfolio to generate regular cash payments, you should begin your manager search by looking at advisors who specialize in balanced or fixed-income products. If you are a particularly tax-sensitive client, you may wish to locate managers who, for example, offer municipal-bond-based products, or who can work with a CPA to coordinate your portfolio.

Importance of personal contact. It's very common for clients to hire out-of-state managers. After all, most investors prefer to evaluate managers based on performance, not physical location. However, you may prefer to work with a manager that you can meet and visit. Or, you may want a manager who will stay in extra close contact with you about developments in your portfolio. If you are such an investor, you will obviously want to look closely at managers located in your city or region. Less obviously, you should find out whether a prospective manager is adding clients at an unusually high rate. A young, fast-growing manager must devote more time and attention to administering the daily affairs of a developing business. This can sometimes divert resources away from securities research and portfolio management.

PROFESSIONAL CONSULTING

Many investors turn to professional consultants for the same reason they hire a money manager: It takes time, effort and research to draw up a short list of suitable manager candidates - just as it takes time, effort and research to manage money successfully. MMR's performance data and risk-adjusted comparisons can make it easier to conduct your manager search. However, some investors feel more comfortable seeking the assistance of an experienced consultant. A consultant is a full-time professional, with broad knowledge of the investment management industry and access to actual account information. If you are an investor seeking to place funds with a money manager, a consultant may be able to provide valuable assistance. It costs nothing to find out more about consulting, and there is no obligation involved in speaking to a consultant. For more information about professional consulting services, contact MMR at (415) 386 7111.