

The Sorting Box: A Framework for Manager Evaluation

Bottom Line

- The manager selection framework is driven by both statistics and qualitative factors.
- Don't judge managers by results alone. It's more important to look at the underlying causes of the results – not just whether the results were good or bad.

Sorting through mutual fund managers requires you to go beyond statistics such as performance and third-party ratings. Good markets can make bad managers look good, and vice versa. A proper evaluation framework relies more on qualitative features such as investment processes and the management team's skill.

True risk

Many investors choose mutual funds based on fund screenings that use performance data, fund comparisons and industry ranks – all of which convey an appealing aura of sophistication. These factors can be a good starting point for picking managers, but the analysis shouldn't end there. Statistics used to capture risk, such as standard deviation, overlook important risk factors if they're the sole risk measure in manager screenings. Real risk is revealed in asset sizes, sector exposures, style bias, market caps, holding concentrations, the management team, sell disciplines, etc. Data provide only a backward view. A qualitative overlay provides a necessary level of insight into the mind of a manager, helping you understand how he would perform in various markets.

Manager framework

You may believe fund managers belong in one of two boxes – good results or bad results. The reality is that skill can come in streaks over the short term – a fund can have good results for bad reasons and bad results for good reasons. Managers may get away with mistakes in a market with good returns and low volatility, but problems surface when the market hits an inflection point – as it always has. The good returns may mask not only poor manager selection but also a lack of diversification in a portfolio that only captured market-favoring trends.

Sorting It Out

Fund managers don't belong in only two boxes – good results and bad results. The reasons behind any results must be considered.

<p>Skill, with favorable conditions Good performance based on consistent and skillful application of a sound investment process</p>	<p>No skill, with favorable conditions The outcome of a market environment that favors the portfolio but likely not repeatable nor the product of skill</p>
<p>Skill, with unfavorable conditions Consistent application of sound investment process not in favor with the market environment</p>	<p>No skill, with unfavorable conditions Poor results due to low skill, unsound process or inconsistent application</p>

The most challenging aspect of the sorting box is to identify and hold skilled managers whose processes aren't in sync with market conditions. Many investors may believe these managers belong in the low skill box and that maintaining exposure to them creates significant portfolio risk. But in reality, the managers may be in good shape to take advantage of the next market shift.

Rethinking risk

Manager selection is an important risk decision when constructing portfolios. The experts don't judge managers solely by good or bad results. Meaningful assessment goes beyond looking at the peer group and removing a fund with bad returns. It demands understanding the root drivers of performance, identifying favorable market cycles and attributing results over a full cycle to skill and structural or market forces. Effective manager evaluation requires a forward-looking framework that uses qualitative and quantitative factors but emphasizes quality.

During the manager evaluation process, you should talk with your financial adviser because he has the investment experience and qualitative information you need to pick managers who add value to your portfolio.

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Asset allocation does not guarantee a profit or eliminate the risk of loss.

Standard deviation measures a fund's range of total returns and identifies the spread of a fund's short-term fluctuations.

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