How to Choose a MONEY MANAGER

by Tony Muhlenkamp

PART ONE – *Making the Match*

The idea of hiring someone has gotten confused with the idea of buying something. We buy, sell, swap, and trade stocks, mutual funds, or annuities as though they were just pieces of paper, and we ignore the idea that these pieces of paper represent a relationship with another person. By buying the paper we have also hired someone to do something for us. When we buy a stock, we hire people to run a company for us. When we buy a mutual fund, we hire people to invest our money for us. I think it is interesting to make that relationship explicit because we can learn things from a different perspective. So, we are going to talk about the relationship between you and your money manager.

We have all read an article at one time or another that started off “If you had invested $10,000 with Warren Buffet (Or Bill Gates, or Steve Jobs, or Mark Zuckerberg) 40 years ago when he first brought out his company you would have a gazillion dollars today”. But how many people did that? Actually put $10,000 in one person’s hands 40 years ago, AND KEPT IT THERE THE WHOLE TIME? Think about that.

How would you have known to invest in one of these gurus when they were first starting out, and what would you have had to know to not pull your money from them the first time they had a bad year? The magazine articles never say.

While I was thinking about that, a friend related the story of his parent’s 40th wedding anniversary. His Dad was called on to make a toast, raised his glass, and said, “Here’s to 30 wonderful years of marriage.” Everyone laughed and reminded him it was his 40th anniversary, and he said, “I know, and 30 of those years have been wonderful.” At which point it got kind of quiet, and they looked at my friend’s Mom, waiting for her to get upset or something, and she looked around and said “Yes, that’s about right, 30 of those 40 years have been pretty terrific.” Now, to those of us who have been married for 10 years or longer, that sounds familiar. For you newlyweds shaking your heads saying “We never go to bed angry” all I can say is, just wait…

Now, what does that have to do with hiring a money manager? Everything. We all wish we had hired today’s winner 40 years ago. Failing that, we all are trying to hire the next winner today. We assume we will recognize him when we find him, and when we find him, we will keep our money with him for the next 40 years. But will we? The only way that will happen is if we are committed to getting through the rotten 10 years together. And we have to recognize that some of those rotten years will be consecutive. **It turns out that commitment is a prerequisite for success, not a result of success.**

I'm suggesting that you select a money manager the same way you selected a spouse, with the idea and the INTENTION of being with this person for the next 40 years. How many of us would marry someone just because a friend suggested it? Or just because we swiped right? We may like the ad in the personal columns, but we don't call or text to propose marriage. We make contact to see if we can get to know them better.

When we invest in a stock or a mutual fund based on an ad, website, a column in a magazine, or based on a recommendation from a friend, a broker, or an advisor without doing any of our own homework, we are jumping into a relationship with a money manager that we really don't know anything about.

Imagine how careful you would be, how much time and energy you would spend learning about the money manager if you thought you had to be there for 40 years. **Warren Buffet has said people should be limited to 3 investment decisions in their lifetime. Well, hiring a money manager would certainly count as one of those three, and you wouldn't want to waste it.**

When I say money manager, I mean the person you have hired to invest your money; the person who decides what you will own and why, and then carries out that decision on your behalf. By this definition, investing in a mutual fund is "hiring a money manager," but working with an advisor who invests your money in a portfolio of mutual funds is not. Someone that invests your money in a portfolio of mutual funds isn't a money manager; she is the matchmaker between you and your money managers. Which can be a useful function, but it raises a question. Once the match has been made, what value does the matchmaker add?

To use my marriage analogy, let's pretend that in your search for a spouse you hire a matchmaker. I suspect you would tell them all about yourself and describe for them what you are looking for in a spouse. In the process, you might learn that what you thought you wanted isn't what you really wanted, and that what you really wanted is completely different from what you thought you wanted. The matchmaker goes to her database of candidates, reads the personals, and comes to you with five people that fit. You meet each of the five, date them each for a while, learn lots of personal and embarrassing things about one another, find your soul mate, and get married. Now what does the matchmaker do? Does she call you in a year and tell you that she has found someone even better? Do you call them in a year and say you're not as happy as you thought you would be, find me someone better? After all, this person was the best they could do.

So in your search for a money manager, start by knowing whether you are looking for a spouse, or for a matchmaker, and then move forward accordingly. And if you are using an advisor to help you find a money manager, talk about what the advisor will be expected to do once you have hired your money manager. Once you and the advisor have found the 4 or 5 money managers that you want to work with, what will you expect the advisor to do? What will the advisor expect you to do?

PART TWO – *Managing the Commitment*

It turns out that before you start looking for a money manager, you have to spend some time looking at yourself. What are you trying to do? What kind of help do you need? What do you already know and believe about investing? How much of what you know is correct, and how much is wrong? How do you know?

Financial Planning is all about answering these questions and putting dollar signs on them where appropriate. I believe that the financial planning process is distinct from the money management process even though they are often carried out by the same professional. Having a financial plan helps you select and evaluate your money manager because it gives you some criteria to use. Having a money manager helps realize your financial plan because every financial plan involves using existing assets to create new assets.

A financial plan will help you define what you want, how long until you want it, and what you have to do along the way to get it. Having a plan will tell you that you need a money manager that can grow your invested assets by at least 5% year over inflation. Because you have a long time before using those assets, and because you plan on using those assets for a long time, you don't need that growth each and every year but should have it over 3 and 5 years. Experience teaches us that we can lose 20% in one year, but we can live with that if we are on track for 3 and 5-year performance.

You might want performance to exceed some benchmark like the S&P 500. You might want to beat this benchmark every year, or on average over several years. Or you might want to never have a down year. Whatever your performance, volatility and time requirements are, they should be based on something concrete that you are trying to accomplish, and you should write them down.

We know returns will be available in different classes of securities at different times for different reasons. If interest rates are more than 3% over inflation, we can probably earn returns from bonds as well as stocks. If inflation is running away from interest rates, we will have to avoid both stocks and bonds (See our "Investment Climate" articles and presentations for more on that topic). From studying, we know that we can turn a good company into a bad investment if we pay too much for it (while some people believe that some companies are so good it doesn't matter what you pay for them, they are always good investments.) Modern Portfolio Theory and Asset Allocation are flawed with the fundamental assumption that BETA is the best measure of risk. By implication that means style boxes don't matter.

Now you take everything you have learned about yourself from your financial plan and your studies, and you create some criteria for a money manager. For example:

1. 3-, 5-, and 10-year performance history of 5% > inflation.
2. At least 10 years of investment experience.
3. A portfolio with above average profitability (Return on Equity) and Growth (Earnings Growth and Revenues Growth), and below average price (Price to Earnings Ratio)

You can take these criteria to any number of databases and create a short list of managers to research. Get copies of prospectuses, annual reports, company brochures, and ADVs. Go to their website and see if you can find articles written BY the money manager (not just articles written about the money manager.) Ask yourself if his ideas make sense, and if you could live with his management style even in down years, or in years when someone else had better performance. Call and see if you can meet the manager. Look at the fees and decide if you are willing to pay them. What kind of reports and communications will you receive from the manager?

Remember, you are looking for someone to spend the next 40 years with—the more you can find out about them, the better. Keep an Investment Journal. and write down what you have learned, what mistakes you have made, what you are trying to accomplish, etc.

Remember the story about the couple on their 40th anniversary? How 30 of those years have been happy? Well, I have another friend whose father has been married for 40 years, but to 4 different women. He hasn't had 30 happy years of marriage, he's been lucky to have 10 happy years, and most of those were with the woman he has been married to for 13 years. And they will be the first ones to tell you that not every year is a happy one, but they are committed to working at the marriage, and they fully intend to be married 30 years from now.

In investing, as in life, success follows commitment. It is important to know and understand the person with whom you are committed so you can get through the disappointments and be around to enjoy the successes. Without knowledge and understanding, there is usually no commitment. And without commitment, there is usually no success.