Implementation: Manager Selection

To create an investment strategy to match your investment objectives, the first step is to consider an asset allocation among stocks, bonds and cash with some limitations on each such as listed below.

Acceptable Ranges of Equity Commitment

Minimum	Target	Maximum
45%	55%	65%

For each component within that asset allocation, a specific style strategy to satisfy the expected return for each asset class must be developed. For instance:

The equity portion may consist of 60% large cap value stocks, 30% small cap growth stocks and 10% international. The bond portion may consist of 60% intermediate term treasuries, 30% intermediate corporates rated "A" or better and 10% European international.

The cash portfolio may consist of 100% money markets.

Manager Selection and Due Diligence

Only after completing a thorough investment objective statement can you think about selecting an investment vehicle. It may be one or more individually managed account managers (with different styles, such as a large cap value manager, a small cap growth manager and an intermediate government fixed income manager; some funds such as an intermediate corporate bond fund, some ETFs such as an international EAFS1 share and an international European bond I-Share and a money market fund (or a reasonable combination thereof--if appropriate). As we stated above, this step can also be undertaken only with a thorough due diligence examination of the various options available.

Money Manager Search and Selection

Money Manager Selection is the Final step in the asset allocation process. Under a traditional approach (pre-consultant) money manager selection is a simple outgrowth of the asset allocation process. Here the emphasis is placed on the choice of style and asset class. All managers within a given style or asset class are assumed to be pretty much the same. The advent of professional consulting has replaced the purely asset allocation driven manager selection process with the newer Value-Added Approach. Under this approach, it is assumed that all managers within a style are not equal, and that a Manager must add value in order to justify their fees (for example, through tax-aware management).

There are Four Basic Steps in the Manager Search and Selection Process:

1. Establishing criteria

2. Screening

3. Selection

4. Implementation

<u>The first step in the manager search and selection process is to establish specific criteria for each potential manager.</u> This involves developing criteria from your written investment objectives (discussed elsewhere). Many consultants will produce a checklist of manager criteria to aid in choosing suitable managers. At this stage, your helper and you should also establish benchmarks, performance standards, and review policies (including a policy on when to change managers or rebalance the account).

<u>The second step is to screen managers according to the manager criteria established.</u> Most large investment firms have an internal department staffed with experts to performs this function, and independent consultants generally have to perform their own manager screening and due diligence, however it is important for any financial advisor to understand the basics of the process involved.

First, potential manager candidates are chosen from the vast universe of managers available. While the extent of the potential manager universe was once limited by the number of managers a consultant knew, the existence of specialized software, electronic databases and search engines have made expanding this universe much easier than in the past. Software and databases may be pricey, however the expense can be worth it.

When a number of manager candidates have been identified, they should be contacted to determine suitability. Profiles and performance data should be prepared and presented to the client at a second meeting. With the client's input, the list of manager candidates can be narrowed to only a few prospective managers ("finalists").

The consultant must now narrow the list further, using Quantitative and Qualitative Analysis of return (Due Diligence) to eliminate unsuitable managers. This should include interviews with key people and at least one on-site visit for each of the finalists.

While screening, you can utilize data and information provided by prospective managers, such as marketing materials, but should also perform independent research whenever possible.

Forms of Quantitative Analysis include Risk/Return Analysis, which uses the measurements of risk and return to compare managers; Attribution Analysis, which traces the performance of a manager to the underlying investments responsible for it; Correlation Analysis, which identifies how the manager has performed compared to other managers and indices; and Sharpe Style Analysis, which compares the Sharpe ratios of various managers within a style.

Qualitative Analysis, or Due Diligence, begins during screening and continues as long as the client maintains their account. It is not only the most important step in the Money Manager selection process (and also applies to selection of non-Managed investments), but virtually defines the role of the financial advisor. Performing Due Diligence on managers and investments demands financial expertise generally unavailable to the average investor.

Due Diligence is an ongoing process used to determine the soundness and suitability of a manager. This requires extensive knowledge and analysis of nearly every aspect of the manager's business. The areas a financial advisor should concentrate on are usually presented in a simple list of easy-to-remember terms known as "the Ps". Different experts use different numbers of Ps—anywhere from three, which is insufficient, to fifteen, which is a little excessive. For the purposes of this course, there are nine.

The 9 Ps (questions to have answered by your investment manager options)

1. Philosophy—what is their investment philosophy?
2. People—who makes the investment decisions, and how talented, trained and dedicated are they?
3. Place—what is their physical location and infrastructure?
4. Process—what is the operational structure?
5. Product—what specific types of investments are offered?
6. Plans—where do they see themselves (and your client's money) in five years, ten years, or more?
7. Progress—how far have they come in realizing their past goals?
8. Performance—probably the first thing your client will want to hear about—performance measurement will be discussed below.
9. Price—"The Double Rule"—expected excess return to the client should be equal to or greater than two times the total fees, including the consultant's fee, after taxes and other known expenses.

The point of "The 9 Ps" is not to memorize a list, but to understand the kind of complete, in-depth knowledge of a manager is required before considering placing client assets with them.

Selection

<u>The third step in the process is selection.</u> If the account is large, this may involve presentations from prospective managers (the so-called "Beauty Pageant"). After you have had a chance to review all of the relevant information, they will be able to select a manager or managers. Note that the final selection of investments is always left up to you—however, the you can expect the expert advice and the recommendation of their

financial advisor. All candidates will then be notified of the decision.

The objective is not the "best" manager; rather, you want to match your objectives to the manager or managers most likely to be successful. Many of the qualities you should expect are specific to the client's circumstances, however some generalizations can be made. Below you will find loose guidelines of the sort of things to look for in distinguishing successful managers from unsuccessful managers.

Some Characteristics of a Successful Manager include:

- Independent thinking
- Personnel discipline
- Flexibility
- Consistency

Some Characteristics of an Unsuccessful Manager include:

- Ineffective bureaucracy
- Personnel turnover in key positions
- Disparity of results among accounts
- Unrestrained asset growth

<u>The fourth step in the process is implementation.</u> It includes hiring the manager (or managers) and a continual evaluation of the due diligence along the way to determine whether it is consistent with your objectives to continue to employ that particular manager, managers or fund vehicles.