The Long View

Selecting an Investment Manager

How should you go about finding the best person or firm to invest your family's money?

Let's start by putting the question into context. Over any period of more than a year, most active investment managers will, after fees, *underperform* the broader market. This is true on a before-tax basis and doubly true after tax. So, finding a manager who can beat the market over time is not only an important task, but a difficult one.

Here are some key considerations.

Comfort and Trust: It is, of course, crucial that you deal with someone with whom you feel comfortable talking about your financial affairs, and in whom you have complete trust. That person or team will focus on *your* circumstances and goals, not *their* product. In addition to trusting your instincts as to whether they are truly putting your interests first, it is a good idea to enquire about their reputation. Ask to speak to an existing client of the firm about their experience. The majority of Canadian investment management firms have high standards, but there are some dramatic exceptions.

Understandable Investment Approach: Naturally, you will enquire about the firm's long term investment returns. (The key here is long term.) Their investment strategy should be proven to work over time, particularly in down markets. Equally important, the investment approach should be easily understood. This test eliminates a surprisingly large number of investment firms, including the large diversified financial institutions which have lots of products on their shelf but no underlying philosophy. You should also ask how decisions are made. Is it by an individual who could leave tomorrow, or does the firm have a disciplined and repeatable process implemented by a qualified team? You should, of course, know exactly which securities you own at all times. If the firm operates a "black box" into which you are not permitted to see, thank them for their time and move on.

A Reasonably Focused Portfolio: Most investment accounts are over- diversified. To quote Warren Buffett, "Diversification is protection against ignorance. It makes little sense if you know what you are doing." Independent studies show that the more stocks in a managed portfolio, the less chance it will, after fees, outperform the broader market. Some geographic and sector diversification is a good thing, but 20 high quality companies operating in at least five industries is sufficient.

Alignment: To ensure that your manager is fully focused on maximizing your investment returns, and has the same risk profile as you, the manager should have substantially all their financial capital invested in the same portfolio as you do. Be sure to ask about this.

Reasonable Fees: Your manager should disclose exactly what fees they charge. The fees should be reasonable for the amount managed. It is stunning that the vast majority of clients have no idea what fees they are paying. All studies prove that, over time, investment returns vary inversely with the amount of fees charged.

The most egregious fees are so-called performance fees, where the investment firm takes a percentage of the return in a given period above a hurdle rate. At first blush, this seems quite reasonable, but typically the performance is measured over too short a period by which to judge – let alone reward – investment success.

A good advisor should truly put your interests first.

Irrespective of your investment manager, your returns will be strongly correlated with those of the broader stock market. Very few people realize that, *in most years, the stock market either rises more than 20% or produces a negative return*. If your manager charges a performance fee and your portfolio rises sharply with the broader market, you will be obliged to pay a hefty additional fee. If the market, along with your portfolio, tanks the following year, the manager will not return that fee. A further problem with performance fees is that the investment firm has an incentive to take additional risk with your money. Rolling the dice results in a big payday for the firm if it works out, while you are left with the loss if it doesn't.

Tax Efficiency: Last, but not least, look for a firm that recognizes you live in an after-tax world. Like fees, taxes erode your capital over time. You pay capital gains tax only when an investment is sold. So, there is a great advantage in finding a manager with low portfolio turnover. This allows your money to compound on a before-tax basis. One test of an advisor is whether they focus on, and talk to you about, your likely long term *after-tax* returns.

Selecting the right investment manager will make a huge difference to your ability to retire comfortably. Your single best investment may be the time you spend making that selection.

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