Financial Planning

To select the right investment adviser, you may need to go beyond examining performance statistics and track records.

Investment Advisers and Mutual Fund Managers: Questions to Ask

By Michael E. Leonetti

As the stock market continues to climb, more and more individuals have allocated assets to stocks and bonds through private advisory accounts and mutual funds. With a large section of our population passing through their peak earning years, this situation is likely to continue for some time.

If this is the route you are taking, you will probably want to know something about the person managing the account—the individual money manager or mutual fund portfolio manager. Most investors focus on performance statistics, and a track record certainly provides valuable information about a manager's ability. But some aspects of management are not necessarily revealed in the numbers.

The following suggestions should help you improve your selection of individual investment advisers and mutual fund managers. Of course, you have the right to interview a prospective investment adviser, as it is your money that is at stake when invested with them. While it may be more difficult to talk directly to a prospective mutual fund portfolio manager, fund literature and published articles about the fund manager may help you fill in the blanks.

A Manager Checklist

Assuming you have already compiled ample data from Morningstar, Standard & Poor's, Value Line and all of the other information sources available, and have looked into each fund manager's background, track record, investment holdings, and general investment management approach, there are still a few key questions to ask that can help you in your decision process.

• *Ask the manager to describe his investment philosophy in terms you can understand.*

Often, investment professionals will discuss their philosophies in terminology not familiar to the average individual. This makes it difficult to determine what truly drives their investment decisions. What does it really mean when a manager says he's growth or value oriented? You need to get the particulars so that you can better determine whether this manager's approach coincides with your desires and objectives.

For example, a growth manager might fundamentally be a momentum player, which means he buys stocks that are temporarily in vogue but that do not necessarily have strong and enduring fundamentals. This can be a risky strategy when the market gets volatile, and you need to be aware of this. Get the manager to define what he interprets as growth. On the other hand, some growth managers ignore momentum and favor high-growth companies with strong and sustainable competitive advantages.

There are also differences among value investors. Some value managers buy inexpensive stocks of companies likely to rebound when a certain event occurs. Others buy strong companies when their stocks decline in price along with the overall market.

• *Ask managers to explain the parameters of their investment style.*

What will the composition of their portfolio look like when they are most aggressive, and what will it look like when they are most defensive? Is the manager willing to overweight attractive sectors and ignore others? With mutual funds, because of the fund's stated objective, some managers have the latitude to swing widely, while others can veer only 10% or so from the sector's weighting in the S&P 500.

Also, ask whether a fund manager must pick stocks from a pre-approved list. Generally speaking, that's a bad sign. This can limit the mistakes a bad manager will make, but it also tends to constrain the better managers and, possibly, hold back good performance.

• *See how well a manager knows his holdings.*

Some managers buy stocks after reading a research report from a large brokerage firm, and they spend most of their time marketing their services. Ideally, you would like someone who insists on doing his own research and constantly seeks to learn more about the individual holdings they want to invest in. If a manager has to refer to notes when asked about their largest

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holdings, it is not a good sign. Another danger sign: the inability to explain a stock clearly. If a manager can't explain why a stock was purchased in a manner that you can understand within a fairly short time period, it should tell you that he doesn't really know what he owns.

• *Determine what the manager's incentive is for excellent performance.*

Usually, manager compensation is based, in part, on performance, but the percentage varies widely. Generally speaking, the higher the incentive, the better.

With respect to mutual funds, whether the manager has an incentive to weigh tax considerations may be important. Most managers don't, but the few who do could possibly offer an edge, as mutual funds pass 100% of their tax burden on to shareholders.

• *Get a feel for the manager's interest in and passion for investing, along with his investing temperament.*

Preferably, you want somebody who lives and breathes their business. Like anything in life, someone who really enjoys what they are doing will be better at it than someone who performs this task merely as a "job."

• *Determine how the manager arrives at his cash position.*

Generally speaking, someone who is trying to time the market will regularly change the percentage of cash in his portfolio, rather than attempting to maintain a target percentage. Attempting to time the market is usually a losers' game, and it is probably best to avoid this type of situation.

• *Try to determine whether the manager occasionally has something new or different to say about stocks.*

If a portfolio manager or investment adviser consistently echoes everyone else, it could be a signal that the manger jumps aboard bandwagons and generally follows whatever trend happens to be going around at the time.

Listen for new ideas rather than old clichés, as the manager with new ideas probably has greater investment creativity and is more likely to be in tune with what's going on in the marketplace on a daily basis.

• *Ask the manager which industry sectors he thinks he will be overweighted or underweighted in over the next six months.*

His answer to this question will give you a sense of where he sees the market going, and it's important that you feel comfortable with his assessment. Generally speaking, managers tend to be protective of individual stock recommendations so you are more likely to get a response by asking about industry sectors rather than specific stocks. With respect to mutual funds, you can get a sense of the stocks the portfolio will own by scanning shareholder reports and seeing which stocks in various sectors the fund has held in the past.

• *Ask if the manager has a worst-case scenario.*

A manager with a good track record who says he sleeps well at night probably does his homework, trusts his instincts, and believes the portfolio will do as well as possible given the portfolio's various constraints and the nature of the market.

On the other hand, I would be concerned about the manager who admits to being nervous. This is especially true with a mutual fund. Managers who are concerned that investors will pull out of their fund after receiving some bad news could signify there is too much "hot money" in the fund. The manager may not have done enough homework or owns too many volatile issues if he is worried about the prospect of negative earnings surprises.

• *Ask a manager if he is committed to his investment style and objective and, if so, ask him to show you examples.*

It's generally a wise idea to avoid managers who shift with the investment markets.

For example, a small stock manager who moves into large stocks when they are hot is probably moving beyond his expertise. Additionally, if you originally wanted to use such a manager to represent small stocks in your portfolio and he moves into large stocks, you have ended up overweighting an area that you did not wish to and underweighting an area in which you thought you were being represented. It's important to combine manager styles so that they wed together portfolio objectives, and it is much easier to maintain this balance if you have managers that do not drift from one style to another.

A Smooth-Riding Portfolio

It can be said that investment portfolios are like automobiles—they come in all makes, sizes, and colors, any one of which can meet your needs and all of which meet someone's need.

The investment managers of your portfolio are like the component parts of the automobile. When connected together and working in unison, they can provide the expected "ride." However, when one part doesn't fit or works improperly, the whole ride can be compromised—sometimes with disastrous results.