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For the Intelligent Investor
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How to Choose a Money Manager

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One of the most common mistakes that investors make is that they move their money from one manager to another frequently, and often at the wrong times. There is a tendency to choose a money manager based on good performance in the last year or two. But then when the manager has a bad year, the investor takes his or her business elsewhere. The problem with this approach is that, in essence, the investor has bought high and sold low. The solution is to do a better job choosing your money manager in the first place so you are confident staying with him or her in the down years. Ron shows us how.

Choosing a professional money manager has much in common with choosing professionals in other fields. As in selecting a lawyer or accountant, it is difficult to judge basic competence and integrity without a lengthy professional history or personal relationship. Therefore an investor must rely on references from existing clients or other professionals.

Money manager referrals can usually be obtained from members of the brokerage community, or from accountants and lawyers, preferably those serving the manager's present clientele.

Beyond the determination of basic integrity and competence, the investor's real need in choosing a money manager is to find a manager with a consistent investment philosophy that the investor is comfortable with. Consistency and comfort are the keys.

There are a number of profitable investment philosophies. Some of the better known are fundamental value, contrarian (which is simply acting in opposition to the conventional wisdom), and earnings momentum. Any of these, if consistently applied, can make money.

The difficulty is in the consistency of application. No matter how good the underlying philosophy, there will be periods when it appears not to be working. It is during these periods that it will be very tempting to try a different philosophy, usually just as it ceases to work. Thus, to a great extent, successful investing depends on standing firm in the face of the current emotional fashion. This can only be done if both the investor and the manager are comfortable with, and have conviction in, what they are doing.

We call this the "sleep factor." People who hire money managers pay them a fee not only to earn a healthy return, but to do so in a fashion that allows the investor to sleep at night. A philosophy or methodology that keeps an investor awake has obvious ill effects on physical and mental health, effects that eventually flow over into the investor's financial health as well.

People who are uncomfortable will change to become comfortable again, so it is critical that the philosophy and methods used for investing be comfortable to the investor so he can stay with them in the face of adversity.

For this reason, a true meeting of the minds must occur between the manager and the investor. The manager must explain his philosophy and methods in terms that the investor understands, and this dialogue must be ongoing; there should be no surprises.

Because there will be periods when the chosen philosophy appears not to be working, there must also be an understanding between the investor and manager of a reasonable period of time for judging whether the manager is in fact doing what he said he would. Is he fulfilling the investor's expectations? Are the expectations consistent with the philosophy and methods chosen?

A long-term, value-oriented philosophy, for example, will not normally outperform the market averages during short-term market upswings. If the investor is unaware of this tendency, he may begin to second guess his selection of a value manager during a roaring bull market. He may become uncomfortable, and consider changing horses in midstream when all he really needs is a better understanding of the horse he is riding.

Again, this sort of indecision can be especially deadly in the investment business, as this year's hero (or bum) rarely repeats. To continue the analogy, often the investor leaps upon a horse which is about to go under, just as his original mount gets a second wind. To avoid these disasters, the investor and manager must share investment goals and perspective.

The final factor in the manager-selection equation is client reporting. An often abused area for many managers, the client reporting jungle is proof positive that the biggest computer doesn't necessarily produce the best reports.

Thirty pages of printout is no good to a person too intimidated by investment jargon to read beyond page one. Designed more to inundate than educate, these elaborate productions often hide poor performance in a tangle of statistics and bond duration equations.

A good and useful report, by contrast, tells the client the value of his portfolio on the day he started with the manager, the change in value over time, and the value today.

It shows the percentage return generated by the portfolio for the given period and, if the client desires, may include a comparison of the client's return with that of market averages (Dow Jones Industrial Average, S&P 500, etc.), or any other bogey the client selects. It shows the securities held, their market value, and their yield. If the account pays taxes, the report also provides realized gain and loss data for use in preparation of tax returns.

Nothing else (unless the client specifically requests it) is required. Simple, straightforward reports are read and understood by clients. Complex, cluttered ones go straight into the (circular?) files.

In summary, a successful investment manager needs a consistent investment philosophy, a sense of perspective, and the confidence and discipline to carry it through. The investor, in turn, must understand and be comfortable with the manager's philosophy. He must know why it works and when it won't work, so he too has the confidence to see it through. A wise investor once said that in the money management business the only surprises are bad surprises. He was right.

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