Investment Planning Answer Book by Jay L. Shein, Fund and Manager Selection

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Once there is an investment policy in place that adequately includes the goals of the client and parameters on how the wealth manager is going to help the client to achieve those goals, the next step is to put the plan to work. The portfolio mix and strategy is determined and, the actual investments will have to be chosen to fulfill the portfolio objectives. the portfolio mix and strategy is determined, the actual investments will have to be chosen to fulfill the portfolio objectives. Some advisors will use individual securities, separate account managers, private accounts, mutual funds, closed end funds, and/or hedge funds. Some advisors will use a combination of the available options above to implement the portfolio. For those that are using money managers or mutual funds as all or part of the portfolio, they will have to have a methodology for selecting, evaluating, and monitoring these managers/funds. Investment advisors recommend suitable portfolios based on the objectives and tolerance for risk of the investor. Once this is determined, the investments used to implement the objectives must be chosen.

Investment Planning Answer Book by Jay L. Shein, Q 17:1, What are key issues to understand in money manager search and selection?

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One important aspect of manager selection is to determine what investor/client expectations are. The investment advisor and investor should come to some agreement on how to measure value added. These expectations should be reasonable. If they are not reasonable, the investor needs to be educated on what would be considered reasonable value added. How success will be measured should be discussed with investors.

Understanding how to screen for money managers and perform due diligence is an important aspect of the process. The investment advisor will always be seeking managers that are skillful with the anticipation that they can be identified in advance. Understanding the various ways that managers can be structured in a portfolio is an important value added strategy. Including various asset classes and strategies such as alternative investments may be an important consideration.

Common mistakes of advisors include placing too much emphasis on short-term or recent performance in manager selection and the failure to have an established IPS in place. A screening process should be coordinated with the IPS. Other mistakes include not comparing a manager's expenses with the expenses of similar managers and lack of style diversification

Investment Planning Answer Book by Jay L. Shein, Q 17:2, Should a wealth manager or financial advisor use an active or passive approach?

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A wealth manager's approach toward implementation will be dictated by his or her choice of active management or passive management. The efficient market hypothesis (EMH) holds that markets are efficient—market prices fully reflect all known information and the price of a security reflects its intrinsic value. An analysis of EMH has identified the following types of available information:

1. The weak form that assumes that prices fully reflect historical stock prices but not nonmarket information;
2. The semi-strong form that assumes security prices reflect all public information, including nonmarket information; and
3. The strong form that assumes that prices reflect all information, including public and private information.

Academic studies have attempted to empirically prove each form. These studies have strongly supported the weak form, have produced mixed results for the semi-strong form, and have not supported the strong form.

Academic studies that have attempted to empirically prove each form have been inconclusive, with strong support for the weak form, no support for the strong form, and mixed results for the semi-strong form. This is not surprising. The strong form depends not only on the existence of efficient markets, quickly discounting all information, but also ideal markets where all information is available to everyone simultaneously. Another important consideration is that availability of information is one thing and the ability to process the information in a cognitive and disciplined manner is quite another. Benjamin Graham observed:

> To establish the right price for a stock, the market must have adequate information, but it by no means follows that if the market has this information it will establish the right price. The market's evaluation of the same data can vary over a wide range, dependent upon bullish enthusiasm, concentrated speculative interest, and similar influences, or bearish disillusionment. Knowledge is only one ingredient on arriving at a stock's proper price. The other ingredient, fully as important as information, is sound judgment. [Benjamin Graham, "The Renaissance of Value," *The Financial Analysts Research Council* (1974)]

Passive strategies that duplicate an underlying market index have become quite popular. Arguments supporting passive management such as index funds include: (1) index funds are more tax efficient due to their low turnover; (2) index funds do not experience the style drift that occurs when an active manager fails to adhere to the stated style; (3) passive management involves low management fees and other expenses; (4) passive management offers broad diversification; and (5) with passive management, the investor is fully invested at all times.

Most proponents of active management will accept Modern Portfolio Theory (MPT) in terms of risk management but will not accept market efficiency beyond the weak form. Mathematically flawless models have attempted to accurately predict security prices. However, these models were not correct when back tested with historical prices. Those who advocate active management point to historical facts that seem to demonstrate that active managers can add value during short-term market inefficiencies and that MPT's assumptions of rational investors and perfect information are not always justified. Some evidence supporting active management has been provided by academic studies.

Often, fixed income managers are more inclined to track an underlying benchmark. Fixed income investments differ from equity in that valuation can be modeled to a highly accurate level since it is based on well-defined factors. Also, volatility of fixed income investments is attributed mostly to credit rating and duration. Practical reasons not to replicate an index include the high degree of variation of the relative values of different fixed income sectors depending on economic and market conditions. That being said, some product vendors have attempted to replicate passive fixed income indices which are now being used by many investment advisors. These products seem to overcome some of the replication problems to some extent.

There are currently new passive hedge fund-like strategies in addition to the many active hedge fund strategies. There is not a lot of research on the value of passive hedge fund strategies.

Investment Planning Answer Book by Jay L. Shein, Q 17:3, What are some of the advantages to a passive strategy?

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The implications of the semi-strong form and strong form are that security prices fully reflect all public information and that any attempt to identify undervalued securities through any form of analysis of public information is futile. A wealth manager who believes this hypothesis will have no interest in identifying active money managers and will attempt to derive the benefits of diversification by investing passively in portfolios that duplicate, as closely as possible, an underlying market index.

In contrast, a wealth manager who accepts the weak form will not believe that value may be added by trading systems that depend on technical analysis of past prices, but may implement investment policy with money managers or strategies that actively attempt to analyze security fundamentals, economic and or other information to identify undervalued securities, sectors or industries. Research in the behavioral finance indicates that investors are not rational, which is a tenet of the Efficient Market Hypothesis (EMH). Technical analysts think that irrational behavior of investors influences stock prices, therefore technical analysis can assist in making market predictions. Behavioral finance combines with the practice of technical analysis. An adviser who thinks that the efficient market hypothesis is not valid will use any legal means possible to achieve an edge in the market. This may give the advisor or manager a unique value added component to their management process.

Investment Planning Answer Book by Jay L. Shein, Q 17:4, What are some of the disadvantages of a passive strategy?

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Wealth managers who are proponents of active management face a dilemma. Most will accept many of the ideas of MPT, especially with regard to managing risk, but have some trouble accepting market efficiency beyond the weak form. Modern finance has long been in search of the Holy Grail of efficiency. Attempts to formulate mathematical models that would accurately predict security prices have resulted in wonderfully constructed equations that, while theoretically sound, did not prove correct when back tested with historical prices. There is good reason why they call it theory. The mathematics was flawless, but markets are made of more than numbers; they are made of people and people are full of flaws. Each argument supporting passive management is consistent within the context of its own theory. Unfortunately some of the theory has trouble explaining fact.

If a person leans toward only a passive management approach, ask her to explain two things within the context of efficient markets: Warren Buffet and the Dutch tulip mania. Mr. Buffet is an anomaly. If markets are efficient, how do you explain an investor who has demonstrated the ability to significantly outperform the market over time (40 years)? Second, how would seemingly rationale Dutchmen and Dutchwomen suddenly decide that tulip bulbs should be the primary investment vehicle for capital growth, regardless of the market efficiency that determined valuations? More recently, how efficient is the Japanese real estate market that determined, for a brief time, that the value of Tokyo real estate was greater than the combined real estate value of the entire United States?

Proponents of active management will point to many historical facts that seem to demonstrate that markets, especially over shorter periods of time, are often very inefficient or that the assumptions on which MPT is based (e.g., rational investors or perfect information) are not always justified, and that active management can provide value during these periods. Much of the statistical analytic work that supports MPT is based on the law of large numbers. This has proven to be sound mathematics, but large numbers in the investment world require very long periods of time.

Academic studies have provided some evidence in support of active management. Roger Ibbottsen's ongoing research indicates there may be a relationship between past and future performance. [Roger G. Ibbotson and William N. Goetzmann, "History Does Repeat Itself," *Financial Planning,* (February 1995) at 95-96] Studies by Fama and French have indicated that Beta, by itself, was not closely related to portfolio returns. In addition, there are certain sectors of the market in which information is not uniformly available. Small cap stocks do not receive the same level of analysis as do large cap stocks. Information on emerging markets is erratic and because of the unstable political, economic, and market conditions in those countries extrapolation of information can be very difficult. Municipalities are not subject to the same degree of disclosure as are other securities, and inefficiencies are well documented (a fact that will be testified to by anyone owning Orange County, California bonds).

The most important determinant of value is achieving the client's goals. For some, a second measure of performance attribution is the relative performance of the portfolio. Periods of exceptional market return will allow the primary goal to be easily attained, and during these times a client may not pay attention to relative performance. Yet, when markets turn south, performance, both nominal and relative, will quickly suffer. For example, look at the performance swing on rolling 12-month performance if the quarter dropped had a 10-percent gain and the quarter added had a 10-percent loss. The result is not a net of zero but a swing of 20 percent. Advisers and clients alike have been spoiled or shocked by the past, but when corrections occur, especially if they are severe, much more attention will be directed at nominal and especially relative returns. Clients will be far more concerned when the market loses 30 percent and they lose 25 percent than they would be if the market gained 30 percent and they gained only 25 percent.

Investment Planning Answer Book by Jay L. Shein, Q 17:5, Is it possible to find skillful managers?

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Much of the research of the portfolio theory has confirmed that the determinants of the variability in a portfolio are heavily biased by the asset allocation decision. Many believe that skillful managers or funds can be selected in advance. These advisors feel that active investment managers can add value even after fees. They are confident that these skillful managers do exist and can be identified in advance. If skill does exist, then these active managers should have consistent and persistent performance.

Investment Planning Answer Book by Jay L. Shein, Q 17:6, What are two major components of active management risk?

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Total risk is measured by standard deviation as part of Modern Portfolio Theory. Standard deviation is divided into two parts, one being beta or systematic risk which is the risk of being invested in the market, and the other is unsystematic risk which is the risk that is unique to a specific company or industry. Systematic risk is also known as non-diversifiable risk, and unsystematic risk is also known as diversifiable risk. Active manager portfolios that are concentrated in a small number of names (e.g., stocks) have the potential for more added value, which is sometimes referred to as alpha. The more securities that are added to a portfolio, the more diversified the portfolio becomes, and the less systematic risk that exists. A fully diversified portfolio will just be subject to market risk, and there will be no value added by the manager. Two of the risks that active managers are exposed to are relative risk which is the risk of having performance different than their benchmark and absolute risk which is the risk of incurring losses that are unrelated to the market.

Investment Planning Answer Book by Jay L. Shein, Q 17:7, What types of portfolios have the propensity for the most alpha?

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Portfolios that are concentrated with smart, skillful people have high relative risk versus their benchmark, and they typically have a high tracking error. Sometimes high tracking error portfolios may be difficult to determine if it is skill, luck, or merely gambling. Besides being concentrated portfolios, these also may include hedge fund strategies. Portfolio managers that are more diversified make more relative risk decisions and active skill bets. Those managers that are more diversified tend to be relative risk avoiders who make small bets. People who hug indexes or manage enhanced indexes fall into this category. Portfolios that are more concentrated in their holdings and strategies have the higher propensity for positive or negative alpha relative to market returns. Those that are more diversified have less chance for positive or negative alpha. For those that feel that no one can beat the market or the benchmark, they should invest passively in the market or the benchmark such as by investing in various index funds or Exchange Traded Funds.

Investment Planning Answer Book by Jay L. Shein, Q 17:8, What absolute goals do private investors and plan sponsors such as pension plans expect?

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Investors and plan sponsors have multiple ways of looking at their investment goals. They may want to attempt to exceed some marginal acceptable return (MAR) such as they want to have a return higher than 5 percent per year, or they may just want positive returns over specified periods of time. Another absolute goal could be to exceed the assumed asset class returns. For example, if they assume that large cap stocks will return 8 percent, then they would want the large cap money manager to outperform the asset class assumption of 8 percent.

Investment Planning Answer Book by Jay L. Shein, Q 17:9, What relative goals may private investors and plan sponsors such as pension plans expect?

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Investors seeking relative goals are trying to outperform something. For instance, they may be trying to outperform a benchmark such as the Dow Jones Industrial average of thirty stocks. These investors are seeking to earn a positive alpha by outperforming their benchmark. Those investors seeking out performance on a relative basis may be very disappointed at times. For instance, the S&P 500 could be down 20 percent; the investment manager that is managing a portfolio with the objective of outperforming the S&P 500 would be doing well if the return was −16 percent. This manager would be doing very well on a relative basis but not an absolute basis. This is a reason many investors seek an approach that focuses more on absolute returns that on relative returns.

Investment Planning Answer Book by Jay L. Shein, Q 17:10, What are two of the major ways for money managers to add value?

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One way for money managers to add value is to use a bottom-up process for security selection. This involves looking for undervalued securities or securities that have a high growth potential to add to the portfolio. If using the bottom-up approach, the portfolio manager could feel that stock in Company XYZ is undervalued based on its price to earnings ratio and other metrics and would purchase that stock to add to the portfolio. The other major method of adding value is a top-down approach which could be referred to as a tactical approach, a timing approach, or a macro approach. This type of manager looks at the macro investment environment to make a decision on where to invest and then looks for the specific securities to match that macro view. For instance, a diversified portfolio manager may feel that technology stocks will probably do well in the future and might overweight their diversified portfolio with technology stocks which could be selected with a bottom-up approach. Using a top-down approach, this manager who decided to invest in technology stocks would look for companies within the technology sector of the economy that they feel are undervalued and purchase their stock.

Investment Planning Answer Book by Jay L. Shein, Q 17:11, How can successful manager search and selection be defined?

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Finding a manager that can implement the policy and investment process as required by the investor is one definition of success. Consistently achieving an investor's objectives on an after-fee basis while minimizing risk to the portfolio also makes up a successful outcome. The advisor's task is to determine if the manager is skillful or simply lucky.

Investment Planning Answer Book by Jay L. Shein, Q 17:12, Where do you look for money managers such as separate accounts, mutual funds, or hedge funds?

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The universe available for money manager selection is very large. There are thousands of Securities and Exchange Commission (SEC) registered investment advisors, private placements, and other managers. Manager search and selection begins with establishing the criteria for the manager. From that point, the investment advisor can use various databases including commercially available and proprietary ones. They can look on the internet at places such as www.morningstar.com and www.hedgeworld.com. They can find managers at various professional investment conferences. One place that many advisors overlook when looking for managers is the managers themselves. Advisors can ask managers who their biggest competitor is and proceed to do research on that competitor. This allows the investment advisor to find managers they may not find when searching through a database. An important thing to remember when using databases to find information is that no one database includes all the money managers available. Managers are not required to report to any particular database. Advisors would be best served by having access to more than one database as that will give them more opportunity to search for more managers. Even though no two databases have the same managers, they typically have a lot of overlap. Sometimes, another place that advisors can find good managers is their clients. Many times, the clients will know of or have heard of a successful money manager and will tell their investment advisor or consultant. The advisor/consultant then has the opportunity to look into that manager to see if they are appropriate for that client or for other clients. Other places to find managers include publications such as *Institutional Investor*, *Pensions and Investments*, and www.nelsoninformation.com.

Investment Planning Answer Book by Jay L. Shein, Q 17:13, What are the advantages of using money manager databases?

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Money manager databases are usually very easy to use. They contain a large amount of data; and the quality of the data is usually very good. Many of the managers self report their information to the database, but much of the quantitative is audited or in compliance with industry reporting standards. Hedge fund data may be more suspect in these databases. The quantity of data is large and allows for a tremendous amount of output in the form of quantitative analysis and some qualitative analysis. For the amount of information available, the cost is very reasonable. Discussion of some of these databases can be found in other chapters of this publication where software is discussed.

Investment Planning Answer Book by Jay L. Shein, Q 17:14, What are the disadvantages of using money manager databases?

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Since databases are not all inclusive of all managers and some information may be inaccurate, the advisor could come to improper conclusions. Since managers are reporting their own information to most of these databases, fraud can be involved. These databases tend to emphasize performance which is driven by returns and may cause the investment advisor to focus too much on performance while avoiding the analysis of the qualitative data. The advisor who is looking for the actual holdings (securities) may find that the database lacks timely and historical listing of those holdings.

Investment Planning Answer Book by Jay L. Shein, Q 17:15, What are the various approaches to investment manager selection?

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The uninformed investment advisors will focus on past performance, the name brand, and the fees and the philosophy of the money manager. The well-informed, professional investment advisors will consider these but will focus on the investment manager's people, the organization, their philosophy, their process, the make-up of their portfolio, and their performance on an absolute and risk-adjusted basis.

Some information to obtain is whether a manager has clearly defined procedures not only for buying but also for selling. Does the manager have defensive strategies designed to protect the portfolio during falling markets?

These questions relate to the organization of the manager. Are portfolios managed on a star system or by group? If a star system is used, what happens if the star leaves to be a star in his or her own shop? What methodology is used in the selection process, and how consistent has the manager been in applying a management process? How long has the manager been in business and what has the growth of assets been? What has the level of client retention (net inflows and outflows) been? These are all questions that relate to the quality of the manager and are more difficult to answer than those that can be answered by quantitative methods. These issues are highly subjective on the part of the wealth manager. While it is difficult to differ on the significance of a Sharpe ratio, two advisers may come to very different conclusions when it comes to assessing the quality of a manager.

Investment Planning Answer Book by Jay L. Shein, Q 17:16, What types of criteria are important in manager search and selection?

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Qualitative and quantitative criteria are both important in manager search and selection. The first seven major criteria are qualitative and are much more important than the quantitative. The qualitative criteria include the philosophy of the investment management firm, the investment process, the people that work at the firm, the firm's business plans, the investment products they offer, how they progress such as how they develop new ideas, and the price or fees. The eighth major criterion is quantitative and involves performance measurement and evaluation.

Investment Planning Answer Book by Jay L. Shein, Q 17:17, What are some elements of the investment management firm's philosophy?

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When evaluating an investment management firm, it is important for the investment advisor to understand the investment product strategy. In other words, does it make sense to the investment advisor? If the investment advisor finds that they do not understand the strategy, then it will be up to the advisor to come up to speed, seek assistance in evaluating the strategy, or decline to use the manager. Questions that arise when evaluating the firm's philosophy would include whether the investment strategy have been tested and whether or not the strategy has been tested using historical information or some type of forward-looking probabilistic simulation. The investment advisor should ask if the strategy has changed over time. For example, a U.S. stock manager states that she is a large capitalization growth manager, but the investment advisor looks at historical holdings in some previous years or performs a returns based style analysis and finds that the manager has been a large capitalization value manager in the past. Obviously, there have been changes made, and the manager will have to be questioned regarding the reason for these changes.

Investment managers should be able to describe their investment capabilities. They should be able to articulate their style of management. Advisors should verify that they consistently adhere to the style that they state.

Investment Planning Answer Book by Jay L. Shein, Q 17:18, Are the people that implement an investment manager firm's strategy important?

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These people can be a major factor in the ultimate outcome of an investment management firm's strategy. A key factor here is whether the people that implement the strategy have relevant experience. This relevant experience should be similar to what they are currently responsible for. For instance, if you are evaluating the firm's employees who implement a small cap growth stock strategy, then those people who implement the strategy should have experience in small cap growth stocks. When looking at specific investment products of an investment management firm, the key investment decision makers should have more than ten years of portfolio management experience that relates directly to the type of product under review. While those that assist in implementation can have less experience, the key ones should have a longer tenure in the type of strategy being used. The investment advisor or consultant might not want to rule out a strategy if the key decision maker has had less than ten years of experience in that strategy. A manager of six years experience in the strategy with additional experience in other investment management strategies might still be worth considering.

When separate accounts are used, it is important for the advisor to know how many investment professionals are assigned per account. Does the investment advisor or consultant have access to the managers and analysts? Who is the primary contact for the investment advisor or consultant? These are some other questions that need to be answered.

Advisors should be clear on who is managing the portfolios on a daily basis and who is doing the marketing. Ask about people that have been hired in the last few years. Discuss the succession plan for the firm.

Investment Planning Answer Book by Jay L. Shein, Q 17:19, What makes an investment manager unique and how do they add value?

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Investment advisors and consultants should ask investment management firms what makes their investment strategy unique. With so many managers running similar strategies, it is important for the manager that you are looking into to have conviction regarding what makes them unique. If the manager feels he is like other major competitors, he has no edge and may be no better than any of the other managers that the advisor is looking at. Investment advisors can ask the manager why he feels that he is unique and what makes him different from all of his competitors.

Investment managers that can add value should offer either absolute returns or relative returns that outperform their benchmark on both an ex-post and ex-ante basis. If the manager has not added value or does not feel that he can add value going forward due to factors such as the economy, then he should be avoided. If the investment advisor feels he is unable to find a manager in a certain asset class that can add value on an ex-ante basis, then he is probably better off investing in a passively managed portfolio such as an index fund.

Investment Planning Answer Book by Jay L. Shein, Q 17:20, What are some important issues regarding the people in a firm?

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Another important criterion or category to consider is the investment management firm's people. It might be said that the firm is equal to the people, and the personnel is what makes the firm what it is. The investment advisor needs to know how the firm is organized and the ownership structure. An organizational chart with key employees and management listed is an important tool to enable this discussion. In all firms, the key people and owners should have their own funds invested in the strategy. The more funds they have invested in the strategies that they offer, the more conviction that they usually have. How these people are incentivized is important. It is logical that people whose livelihood is directly impacted by the results will work harder. Incentives are usually monetary or involve direct or indirect ownership of the firm. In a perfect situation, the key investment professionals would receive higher compensation than others that manage the same asset class in the same geographical area. All these investment professionals would have a stake in the equity of the company or will eventually have some. Do not consider this a benchmark as you may find some good management firms where the compensation is similar to those managing the same asset class in the same geographical area. You may also find that only some of the key investment professionals have a stake in the firm. A key investment professional that does not have a stake in the firm may enjoy working at the firm due to the intellectual experience they have from working with the other people in the firm. For some, this might be sufficient incentive.

Investment Planning Answer Book by Jay L. Shein, Q 17:21, How important are the qualifications of an investment management firm's people?

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The qualifications of the people in the firm are very important. The single most important qualification is experience. How many years of experience does this manager have in this strategy? How many years in the industry have the key investment professionals had? Ask the key investment professionals what they did during each year of their experience that they state. A person who has been in the investment industry twenty years but has only managed a particular strategy for one year would not be a good choice. Investment advisors and consultants should verify any certifications, designations, or licenses that the firm's key personnel state they have in their biography. Most certifications, designations, and licenses can be verified directly with the issuing college or university, institution, or organization granting such. For example, if a person wants to verify that a person is a Certified Financial Planner™ professional, they can check with the Certified Financial Planner Board of Standards, Inc. which can be found at www.cfp.net. A Certified Investment Management Analyst℠ can be verified with the Investment Management Consultants Association℠ at www.imca.org.

Ideally, the key investment personnel at a money management firm do not have the same experience and background. If this is not true about a money management firm, there may be more of a tendency for group thinking and less creativity. Investment advisors should also check to see if there are any regulatory violations or censures. Just because a firm has had a violation or censure does not mean they should be eliminated as a possible candidate for inclusion in a portfolio. Some violations can be because of errors in judgment but do not have a material effect or change the value of what the investment firm does. Of course, if the firm was involved in fraud that would definitely be a red flag.

Investment Planning Answer Book by Jay L. Shein, Q 17:22, Should the advisor or consultant ask questions regarding turnover of personnel and allocation of resources?

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A firm that has a lot of turnover in the key investment professionals is problematic. If the key professionals are leaving, it is unlikely that a successful strategy would be able to be continued. Investment management firms will sometimes state that if key personnel leave, it is not a major issue as they work as a team and are all similarly trained. This author does not buy into that argument. If key investment professionals are leaving a firm, there is a reason. Maybe they are not adequately compensated or incentivized. This may cause problems in the future for any current professionals left or future ones that are hired. Investment advisors and consultants should always question a firm diligently that is having turnover in key investment professionals. If you hire an investment manager firm or mutual fund, you could email or fax them quarterly asking them if there has been any changes in the key investment professionals responsible for managing the particular strategy that they were hired for.

How a firm allocates their resources demonstrates their priorities in running the firm and also may give an indication of the probability of a future acceptable outcome. For instance, firms that allocate too much of their resources to sales and marketing may not give adequate funds for the benefit of the investment professionals and the research they require to maintain their results. A firm that is very small that is allocating nothing to marketing may have insufficient growth to reach a critical mass that will enable them to receive enough capital to continue the business. A firm that no longer markets but has reached a point where they are acceptably profitable may allocate most of their resources to investment management and research. Be cautious with firms that have many expensive brochures and allocate large sums to their marketing and sales department.

Investment Planning Answer Book by Jay L. Shein, Q 17:23, What are considerations for investment management firm's criteria regarding their future plans?

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Discussing with an investment management firm its objectives for growth will assist the investment advisor or consultant in determining how well a firm can cope with the future regarding their firm. Will the firm try to grow significantly or will it stay static? This discussion is designed to uncover how well a firm can handle its operations today and in the future. A firm may adequately take care of its current resources and needs but may experience growing pains if it does not adequately plan for its needs and resources should projected growth occur. Rapid growth without adequate planning can be a distraction that strains the overall resources of the firm such as personnel, office space, and anything else that would be necessary to have a smoothly run operation. If a firm is planning on growing rapidly, then a firm that has resources that are currently greater than its current needs would be ideal as long as the firm plans to stay ahead of projected growth. A firm that just matches or moderately exceeds its resources with little plans to handle rapid growth may be a problem in the future.

It is also important to understand how much of a firm's assets under management are institutional versus individual private investors. For example, a firm that mostly handles institutional tax exempt clients may not be prepared to adequately manage a portfolio for a taxable investor.

Investment Planning Answer Book by Jay L. Shein, Q 17:24, What are some product related criteria for investment manager search and evaluation?

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Is the investment product itself designed in such a way that it is the best way to put into affect the investment firm's philosophy? Is the investment strategy/product flexible enough to meet the needs of the investment advisor? For example, if it is a small cap stock manager with an investor who works in the technology industry, she might require excluding technology stocks in the portfolio so as not to have too much concentrated risk regarding her wealth and income. Does the manager offer a variety of styles and does her experience managing these styles match?

Investment Planning Answer Book by Jay L. Shein, Q 17:25, How important is the investment management firm's process?

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The investment process at a firm is one of the most important criteria in evaluating a firm. It involves many elements. Some of those elements will be discussed. The following are some questions that need to be answered and will affect the final outcome of an investment portfolio. Is the firm more active or passive in its trading strategy? How are its systems used for trading? Does its process focus on specific market capitalizations? Does its process lean more toward growth style or value style of investing? Or does it try to adhere to a specific style? Does it feel that a diversified portfolio which will have a smaller tracking error to the benchmark or a more concentrated portfolio which may have higher positive alpha and a high tracking error to the benchmark be more appropriate? Does its process look at different themes or rotating sectors, or does it take a contrarian approach to investing? Does the investment security selection process involve fundamental and/or technical analysis? Many believe that technical analysis is of little value. What is the number of securities typically in a portfolio? How much turnover does it have in its portfolio? If it has significant turnover, how does that affect realized gains and losses for income tax purposes? Is it tax efficient or tax aware? Ask it what its methodology for screening and selecting securities is. Ask the investment management firm to give you an example of securities it has recently purchased. Have it take you through the analysis and selection process for those securities. Its discipline used to make a sell decision is one of the most important. Have the investment manager take you through the process and analysis on one or two securities that were sold recently. Many investment management firms hold onto their losers too long, therefore, it is important that they have a defined sell discipline.

It is important that an investment management firm have adequate accounting and administration systems. If a firm is audited, the investment advisor should call the auditor and discuss the audit and the extent of the audit. If possible, get a copy of the audit especially when reviewing a hedge fund. It is important that a firm have adequate back-up procedures. Make sure the company has the ability to recover their data in case of an emergency such as a hurricane, fire, or explosion. It should also have adequate procedures in place to continue operations if its computers are stolen or impacted with a virus. If a firm cannot retrieve their data in a timely manner, this could negatively impact the management of a client's portfolio. Frequent back-ups and the ability to recover from a catastrophe quickly are very important. A firm that keeps all its back-ups offsite and could recover all of its operations in an hour or two would be exceptional. Of course, investment advisors would want to know the fee structure for the portfolio and if there are any break points for larger amounts invested.

Asking the firm to discuss any conflicts of interest that it feels it may have is important. Ask the firm about any soft dollar arrangements that it may have. Soft dollars are funds that are accumulated at a brokerage firm where the money manager trades that are based on the amount of commissions generated by the transactions at that brokerage firm. Many investment management firms have soft dollar arrangements. The conflict that may arise could be that an investment management firm pays more for trades in order to receive more soft dollars at a particular firm. Soft dollars are neither good nor bad. They are just something that is available for many firms. Since soft dollars are based on the amount of client trades, the investment firm needs to have the investors' best interest in mind. To make sure that soft dollars are being used properly, ask for a written list of all expenses paid by soft dollars. Typically, this list will be mostly research that is used to assist the firm to manage portfolios and make more informed decision. Investment advisors and consultants should verify that the process that the investment management firm is using supports the investment philosophy that they are propagating. Advisors should also make sure they understand the research capabilities of the firm. Ideally, a firm uses both internal and outside research. Does what the firm says they do reflect what they really do?

Another idea is to ask the investment manager that would be managing the portfolios for the advisor's clients to describe her daily or weekly routines. Ask when and if a manager changes her exposure to risk if there are changes in the market. Would this include changes that are not within the manager's purported style?

Investment Planning Answer Book by Jay L. Shein, Q 17:26, How does progress play a role in manager search and selection?

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It is important to understand how investment managers change with the times. Will their philosophy evolve when there are changes in the economic environment or with structural changes in the market such as decimalization, removal of the uptake rule for shorting, or the compression of bid ask spreads? Does the manager judge new ideas on the quality of the idea or just on quantitative observation? If the firm does not change with the times, this may negatively affect performance. Also if the firm is experiencing high turnover of key investment professionals, how are they addressing this? A firm that does not evolve will not be a good candidate for inclusion in a portfolio.

Investment Planning Answer Book by Jay L. Shein, Q 17:27, What are some important criteria for pricing?

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It is important for the advisor to know the cost involved for using an investment management firm's services. Are the fees wrapped where they include transaction costs, or are they unbundled where the management fees are separate from the transaction costs? What are the fees for the custodian? Fees are important but should not be the focus of the decision. A manager that has higher fees but consistently outperforms on a regular basis is better than a manager with lower fees that has average returns. A good rule of thumb for advisors and consultants is to look for managers whose expected returns over their benchmark is greater than two times the total fee. While mutual fund performance is always reported on a net basis, make sure that separate account managers report both net and gross before fees.

Investment Planning Answer Book by Jay L. Shein, Q 17:28, What are some qualitative procedural issues with the Department of Labor (DOL) or Employee Retirement Income Security Act (ERISA)?

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When choosing an investment manager to include in a portfolio, there should be written investment guidelines. The consultant can choose from a range of qualified candidates but must document the process. He has to evaluate items discussed in this chapter such as but not limited to the qualifications of the manager, the structure of the business, their assets under management, the number of accounts they manage, how many professionals they employ, and the references of those professionals. For ERISA plans, the investment manager must meet the definition of "qualified advisor" under ERISA 3 (38). The capitalization and financial position of the firm is also important. It needs to have a fidelity bond, and of course, its track record, investment management style, and performance should also be evaluated.

Investment Planning Answer Book by Jay L. Shein, Q 17:29, Once an investment manager has been selected, is the search and selection process over?

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So far in this chapter, there has been discussion of the seven qualitative criteria or categories involved in manager search and selection. The eighth criterion is performance. Once a manager has been selected by the advisor or consultant for inclusion in a portfolio, the job is not finished. Key portfolio managers or analysts may leave. This could negatively affect performance on an absolute or risk adjusted basis. The firm may grow rapidly without adequate control which may cause it to become administratively inefficient. The firm's investment style may change over time which may not be the style the advisor hired it for in the first place. Investment managers that are under pressure to continue performance may take more risk than they were originally hired for. This must be monitored. Also, a manager may be underperforming and may increase her risk in order to catch up as she knows that the advisor is watching her. She may also be doing very well and reduces her risk in order not to lose the profits she has already made. As can be seen by these thoughts and questions, it is very important to continue to monitor a money manager, mutual fund, or hedge fund after she is hired. It is important to continuously ask questions.

Investment Planning Answer Book by Jay L. Shein, Q 17:30, What are the two major components of money manager search and selection?

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The investment manager search and selection process includes qualitative and quantitative evaluation. Advisors that only focus on the quantitative side which includes both absolute and risk-adjusted performance will find many times that they are disappointed in the results going forward when they exclude the elements of the qualitative analysis. In fact, it should be noted here that the qualitative analysis is much more important than the quantitative analysis. Without good qualitative information, it is unlikely that advisors will choose good managers going forward. Remember, it is the advisor's goal to differentiate skill from luck. Managers that provide good qualitative information are more likely to result in consistent good performance in the future than managers that only have good quantitative numbers.

Investment Planning Answer Book by Jay L. Shein, Q 17:31, What are some quantitative due diligence methods that advisor's can perform on money managers?

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Quantitative methods in analyzing methods are the eighth criterion that completes the money manager search and selection process. These include such things as return based analysis and holding based analysis. This performance driven criteria is the proof of the seven qualitative analysis criteria.

Investment Planning Answer Book by Jay L. Shein, Q 17:32, What are some returns based quantitative methods for manager search and selection?

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- Risk/Return Analysis
- Correlation/R-squared Analysis
- Sharpe Style Analysis (also known as Returns Based Style Analysis)

Investment Planning Answer Book by Jay L. Shein, Q 17:33, What is Risk/Return Analysis?

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Advisors can use risk/return analysis methods to assist in the analysis of money managers. They can use a risk/return analysis such as measuring expected return of the portfolio versus the standard deviation of the portfolio for ex-ante predictions. For ex-post analysis, they can look at historical returns versus the standard deviation of the portfolio. For ex-ante observations, they can simply calculate it by dividing the expected return of the portfolio by the expected standard deviation of the portfolio. For historical (ex-post) calculations, take the historical return divided by the historical standard deviation. Generally, when looking at historical numbers, standard deviation will be adjusted for one degree of freedom; the number of periods in the calculation for standard deviation will be equal to $n-1$ where n is the number of periods. This method generally assumes that the investor is a risk taker and is difficult to use when comparing portfolios. A method of scaling would be better which assumes that investors are risk averse. Risk averse investors would most likely be interested in returns above the risk-free rate when taking on risk. One popular method of scaling is using the Sharpe ratio which is discussed in this publication.

Investment Planning Answer Book by Jay L. Shein, Q 17:34, What is Correlation/R-squared Analysis?

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Advisors can also do a correlation analysis or an R-squared analysis. This simple method of getting R-squared is simply to square the correlation. If the advisor already has the calculation for R-squared, he can take the square root of the R-squared to get the correlation. This allows the advisor to see how closely the manager being analyzed is moving relative to its portfolio benchmark. R-squared is revealing as to how much of a manager's return can be explained by the benchmark. For example, if an advisor is looking for a small capitalization growth stock manager, he should have a fairly high R-squared relative to the small growth benchmark that is being used. Higher R-squared values also tell the advisor that other statistics being calculated relative to the benchmark have some validity. The advisor should look for R-squared values higher than 70 while being higher than 80 is even more preferable. One caveat here is that if the R-squared is too high (such as 98), then the manager is most likely tracking the benchmark, and the advisor might just be better off investing in a benchmark through some investment vehicle that tracks the benchmark very closely. The high R-squared indicates that most of the money manager's returns can be explained by the benchmark. Since the fees for investing in an index that mimics the benchmark are usually less, it would make sense to just buy that investment vehicle as opposed to investing in that money manager.

When using the correlation or R-squared analysis, the advisor is looking for a comparison standard. The benchmark that the advisor selects would match the client's risk preferences and investment objectives. The portfolio manager return would then be compared to the benchmark. For example, for an investor's portfolio that specifies lower risk should compare the portfolio's manager's performance to the lower risk benchmark. The manager should have a high correlation or R-squared to that benchmark. The correlation/R-squared analysis is a relative measure of risk and not an absolute. If a manager is being judged on a relative basis, he should be judged relative to the stated benchmark.

Investment Planning Answer Book by Jay L. Shein, Q 17:35, What is the advantage of Returns Based Style Analysis (RBSA)?

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Returns Based Style Analysis was developed by Nobel laureate William Sharpe and is sometimes referred to as Sharpe style analysis. Each money manager typically would state that she is unique, and therefore, it is truly difficult to box that manager in relative to her stated benchmark or one of the advisor's choosing. If each manager is truly unique, then she should have their own custom benchmark designed to represent their style of investing.

The mathematical process of using RBSA is designed to detect a manager's style drift by using historical data. This methodology can determine the effective style mix of a manager and whether their objectives or styles have changed over time. An effective style analysis requires using appropriate style benchmarks and accurate data with a sufficient length of time. RBSA tells the advisor the style of the manager, how consistent that manager's style has been over time, and what have been the risk and return implications of an investment manager's decisions over time. RBSA does not tell the investment advisor the exact holdings of the manager. RBSA is not an investment manager or mutual fund system for ranking managers.

Returns Based Style Analysis is a method of attributing performance and interpreting the behavior of the manager. It considers R-squared in its analysis and will help the advisor decide on how that investment manager should be allocated in a portfolio. RBSA using Sharpe's formula has a high resemblance to a typical constrained, multivariate, regression analysis. The mathematics behind RBSA is a quadratic optimization. In other words, the style attribution coefficients are determined in a manner so the variance of the excess return of the manager or fund versus the style benchmark is minimal. In William Sharpe's original work, all coefficients were required to be between zero and one, and they all had to add up to one. Sharpe's method determines the style attribution coefficients in a way so that the variance of the series given as $M - (c_2A_1 + c_2A_2 + c_3A_3 + c_4A_4)$ becomes minimal.

Where:

M is the manager or mutual fund return series

A_1, A_2, A_3, and A_4 is the return series for the style indices

c_1, c_2, c_3, and c_4 are the style attribution coefficients

Any number of asset classes can be used, although four was used in this example.

For an example of RBSA, let us assume that money manager A is being subjected to a Returns Based Style Analysis. The style analysis indicated that the money manager is 70 percent large growth stocks and 30 percent mid-sized growth stocks. If the manager was outperforming this custom style mix, then the manager would be adding alpha versus their style benchmark.

Another example is for an advisor designing a portfolio that indicates the need to have 30 percent in large growth stocks. They could use RBSA to see if the money manager, portfolio of individual securities, or fund that the advisor wants to include in the portfolio is truly tilted toward large capitalization growth stocks. RBSA is a powerful method to analyze money managers or mutual funds. It can help determine if the manager is truly adding value versus their custom style benchmark.

Investment Planning Answer Book by Jay L. Shein, Q 17:36, Are there any caveats when using Returns Based Style Analysis (RBSA)?

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One of the arguments against RBSA is that it does not tell the investment advisor or consultant what the actual holdings are in a portfolio. It does tell the advisor how that manager acts. For example, RBSA using the appropriate style indices should show that the manager's style is that of a small cap value manager. When looking at the actual holdings of the portfolio, they should be dominated by small cap value stocks.

Sometimes, a manager that has high income producing stocks such as utilities in a portfolio may look partially like a fixed income manager depending on the underlying style indices used to create the quadratic optimization of the style analysis algorithm. There are indications that managers that do not adhere strictly to a style of management are more able to add alpha as they are not constrained as much.

One of the problems that have appeared in the past using RBSA has been the analysis that is obscured by country weightings. One difficulty in style analysis in foreign markets is that investors in other parts of the world approach investing differently. Some investors in some countries may be dominated by a value approach so they become cyclical type investors.

Since RBSA uses the pattern of past returns for a manager in conjunction with a time series of various indices with different investment styles, it is difficult to use this analysis to predict the future. It is the effective historical style of the manager. The objective is to understand the underlying influences responsible for a manager's performance. This allows the advisor to classify the manager and to compare one manager with another. With RBSA, the advisor can see what the manager actually is as opposed to what he says he is. Various indices can be used in the style analysis. The best indices are mutually exclusive. Some of the popular ones that are used today are the Surz Indices, Willshire Indices, and the Russell Indices. Typically, RBSA will include T-bills, intermediate term government bonds, corporate bonds, mortgage-backed securities, various stock style indices, and foreign stock indices.

RBSA is quick to use and is inexpensive. Its optimizing process minimizes tracking error to the indices. With all of its benefits, it can still be misinterpreted and avoids analyzing the actual holdings in a portfolio. If the tracking error is too high in RBSA, then the analysis might not be reliable. Advisors should look at the rolling R-squared values to make sure they are not too low. Too low rolling R-squared values could also indicate an unreliable analysis. If RBSA does not match a holding based analysis, the advisor should look deeper since usually there should not be large discrepancies. RBSA can also be used with a blend of money managers. The advisor can take the money manager blend and perform a RBSA on it to determine the effective style of that blend.

RBSA is quick to use and relatively inexpensive. Its optimizing process minimizes tracking error to the indices. With all of its benefits, it can still be misinterpreted, and it avoids analyzing the actual holdings in a portfolio. If the tracking error is too high in RBSA, then the analysis might not be reliable. Advisors should look at the rolling R-squared (R^2) values to make sure they are not too low, since this could also indicate an unreliable analysis. The R^2 indicates how much of a portfolio or manager's return can be explained by the style benchmark. The higher the R^2, the more explanatory power the style benchmark has.

If RBSA does not match a holding based analysis, the advisor should look deeper since there should not usually be large discrepancies between the two. RBSA can also be used with a blend of money managers. The advisor can take the money manager blend and perform RBSA on it to determine the effective style of that blend. With RBSA, a manager's skill is indicated by the difference between the manager's returns and the style benchmark returns, and can be observed on both absolute return and risk-adjusted return. A positive excess return above a style benchmark would indicate that the manager added value above the style benchmark. A return below the benchmark would indicate that no value was added, and therefore would be inferior to owning the style benchmark. RBSA is much faster than a holdings based approach and gives fairly good results. RBSA does not have all the answers and can be misinterpreted; therefore, advisors and consultants should only use RBSA when there is an understanding of its advantages, limitations, and interpretation. RBSA should not be used in isolation to the exclusion of other qualitative and quantitative methods.

Investment Planning Answer Book by Jay L. Shein, Q 17:37, What is Holdings Based Analysis (HBA)?

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Holdings Based Analysis is also important when evaluating a money manager. This is also a quantitative criteria used in the manager search and selection process. Holdings Based Analysis looks at quantitative items such as:

- Industry/Sector Attributions
- Market Capitalization Attribution
- Characteristic Attributions
- Style Attribution
- Multi-Factor Models
- Portfolio Opportunity Distributions (PODs)

HBA considers the actual holdings in the portfolio to determine the attributes of the portfolio. One of the best ways for an advisor to make an informed decision is to make sure that the advisor is fully informed. Using both Returns Based analysis and Holdings Based analysis will assist in this endeavor.

Investment Planning Answer Book by Jay L. Shein, Q 17:38, What can be observed by looking at a manager sector or industry attribution?

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Managers perform by having good security selection or by making good sector or industry bets. The advisor can look at the sector weightings versus the manager's benchmark to see if they are underweighting or overweighting specific sectors of the economy. These sectors include areas such as energy, materials, industrials, consumer discretionary, consumer staples, healthcare, financials, information technology, telecommunication services, and utilities. A manager's weighting to cash relative to benchmarks should also be considered. The advisor can ask the manager for a sector attributions analysis on a quarterly basis. This attribution should use some classification standard such as the Global Industry Classification Standard (GICS). This attribution analysis should show the benchmark weighting for each economic sector and the portfolio manager's weighting for each economic sector. Ideally, this analysis will show the return for each sector in the benchmark. This analysis should then indicate whether the portfolio sector weighting was a positive or negative contribution to returns for the period of time being measured. This is ideally done on a quarterly basis. The manager should also supply the advisor with information as to whether his stock selection was a positive or negative contribution to returns during that period of time in each sector. A manager should also provide whether the total active decision making which includes sector bets and security selection bets was a positive or negative contribution for that sector.

The same thing that is done for a sector attribution can be done for an industry attribution. The advisor can look at the weighting by industry of the portfolio manager versus the benchmark. He can then look at the contributions made by the industry bets, the stock selection, and the total active contributions by industry. Industries can include areas such as oil and gas and fuel, semiconductors and equipment, software, energy equipment and services, pharmaceuticals, communication equipment, hotel restaurant and leisure, healthcare equipment and supplies, internet software and services, and/or specialty retail. The advisor might rather just review the top ten industry attributions based on asset weight in the portfolio. The advisor might also find it valuable to look at the top positive industry contributions for the portfolio as well as the top negative contributions. These attribution analyses can usually be provided by the money managers themselves.

Investment Planning Answer Book by Jay L. Shein, Q 17:39, What is Market Capitalization Attribution?

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Market capitalization attribution is similar to sector and industry attribution analysis. Analysis of attributions from market capitalization is typically derived from the portfolio manager. With this type of attribution, you might be looking at a breakdown of the market capitalization of the portfolio relative to its benchmark. You could look at how much is allocated in such groupings such as capitalizations above $15 billion, between $7 billion and $15 billion, between $5 billion and $7 billion, between $3 billion and $5 billion, between $1 billion and $3 billion, between $800 million and $1 billion, between $500 million and $800 million, between $300 million and $500 million, and between $100 million and $300 million. The attributions should show the weighting for the various capitalization ranges and the percentage allocation of those ranges to the benchmark. This attribution should also ideally indicate the benchmark return for each market capitalization grouping and the contribution to returns for the allocations to the particular market capitalization groups and the stock selection contributions in those groups. Each portfolio manager may provide a slightly different attribution analysis. Whatever is available to the advisor will help the advisor to determine the style and methodology and added value of the manager.

The managers that are adding the most alpha will typically have attributions that do not closely track the benchmark. William Sharpe, one of the 1990 Nobel Prize winners in economics, answered the following question affirmatively in an interview by *Advisor Perspectives*, October 16, 2007, at http://www.advisorperspectives.com: "A number of studies have asserted that index-hugging active fund managers deliver inferior returns, and that superior managers can be identified—in part—by looking for those that have the flexibility to select investments from the broadest possible universe. Do you agree with this proposition?"

Investment Planning Answer Book by Jay L. Shein, Q 17:40, What are Characteristic Attributions?

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Looking at the characteristics of a portfolio such as price to earnings (P/E) ratio, price to book ratio, price to cash flow, and return on assets can provide the advisor with valuable information regarding a specific money manager or mutual fund. For instance, a high price to earnings ratio might indicate that the manager's style is some type of growth style while a low price to earnings ratio would most likely indicate a value manager. The benefit of looking at any attribution analysis including historical portfolio statistics and characteristics is to evaluate the attribution analysis and trends over longer periods of time. These characteristic attributions could also be referred to as fundamental characteristics. The advisor could look at the weightings of these fundamental characteristics in the portfolio relative to the manager's benchmark. From this analysis, the advisor or consultant could see where the most value was added in the fundamental characteristic weightings of a portfolio.

A simple example to see how these portfolio characteristics can be evaluated is as follows. Suppose a manager of mid capitalization U.S. stocks had 50 percent of their stocks in high P/E stocks and 50 percent in low P/E stocks. This would indicate that the manager was probably a core type manager as opposed to a pure or heavily tilted growth or value manager.

Investment Planning Answer Book by Jay L. Shein, Q 17:41, How can Style Attribution be used?

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When evaluating money managers or mutual funds, it is important to determine their effective mix as that is how they will act when included in a portfolio. One way to determine this mix is to use Returns Based Style Analysis (RBSA). While an index or passive manager has a specific style, an active manager benefits from both style return and security selection. When using benchmarks or indices to evaluate a money manager or fund, the benchmark should be able to be identified in advance, should be a feasible alternative to the manager, and should be available at a low cost. RBSA is a method that accommodates these criteria. RBSA is discussed in other portions of this publication. The objective of style analysis is to establish the various weights of the indices used in a method in order that the weighted sum of returns is the style benchmark for a particular manager. The following formula can be used with any number of indices and weightings to get the effective style mix for a manager. This particular example uses five indices.

$$S = w_{sg} \cdot R_{sg} + w_{sv} \cdot R_{sv} + w_{lg} \cdot R_{lg} + w_{lv} \cdot R_{lv} + w_{tb} \cdot R_{tb}$$

Where:

S = weighted sum of returns

w_{sg} = the weight of the small growth index

R_{sg} = the return of the small growth index

w_{sv} = the weight of the small value index

R_{sv} = the return of the small value index

w_{lg} = the weight of the large growth index

R_{lg} = the return of the large growth index

w_{lv} = the weight of the large value index

R_{lv} = the return of the large value index

w_{tb} = the weight of the Treasury bill index

R_{tb} = the return of the Treasury bill index

The measure of the manager's skill is equal to the return of the manager less the return of the style benchmark. Style analysis establishes the weights so that the asset class weights minimize the variance of excess return. Advisors should use the assistance of a software package to properly calculate a manager's return based style analysis.

Investment Planning Answer Book by Jay L. Shein, Q 17:42, What are factor models?

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The movements of securities are affected by many common factors. Decomposing a security's factors provides information that can assist in evaluating portfolio risk and expected outcome. With these models, advisors can quantify risk and assist in making investment decisions with a high probability of realizing the expected outcome.

There are basically three types of factor models. The first model looks at fundamental factors and includes the Fama and French factor models and the Barra type factor models. More information can be found on Barra models at www.mscibarra.com/index.jsp. A fundamental factor model may look at such things as the size of a company, its dividend yield, and what industry it is in to establish common factors that affect the investment return. The second type of factor model is the statistical factor model which looks at factor analysis and principal component analysis. In a statistical factor model, information such as the variables of the factors and the factor loadings need to be approximated. The third type of factor model is a macroeconomic factor model including the following examples: Capital Asset Pricing Model (CAPM), general macroeconomic factor models, and the Arbitrage Pricing Theory (APT). Macroeconomic models may look at things including discernible economic time series such as inflation, interest rates, unemployment, and industrial production as measure of some common factors in asset returns.

Factor models are used to look at asset returns, often where the common factors are construed as capturing fundamental risk components where the factor model isolates a particular asset's sensitivity to these factors. Factor models can be used to estimate the probability of abnormal returns, to predict returns, to recognize sensitivities to risk, and to estimate the variability of returns.

Based on research by Gregory Connor and described in his paper "The Three Types of Factor Models: A Comparison of Their Explanatory Power" published in the May/June 1995 *Financial Analyst Journal*, he concluded that the statistical and fundamental factor models significantly surpassed the macroeconomic factor model. While these conclusions are valuable, it should not be assumed that any one model is better than the others.

Investment Planning Answer Book by Jay L. Shein, Q 17:43, What are Peer Group comparisons?

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The next level of performance comparison is at the peer level. Here we are comparing the performance of a manager to his or her peer group. It is important that the peer database that is used in this screen is analytically sound. If the methodology used to construct the peer database is corrupt there will be no statistical validity to this comparison. Wealth managers may build a database of manager performance internally but this is extremely costly and would make no sense unless the firm was amortizing this cost over a very large capital base. There are many manager databases available in the marketplace for mutual funds, separate accounts, variable annuities, closed end funds, and hedge funds. Some of these include Morningstar, Value Line, Zephyr, Nelsons, and plan Sponsor network (PSN).

Investment Planning Answer Book by Jay L. Shein, Q 17:44, What are Portfolio Opportunity Distributions (PODs)?

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Trying to evaluate a money manager and discerning whether their historical performance is because of luck or skill is a difficult process. Managers are typically compared against a specific benchmark such as the S&P 500 and a benchmark peer group that most closely matches the manager's style of investing. One of the problems with peer groups is the concept of survivorship bias. By using PODs that randomly create portfolios that are similar in style to the manager that is being evaluated, we can eliminate survivorship bias. With PODs, a custom peer group benchmark is created. The advisor can then see how the manager or mutual fund performed relative to hundreds of randomly selected portfolios with similar styles to the manager. For instance, if a manager was in the bottom two quartiles relative to her mean POD, then the manager is not outperforming the majority of randomly selected portfolios. It could then be said that the manager has less skill than the average randomly selected portfolio. This type of peer group analysis (PODs) tells you if a manager is adding value over and above that which would be indicated by pure chance. Further detailed discussion of PODs can be found in another chapter of this publication.

Investment Planning Answer Book by Jay L. Shein, Q 17:45, Can historical returns be used to select a money manager?

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Every advisor and investor looks at historical returns when evaluating whether he should invest with a private money manager, mutual fund, or separate account manager. The question then becomes the following: Does looking at historical information provide information to select a manager that will do well on an ex-ante basis? This question has been pondered, researched, and debated for many years with still no conclusion. Without looking at historical information, all that is available to an investment advisor is conjecture, speculation, and estimates of probabilities of outcomes. If advisors look strictly at historical information to make their choices for the future, they will find that many times, they are disappointed in future results.

Let's look at a brief case study of selecting a hypothetical money manager with two possible candidates to choose from. In the following Table 1, you can see the total yearly return for two different money managers and the benchmark index for those money managers. In this example, the charge to the investment advisor or consultant was to find a small capitalization growth stock manager. These managers were produced by screening for managers that had good risk-adjusted returns and appeared to be relatively consistent based on the search criteria used. Returns Based Style Analysis was used to determine the dominant style of these managers. Both managers were predominantly small capitalization growth managers. Both managers had a high R-squared to their return based style benchmark and their index benchmark. The high R-squared gives us confidence that some of the statistical analysis that we will perform will be valid. Looking at this table, we see a lot of variability of returns from year to year of the two different managers and their index benchmark. When looking at historical performance, many advisors tend to be very shortsighted and look at small periods of time such as a recent one year period. As can be seen by Table 1, looking at a short period of time would give no indication of how the manager would do on a relative performance compared to his index benchmark.

Another mistake many advisors and consultants make is focusing on snapshots in time such as the most recent three year, five year, seven year, or ten year period. Looking at these specific time periods does not allow the advisor to evaluate the consistency of the managers' returns relative to other possible choices. These three, five, seven, or ten year periods of time may assist an advisor when they are searching through a database looking for an appropriate manager. For example, an advisor could search for managers that have a high R-squared to their index benchmark and/or a returns based style benchmark (using Returns Based Style Analysis) and have three, five, seven, and ten year period returns that are higher than the benchmark. This could reduce the number of candidates that have to be evaluated from all of the possibilities in a database of money managers or mutual funds. With these hypothetical managers, it was found that both of them outperformed their benchmark both on an absolute and risk-adjusted basis. Looking at the style of these managers using Returns Based Style Analysis, these managers are not pure small cap growth managers but that is their dominant style.

A better way to look at manager return consistency instead of using a three, five, seven, ten year snapshot in time would be to look at rolling period returns and plot the managers' rolling period returns relative to each other. Many advisors will look at floating bar charts or manager universes to compare managers to their peer group. Floating bar charts do provide some information but do not allow the advisor to see what is happening in between the time periods. A better way to look at the consistency of returns relative to their peers would be to plot each manager's thirty-six month return, then move it forward one month, and plot the previous thirty-six month return from that month. These returns can be measured against their peer group returns or against each other. In our hypothetical example for the period ending December 2008, we find that ABC manager was consistently a top quartile manager for the first four years. After that, its thirty-six month rolling period return declined to the bottom two quartiles; whereas, XYZ manager's thirty-six month rolling period return consistently became a top quartile manager. This type of analysis does observe what is going on, but does not explain the cause. Managers whose qualitative analysis is good are most likely to have excellent performance.

Table 1. Yearly Return

	2008	*2007*	*2006*	*2005*	*2004*	*2003*	*2002*	*2001*	*2000*	*1999*
ABC Small Stock Manager	−37.8	7.2%	7.2%	4.5%	11.7%	33.3%	−20.7	21.6	15.3%	36.9%
XYZ Small Stock Manager	−38.7%	19.8%	14.4%	16.2%	9.9%	39.6%	−24.3%	−12.6%	3.6%	54%
Small Stock Index-Benchmark	−35.1%	6.3%	11.7%	3.6%	12.6%	44.1%	−27%	−8.1%	−19.8%	38.7%

Investment Planning Answer Book by Jay L. Shein, Q 17:46, What are two valuable statistics to use when evaluating money managers?

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Tracking error and information ratio are two valuable components of the money manager search and selection process. Tracking error measures residual risk and is discussed in another part of this publication. The tracking error is measuring the annualized standard deviation of the difference between the money manager and the benchmark returns. This can be used with an index type benchmark or a Returns Based Style Analysis benchmark. Managers with lower tracking error will most likely be more consistent to their style of management.

Another important statistic is the information ratio. This does seem to have some value when looking at the ex-post information and using it for ex-ante projections. Information ratio measures how much excess return a manager is getting relative to her residual risk. It is a measurement of consistency and how well a manager is doing on a risk-adjusted basis. Managers who have higher information ratios are most likely consistently making successful decisions on a regular basis.

Let's look at the hypothetical example examining tracking error and information ratio and the role they can play in manager search and selection as seen in Table 2. Manager ABC, XYZ, and ABC–Small Stock Index all had a high R-squared relative to their style benchmark and their index, therefore, giving comfort that the analysis is reliable. ABC–Small Stock Index is a combination of 50 percent invested in ABC small stock manager and 50 percent invested in the small stock index rebalanced once per year. The information was calculated over a ten year period of rolling twelve month returns. Looking at the information in the table, the tendency would be for the advisor to select ABC small stock manager because their annual return is the highest with an acceptable information ratio relative to the other choices. This might be an unwise choice. First of all, this is looking at annualized information and returns over a ten year period. The fact that extremely good years may overcome some of the bad years can show a manager in a more favorable light than she deserves. If the portfolio or investor requirements were to be more tax aware, lower tracking error, and more consistent performance, the advisor might consider the combination of the ABC small stock manager and the ABC–Small Stock Index rebalanced annually as it has a lower tracking error and a higher information ratio which gives a better opportunity for consistency looking forward. Blending in the index also may reduce cost since investments that mimic an investment tend to have lower fees and are usually tax efficient. Many of these indices can be invested in through the use of Exchange Traded Funds (ETFs).

Table 2

	Performance		***Versus The Style Benchmark***		***Versus The Small Stock Index***	
	Annual Return	***Standard Deviation***	***Information Ratio***	***Tracking Error***	***Information Ratio***	***Tracking Error***
ABC Small Stock Manager	5.4%	19.8%	0.63%	6.3%	0.63%	9%
XYZ Small Stock Manager	3.6%	21.6%	0.63%	6.3%	0.63%	7.2%
ABC–Small Stock Index	2.7%	20.7%	0.72%	3.6%	0.63%	4.5%
Small Stock Index–Benchmark	−0.72%	22.5%	0%	0%	0%	0%

The ABC small stock manager has more style drift that XYZ small stock manager. The style drift can be reduced by blending in an index such as the Small Stock Index. This in turn reduces tracking error. Many advisors will incorrectly choose a manager based on this ex-post information by selecting the one with the higher return only to be disappointed in the future. These managers have significantly different patterns of returns relative to each other.

The information ratio is an important component to the active manager selection. When an advisor or consultant is speaking to a money manager firm, they should ask the firm what their target information ratio is and how they came to the conclusion regarding their target information ratio. If this manager is hired, one will be able to evaluate them relative to their stated target to see if they are meeting their objectives.

It is important that the advisor looks at all of the quantitative and qualitative information when selecting a money manager. The information in the example previously described is not sufficient to select a manager. The qualitative component is extremely important. For instance, we might find that a high tracking error is due to the fact that key decision makers in the firm were on sabbatical for a few years, and hence, some of the early year performance that is included in this statistical analysis might not match later years' performance and tracking error. When advisors see discrepancies in various periods of times, especially when looking at rolling time periods, it should motivate them to seek further information to understand the seemingly irregularities being observed.

Looking at standard deviation alone in Table 2 is not sufficient to make an evaluation of risk. The standard deviations are too close together. If there was a larger difference in the standard deviations of the managers, you would probably have a higher tracking error. High standard deviations and tracking error may be acceptable depending on objectives when selecting a manager. No statistic or calculation should be relied upon by itself. Each quantitative measure combined with the qualitative information is important in order to make an informed decision. The tracking error and information ratio of the index relative to the index will always be zero since there is no return differential between the index and itself.

Investment Planning Answer Book by Jay L. Shein, Q 17:47, How can managers be evaluated looking at statistical information for specific time periods?

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One way to look for consistency of managers is to look at various time periods for the manager. Table 3 is the first five years of a manager's experience out of a ten year period. Table 4 is the second five years out of the same ten year period. When looking at manager results or information by this method, you can begin to see inconsistencies. In the first five years, ABC manager was by far the best manager when the factors including annual return, information ratio, and tracking error were considered. When looking at the second five year period, ABC small stock manager was no longer the best choice. These tables demonstrate the need to analyze statistics over many periods of time, whether that is by the use of snapshots in time or rolling periods. Again, remembering that the qualitative component is an extremely important part of money manager evaluation.

Table 3

	Performance		*Versus The Style Benchmark*		*Versus The Small Stock Index*	
	Annual Return	***Standard Deviation***	***Information Ratio***	***Tracking Error***	***Information Ratio***	***Tracking Error***
ABC Small Stock Manager	15.3%	23.4%	1.8%	8.1%	0.9%	11.7%
XYZ Small Stock Manager	8.1%	25.2%	0.81%	8.1%	0.81%	9%
ABC–Small Stock Index	8.1%	24.3%	1.8%	4.5%	0.9%	5.4%
Small Stock Index-Benchmark	0.81%	27%	0%	0%	0%	0%

Table 4

	Performance		***Versus The Style Benchmark***		***Versus The Small Stock Index***	
	Annual Return	***Standard Deviation***	***Information Ratio***	***Tracking Error***	***Information Ratio***	***Tracking Error***
ABC Small Stock Manager	−3.6%	16.2%	−0.36%	3.6%	−0.27%	5.4%
XYZ Small Stock Manager	0.09%	18%	0.45%	3.6%	0.45%	4.5%
ABC–Small Stock Index	−2.7%	16.2%	−0.36%	1.8%	−0.27%	2.7%
Small Stock Index- Benchmark	−1.8%	18%	0%	0%	0%	0%

Investment Planning Answer Book by Jay L. Shein, Q 17:48, What are some quantitative risk measures that should be used or considered when evaluating a money manager?

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There are many quantitative measurements that can be used when evaluating a money manager. These are just some of the measurements that should be considered. They are discussed in other parts of this publication. These quantitative measurements include but are not limited to the following:

- Beta
- Volatility as measured by standard deviation
- Downside measures of risk such as downside deviation or downside variance
- Sharpe ratio
- Duration and convexity for fixed income managers
- Selection Sharpe ratio, also known as the information ratio
- Capture ratio
- Sortino ratio

Investment Planning Answer Book by Jay L. Shein, Q 17:49, Is a manager who is not style specific a bad manager?

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Many good money managers do not adhere strictly to a particular style of management. In other words, they are not pure style managers. The purer the money manager's style of management, the less likely that that manager will be able to add an acceptable amount of alpha. Some have argued that pure style managers do add alpha and are more consistent. There is no conclusive proof for this argument. Managers that are allowed to drift some from their style should have more opportunities to outperform on a risk-adjusted basis. Giving a manager more flexibility increases the opportunities for them to make decisions outside of one specific style. If these decisions are consistent and successful, they should be reflected in a higher information ratio. For those who want a pure style manager, they may want to consider a fund that mimics the style they are seeking as opposed to active management. Active managers that have strong skill sets across many styles should be able to outperform their returns based style benchmark on a risk-adjusted basis. More flexible managers are focusing more on absolute returns than relative returns.

Investment Planning Answer Book by Jay L. Shein, Q 17:50, How can an advisor avoid time period bias when looking at a manager?

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Time period bias reveals itself when an advisor looks at different time periods in a manager's track record. Many times, a money management firm's literature will focus on a time period that shows them in the best light. For instance, their ten year period may be extremely good, but their five year period may not be. When looking at long periods of time, try dropping off the first few years in that time period and looking at the returns and other statistics. Then look at the longer time period and drop off the most recent few years in the analysis.

Investment Planning Answer Book by Jay L. Shein, Q 17:51, What are some items to observe that demonstrate a money manager's consistency?

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The following are valuable when looking for consistency in a money manager:

- Rolling period returns versus a peer group
- Rolling period returns versus their Portfolio Opportunity Distributions (PODs)
- Rolling period returns versus their benchmark
- Rolling period information ratios versus their peers

Investment Planning Answer Book by Jay L. Shein, Q 17:52, What are money manager composites?

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Money manager composites are a capitalization weighted or equal weighted averages measuring the returns of the portfolios of a specific money manager product such as those found in a separate account or a private money manager. For instance, an all capitalization stock manager has a hundred different investors, hence, a hundred different portfolios. The composite return will typically be a number that not one of the hundred investors achieved. The investors came into the strategy at a different period of time so stocks were bought at different periods of time. Some portfolios may hold some stocks that other portfolios do not. This causes a dispersion of returns relative to the manager's composite. The advisor should ask the manager for the dispersion of returns relative to the composite which is the tracking error of the composite. If the advisor sees a large dispersion of returns, it may indicate that the manager is administratively inefficient, may not have a disciplined process, or other problems.

If a composite return over the last ten year averaged 7 percent per year for a particular money manager and the dispersion of returns was 3 percent, this would indicate that approximately 68 percent of the portfolios range from a return of 10 percent to a low of 4 percent. Approximately 95 percent of the portfolios would range from a high of 13 percent to a low of 1 percent. As can be seen, it is important to have a low dispersion of return so the advisor can have confidence that his client will have a return closer to the composite return which is the return that many decisions are based on. This differs from a mutual fund because of the fact that every investor has the same return for the same time period in a mutual fund, and there is no dispersion of returns as each investor has the exact same portfolio.

The advisor should also ask for the highest returning portfolio and the lowest returning portfolio in the composite over various time periods and for each year. This will allow the advisor to get a better view of how well the portfolios are managed to track the composite.

Investment Planning Answer Book by Jay L. Shein, Q 17:53, Is an investment manager skilled or lucky?

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The question each advisor must ponder when searching for and selecting money managers or mutual funds is whether the historical quantitative information and the qualitative information obtained is the result of skill or luck. Because the future is always uncertain, the advisor will never know for sure. Statistically, depending on the confidence level desired, the advisor will not know for sure if a money manager is skillful or just lucky for thirty to fifty years. The advisor's objective is to gather the information, use the best judgment, and to make an informed decision.

Investment Planning Answer Book by Jay L. Shein, Q 17:54, What are some of the tricks that money managers may use when presenting performance reports?

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The following includes some of the ruses that may be used by money managers when presenting reports.

- Selected time periods
- Selected accounts
- Composite weightings
- Paper portfolios
- Portable records

Investment Planning Answer Book by Jay L. Shein, Q 17:55, How do advisors overcome a manager selecting time periods for their presentation?

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Money managers always like to show their performance records in the best light. One of the things they may do is to select specific time periods such as three, five, or ten year periods to show how their average annual returns have been excellent. One way to overcome this is to look at three, five, and ten year rolling period returns.

Investment Planning Answer Book by Jay L. Shein, Q 17:56, How do some money managers select accounts for favorable presentation?

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They can also select specific accounts to present to you. For instance, their composite may be made up strictly of their fully discretionary institutional accounts to the exclusion of their accounts for taxable investors. The advisor can ask for a composite that is relative to the use that is relevant to the specific investor. The advisor could also ask for a firm wide composite for that style of investing being presented.

Investment Planning Answer Book by Jay L. Shein, Q 17:57, What are the most common composite weighting types that money managers may present?

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Advisors may be presented composites that have different weightings; e.g., the composite may be equal weighted or capitalization weighted. Equal weighting weights each portfolio the same so a very small portfolio gets the same weight as a very large portfolio. Capitalization weighted portfolios give more weight to the large portfolios and less to the smaller ones. Advisors should ask to see composites weighted equally and by capitalization to see if there are large discrepancies between the different types of composites. Capitalization weighted portfolios give better information and should be relied upon over equal weighted portfolios.

Investment Planning Answer Book by Jay L. Shein, Q 17:58, What are paper portfolios when presenting performance?

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Money managers may also use paper portfolios to demonstrate how their strategy would have performed. The managers will back-test their strategy and present that performance. Legally, managers have to disclose if they are using back-tested paper portfolios. Back-tested paper portfolios show what would have happened if their process had been implemented, but it does not tell you if it did work or if it will work in the future. Paper portfolios are used frequently by newer hedge funds.

Investment Planning Answer Book by Jay L. Shein, Q 17:59, What are portable records when presenting performance?

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Some money managers use portable records as part of their historical performance and success. These are performance numbers that were at a previous firm for the same strategy or product that is being presented. This is legal if it is disclosed but may be problematic. While the manger may have had a great track record at the previous firm, perhaps the resources and analysts that assisted the manager are different at the new firm. Portable records are okay to consider but remember there are caveats.

Investment Planning Answer Book by Jay L. Shein, Q 17:60, Why would an advisor use multiple managers?

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Investment advisors that use money managers and/or mutual funds as part of their portfolio may want to consider using multiple managers or blending managers. This could be two active money managers with the same style of investing or an active money manager mixed with an index to reduce style drift. Many investors like this multi-manager approach. This approach may give more consistency and reduce tracking error and offers more diversification. This typically will reduce risk as no two managers track each other exactly. Advisors can select specialists in various areas to complete a portfolio with the use of multiple managers. This is different from one stop shopping. For example, an advisor could pick three managers to represent the U.S. stock portion of a portfolio as opposed to selecting one manager. Using multiple managers makes it easier to remove poor performers as the advisor can remove only the manager who is performing poorly and not the complete asset class. Because the portfolio is becoming more diversified by adding more managers, this is probably not a return enhancement strategy.

Investment Planning Answer Book by Jay L. Shein, Q 17:61, What are some of the disadvantages of using multiple managers?

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Using multiple managers or blending of managers with an index may decrease value added. As more and more managers and indices are added to the portfolio, that part of the portfolio moves closer to an index fund. The more managers in the portfolio, the more the analysis of that part of the portfolio is benchmark dependent. Because there are few pure style managers, there may be overlap. How cash is used when sitting in the portfolio and how it is allocated when new money comes in when using multiple managers is an important question to ask. Using multiple managers may also incur higher fees since placing more assets with one manager will usually allow for a lower fee than placing parts of the portfolio with different managers. This may not be a problem with mutual funds unless mutual funds have different share classes that have lower fees for higher minimum contributions.

Investment Planning Answer Book by Jay L. Shein, Q 17:62, What is a barbell strategy for active risk budgeting?

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A barbell strategy is a type of multi-manager strategy. For instance, if an advisor wants to use an active money manger that has a higher tracking error than what was allowed or budgeted, then they could blend in the benchmark index with the active manager until the acceptable risk budget was reached. So the mix of the active manager could be 50 percent active and 50 percent index, 40 percent active and 60 percent index, or any other combination of the active money manager and the index. This may offer more consistency, tax efficiency, and reduce tracking error risk.

Investment Planning Answer Book by Jay L. Shein, Q 17:63, What is a spectrum strategy using multiple managers?

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The spectrum strategy uses three different money manager strategies in combination which includes the following. First, there is the traditional manager who typically has a smaller number of names in the portfolio (twenty to fifty names) and has a high tracking error relative to their benchmark. These are typically higher alpha seeking managers. Second, there is the structured manager who has many more names in it than the traditional manager. They will have a lower tracking manager than the benchmark and will typically have less alpha. The structured manager's returns will be closer to their benchmark and are measured more on a relative basis. An enhanced index is also a type of structured manager where the manager may slightly overweight or underweight specific securities, sectors, or industries in order to add a small amount of alpha over and above the index in a cost effective manner. The third part of the spectrum strategy is a passive manager such as an index fund.

Many times by combining all three of these strategies, the advisor can increase the expected information ratio and hence have a better risk-adjusted return. Finding the right mix of the three strategies will take time and effort. This time and effort should be well-rewarded in the long term. Let's look at a hypothetical example combining U.S. stock managers for a ten year period ending 2008 (which was a bad ten years for the U.S. stock market). This example shows what we might find with these three different strategies combined on an ex-post basis.

Table 5

	Annual Return	***Standard Deviation***	***Information Ratio***
100% active traditional manager	2.6%	18.2%	0.28%
Barbell with 25% active traditional and 75% passive	3.3%	18.9%	0.33%
Barbell with 50% active traditional and 50% passive	3.1%	18.6%	0.31%
Spectrum Strategy with 25% active structured, 50% passive, and 25% active traditional	4.7%	19%	0.75%

This example demonstrates the advantages of the spectrum strategy. The higher information ratios are obtained with the barbell strategy which mixes the traditional manager with a passive manager. The highest information ratio can be seen using the spectrum strategy which mixes the structured, passive, and traditional approach. Typically, each of these combinations, the barbell and spectrum, will be highly correlated to each other so whichever one of these strategies that the advisor feels adds the most value should be used. While this example shows the spectrum strategy in a favorable light, advisors should be cautious as with any strategy as past performance is not indication or guarantee of the future. This is just another way of thinking about the multi-manager approach.

Investment Planning Answer Book by Jay L. Shein, Q 17:64, What are the basic steps in manager structuring?

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Advisors that are using money managers or mutual funds need to determine the client/investor's objectives, select the asset allocation and overall asset allocation strategy (strategic, tactical, or macro opportunistic), develop a normal portfolio, identify and compare different managers and strategies, and recommend or implement the portfolio.

Investment Planning Answer Book by Jay L. Shein, Q 17:65, What are important considerations when identifying money manager?

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When looking at a separate account money manager or a mutual fund which is another type of money manager, the advisor should look for managers who outperform their style and benchmarks. This can be on an ex-post basis and/or an ex-ante basis. Advisors should consider how disciplined they are to their style and whether the advisor feels that allowing the manager to drift from their style is acceptable. The advisor should analyze what factors are contributing to returns such as by performing an attribution analysis. Advisors are looking for smart people with a sensible approach. It is not a simple task to select a manager. Even the best advisors will be disappointed by some of their selections. The best thinking is to make an informed decision and monitor it. Many advisors and consultants feel that active management can add value and that superior managers can be identified in advance. Advisors who do not feel that active management adds any value should stick to broad-based index/passive strategies.

Investment Planning Answer Book by Jay L. Shein, Q 17:66, What is the core-satellite approach?

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The core-satellite approach has many of the attributes of the barbell and spectrum approach. Because some feel that it is hard to find active managers that can outperform, they look to the core satellite approach. This has been used for many years by institutions and has become popular with advisors to private investors in the last ten years. The following example is how a core-satellite approach would work. For the U.S. stock portion of a portfolio, an advisor could put 70 percent of the allocation in a broad-based index of U.S. stocks that is capitalization weighted to include large company, mid-sized companies, and small companies. The other 30 percent could be divided into a few high alpha seeking managers including one or more that make hedged bets to try to outperform while still keeping the overall stock portfolio close to the broad-based index. This strategy may offer more alpha, have lower fees because of the low cost of the index, and offer similar diversification as if many active managers were used. Using the broad-based index as part of the portfolio would also be very tax efficient. For instance, a small company stock which grew to a mid cap or large cap stock would still be in the index and would not be sold as if it was just in a small company index. This core-satellite approach is another multi-manager structure that should be considered in the investment advisor/consultant's cornucopia of investment tools.

Investment Planning Answer Book by Jay L. Shein, Q 17:67, Can a core-satellite or multi-manager approach be used with hedge funds?

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When an advisor is selecting hedge funds, she can use a multi-manager type approach. She can pick a lot of individual manager strategies and combine them in a portfolio. Advisors could also use a type of core-satellite approach with hedge funds. They would do this by buying a well-diversified fund of funds to represent the core of the portfolio of hedge funds and select single strategy managers they felt had a lot of opportunity to add value allocated around the fund of funds. For instance, the advisor could put 60 percent of the portfolio in a well-diversified fund of funds and 40 percent mixed between four different single strategy funds.

Investment Planning Answer Book by Jay L. Shein, Q 17:68, What is some of the information that advisors should ask for from the money manager firm to assist in the evaluation of a money manager?

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When evaluating a money manager firm, ask for copies of all of their brochures and disclosure documents. Many firms will have prepared a standardized type of due diligence report that they can also provide. This information will assist the investment advisor or consultant in making decisions and will lead to other questions. Financial information on the firm is also important.

For mutual funds, advisors should ask for brochures, prospectuses, and a statement of additional information. Advisors should also look at databases for information on the managers or funds.

When looking at private placement hedge funds, advisors will need to look at their brochures, offering memorandum, financial audits, and financial statements. This information for managers is just the basics. Advisors should seek any and all information available or that they can think of.

Investment Planning Answer Book by Jay L. Shein, Q 17:69, What are some of the questions that need to be answered by money managers?

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The following are some of the questions that advisors should ask money managers:

- Fund name.
- Date completed.
- Contact person(s).
- Phone numbers.
- Address of money manager firm.
- Describe the origins and history of the company.
- Briefly review your strategy and process.
- What are the components that drive your performance?
- How long has the firm been in business?
- Describe the experience of staff, principals and traders.
- Describe how the strategy has changed since the firm's inception.
- Describe how your research team is structured. Describe the individual responsibilities and contributions/specialties of each team member.
- For hedge funds: describe in detail how you source your managers/funds. Do you use personal contacts, databases, prime brokers, or other information?
- Describe your target returns and estimates of volatility. Explain how you arrived at each of these figures.
- Describe what you feel is your competitive edge.
- What is the frequency of the firm's scheduled investment policy or strategy meetings?
- Will new money be accepted from current investors after capacity is reached? If so, what is the "soft-close" figure? Is there a hard-close figure?
- Describe the risks inherent in your portfolio—what can go wrong? Address each of the following: volatility risk, credit risk, liquidity risk, geopolitical risk, leverage risk, and fraud risk.
- How does the business or market cycle affect your strategy?
- Do you use leverage? If so, how much? If you use leverage, how do you manage that risk?
- For anyone who uses leverage or hedge funds ask the following: who are your primary lenders/sources of financing?
- What benchmark do you feel is most appropriate for measuring your performance? Why?
- What were your three largest drawdowns? What were the circumstances that caused these? Did you make any changes to your strategy as a result of this?
- Have there been any changes to your strategy that would render a portion of your track record less meaningful to a current evaluation?
- What is your performance gross and net of fees? Are they all audited numbers?
- Please provide biographies/resumes of the principals and key employees. (Please include current residence, past employers, outside activities and organizations, etc.) Provide copies of your ADV.
- Have you lost any key personnel in the last three years and why?
- What is the size of your assets under management for this strategy or fund? What were the assets for each of the last 5 years?
- What is your approximate number of clients?
- What is the current client mix?
- Is there subjective pricing (i.e. illiquid or thinly traded securities)? If so, who is responsible for establishing pricing? Describe the process?
- What percentage of the fund is in Level I, II, and III securities?

- State all potential conflicts of interest that might arise between the fund of funds and the underlying hedge fund managers.

Investment Planning Answer Book by Jay L. Shein, Q 17:70, What are some questions to ask a mutual fund manager?

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Advisors may find that questions from different questionnaires can be combined into one that is unique to their needs and preferences. For instance, they may find some questions in a money manager questionnaire that they may want to add to a mutual fund questionnaire or questions from a hedge fund questionnaire that they may want to add to another questionnaire. The following mutual fund questionnaire offers some questions that advisors may want answered:

- Background information.
- Fund name and address.
- Person completing questionnaire.
- Title of person completing questionnaire.
- Primary contact's name and phone number.
- Date fund was effective with SEC.
- Explain your fund's investment approach or philosophy.
- What distinguishes your fund from other funds with the same investment objective?
- What do you consider your fund's source of Alpha?
- What do you consider the fund's benchmark to be?
- Do you use derivatives in your fund? If so, please explain.
- Is the fund permitted to invest in illiquid securities? If yes, please describe in detail (e.g. How do you value these securities? What are your limitations? What percentage of the portfolio was invested in these over the past five years?)
- Has the fund company ever closed a fund? If so, who was permitted to continue investing in the fund?
- What is the size of the fund? What are the assets under management of the fund each of the last ten years?
- What is the fund's tax accounting method? (E.g., do you use HIFO accounting?)
- What percentage of your fund is owned by institutions, 401Ks, registered investment advisors/planners or the retail public?
- Is the fund managed by individuals or teams?
- What are the maximum dollar amounts and/or number of assets you feel you can manage in this strategy? Explain how you arrived at this figure and how and what may change this over time?
- What other products does your firm offer?
- How many professionals in your firm manage this product?
- What are the qualifications of the professionals managing this fund?
- Describe any of the fund managers' conflict of interest?
- Explain the company's long-term compensation and retention plans?
- How much of the fund is owned by the portfolio managers?
- What is your firm's brokerage commission rate and how do you monitor transaction costs?
- Does the fund enter into soft dollar arrangements? If so, how much did the fund pay in soft-dollars? What did it buy?
- What type of redemption fees does the fund have?
- Does the fund make any effort to minimize taxes?
- What is the fund's embedded capital gains?
- Provide copies of prospectus, statement of additional information, ADV, and brochures.

Investment Planning Answer Book by Jay L. Shein, Q 17:71, What are some questions that an advisor can ask a hedge fund manager?

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Like any manager questionnaire, the following are just some of the questions that might be asked of a hedge fund manager and its firm?

- Fund name.
- Date questionnaire completed.
- Contact person(s).
- Contact person phone numbers and address.
- Describe the origins and history of the company.
- Review the strategy and process in detail.
- To what factors do you attribute your performance?
- How long has this fund been operating?
- Describe the experience of staff, principals, and traders.
- Describe how the strategy has changed since the fund's inception.
- Describe how your research team is structured. Describe the individual responsibilities and contributions/specialties of each team member.
- For a fund of funds: Describe in detail how you source your managers. Do you use personal contacts, databases, prime brokers, or other information?
- Describe your target returns and estimates of volatility. Explain how you arrived at each figure.
- What do you feel is the advantage you have over your competitors?
- How often do you schedule investment policy or strategy meetings?
- Will new money be accepted from current investors after capacity is reached? If so, what is the "soft-close" figure? Is there a hard-close figure?
- Describe the risks inherent in your portfolio—what can go wrong? Address each of the following: volatility risk, credit risk, liquidity risk, geopolitical risk, leverage risk, and fraud risk.
- Describe how the business or market cycle affects your strategy?
- Do you use leverage? If so, how much? How is the risk from leverage managed?
- Who are your prime brokers and primary lenders/sources of financing? How do you manage counterparty risk?
- What benchmark do you measure your performance against? Why do you feel that is an appropriate benchmark?
- What were your three largest drawdowns? What were the circumstances that caused these? Were there any changes to your strategy as a result of this?
- Have there been any changes to your strategy that would render a portion of your track record less meaningful to a current evaluation?
- What fat tail risks do you worry about?
- What is your performance net of fees? Are they all audited numbers?
- Please provide biographies/resumes of the principals and key employees. (Please include current residence, past employers, outside activities and organizations, etc.)
- Have you ever lost any key personnel and why?
- What is the size of your assets under management for this fund? What were the assets for each of the last 10 years?
- What is the approximate number of investors you have?
- What is your current mix of investors (e.g. institutional versus individuals)?
- What are your key drivers of performance?
- Is there subjective pricing (i.e., illiquid or thinly trade securities)? If so, who is responsible for establishing pricing? Describe the process?

- What percentage of the fund is in Level I, II, and III securities?
- For fund of funds, state all potential conflicts of interest that might arise between the fund of funds and the underlying hedge fund managers. Do any of the underlying hedge funds pay the fund of funds for any services? If so, which funds and which services? Is there any fee sharing arrangement between the fund and the underlying funds?
- Describe the firm's future plans, growth, and activities.
- Do you have any plans to cap or limit your growth in terms of total assets?
- When do K1's come out?
- Why does the market inefficiency you exploit exist?
- Do you have a lock up period or any gates that prevent redemptions?
- How are your securities priced?
- How do you preserve your ability to leverage (if used) during difficult times?
- How do you manage risk, e.g., diversification methods, cutting your losses?
- How do you mange your factor exposures (betas)?
- Please provide a copy of your offering memorandum, ADV and brochures.

Additional questions for Fund of Funds managers:

- What are the criteria you use to select underlying managers?
- How is your research team structured, and what are the individual responsibilities and contributions/ specialties of each team member?
- What is your diversification policy with regard to number of managers, sector, industry, and geographic distribution?
- What are the criteria for manager termination?
- How much leverage do you typically use and how is it monitored?
- Describe the transparency you have with regard to underlying managers and their investments.

Investment Planning Answer Book by Jay L. Shein, Q 17:72, Can ex-post information be used to make ex-ante predictions?

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Ex-post information cannot make absolute ex-ante predictions. Ex-post information can be used to assist in making informed decisions. This is because of the fact that no past information can accurately predict the future. Many advisors incorrectly use past information to make all of their decisions. Advisors should use all the information available including past, current, and expected to evaluate and make their choices.